Pepperdine Law Review

Volume 37
Issue 2 *Symposium: Bringing Down the Curtain on the Current Mortgage Crisis and Preventing a Return Engagement*

Article 2

2-15-2010

Foreclosure by Arbitration?

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The recession and the drastic decline in home values have combined to trigger a wave of foreclosures. Predictably, legislators, policymakers, scholars, and consumer advocates have responded with a wide range of proposals designed to protect distressed mortgagors from losing their homes. While most attention has focused upon efforts to assist homeowners in restructuring their mortgages—such as HUD's Hope for Homeowners[1] and the Treasury's Making Home Affordable[2] programs—other legislative proposals have focused specifically upon the foreclosure process and the role that alternative dispute resolution plays (or can play) within that process.[3] Some proposals are relatively modest and seek to provide the distressed borrower with an additional limited opportunity for repaying or restructuring the loan. For example, California adopted a temporary ninety-day moratorium on the foreclosure of residential first mortgage liens, explicitly intended to provide additional time for homeowners to obtain loan modifications.[4] Other state legislatures have introduced bills that would require a mortgagee to engage in mediation with the mortgagor prior to instituting a foreclosure proceeding.[5] Other proposals are more far-reaching. Perhaps the most extreme is the recommendation of the National Consumer

1. 12 U.S.C. §§ 1715(z)-1723(2008).

2. Making Home Affordable, http://makinghomeaffordable.gov/ (last visited Oct. 29, 2009).

3. *See infra* notes 4–6 and accompanying text.

4. *See* CAL. CIV. CODE §§ 2923.52–.55 (West 2009). The Act expires on January 1, 2011, and contains an exception for mortgage servicers that have established a comprehensive loan modification program. *Id.* §§ 2923.52–.53. In enacting this Act, the California legislature made the following findings:

> It is essential to the economic health of California for the state to ameliorate the deleterious effects that will result from the continued high rate of foreclosure of residential properties by modifying the foreclosure process to provide additional time for borrowers to work out loan modifications while providing an exemption for mortgage loan servicers that have implemented a comprehensive loan modification program. This change in accessing the state's foreclosure process is essential to ensure that the process does not exacerbate the current crisis by adding more foreclosures to the glut of foreclosed properties already on the market if the foreclosure may be avoided through a loan modification.

2009 Cal. Legis. Serv. 48 (West).

5. S.B. 1328, 25th Leg., Reg. Sess. (Haw. 2009); H.B. 4453, 95th Leg., Reg. Sess. (Mich. 2009); H.B. 354, 2009 Leg., 86th Sess. (Minn. 2009); H.B. 5492, 2009 Gen. Assem., Jan. Sess. (R.I. 2009).

Law Center, which advocates that states currently permitting power of sale foreclosure either repeal their authorizing statutes altogether or incorporate explicit due process protections into power of sale foreclosure.[6]

The mortgage crisis certainly provides an opportunity to evaluate the structure and utility of the current foreclosure process and to make appropriate changes. But it is important that legislatures do not overreact in doing so. To avoid an overreaction, it is important for policymakers to keep in mind where our current foreclosure process fits within the legal system's overall dispute resolution structure. Viewing foreclosure in this context presents an as-yet unexplored question: Given the growing role that arbitration processes have played in our system's overall dispute resolution structure, could—or should—arbitration play a role in mortgage foreclosure?

Since its enactment in 1925, the Federal Arbitration Act (FAA)[7] has provided that agreements to arbitrate commercial disputes are generally enforceable.[8] Over the past quarter-century, the United States Supreme Court has interpreted the FAA with breathtaking expansiveness, holding that the FAA establishes a federal policy favoring arbitration,[9] preempts contrary state law restricting arbitrability of disputes,[10] mandates the enforceability of agreements to arbitrate even federal statutory claims,[11] and applies to an arbitration agreement in any commercial transaction that Congress has the

6. John Rao & Geoff Walsh, Nat'l Consumer Law Ctr., *Foreclosing a Dream: State Laws Deprive Homeowners of Basic Protections*, Feb. 2009, at 4, *available at* http://www.consumerlaw.org/issues/foreclosure/content/FORE-Report0209.pdf ("Many states now allow mortgage holders to bypass the courts and use non-judicial procedures to take away homes from their owners. These procedures create enormous barriers for homeowners who want to assert legal claims and raise defenses against lenders, servicers, and mortgage holders. States should either completely abandon the power of sale method and require judicial foreclosure, or they should incorporate essential due process protections into the existing non-judicial procedure.").

7. 9 U.S.C. §§ 1–307 (2006).

8. *Id.* § 2 ("A written provision in any . . . contract evidencing a transaction involving commerce to settle by arbitration a controversy thereafter arising out of such contract or transaction . . . shall be valid, irrevocable, and enforceable, save upon such grounds as exist at law or in equity for the revocation of any contract."). The primary purpose of the FAA was to overturn the "ouster" or "revocability" doctrine, under which courts had refused to enforce commercial arbitration agreements. IAN R. MACNEIL, AMERICAN ARBITRATION LAW: REFORMATION, NATIONALIZATION, INTERNATIONALIZATION 28–30 (1992); Richard C. Reuben, *Process Purity and Innovation: A Response to Professors Stempel, Cole, and Drahozal*, 8 NEV. L.J. 271, 285 (2007).

9. Moses H. Cone Mem'l Hosp. v. Mercury Constr. Corp., 460 U.S. 1, 24–25 (1983).

10. Southland Corp. v. Keating, 465 U.S. 1, 16 (1984).

11. Gilmer v. Interstate/Johnson Lane Corp., 500 U.S. 20, 35 (1991) (arbitrability of ADEA claims); Shearson/Am. Express Inc. v. McMahon, 482 U.S. 220, 238 (1987) (arbitrability of Securities Act of 1934 claims).

power to regulate under the Commerce Clause.[12] Against this background, the United States has experienced a dramatic expansion in the use of pre-dispute arbitration agreements in nearly all segments of commerce.

Yet despite this expansion, we have not seen lenders incorporate foreclosure-by-arbitration clauses into mortgage documentation. This phenomenon is quite understandable in states that permit a mortgagee to conduct a nonjudicial foreclosure sale. Where nonjudicial foreclosure is permitted, a mortgage lender can complete a foreclosure within a relatively short period of time (in some states, as little as thirty to forty-five days) and without incurring the expense associated with adjudication.[13] In these states, arbitration could not occur any faster than nonjudicial foreclosure and would require the parties to incur the additional expense of adjudication.[14] As a result, a mortgagee in a power-of-sale foreclosure state has no real incentive to offer or accept an agreement to privatize the foreclosure process through arbitration.

The incentives are different, however, in states that require foreclosure through judicial process and thus already require the parties to incur the expenses of adjudication. Mortgages in these states would appear to be plausible candidates for foreclosure-by-arbitration clauses, especially if such a clause could permit a mortgagee to complete a foreclosure more quickly than would be possible in the public courts (where the pace of foreclosure litigation may be influenced by exogenous factors such as time periods dictated by rules of civil procedure and delays dictated by state court docket congestion).

Despite the potential advantages that foreclosure-by-arbitration clauses could offer, such clauses have not become customary in mortgage transactions. This article explores why this is so and whether there are any structural legal barriers that would prevent a mortgagee from privatizing the foreclosure process through arbitration. Parts I and II provide the appropriate background. Part I addresses the judicial/nonjudicial foreclosure divide in American real estate law, explaining why the potential utility of arbitration varies depending upon what foreclosure methods a state has legally authorized.[15] Part II provides similar background on arbitration—the process characteristics of arbitration as compared to public adjudication, the process values sought to be advanced by the use of arbitration, and how these process characteristics and values are implicated in the context of mortgage foreclosure.[16] Part III then addresses whether there are any legal

12. Allied-Bruce Terminix Cos. v. Dobson, 513 U.S. 265, 273–77 (1995).
13. *See infra* notes 36–45 and accompanying text.
14. *See infra* notes 109–11 and accompanying text.
15. *See infra* notes 20–60 and accompanying text.
16. *See infra* notes 61–113 and accompanying text.

barriers to the use of arbitration in lieu of judicial foreclosure and concludes that no such barriers exist.[17]

This article focuses primarily on the descriptive question (i.e., can a mortgage lender privatize the foreclosure process through arbitration?). There remain substantial differences of opinion about whether mandatory pre-dispute arbitration is just, particularly in the consumer context, and efforts continue in Congress to amend the FAA to prohibit mandatory pre-dispute arbitration in consumer disputes (which would include enforcement of residential mortgages).[18] While this article is not intended to resolve the broader normative question (i.e., should a mortgage lender be able to privatize the foreclosure process through arbitration?), Part IV does offer some concluding thoughts about foreclosure-by-arbitration in the context of residential mortgages.[19]

I. FORECLOSURE METHODS

At early common law, there were no foreclosure protections for the borrower.[20] The mortgage loan transaction involved a conveyance of fee simple ownership to the mortgagee on condition subsequent.[21] If the mortgagor repaid the loan by the date specified in the language of the condition subsequent ("law day"), the mortgagor could re-enter and terminate the mortgagee's estate; if not, the mortgagee's fee simple title became absolute.[22]

Over time, in recognition of the fact that the mortgagee had taken title to the mortgaged premises as security for a debt, equity intervened to provide increasing levels of relief to a mortgagor who had defaulted but nevertheless had the capacity to repay the loan.[23] Equity permitted a defaulting mortgagor to redeem title from the mortgagee by paying off the full balance of the mortgage loan as long as this payment occurred within a reasonable time after law day.[24] In addition, equity obligated the mortgagee to account

17. *See infra* notes 114–285 and accompanying text.

18. The pending Arbitration Fairness Act of 2009 would amend FAA § 2 to provide that "[n]o predispute arbitration agreement shall be valid or enforceable if it requires arbitration of (1) an employment, consumer, or franchise dispute." H.R. 1020, 111th Cong. § 4 (2009).

19. *See infra* notes 286–300 and accompanying text.

20. *See* 1 GRANT S. NELSON & DALE A. WHITMAN, REAL ESTATE FINANCE LAW § 1.2, at 7–8 (5th ed. 2007).

21. *Id.* § 1.2, at 7.

22. *Id.* § 1.2, at 8.

23. *Id.* §1.3, at 8.

24. *Id.*

for any profits received from the mortgaged premises in excess of the amount of the debt.[25] Nevertheless, because the availability of equitable relief created a substantial cloud upon the mortgagee's title, equity also developed a process to permit the mortgagee to extinguish the mortgagor's ability to obtain equitable relief.[26] In this process, which came to be known as strict foreclosure, the mortgagee could obtain from the Chancellor an order compelling the mortgagor to pay off the full balance of the debt by a certain date or be forever barred thereafter from redemption.[27]

Strict foreclosure was a harsh consequence for a mortgagor that had accumulated significant equity in the mortgaged land but lacked either the cash to pay off the debt or the credit needed to refinance that debt. As mortgagors suffered such losses due to strict foreclosure, many American states began to adopt judicial foreclosure procedures under which the mortgagee had to sell the mortgaged land and apply the sale proceeds to pay off the debt.[28] In this way, the foreclosure sale became the predominant feature of mortgage enforcement under American law.[29] While a few states retain the availability of strict foreclosure,[30] American mortgage law nearly universally requires that a foreclosure occur through a public auction sale of the mortgaged land.[31]

Today, every jurisdiction allows the mortgagee to effect a foreclosure sale through judicial process.[32] As Professors Grant Nelson and Dale Whitman explain, judicial foreclosure typically involves the following steps:

> [A] preliminary title search to determine all parties in interest; filing of the foreclosure bill of complaint and lis pendens notice; service of process; a hearing . . . ; the decree or judgment; notice of sale; actual sale and issuance of certificate of sale; report of the sale; proceedings for determination of the right to any surplus; possible

25. 5 SIR WILLIAM HOLDSWORTH, A HISTORY OF ENGLISH LAW 331 (1956); 6 SIR WILLIAM HOLDSWORTH, A HISTORY OF ENGLISH LAW 663–64 (1956).

26. 5 HOLDSWORTH, *supra* note 25, at 331–32.

27. *Id.*; NELSON & WHITMAN, *supra* note 20, § 1.3, at 8.

28. ROBIN PAUL MALLOY & JAMES CHARLES SMITH, REAL ESTATE TRANSACTIONS 450 (3d ed. 2007).

29. NELSON & WHITMAN, *supra* note 20, § 1.4, at 9.

30. CONN. GEN. STAT. § 49-15 (West 2008); VT. STAT. ANN. tit. 12, § 4528 (2008). Courts have also recognized strict foreclosure in limited other circumstances, discussed in NELSON & WHITMAN, *supra* note 20, §§ 7.10, 7.15. The Uniform Commercial Code (UCC) permits strict foreclosure of a security interest in certain personal property collateral, although it also permits the owner of the collateral to compel the secured party to foreclose by sale. U.C.C. §§ 9-620 to 9-622 (2000); WILLIAM H. LAWRENCE, WILLIAM H. HENNING & R. WILSON FREYERMUTH, UNDERSTANDING SECURED TRANSACTIONS 455–58 (4th ed. 2007).

31. NELSON & WHITMAN, *supra* note 20, § 1.4, at 10.

32. *Id.* § 7.11, at 806.

redemptions from foreclosure sale; and the entry of a decree for a deficiency.[33]

Proper compliance with these steps provides finality in two important respects. First, it assures that foreclosure will bind all persons whose interests need to be extinguished (i.e., the holders of subordinate encumbrances) so that the foreclosure sale buyer can receive title of the same quality that existed on the date that the mortgagor granted the mortgage being foreclosed.[34] Second, it reduces doubt about the validity of the sale itself, as the predicate findings (e.g., the validity of the mortgage, the existence of a default, the mortgagee's right to foreclose) are established by the court only after the parties have had a full and fair opportunity to present relevant evidence.[35]

Nevertheless, this certainty comes at a cost. Judicial foreclosure requires the mortgagee to incur filing fees, service of process costs, and the customary professional expenses (e.g., attorney fees) associated with litigation. Furthermore, judicial foreclosure can take significant time, both due to mandatory rules of civil procedure (e.g., required time periods for response to pleadings and/or conduct of discovery) and due to delay occasioned by docket congestion. The more quickly the mortgagee can conduct a sale and obtain the sale proceeds, the more quickly the mortgagee can invest them by making a loan to a creditworthy borrower. By contrast, the longer judicial foreclosure takes, the greater the mortgagee's lost opportunity cost. Although interest may continue to accrue on the mortgage debt during the delay, the mortgagor is unlikely (absent redemption) to pay that interest once the foreclosure process begins. Further, if the foreclosure sale price is insufficient to pay off the full balance of the debt, the borrower may be unable to satisfy the deficiency—or, in jurisdictions with anti-deficiency protections, may have no legal obligation to do so. Thus, the longer the foreclosure process, the greater the risk that the mortgagee will bear costs that go uncompensated by the mortgaged land, the mortgagor, or both.

While judicial foreclosure is available in all states, thirty-one states and the District of Columbia permit foreclosure to occur by a public sale conducted without *any* judicial process, as long as the mortgage instrument contains a power of sale so authorizing.[36] Likewise, federal statutes

33. *Id.* § 7.11, at 807–08.
34. *Id.* § 7.12, at 808–09.
35. *Id.* § 7.18, at 843–45.
36. ALA. CODE §§ 35-10-1 (LexisNexis 1991) (mortgages executed prior to Jan. 1, 1989), 35-

authorize power of sale foreclosure of certain residential mortgages held by the Department of Housing and Urban Development, even in states without statutes otherwise authorizing power of sale foreclosure.[37] The process by which power of sale foreclosure occurs varies from state to state in significant ways,[38] but some generalization is possible. Generally, the mortgagee need not file any judicial proceeding, or obtain a court order

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10-12 (mortgages executed after Dec. 31, 1988); ALASKA STAT. § 34.20.070 (2006) (deeds of trust only); ARIZ. REV. STAT. ANN. § 33-807 (2009) (deeds of trust only); ARK. CODE ANN. §§ 18-50-101 to -117 (2003); CAL. CIV. CODE §§ 2924 to 2924*l* (Deering 2005); D.C. CODE § 42-815(b) (1981); GA. CODE ANN. § 23-2-114 (1982); HAW. REV. STAT. ANN. § 667-5 (1993); IDAHO CODE ANN. §§ 45-1505 to -1511 (2003) (deeds of trust only); ME. REV. STAT. ANN. tit. 14, § 6203-A (2003) (only where premises held for "business, commercial, or agricultural purpose"); MASS. GEN. LAWS ANN. ch. 244, § 14 (West 2004); MICH. COMP. LAWS ANN. §§ 600.3201–.3285 (West 2000); MINN. STAT. ANN. §§ 580.01–.30 (West 2000); MISS. CODE ANN. §§ 89-1-55, 89-1-57, 89-1-63 (West 2000); MO. REV. STAT. §§ 443.290 (2000) (mortgages), 443.410 (deeds of trust); MONT. CODE ANN. § 71-1-223 (2008); NEB. REV. STAT. §§ 76-1005 to -1017 (2003) (deeds of trust only); NEV. REV. STAT. ANN. § 107.080–.100 (2000) (deeds of trust only); N.H. REV. STAT. ANN. § 479:25 (2001); N.M. STAT. ANN. §§ 48-10-1 to -21 (LexisNexis 1978 and Supp. 2007) (deeds of trust); OKLA. STAT. ANN. tit. 46 §§ 40-49 (West 1996) (mortgagor of homestead may compel judicial foreclosure); OR. REV. STAT. ANN. §§ 86.735–.795 (West 1989) (deeds of trust only); R.I. GEN. LAWS ANN. § 34-27-4 (2006); S.D. CODIFIED LAWS §§ 21-48-1 to -26 (2009); TENN. CODE ANN. §§ 35-5-101 to -116 (2007); TEX. PROP. CODE ANN. § 51.002 (Vernon 2007); UTAH CODE ANN. §§ 57-1-23 to -43 (2004) (deeds of trust only); VA. CODE ANN. §§ 55-59.1 to -66.6 (2009) (deeds of trust only); VT. STAT. ANN. tit. 12, §§ 4531(a)–4352 (2009) (does not apply to farmland or dwelling house of two units or less that is occupied as the owner's principal residence); WASH. REV. CODE ANN. § 61.24.020 (2009) (deeds of trust only); W. VA. CODE ANN. §§ 38-1-3 to -15 (LexisNexis 1966) (deeds of trust only); WYO. STAT. ANN. §§ 34-4-101 to -113 (1977). Power of sale foreclosure is also permissible in three additional states, but only in conjunction with some minimal judicial or quasi-judicial process short of a judgment. In North Carolina, a foreclosing lender must institute a quasi-judicial hearing before the clerk of the superior court in the county where the land is located, and the clerk must enter an order authorizing the foreclosure sale. N.C. GEN. STAT. § 45-21.16 (2007). However, this hearing is frequently conducted on an *ex parte* basis, without prior notice to the mortgagor. In Colorado, power of sale foreclosure is conducted by an official known as the Public Trustee, who must obtain a court order authorizing the sale. COLO. REV. STAT. ANN. § 38-37-140 (West 2009). In Maryland, a foreclosure sale may occur under power of sale without a final judgment, but the filing of an action to foreclose is still a precondition to the conduct of the sale. MD. CODE. ANN., REAL PROP. § 7-105.1 (West 2009).

37. Multifamily Mortgage Foreclosure Act, 12 U.S.C. §§ 3701–3717 (1981); Single Family Mortgage Foreclosure Act, 12 U.S.C. §§ 3751–3768 (1994).

38. Efforts to achieve uniformity in state laws of foreclosure have not met with success. The National Conference of Commissioners on Uniform State Laws (NCCUSL) included a power-of-sale foreclosure procedure in both the Uniform Land Transactions Act (1975) and the Uniform Land Security Interest Act (1985), but neither was adopted in any state. Gerald Korngold, *Legal and Policy Choices in the Aftermath of the Subprime and Mortgage Financing* Crisis, 60 S. CAR. L. REV. 727, 736-37 (2009). More recently in 2002, NCCUSL promulgated the Uniform Nonjudicial Foreclosure Act (UNFA), but it likewise has not been adopted in any state. Prentiss Cox, *Foreclosure Reform and Mortgage Lending Turmoil: A Public Purpose Approach*, 45 HOUS. L. REV. 683, 743 n.373 (2008). This lack of success has prompted Professors Nelson and Whitman to call for Congress to adopt the UNFA as federal law under its power to regulate interstate commerce. Grant S. Nelson & Dale A. Whitman, *Reforming Foreclosure: The Uniform Nonjudicial Foreclosure Act*, 53 DUKE L.J. 1399, 1509 (2004).

authorizing the sale.[39] Before conducting a sale, the mortgagee must give prior notice of the sale, typically by mail or personal service, to all persons designated by the statute as entitled to notice.[40] Finally, before conducting a sale, the mortgagee must advertise the sale in the manner specified by the authorizing statute.[41]

If the mortgagor has not redeemed the land prior to the sale, the mortgagee conducts the sale at the time and place specified in the pre-sale notice (typically, at the county courthouse), applies the sale proceeds to reduce the mortgage debt, and distributes any surplus to the mortgagor or any junior lienholders entitled to the surplus.[42] The sale becomes final without confirmation or supervision by a court (absent successful collateral attack by the mortgagor or a junior lienholder based upon defects in the conduct of the sale).[43]

For the mortgagee, the primary benefit of power of sale foreclosure is speed. In states that authorize power of sale foreclosure, a mortgagee can complete a foreclosure sale in as little as thirty to forty-five days.[44] Because judicial foreclosure can take substantially longer, power of sale foreclosure (where available) permits the mortgagee to minimize the lost opportunity

39. *See supra* note 36.

40. There is substantial state-to-state variation in the persons entitled to pre-sale notice. Most jurisdictions require that the mortgagee provide pre-sale notice to the owner of the mortgaged land. Some require that the mortgagee provide notice to any persons holding a subordinate lien on the land; others require notice to any persons who had recorded a timely request for pre-sale foreclosure notice. Yet others are silent and thus do not appear to require the mortgagee to provide any notice to subordinate lienholders (although many foreclosing mortgagees, by custom, will provide pre-sale notice to any subordinate lienholders of whom they are aware). For a more thorough discussion of these variations, see NELSON & WHITMAN, *supra* note 20, § 7.19, at 846–47.

41. The term "advertise" is charitably misleading; in most states, statutes require only the publication of a specified number of legal notices in classified advertisements in newspapers of general circulation in the county where the mortgaged land is located. These legal notices often describe the land only by a legal description rather than by a street address and contain no information about the characteristics of any improvements on the land. *See, e.g.*, MO. REV. STAT. § 443.320 (2000) (notice shall contain recording information for mortgage, name of mortgagor, time, terms and place of sale, and description of land; notice shall appear at least twenty times, including date of sale, in a daily newspaper; for smaller counties without a daily paper, notice shall appear in some county newspaper once per week for at least four consecutive weeks).

42. NELSON & WHITMAN, *supra* note 20, § 7.31, at 920–21.

43. *Id.* § 7.19, at 845–86.

44. The thirty to forty-five day period is not representative of all states that authorize power of sale foreclosure. In some states, a longer waiting period is required prior to the conduct of the sale. *See, e.g.*, ARIZ. REV. STAT. § 33-807(D) (2009) (ninety days); ARK. CODE ANN. § 18-50-103(5) (2004) (sixty days). In most power of sale foreclosure states, however, anecdotal evidence indicates that a mortgagee could complete a power of sale foreclosure in less time than a judicial foreclosure. *See* FORECLOSURE LAW & RELATED REMEDIES: A STATE-BY-STATE DIGEST (Sidney A. Keyles, ed., 1995).

cost associated with the longer recovery period attendant to judicial foreclosure.[45]

There is a trade-off for the mortgagee, however—the title produced by a power of sale foreclosure *may* be less certain or "final" than the title produced by a judicial foreclosure sale.[46] A judicial foreclosure sale unquestionably extinguishes all interests junior to the foreclosed mortgage, as long as the mortgagee joined the holders of those interests as defendants to the foreclosure proceeding.[47] Because principles of preclusion are relatively clear, a judicial foreclosure sale rarely receives collateral attack (i.e., a post-sale judicial challenge to the sale's validity) where the mortgagee joined all necessary parties.[48] By contrast, a power of sale foreclosure involves no judicial determination of issues such as the validity or balance of the debt, the existence of a default, the mortgagee's right to foreclose, or the sale's compliance with the state's power of sale foreclosure statute.[49] As a result, the title obtained at a power of sale foreclosure is more likely to be collaterally attacked by the mortgagor or the holder of a junior interest in the mortgaged land.[50]

There are two basic types of collateral attacks on power of sale foreclosure titles. The first is a constitutional challenge to power of sale foreclosure as a denial of due process to the borrower, the holders of junior interests in the mortgaged land, or both.[51] For the most part, courts have rejected these challenges, frequently concluding that power of sale foreclosure does not involve state action subject to due process requirements.[52] The second, and more common, type of collateral attack involves a statutory challenge to the validity of the sale based upon the absence of a default, an inadequate sale price, the mortgagee's noncompliance with the power of sale foreclosure statute, or a combination thereof. A sale conducted in the absence of a default is void, as the mortgagee lacks any authority to conduct a sale in those circumstances.[53] While an inadequate sale price by itself usually does not invalidate a sale, it typically prompts the court to search for evidence of the mortgagee's

45. NELSON & WHITMAN, *supra* note 20, § 7.19, at 848.

46. *Id.* § 7.19, at 848–49.

47. *Id.* § 7.12, at 808–09.

48. *Id.* § 7.19, at 849.

49. *Id.* § 7.19, at 846.

50. *Id.* § 7.19, at 849.

51. *Id.* §§ 7.23–.30, at 889–920.

52. Pappas v. E. Sav. Bank, 911 A.2d 1230 (D.C. 2006); Cheff v. Edwards, 513 N.W.2d 439 (Mich. Ct. App. 1994); AgriBank FCB v. Cross Timbers Ranch, Inc., 919 S.W.2d 263 (Mo. Ct. App. 1996); *see also* NELSON & WHITMAN, *supra* note 20, § 7.27, at 904 n.2 (collecting cases that reflect a trend against finding state action). Whether power of sale foreclosure statutes implicate constitutional concerns is beyond the intended scope of this article.

53. NELSON & WHITMAN, *supra* note 20, § 7.20, at 849–50.

noncompliance with the foreclosure statute,[54] and courts finding such evidence of noncompliance have often allowed the mortgagor or a junior encumbrancer to set aside such sales.[55]

If a foreclosure sale bidder cannot eliminate the risk of collateral attack, the bidder will presumably respond by discounting the bid to account for that risk. If the goal of the foreclosure process is to produce a sale price that reflects the value of the mortgaged land (if not enough to satisfy the debt entirely), the uncertainty associated with the risk of collateral attack potentially reduces the efficacy of power of sale foreclosure. For this reason, statutes authorizing power of sale foreclosure attempt to minimize this risk by providing enhanced finality rules.[56] For example, statutes in some states provide that if the foreclosure sale deed recites that the mortgagee complied with all statutory requirements, the recitals constitute conclusive evidence of the mortgagee's compliance in favor of a good faith purchaser of the land for value.[57]

Though power of sale foreclosure is available in more than thirty jurisdictions,[58] there remain a significant number of states in which foreclosure cannot occur without judicial process.[59] In five such states—Florida, Illinois, Iowa, Kentucky, and South Carolina—there is an affirmative statutory mandate that foreclosure must occur through judicial action.[60] In ten other states—Connecticut, Delaware, Indiana, Kansas, Louisiana, New Jersey, North Dakota, Ohio, Pennsylvania, and Wisconsin—foreclosure occurs by judicial process (even without an affirmative statutory

54. *Id.* § 7.21, at 853–76 (chronicling specific problems with power of sale foreclosures).

55. *Id.* § 7.22, at 880–82.

56. *Id.* § 7.21, at 873–76.

57. *See, e.g.*, ARIZ. REV. STAT. § 33-811 (2009); ARK. CODE ANN. § 18-50-111 (2004); MONT. CODE ANN. § 71-1-318 (2008); UTAH CODE ANN. § 57-1-28 (2004).

58. NELSON & WHITMAN, *supra* note 20, § 7.19, at 845 n.1.

59. *Id.* § 7.11, at 806 n.1.

60. FLA. STAT. ANN. § 702.01 (West 1994) ("All mortgages shall be foreclosed in equity."); 735 ILL. COMP. STAT. ANN. 5/15-1405 (West 2003) ("No real estate within this State may be sold by virtue of any power of sale contained in a mortgage or any other agreement . . . ."); IOWA CODE ANN. § 654.1 (West 1995) ("[A] deed of trust or mortgage of real estate shall not be foreclosed in any other manner than by action in court by equitable proceedings."); KY. REV. STAT. ANN. § 426.525 (1992) ("[Private] foreclosure of a mortgage is forbidden . . . ."); S.C. CODE ANN. § 29-3-630 (1976) ("No sale under or by virtue of any mortgage or other instrument in writing intended as security for a debt, conferring a power upon the mortgagee or creditor to sell the mortgaged or pledged property . . . shall be valid to pass the title of the land mortgaged unless the debt for which the security is given shall be first established by the judgment of some court of competent jurisdiction or unless the amount of the debt be consented to in writing by the debtor subsequently to the maturity of the debt . . . .").

mandate) due to the lack of any express statutory authority for power of sale foreclosure.

II. ARBITRATION AND ITS CHARACTERISTICS AND VALUES

Arbitration is the private adjudication of legal disputes before a neutral decision maker whose final determination, or "award," is binding upon the parties.[61] By its nature, arbitration depends upon the consent of the parties to the dispute. Once a dispute arises, parties can agree to submit the dispute to an arbitrator rather than to the public courts.[62] More commonly, however, disputes come to arbitration by virtue of mandatory pre-dispute arbitration clauses in contracts, which require the parties to submit the entire dispute (or perhaps specific issues) to arbitration.[63]

In some key respects, arbitration is akin to litigation.[64] Like litigation, it is by nature an adversarial process designed to generate information that the decision maker will use to evaluate the merits of the dispute and reach an appropriate determination:

> Most arbitrations involve a hearing in which attorneys may represent the parties; witnesses are sworn, examined and cross-examined; and exhibits are entered into evidence. In many cases, parties request a transcript of the proceedings and file post-hearing briefs. After all of the evidence and briefs (if filed) are in, the arbitrator will issue a decision.[65]

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61. 1 THOMAS H. OEHMKE, COMMERCIAL ARBITRATION § 1:2, at 1–9 (3d ed. 2003); LEONARD L. RISKIN ET AL., DISPUTE RESOLUTION AND LAWYERS 506–07 (3d ed. 2005). The statement in the text is somewhat overbroad, as there exist some forms of nonbinding nonjudicial dispute resolution techniques that are sometimes called "nonbinding arbitration," such as the "mini-trial." *See* OEHMKE, *supra*, § 1:4, at 1–15 ("The mini-trial is a structured settlement procedure providing for a confidential, nonbinding exchange of information to facilitate dialogue between the parties on the merits."). Courts have not reached consensus on whether these nonbinding mechanisms constitute "arbitration" within the meaning of the FAA. *Compare* Wolsey, Ltd. v. Foodmaker, Inc., 144 F.3d 1205 (9th Cir. 1998) (stating that a dispute resolution procedure established by franchise agreement requiring submission of disputes to arbitration qualified as "arbitration" governed by FAA, even though award was nonbinding), *with* Dluhos v. Strasberg, 321 F.3d 365, 373 (3d Cir. 2003) (holding that the ICANN dispute resolution procedure for domain name registration disputes is not "arbitration" within the meaning of the FAA because the FAA applies only to "binding proceedings likely to 'realistically settle the dispute'"). As discussed in Part I, because title clearance is a fundamental attribute of an effective foreclosure process, an arbitration procedure governing foreclosure would serve little purpose unless it was mandatory and binding. Accordingly, this article will use the term "arbitration" to describe a private adjudication that is both mandatory and binding.

62. RISKIN ET AL., *supra* note 61, at 507.

63. *Id.* at 507; *see also* 1 LARRY E. EDMONSON, DOMKE ON COMMERCIAL ARBITRATION § 1:2 (3d ed. 2009).

64. RISKIN ET AL., *supra* note 61, at 511.

65. *Id.* at 511. The statement in the text is certainly an over-generalization; arbitration processes

Nevertheless, arbitration is not identical to public adjudication.[66] To provide a framework for evaluating the merits of litigation and arbitration as potential means of accomplishing foreclosure of a mortgage, Part II compares and contrasts the structure ("process characteristics") of public adjudication and arbitration,[67] thus highlighting some of the objectives ("process values") that one or both parties[68] might seek to capture through the use of arbitration.[69] In describing these process characteristics and process values, Part II also explores their relevance to the potential utility of arbitration as a substitute for judicial foreclosure.[70]

A. The Process Characteristics of Arbitration

1. Informality and Flexibility of Process

Public adjudication is ostensibly characterized by strict adherence to the rules of evidence and civil procedure (including discovery rules).[71] In contrast, pleadings, discovery, and presentation of evidence by the parties to

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will vary considerably depending upon the context. For example, just as debt-collection litigation frequently involves default judgments without trial, debt-collection arbitration might proceed without any appearance by the debtor or any hearing before the arbitrator, particularly if the debtor has no defense to payment of the debt.

66. *Id.*

67. *See infra* notes 71–98 and accompanying text. The textual description of arbitration is by necessity an overgeneralization. The arbitration process will vary greatly depending upon context.

68. In many contexts—perhaps most—mandatory pre-dispute arbitration clauses are not the product of active negotiation between the parties over their ideal dispute resolution structure. Instead, a mandatory pre-dispute arbitration clause is often adhesive in nature, insisted upon by one party to the contract on a "take-it-or-leave-it" basis. *See* Jean R. Sternlight, *Panacea or Corporate Tool?: Debunking the Supreme Court's Preference for Binding Arbitration*, 74 WASH. U. L.Q. 637 (1996). By itself, this observation does not inherently call into question the legitimacy of such a mandatory pre-dispute arbitration clause. One might still characterize such a clause as the product of "consent," particularly if the "consenting" party believed that the overall gains available from the transaction justified acceptance of the arbitration clause. *See* Stephen J. Ware, *The Case for Enforcing Adhesive Arbitration Agreements—with Particular Consideration of Class Actions and Arbitration Fees*, 5 J. AM. ARB. 251, 252–53 (2006). Whether mandatory pre-dispute arbitration clauses should be enforced, and in what contexts (particularly in consumer transactions) is an important normative question. However, this article does not directly address that question and is not meant to resolve it.

69. *See infra* notes 99–108 and accompanying text. I have borrowed the labels "process characteristics" and "process values" from the work of my colleague Richard Reuben. Reuben, *supra* note 8, at 278.

70. *See infra* notes 109–13 and accompanying text.

71. *See* Reuben, *supra* note 8, at 278.

an arbitration are governed by rules established by the parties themselves.[72] Commonly, these rules are established when the parties contract to incorporate arbitration rules promulgated by arbitration service providers such as the American Arbitration Association (AAA) or the Judicial Arbitration and Mediation Service (JAMS). However, arbitration also permits the parties to customize the adjudication process to their own specific needs.[73] Thus, the parties could design their own expedited timetable and rules for the preparation and filing of pleadings, the exchange of relevant information, and the conduct of the hearing. In this regard, as compared to the ordinary rules of civil pleading and procedure, arbitration can give parties the flexibility to establish a process more appropriately tailored to the nature and complexity of their dispute or to their own commercial exigencies.

2. Identity of the Decision Maker

In public adjudication, the parties are assigned a judge who may or may not be familiar with the issues and legal background presented by a particular transaction.[74] By contrast, the parties to an arbitration are free to choose their own arbitrator.[75] Theoretically, this enables the parties to select a decision maker ideally suited to resolve their particular dispute—whether because of her expertise with respect to the type of transaction, her past experience in arbitrating similar disputes, her reputation or stature within the community, or any combination of the above.[76]

3. The Rule and Form of Decision

In public adjudication, a judge is expected to adhere to the rule of law and use the existing rule of law within the applicable jurisdiction as the basis of her decision. If a judge fails to do so, she likely will be reversed if the

72. RISKIN ET AL., *supra* note 61, at 511 ("Generalizing about the arbitration process is difficult because the parties [themselves] have the autonomy to design their arbitration system."); Stephen Hayford & Ralph Peeples, *Commercial Arbitration in Evolution: An Assessment and Call for Dialogue*, 10 OHIO ST. J. ON DISP. RESOL. 343, 367 (1995) (noting the "comparative simplicity" of pleading and pre-hearing stages of commercial arbitration as compared to the more extensive pleading and pre-hearing motion practice typical of litigation).

73. EDWARD BRUNET, RICHARD E. SPEIDEL, JEAN R. STERNLIGHT & STEPHEN J. WARE, ARBITRATION LAW IN AMERICA: A CRITICAL ASSESSMENT 4 (2006) ("Under a contractual approach the parties exercise their will by covenanting for specific arbitration procedures rather than merely opting for an undefined agreement to arbitrate, which will leave much of the choice of the arbitration procedure to the arbitrator or organization selected to administer the arbitration process.").

74. Reuben, *supra* note 8, at 280.

75. RISKIN ET AL., *supra* note 61, at 510.

76. Reuben, *supra* note 8, at 280; *see also* BRUNET, *supra* note 73, § 1.3, at 12–15 (addressing the existence and potential/perceived benefit of arbitrator expertise).

losing party appeals. Further, a judge typically provides an opinion that explains her decision; theoretically, this facilitates both accuracy in decision making (i.e., a judge forced to justify her conclusion will be more likely to reason carefully and thus reach the correct conclusion) and judicial accountability (i.e., poor opinions are more likely to be reversed on appeal or subjected to public criticism, in turn prompting judges to exercise greater care). By contrast, absent a contrary agreement of the parties, an arbitrator need not apply the law in resolving the dispute and may instead base her award upon broad principles of equity and justice or industry standards and practices.[77] Further, an arbitrator need not provide formal opinions explaining or justifying her decision (again, absent contrary agreement by the parties).[78] This flexibility permits the parties to designate rules of decision more appropriate to the context of their particular transaction and can produce decision making efficiency (i.e., an arbitrator can render a decision more quickly and at a lower cost if she need not devote the time necessary to produce a reasoned opinion).

The preceding paragraph suggests a difference between litigation and arbitration that is in some contexts more theoretical than real. Parties can, and frequently do, specify in their agreement that the arbitrator shall decide the dispute in accordance with existing legal rules.[79] In fact, arbitrators may market themselves as prospective decision makers by touting their expertise and familiarity with existing legal rules.[80] Furthermore, it is customary in many contexts (such as labor-management arbitration and international

77. Lisa Bernstein, *Opting Out of the Legal System: Extralegal Contractual Relations in the Diamond Industry*, 21 J. LEGAL STUD. 115, 127 (1992) (arbitrators in disputes involving diamond merchants resolved disputes based upon "custom and usage, a little common sense, some Jewish law, and, last, common-law legal principles"); Stephen J. Ware, *Default Rules from Mandatory Rules: Privatizing Law Through Arbitration*, 83 MINN. L. REV. 703, 726–27 (1999) ("[An arbitration agreement] contracts out of all the law that would have been applied by a court but for the agreement. All such law, in effect, consists of default rules because arbitration agreements are enforced. Arbitration agreements contract out of substantive law; they privatize law.").

78. Richard Reuben suggests that the traditional reluctance of arbitrators to provide written and reasoned opinions stems from a concern that a reasoned opinion would be more susceptible to the threat of judicial review, thereby "undermining the goal of finality." Reuben, *supra* note 8, at 281.

79. BRUNET, *supra* note 73, § 3.4, at 74 (2006) ("The popularity of choice-of-law clauses is unquestioned. These clauses help to achieve simplicity in an overly complex legal and business world by restricting the number of potentially applicable laws and thereby reducing the transaction costs of negotiating and contracting.").

80. Reuben, *supra* note 8, at 280 n.49 (noting that the National Arbitration Forum's marketing information emphasizes that its arbitrators "review the facts and render decisions based on known rules and substantive law").

commercial arbitration) for arbitrators to include a reasoned decision accompanying the award.[81]

4. Enforceability of Award/Decision

Enforceability is a key similarity between public adjudication and arbitration. If the parties have so agreed, the arbitrator's decision is fully binding on the parties,[82] even if the award has not been judicially confirmed.[83] If the party against whom an arbitration award is made fails to satisfy that award, the other party may enforce that award in the public courts.[84] This feature is critical to the effectiveness of arbitration as a dispute resolution mechanism: if the arbitrator's decision is merely advisory (nonbinding), the party against whom an arbitration award was entered could simply choose to ignore it.[85]

5. Finality of Award/Decision

Public adjudication generally offers the losing litigant the opportunity, as a matter of right, to appellate review of an adverse judgment. While some deference is due the trial judge as to questions of fact—an appellate court may reject findings of fact only if those findings are clearly erroneous[86]—no such deference is due to the trial court's conclusions of law, which the appellate court may evaluate de novo. By contrast, an arbitration award is, for the most part, substantively unreviewable.[87] For arbitrations governed by the FAA, a court may vacate the arbitrator's award only if "the award was procured by corruption, fraud, or undue [influence]"; the arbitrator was evidently partial, corrupt, or both; the arbitrator was guilty of certain prejudicial misconduct in conducting the arbitration; or the arbitrator

81. RISKIN ET AL., *supra* note 61, at 511.

82. *Id.* at 507.

83. EDMONSON, *supra* note 63, § 41:3, at 41-2 to 41-3 ("[An] award which is not confirmed by a judgment in the usual summary procedure may nevertheless serve as a cause of action, to be enforced in ordinary court procedure, as an action on the award."); CAL. CIV. PROC. CODE § 1287.6 (West 2009) ("An award that has not been confirmed or vacated has the same force and effect as a contract in writing between the parties to the arbitration."). In the context of foreclosure, the enforceability of the award without confirmation has some practical significance in terms of efficiency. For example, if the mortgagor has relinquished possession of the land voluntarily, the foreclosure sale buyer at a foreclosure-by-arbitration could take possession of the land without the need to judicially confirm the award. Moreover, even if the mortgagor has not relinquished possession of the land, the foreclosure sale buyer could bring an action to obtain possession of the land based on the unconfirmed award. In other words, the foreclosure sale buyer would not have to go to the additional expense of confirming the award just to obtain possession of the land.

84. EDMONSON, *supra* note 63, §§ 42.2, 42.3.

85. Reuben, *supra* note 8, at 282.

86. FED. R. CIV. P. 52(a)(6).

87. 9 U.S.C. § 10(a) (2006).

exceeded his powers or the award fails to reach a final and binding resolution upon a matter submitted to arbitration.[88]

Likewise, the FAA authorizes the judicial modification or correction of an arbitration award only under limited circumstances, typically involving either an evident arithmetical or descriptive error or an award that exceeds the scope of the matter submitted to arbitration.[89] The Supreme Court has recently held that these statutory grounds are exclusive and not merely threshold provisions open to expansion by agreement.[90] In addition, courts typically permit vacatur of arbitration awards on nonstatutory grounds only where the party attacking the award can demonstrate that the award reflects "'manifest disregard' of the law"[91] or is "void as against public policy."[92] Vacatur of commercial arbitration awards on these nonstatutory grounds appears to be relatively rare, though it is perhaps increasing.[93]

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88. *Id.*

89. *Id.* § 11(a), (b). Modification is also possible "where the award is imperfect in matter of form not affecting the merits of the controversy." *Id.* § 11(c).

90. In *Hall Street Associates v. Mattel, Inc.*, the parties' pre-dispute arbitration clause provided that the federal district court "shall vacate, modify or correct any award: (i) where the arbitrator's findings of facts are not supported by substantial evidence, or (ii) where the arbitrator's conclusions of law are erroneous." 128 S. Ct. 1396, 1400–01 (2008). The Court reversed the district court's vacatur of an award based upon the arbitrator's erroneous conclusion of law, rejecting the petitioner's argument that the clause expanded the permissible grounds for vacatur. *Id.* at 1405 ("On application for an order confirming the arbitration award, the court 'must grant' the order 'unless the award is vacated, modified, or corrected as prescribed in sections 10 and 11 of this title.' There is nothing malleable about 'must grant,' which unequivocally tells courts to grant confirmation in all cases, except when one of the 'prescribed' exceptions applies. This does not sound remotely like a provision meant to tell a court what to do just in case the parties say nothing else.").

91. Ware, *supra* note 77, at 724.

92. Sobel v. Hertz, Warner & Co., 469 F.2d 1211, 1216 (2d Cir. 1972); *see also* Ware, *supra* note 77, at 724.

93. Writing in a 1996 article, Professor Steven Hayford noted that based upon a review of circuit court cases, "no commercial arbitration award has been vacated" based upon the "'manifest disregard' of the law" standard. Stephen L. Hayford, *Law in Disarray: Judicial Standards for Vacatur of Commercial Arbitration Awards*, 30 GA. L. REV. 731, 776 (1996). A recent article by Professor Michael LeRoy, however, suggests that some (though not all) courts have become more receptive to vacatur based upon manifest disregard. Michael H. LeRoy, *Do Courts Create Moral Hazard? When Judges Nullify Employer Liability in Arbitrations*, 93 MINN. L. REV. 998, 1031–32 (2009). *Compare,* DeGaetano v. Smith Barney, Inc., 983 F. Supp. 459, 464 (S.D.N.Y. 1997) (vacating panel's denial of attorney fees because the arbitrators "appreciate[d] the existence of a clearly governing legal principle but decide[d] to ignore or pay no attention to it" (quoting DiRussa v. Dean Witter Reynolds, Inc., 121 F.3d 818, 821 (2d. Cir. 1997))), *and* Halligan v. Piper Jaffray, Inc., 148 F.3d 197, 198 (2d Cir. 1998) (vacating award that denied employee's age discrimination claim, based on manifest disregard, where evidence reflected that the parties agreed on the governing law and had explained it to the arbitrator), *with* Baravati v. Josephthal, Lyon & Ross, Inc., 28 F.3d 704, 706 (7th Cir. 1994) (expressing doubts about "manifest disregard" standard, saying "[w]e can understand neither the need for the formula nor the role that it plays in judicial review of arbitration

While the finality of an arbitration award means that an arbitrator's errors may not be readily corrected, this characteristic permits the parties to achieve efficiency in the resolution of disputes.[94] As the Supreme Court has noted, parties that choose binding arbitration "trade[] the procedures and opportunity for review of the courtroom for the simplicity, informality, and expedition of arbitration."[95]

6. Privacy

Public adjudication occurs within the public sphere. Unless a court issues a protective order that prevents public access to the pleadings and evidence presented by the parties, judicial resolution of disputes occurs subject to public scrutiny. By contrast, an arbitration hearing typically occurs in private.[96] The parties to an arbitration may agree that the pleadings and evidence presented to the arbitrator are private matters that neither the parties nor the arbitrator may disclose to third parties. Such an agreement can even include the identity of the parties to an arbitration and the fact that the dispute is being arbitrated.[97] Thus, if one party believes public access to a hearing or decision carries the threat of commercial disadvantage or embarrassment, that party may prefer arbitration to public adjudication.[98]

B. The Process Values of Commercial Arbitration

The foregoing process characteristics of arbitration enable commercial actors to use arbitration agreements as a means to obtain certain desired objectives (or "process values"). For example, some have argued that arbitration may help to preserve existing business relationships[99] and that its

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(we suspect none—that it is just words). If it is meant to smuggle review for clear error in by the back door, it is inconsistent with the entire modern law of arbitration.").

94. Ware, *supra* note 77, at 723 ("The standard policy rationale for judicial deference to arbitration awards . . . is that arbitration should be a substitute for litigation, not a prelude to litigation.").

95. Mitsubishi Motors Corp. v. Soler Chrysler-Plymouth, Inc., 473 U.S. 614, 628 (1985).

96. RISKIN ET AL., *supra* note 61, at 506.

97. BRUNET, *supra* note 73, § 1.2, at 8 ("The desire for secrecy can be a prime determinant in selecting arbitration. Often one or more party to an arbitration agreement has an interest in avoiding a public trial with unwanted adverse publicity. . . . The last thing a restaurant chain or a bank needs is a public airing of dirty linen involving allegations of discrimination. In this context, secrecy in disputing may be the primary reason that a business seeks arbitration.").

98. Reuben, *supra* note 8, at 283; Richard C. Reuben, *Confidentiality in Arbitration: Beyond the Myth*, 54 U. KAN. L. REV. 1255, 1277–78 (2006).

99. EDMSONSON, *supra* note 63, § 1:5, at 1–16 ("[T]he arbitration process can often be valuable because it may help to preserve an ongoing relationship between the parties."); DAVID B. LIPSKY & RONALD L. SEEBER, THE APPROPRIATE RESOLUTION OF CORPORATE DISPUTES: A REPORT ON THE GROWING USE OF ADR BY U.S. CORPORATIONS 17 (1998) (noting that 41.3% of survey respondents indicated preservation of good relationships as a reason for using arbitration).

structure and informality relative to litigation may foster greater civility among disputants.[100] As noted above, the structure of arbitration can foster a party's desire for secrecy, whether for purposes of protection from competitors or avoidance of personal embarrassment.[101] The most dominant objectives, however—and those most relevant to whether arbitration might provide an effective substitute for judicial foreclosure—are efficiency and autonomy.

1. Efficiency

The most evident objective sought by parties in choosing arbitration is efficiency.[102] Parties can use arbitration to circumvent long delays attendant to docket congestion in public courts, and they may adopt their own timetable for pleadings and the exchange of relevant information (rather than the potentially longer timetables applicable to civil pleading and discovery). The finality of an arbitral award permits its immediate enforcement without the potential delay occasioned by an appeal. By allowing the parties to select their own decision maker, procedural rules and timetables, and substantive rules of decision, and by according finality to the award, arbitration ostensibly permits parties to create a dispute resolution process that can produce a final result much more rapidly than public adjudication.[103] Theoretically, this permits parties to create a process that can resolve disputes at a lower overall cost than judicial adjudication.[104]

100. Reuben, *supra* note 8, at 283.

101. *See supra* notes 96–98 and accompanying text.

102. BRUNET, *supra* note 73, § 1.5, at 17 ("Efficiency represents one of the perceived core tenets of arbitration. Much of arbitration's popularity rests on a reputation of delivering efficient, low transaction costs results when compared to the excesses of the litigation system.").

103. *See* LIPSKY, *supra* note 99, at 17 (noting that 68.5% of survey respondents indicated time savings as a reason for using arbitration).

104. *See id.* (stating that 68.6% of survey respondents indicated savings of money as a reason for using arbitration). Obviously, whether arbitration actually delivers substantial efficiencies over litigation is an empirical question, and the data is mixed. *Compare* Thomas Stipanowich, *Rethinking American Arbitration*, 63 IND. L.J. 425, 472 (1988) (claims of arbitration speed and efficiency are well-founded, especially in small cases), *with* BRUNET, *supra* note 73, § 1.5, at 18 ("The case for efficiency as a paramount value underlying arbitration is tepid at best. . . . [T]here is little empirical evidence that the arbitration system guarantees a more efficient outcome than trial, and emerging evidence suggests that trials can be as efficient as arbitration.").

2. Autonomy

In theory, the enforceability of arbitration agreements should provide persons with substantial autonomy in deciding how to resolve disputes. In fact, as Professor Stephen Ware has argued, one might view autonomy as *the* dominant process value of arbitration:

> I do not see secrecy, arbitrator expertise, adjudication efficiency or finality as *necessary* values of arbitration. I see autonomy as the value that transcends these other values. Because arbitration law gives the parties autonomy, they can choose to have their arbitration be secret or not. Because arbitration law gives the parties autonomy, they can choose to have their arbitrator be an expert or not. Because arbitration law gives the parties autonomy, they can choose to have their arbitration use quick and efficient procedures or not. Because arbitration law gives the parties autonomy, they can choose to make their arbitration final or—by having an appellate arbitration panel or expanding the grounds for vacatur—not.
>
> It is certainly true that most parties to arbitration agreements choose to use their autonomy to advance the values of secrecy, arbitrator expertise, adjudication efficiency, and finality. But, in my view, that does not show that these are core values of arbitration; it shows that these are core values of most of the parties who agree to arbitrate. If the values of those people changed, arbitration would change accordingly; but it would do so because of its core value, autonomy, not because it was abandoning other core values.[105]

By allowing parties to choose private adjudication, the identity of the adjudicator, and the procedures and substantive rules to govern the adjudication, arbitration thus empowers persons to resolve their own disputes through a self-defined process in a way that public adjudication cannot.[106] As Professor Edward Brunet has noted, the availability of arbitration thus reinforces the "freedom essential in a democratic state."[107]

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105. BRUNET, *supra* note 73, at 339.

106. Certainly, this argument finesses the question of whether parties to mandatory pre-dispute arbitration clauses are really equally autonomous actors who are readily "agreeing" to arbitration, particularly in the context of consumer transactions. Again, this article does not (and is not meant to) take a normative position on the fairness of mandatory pre-dispute consumer arbitration. This article is meant only to explore whether a mortgagee legally could accomplish the objectives of a mortgage foreclosure through arbitration, and, if so, why pre-dispute foreclosure-by-arbitration agreements have not become customary.

107. BRUNET, *supra* note 73, § 1.1, at 4–5 (2006) ("In a democratic society, party autonomy should be the fundamental value that shapes arbitration. The personal autonomy inherent in arbitration constitutes a dominant policy in all areas of a democracy. The freedom to select arbitration procedure is a choice that one anticipates should exist in a state that values personal

In this way, arbitration could produce greater disputant satisfaction—if not with the result, at least with the process by which it was reached.[108]

C. Arbitration and the Objectives of the Foreclosure Process

Where permitted, power of sale foreclosure shares many (although not all) of the same process characteristics and values as arbitration. As discussed in Part I, power of sale foreclosure provides for a streamlined procedure for the sale of mortgaged realty without the filing of a complaint or judicial supervision.[109] Where it is available, a lender can complete a power of sale foreclosure much more quickly than it could complete a judicial foreclosure of the same property, potentially achieving substantial efficiencies.[110] Furthermore, without judicial supervision, the details of the dispute are not a matter of public record.[111] Thus, in states that permit power of sale foreclosure, a mortgage lender has no real incentive to contract for and use an arbitration process for foreclosure.

In states that require judicial foreclosure, however, mortgagees appear to have substantial incentives to create and use a contractual arbitration process for foreclosure. While judicial foreclosure in many states takes seven months or longer,[112] an arbitration agreement could establish an expedited procedure that would enable foreclosure to be completed on a timetable much closer to that prevailing in power of sale foreclosure states. Further,

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autonomy."); *see also* Richard C. Reuben, *Democracy and Dispute Resolution: The Problem of Arbitration*, 67 LAW & CONTEMP. PROBS. 279, 303 (2004).

108. LIPSKY, *supra* note 99, at 18–19 (in responding to a survey asking why companies use arbitration, 49.9% of survey respondents indicated the ability to use the arbitrator's expertise; 34.8% indicated "more satisfactory settlements"; 60.5% indicated "more satisfactory process"); RISKIN ET AL., *supra* note 61.

109. *See supra* note 36.

110. *See supra* note 44 and accompanying text.

111. Nothing prevents a mortgagor from instituting a civil action seeking an injunction against a power of sale foreclosure, either because the mortgagee is not entitled to foreclose (e.g., because the loan is not in default or because the mortgagee has waived a default) or because there is a substantial defect in the mortgagee's compliance with the power of sale foreclosure statute (e.g., failure of the mortgagee to publish the required sale notices, scheduling of the sale at a time not permitted by the statute, or collusion between the mortgagee and potential bidders). At that point, public litigation will be necessary to resolve questions about the existence of a default, the mortgagee's right to foreclose, and the mortgagee's compliance with the statutory process governing power of sale foreclosure.

112. When the then-Real Property, Probate and Trust Law Section of the ABA gathered survey data in the early 1990s, the time period for an uncontested judicial foreclosure averaged seven months, and became significantly longer in contested cases or in courts with congested dockets. *See generally* FORECLOSURE LAW & RELATED REMEDIES, *supra* note 44.

because arbitration would occur outside the context of the public courts, the arbitrator's award would not be a public record, providing the mortgagee with a measure of privacy not available in litigation.[113]

III. CAN ARBITRATION LEGALLY SUBSTITUTE FOR JUDICIAL FORECLOSURE?

Despite the increasing use of arbitration clauses in a wide range of commercial transactions, lenders have not incorporated foreclosure-by-arbitration clauses into mortgages.[114] As explained earlier, this is understandable in states where nonjudicial foreclosure provides the mortgagee with a quick and effective remedy.[115] But why have we not seen foreclosure-by-arbitration clauses adopted in judicial-foreclosure-only states, given the efficiencies potentially presented by arbitration as compared to judicial foreclosure?

The most likely structural explanation for this phenomenon lies in the influence of secondary market purchasers. Mortgage lenders want to be able to sell their loans on the secondary market and thus must ensure that their loan documents comply with the requirements of secondary market purchasers. To this point, standard mortgage forms do not contain arbitration clauses at all,[116] or, if they do, they "carve out" foreclosure from their scope.[117]

In consumer mortgages, the absence of pre-dispute arbitration provisions bears the clear fingerprints of the major secondary market actors Fannie Mae and Freddie Mac. In December 2003, Freddie Mac announced that it would not purchase subprime mortgages containing mandatory arbitration clauses,[118] and in February 2004, Fannie Mae made a similar

113. This is not to say that a foreclosure by means of arbitration would be entirely "private." Obviously, because the mortgagee is seeking to sell the mortgaged property in a public sale, the mortgagee would certainly disclose to buyers that it had obtained an arbitration award finding the existence of a default and the mortgagee's right to conduct a foreclosure sale. Further, because a foreclosure will frequently require the joinder of junior interests (e.g., persons whose liens must be extinguished for a sale to deliver clear title to the purchaser), a mortgagee could not effectively ensure the complete confidentiality of arbitration proceedings.

114. *See* Martha Neil, *Litigation Over Arbitration: Courts Differ on Enforceability of Mandatory Clauses*, 91 A.B.A.J. 50, 55 (2005).

115. *See supra* notes 13–14, 36–45 and accompanying text.

116. *See* Neil, *supra* note 114, at 54 (stating that "the nation's major purchasers of mortgages, Freddie Mac and Fannie Mae, [do] not . . . allow mandatory arbitration provisions in mortgages they buy").

117. 2 MICHAEL T. MADISON, JEFFRY R. DWYER & STEVEN W. BENDER, LAW OF REAL ESTATE FINANCING § 14:32 n.3 (2009) (giving several examples of arbitration clause "carve outs" for foreclosure).

118. *Banking—Mortgages: Freddie Mac Will Not Buy Subprime Loans that Contain Mandatory Arbitration Clauses*, 72 U.S.L.W. 2342 (2003).

announcement.[119] These decisions by Fannie and Freddie reflected substantial political pressure—brought to bear by a wide range of consumer and civil rights organizations[120]—regarding the perceived unfairness of mandatory consumer arbitration.[121]

These fairness concerns carry much less weight, if any, in the commercial setting, where there has also been an active secondary market for commercial mortgage-backed securities. However, we have not seen foreclosure-by-arbitration provisions being incorporated into commercial mortgage documentation here either.[122] But why? One answer is that the marketability of a mortgage loan is (at least in part) a function of investor confidence in the legal mechanisms to enforce the terms of the loan documents after default. In this regard, there has never been any doubt about the availability and legal effect of judicial foreclosure. By contrast, arbitration as a substitute for foreclosure has no track record. No court has ever explicitly held that the entire mortgage foreclosure process can be privatized through arbitration. Absent explicit statutory or judicial authority, lawyers for borrowers and lenders might be understandably reluctant to

119. *Banking—Mortgages: Fannie Mae Will Not Buy Home Mortgages with Mandatory Arbitration Clauses*, 72 U.S.L.W. 2463 (2004).

120. A December 9, 2003 press conference following Freddie Mac's announcement involved representatives of the American Association of Retired Persons, Consumer Federation of America, National Community Reinvestment Coalition, Leadership Conference on Civil Rights, National Association for the Advancement of Colored People, National Association of Consumer Advocates, National Consumer Law Center, Association of Community Organizations for Reform Now, Trial Lawyers for Public Justice, U.S. Public Interest Research Group, and Self-Help Credit Union. 72 U.S.L.W. 2342 (2003).

121. These concerns apply more broadly, of course, than just in the context of foreclosure of consumer mortgages. Professor Jean R. Sternlight has been a vocal and articulate critic of the fairness of mandatory pre-dispute arbitration and has proposed that "legislation should clearly and simply proscribe the use of mandatory pre-dispute arbitration with respect to consumer transactions." Jean R. Sternlight, *Consumer Arbitration*, *in* ARBITRATION LAW IN AMERICA: A CRITICAL ASSESSMENT, *supra* note 73, § 5.7, at 183. By contrast, Professor Stephen Ware has written articulately in defense of mandatory arbitration in the consumer context (though not specifically in the context of mortgage foreclosure). Stephen J. Ware, *Consumer Arbitration as Exceptional Consumer Law*, 29 MCGEORGE L. REV. 195, 213 (1998) (arguing that consumers should have an alienable right "to get consideration for the right to government adjudication"); Stephen J. Ware, *Paying the Price of Process: Judicial Regulation of Consumer Arbitration Agreements*, 2001 J. DISP. RESOL. 89. The proposed Arbitration Fairness Act of 2009, still pending in Congress, would amend the FAA to abolish arbitration pursuant to mandatory pre-dispute agreements in the context of consumer transactions. H.R. 1020, 111th Cong., § 4 (2009). Again, it is not my intention in this article to address the normative question of whether foreclosure via mandatory pre-dispute arbitration clauses would be a good thing. Nevertheless, Part IV offers some concluding thoughts on this normative question. *See infra* notes 286–300 and accompanying text.

122. *See* Ann M. Burkhart, *Real Estate Practice in the Twenty-First Century*, 72 MO. L. REV. 1031, 1034 (2007).

opine regarding the enforceability of a foreclosure-by-arbitration clause. As a result, it is not entirely surprising that even in a judicial-foreclosure-only state, lenders have not chosen to contract for the potential uncertainty of whether the foreclosure process could be entirely privatized through arbitration.

As this Part explains, however, there are no structural legal barriers preventing a mortgage lender from accomplishing foreclosure through arbitration as a substitute for judicial process. First, if the mortgage contained a pre-dispute arbitration clause submitting the entire foreclosure process to arbitration (i.e., the final and binding determination and supervision of a neutral decision maker) governed by the FAA, FAA § 2 will preempt contrary state law—such as a state judicial-foreclosure-only statute—that would limit or condition the enforceability of the clause.[123] Second, even though FAA § 2 preserves the possibility of contract defenses such as unconscionability, a foreclosure-by-arbitration clause could not properly be viewed as unconscionable (unless it was drafted in such a one-sided, mortgagee-favorable fashion as to "shock the conscience").[124] Finally, even though junior lienholders would not be signatories to the mortgage containing a foreclosure-by-arbitration clause, that clause is still legally enforceable against them under existing law governing the enforcement of covenants against successors.[125] Part III discusses each of these issues in turn.

A. The Preemptive Effect of FAA § 2

Where a mortgagor and mortgagee agree to a pre-dispute arbitration provision, the FAA preempts state law that would purport to limit the enforceability of that agreement. FAA § 2 provides that:

> A written provision in any maritime transaction or a contract evidencing a transaction involving commerce to settle by arbitration a controversy thereafter arising out of such contract or transaction . . . shall be valid, irrevocable, and enforceable, save upon such grounds as exist at law or in equity for the revocation of any contract.[126]

The Supreme Court has consistently reaffirmed that this language has preemptive effect.[127] As the Court held in *Southland Corp. v. Keating*,[128]

123. *See infra* notes 126–79 and accompanying text.
124. *See infra* notes 180–200 and accompanying text.
125. *See infra* notes 201–87 and accompanying text.
126. 9 U.S.C. § 2 (2006).
127. *See infra* notes 128–35 and accompanying text.

FAA § 2 preempts any contrary state law that restricts the arbitrability of disputes covered by the FAA or the enforceability of an agreement to arbitrate such a dispute.[129] The Court reaffirmed this principle in *Perry v. Thomas*, in which a brokerage employee sought to litigate a wage collection dispute with his employer, despite the arbitration requirement of New York Stock Exchange rules.[130] The employee argued that California Labor Code section 229 expressly conferred on him a right to bring a wage collection action despite the existence of a private arbitration agreement.[131] The Court rejected this argument, holding that the FAA preempted the California statute.[132] These cases have established that states may not implement an anti-arbitration law or policy that would frustrate the FAA's purpose of overcoming judicial hostility to arbitration agreements.[133] The Court has continued to reaffirm the FAA's preemptive effect, most recently in *Buckeye Check Cashing, Inc. v. Cardegna*[134] and *Preston v. Ferrer*.[135]

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128. 465 U.S. 1 (1984).

129. In *Southland*, the Court held that the California Franchise Investment Law, which required judicial consideration of claims brought under that law, conflicted with § 2 and thus violated the Supremacy Clause. *Id.* at 10; *see also* Perry v. Thomas, 482 U.S. 483 (1987) (holding that the FAA preempted California Labor Code section 229, which authorized action for collection of wages "without regard to the existence of any private agreement to arbitrate"); Doctor's Assocs., Inc. v. Hamilton, 150 F.3d 157 (2d Cir. 1998) (finding that the FAA preempted a New Jersey law that required disputes arising under a state franchise protection act to be resolved in New Jersey courts).

130. *Perry*, 482 U.S. at 486.

131. *Id.*

132. *Id.* at 491 ("This clear federal policy [of rigorous enforcement of arbitration agreements] places § 2 of the Act in unmistakable conflict with California's § 229 requirement that litigants be provided a judicial forum for resolving wage disputes. Therefore, under the Supremacy Clause, the state statute must give way."). One might attempt to distinguish *Perry* by arguing that the California statute expressed explicit hostility to arbitration agreements in that it purported to affirm the employee's right to sue for wage collection despite the existence of a private arbitration agreement. By contrast, those state statutes mandating judicial foreclosure of a mortgage are simply silent as to arbitration (i.e., they do not state that a private foreclosure-by-arbitration agreement would be unenforceable). As a policy matter, however, such a distinction would have to fail, as it would permit state legislatures to circumvent arbitration agreements simply by adopting statutes that create a right to sue in court without mentioning the enforceability of a private arbitration agreement.

133. Moses H. Cone Mem'l Hosp. v. Mercury Constr. Corp., 460 U.S. 1, 24 (1983) (noting the FAA established "a liberal federal policy favoring arbitration agreements, notwithstanding any state substantive or procedural policies to the contrary."); OEHMKE, *supra* note 61, § 3:17, at 3-33.

134. 546 U.S. 440 (2006) (holding an arbitration provision in a "check-into-cash" loan agreement was enforceable even if the agreement violated Florida usury laws and was void ab initio under Florida law).

135. 128 S. Ct. 978 (2008) (finding a pre-dispute arbitration agreement in an attorney services contract enforceable even though California law purported to vest jurisdiction over fee disputes in the state labor commissioner).

So if a mortgage contains an agreement to resolve foreclosure through arbitration governed by the FAA, would § 2 require a court to enforce the agreement and disregard state law that would otherwise compel foreclosure through judicial process? When a party raises a challenge to the enforceability of a contractual provision requiring arbitration governed by the FAA, there are two threshold questions to be resolved. The first is whether the transaction in question "involves commerce" within the meaning of the FAA.[136] The second is whether the contract contains an agreement for "arbitration" within the meaning of the FAA.[137] For § 2 to preempt contrary state laws, both questions must be answered yes, and, as discussed below, both questions should be answered yes in evaluating preemption in the context of a foreclosure-by-arbitration clause.

1. Mortgage Transactions "Involve Commerce" Within the Meaning of the FAA

One might attempt to challenge foreclosure-by-arbitration by arguing that the granting and enforcement of a mortgage is local activity rather than activity in interstate commerce, and thus is outside the scope of the FAA. However, there is no longer any legal doubt that a mortgage transaction is one "involving commerce" within the meaning of FAA § 2.[138]

The Supreme Court has held that in exercising power under the Commerce Clause, Congress need not show any specific effect upon interstate commerce; instead, it is sufficient that the economic activity in question "would represent 'a general practice . . . subject to federal control'"[139] or that "bear[s] on interstate commerce in a substantial way."[140] Given the role that real estate mortgage lending and securitization played in our current national recession, there can be no doubt that real estate mortgage lending has a substantial (if imprecise) impact upon interstate commerce.[141] Furthermore, in interpreting FAA § 2, the Court has held that

136. 9 U.S.C. § 2 (2009) (applying to arbitration agreements written in contracts "evidencing a transaction *involving commerce*" (emphasis added)).

137. *Id.*

138. *See infra* notes 139–58 and accompanying text.

139. Citizens Bank v. Alafabco, Inc., 539 U.S. 52, 57 (2003) (quoting Mandeville Island Farms, Inc. v. Am. Crystal Sugar Co., 334 U.S. 219, 236 (1948)).

140. *Id.* at 57 (citing Maryland v. Wirtz, 392 U.S. 183, 196–197 n.27 (1968) and NLRB v. Jones & Laughlin Steel Corp., 301 U.S. 1, 37–38 (1937)).

141. Well before the origination and securitization of subprime mortgages accelerated to record levels in the early to mid-2000s, Professors Grant Nelson and Bob Pushaw argued that the proper understanding of the Commerce Clause would justify a federal real estate security code. Grant S. Nelson & Robert J. Pushaw, Jr., *Rethinking the Commerce Clause: Applying First Principles to Uphold Federal Commercial Regulations but Preserve State Control Over Social Issues*, 85 IOWA L. REV. 1, 164–69 (1999). Professor Nelson has continued to urge Congress to use its Commerce Clause power to replace disparate provisions of state real estate law (such as real estate foreclosure

§ 2 is to be broadly construed to extend its reach to the full extent of Congress's power to regulate interstate commerce.[142]

The Supreme Court's opinion in *Citizens Bank v. Alafabco, Inc.*,[143] makes clear that a real estate mortgage loan is a transaction "involving commerce" under FAA § 2, even if the borrower, lender, and mortgaged land are all located in the same jurisdiction.[144] Alafabco was an Alabama-based fabrication and construction company, which in 1986 obtained an operating credit line from Citizens Bank, an Alabama-based lender.[145] In 1998, Alafabco bid upon a large contract for construction in Courtland, Alabama, allegedly with Citizens Bank's encouragement.[146] However, Citizens Bank did not provide the credit needed to complete the project.[147] As a result, Alafabco allegedly had to complete the project by diverting funds that otherwise would have been used to repay the debt to Citizens Bank, resulting in a default.[148] Alafabco and Citizens Bank then entered into a written agreement restructuring the debt and securing the debt with mortgages on both residential and commercial real estate in Alabama as well as Alafabco's accounts receivable, inventory, supplies, fixtures, machinery, and equipment.[149] The agreement included a clause providing that "all disputes, claims, or controversies" regarding the "construction, interpretation, and enforcement" of the agreement would be resolved by arbitration governed by the FAA.[150] Alafabco later filed suit against Citizens Bank in Alabama state court alleging breach of contract, fraud, and breach of fiduciary duty, while making several other state law claims arising

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and enforcement of assignments of rents) with uniform federal legislation. *See* Nelson & Whitman, *supra* note 38, at 1509–13; Grant S. Nelson, *A Commerce Clause Standard for the New Millennium: "Yes" to Broad Congressional Control over Commercial Transactions; "No" to Federal Legislation on Social and Cultural Issues*, 55 ARK. L. REV. 1213, 1248 (2003); Grant S. Nelson, *Confronting the Mortgage Meltdown: A Brief for the Federalization of State Mortgage Foreclosure Law*, 37 PEPP. L. REV. (forthcoming Feb. 2010).

142. Allied-Bruce Terminix Cos.,. v. Dobson, 513 U.S. 265 (1995) (enforcing an arbitration agreement contained in a contract to provide termite prevention service for a Birmingham, Alabama home); *see also* OEHMKE, *supra* note 61, § 3:6, at 3-12 ("[T]he FAA § 2 term involving commerce is the "functional equivalent of the more familiar term affecting commerce (i.e., words of art that ordinarily signal the fullest and broadest permissible exercise of Congress' Commerce Clause power).").

143. 539 U.S. 52 (2003).

144. *Id.* at 53.

145. *Id.*

146. *Id.*

147. *Id.*

148. *Id.*

149. *Id.* at 53–54.

150. *Id.* at 54.

out of Citizens Bank's failure to provide sufficient credit to complete the Courtland project.[151] In response, Citizens Bank moved to compel arbitration.[152] The trial court granted this motion, but the Alabama Supreme Court reversed, concluding that "[b]ecause there was no showing 'that any portion of the restructured debt was . . . attributable to [out-of-state] transactions,'" there was an "insufficient nexus with interstate commerce" for the FAA to control the resolution of the dispute.[153]

The United States Supreme Court unanimously reversed, remanding the case to permit arbitration according to the debt-restructuring agreement.[154] While the Court noted that Alafabco had used some of the restructured loans on out-of-state projects and that the goods serving as collateral for the restructured loans had moved in interstate commerce, the Court squarely rejected any notion that Citizens Bank had to demonstrate that the transaction had "substantial" interstate effects:

> [W]ere there any residual doubt about the magnitude of the impact on interstate commerce caused by the particular economic transactions in which the parties were engaged, that doubt would dissipate upon consideration of the "general practice" those transactions represent. No elaborate explanation is needed to make evident the broad impact of commercial lending on the national economy or Congress' power to regulate that activity pursuant to the Commerce Clause.[155]

Consistent with this approach, courts have invoked the FAA in enforcing arbitration agreements contained in manufactured home financing contracts (which are analytically comparable to mortgages),[156] as well as contracts for the purchase and sale of land, manufactured homes, or both.[157] As such, there is no doubt that a mortgage containing a clause requiring

151. *Id.*

152. *Id.*

153. *Id.* at 54–55 (quoting Alafabco, Inc. v. Citizens Bank, 872 So. 2d 798, 805 (Ala. 2002)).

154. *Id.* at 58.

155. *Id.* at 56–58 (citations omitted).

156. *See, e.g.*, Toler v. Green Tree Servicing, L.L.C., No. 08-0164, 2008 WL 2858728 (W.D. La. July 24, 2008); H & S Homes, L.L.C. v. Shaner, 940 So. 2d 981 (Ala. 2006); Adams v. Greenpoint Credit, L.L.C, 943 So. 2d 703 (Miss. 2006); In re Greenpoint Credit, L.L.C., No. 04-04-007940-CV, 2004 WL 2997924 (Tex. App. Dec. 29, 2004); *see also* Stevens v. Phillips, 852 So. 2d 123 (Ala. 2002) (sale of manufactured home substantially affected interstate commerce even though home was manufactured and sold in Alabama to Alabama resident).

157. *See, e.g.*, Fleetwood Enters. v. Bruno, 784 So. 2d 277 (Ala. 2000); Affholter v. Franklin County Water Dist., No. 1:07-CV-0388, 2008 WL 5385810 (E.D. Cal. Dec. 23, 2008); Kinder Mobile Home Sales, Inc. v. Clemens, 794 So. 2d 677 (Fla. Dist. Ct. App. 2001); Louisville Peterbilt, Inc. v. Cox, 132 S.W.3d 850 (Ky. 2004).

foreclosure by FAA arbitration would be a "contract evidencing a transaction involving commerce" within the meaning of FAA § 2.[158]

2. Privatizing Foreclosure by Agreement in the Mortgage Would Constitute "Arbitration" Within the Meaning of the FAA

The second threshold question in resolving the preemptive effect of FAA § 2 is whether the contract contains an agreement to "arbitrate" the dispute in question.[159] If the parties have agreed to "arbitration" governed by the FAA, then § 2 preempts any contrary state law that would limit the enforcement of their agreement.[160] By contrast, if the parties' agreed-upon dispute resolution process is not "arbitration," then the FAA does not apply and could thus have no preemptive effect on otherwise applicable state law.[161]

The FAA does not specifically define arbitration.[162] Applicable case law suggests that whether the agreed-upon dispute resolution procedure is arbitration is a function of "how closely the specified procedure resembles classic arbitration, that is, where contestants empower a third party to render a decision settling their dispute."[163] As the Tenth Circuit noted:

> Parties need not establish quasi-judicial proceedings resolving their disputes to gain the protections of the FAA, but may choose from a broad range of procedures and tailor arbitration to suit their peculiar circumstances. However, one feature that must necessarily appertain to a process to render it an arbitration is that the third party's decision will settle the dispute.[164]

Thus, for example, federal courts have held that agreements for appraising the value of property or property damage do not constitute arbitration where the appraisal would not resolve all relevant issues in

158. *See* 9 U.S.C. § 2 (2006).

159. *See* OEHMKE, *supra* note 61, § 1:1, at 1-7.

160. *See* Allied-Bruce Terminix Cos. v. Dobson, 513 U.S. 265, 273–77 (1985).

161. *See id.* at 765.

162. Courts have uniformly concluded that the interpretation of the term "arbitration" is a matter of federal law. *E.g.*, Salt Lake Tribune Publ'g Co., L.L.C. v. Mgmt. Planning, Inc., 390 F.3d 684, 687 (10th Cir. 2004). As Oehmke notes,"[t]his is because federal law applies nationally and, as such, meets the declared need of Congress for uniformity; moreover, relying on federal law avoids the patchwork that would be woven together if the FAA meant one thing in one state and something else in another." OEHMKE, *supra* note 61, § 1:1, at 1-7.

163. OEHMKE, *supra* note 61, § 1:1, at 1-7

164. *Salt Lake Tribune*, 390 F.3d at 690.

dispute between the parties.[165] In a similar fashion, federal courts have held that the mandatory but nonbinding administrative proceeding dictated by the Uniform Domain Name Dispute Resolution Policy (UDRP) does not constitute arbitration within the meaning of the FAA, even though arbitrators typically handle these proceedings.[166]

So, would a provision under which the mortgagor and mortgagee agree to submit the foreclosure process to the determination and supervision of a binding, neutral decision maker constitute arbitration, thus triggering FAA § 2's preemption of state law compelling judicial foreclosure? In attempting to resolve this question, it is useful to articulate the four basic functions served by the judicial foreclosure process. First, judicial foreclosure resolves any question about the validity and priority of the lender's mortgage, the existence of a default, and the lender's right to foreclose.[167] Second, judicial foreclosure accomplishes a sale of the mortgaged property, subject to review and confirmation by the court to establish the sale's compliance with applicable requirements.[168] Third, judicial foreclosure serves a title-clearing function (i.e., it extinguishes subordinate interests so that the foreclosure buyer receives title as it existed on the date on which the mortgagor granted the mortgage that is being foreclosed).[169] Fourth, judicial foreclosure resolves how the sale proceeds should be distributed and any liability of the mortgagor for a deficiency if the sale proceeds do not satisfy the mortgage debt in full.[170]

Most of the acts involved in accomplishing these functions involve basic fact-finding and the making of legal conclusions—actions which are plainly adjudicative in nature.[171] Within the framework of the FAA and its motivating policies, there is no meaningful difference between a judge's

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165. *E.g.*, *id.* at 691 (appraisal process for valuing option to acquire newspaper was not FAA arbitration where agreement permitted, but did not require, parties to seek judicial guidance in resolving certain disputes); Fulcrum Fin. Partners v. Meridian Leasing Corp., 230 F.3d 1004, 1008 (7th Cir. 2000) (agreement for equipment appraisal was not FAA arbitration where appraisal did not resolve allocation of sale proceeds among parties to settlement agreement).

166. *E.g.*, Storey v. Cello Holdings, L.L.C, 347 F.3d 370, 384-85 (2d Cir. 2003) (applying similar reasoning in holding that UDRP administrative determination is not entitled to deference in subsequent judicial proceeding); Hawes v. Network Solutions, Inc., 337 F.3d 377, 386 (4th Cir. 2003) (same); Dluhos v. Strasberg, 321 F.3d 365, 372 (3d Cir. 2003) (UDRP does not prevent either party to domain name registration dispute from submitting dispute to judicial determination; therefore UDRP dispute resolution mechanism is not FAA arbitration because it will not necessarily settle the dispute); *see also* Amy J. Schmitz, *Ending a Mud Bowl: Defining Arbitration's Finality Through Functional Analysis*, 37 GA. L. REV. 123, 203 (2002) (private dispute resolution procedures that incorporate substantive judicial review are not sufficiently "final" to constitute FAA arbitration).

167. *See* NELSON & WHITMAN, *supra* note 20, § 7.11.

168. *See id.*

169. *See id.* §§ 7.11, 7.14.

170. *See id.*§ 7.11.

171. *See id.*

ruling that foreclosure is appropriate and a comparable ruling by an arbitrator.[172]

But what of the conduct and supervision of the sale itself? At first blush, one might argue that arbitration in this context would include only the determination of factual and legal issues (e.g., the validity of the debt, the existence of default, the mortgagee's right to foreclose, and the mortgagor's liability for a deficiency), but not the conduct of the sale itself. If this is correct, an agreement under which the parties agreed to have a private, neutral arbitrator conduct and confirm a foreclosure sale would not be arbitration under the FAA, and thus the FAA would not preempt otherwise applicable state law compelling judicial foreclosure. Under this view, a mortgagee could seek arbitration and obtain an arbitral award establishing the mortgagee's right to have the property sold at foreclosure. However, the mortgagee could not then conduct a sale without first obtaining a judicial confirmation of the award and then obtaining a judicial sale (subject to review and confirmation by the court). If that view is correct, foreclosure-by-arbitration could provide no meaningful efficiency gains in comparison to judicial foreclosure.

Yet there is no good reason to construe arbitration so narrowly. Suppose, for example, that the mortgagor and mortgagee expressly agreed to have the mortgagee's right to foreclose, but not the sale itself, resolved by the final and binding determination of an arbitrator. Certainly, FAA § 2 would preempt a state's judicial foreclosure statute to the extent it purported to require litigation of the mortgagee's right to foreclose. As with any other arbitral award that complies with applicable requirements, an award establishing the mortgagee's right to foreclose would receive the same benefits of res judicata as would the judgment of a court and could be confirmed by a court if necessary.[173]

So why not allow the parties to agree to place the entire foreclosure process—sale and all—in the arbitrator's control? The conduct, review, and confirmation of a foreclosure sale, the distribution of foreclosure sale proceeds, and the determination of any applicable deficiency are no less "judicial" functions than is the determination of the mortgagee's right to foreclose. It is true that a judicial foreclosure sale is not conducted by the judge, but instead by an official such as the sheriff or clerk.[174] Yet this

172. OEHMKE, *supra* note 61, § 1:1, at 1-7.

173. U.S. West Fin. Servs., Inc. v. Buhler, Inc., 150 F.3d 929, 932 (8th Cir. 1998) ("A final arbitration award, unless it is set aside for a legally sufficient reason, has same preclusive effect as judgment."); EDMONSON, *supra* note 63, § 36:2, at 36-2.

174. 1 DAN B. DOBBS, LAW OF REMEDIES § 1.4, at 15–16 (2d ed. 1993).

distinction is purely technical; the sheriff or clerk acts only pursuant to the judge's order, and in this sense, is carrying out judicial authority delegated either by statute, court rules, or both.[175]

To the extent the FAA establishes an effective equivalence between the decisions of a judge and those of an arbitrator acting pursuant to and within the scope of a pre-dispute arbitration agreement, there is no structural barrier to the development and use of a mortgage provision that privatizes the foreclosure process through a comprehensive arbitration agreement. Courts have recognized that arbitrators have broad equitable powers, including the power to order specific performance of a contract even where the contract does not provide for such relief,[176] and American Arbitration Association rules permit the arbitrator to "grant any remedy or relief that the arbitrator deems just and equitable and within the scope of the agreement of the parties."[177] If the agreement authorizes the arbitrator to conduct a sale of the mortgaged property and deliver a deed to the successful purchaser pursuant to an arbitral award in favor of the mortgagee, the deed would be sufficient to transfer title to the purchaser. In turn, the purchaser could use this deed as the basis for a successful cause of action for possession of the land if the mortgagor had not delivered possession voluntarily.[178]

Courts interpreting the FAA have repeatedly noted that its purpose is "'to relieve congestion in the courts and to provide parties with an alternative method for dispute resolution that would be speedier and less costly than litigation.'"[179] If the parties to a mortgage agree that the arbitrator can order, conduct, and review the sale, a determination that the decision making process is not arbitration within the meaning of the FAA would frustrate both the agreement of the parties and the federal policy of providing parties with an effective means to obtain binding adjudication outside the public courts.

B. A Foreclosure-by-Arbitration Agreement in a Mortgage Is Not Unconscionable Under Existing Law

FAA § 2 mandates the enforceability of pre-dispute arbitration agreements "'save upon such grounds as exist at law or in equity for the

175. *See, e.g.*, IOWA CT. R. 1.1018; MINN. STAT. ANN. § 550.04 (2000); MO. R. CIV. PROC. 76.18.

176. 3 OEHMKE, *supra* note 61, § 119:2, at 119-3.

177. AAA Commercial Arbitration Rule 43(a) (June 1, 2009), *available at* http://www.adr.org/sp.asp?id=22440#R43.

178. EDMONSON, *supra* note 63, § 41:3, at 41-2 to -3 ("award which is not confirmed . . . may nevertheless serve as a cause of action, to be enforced in ordinary court procedure, as an action on the award").

179. O.R. Sec., Inc. v. Prof'l Planning Assocs., Inc., 857 F.2d 742, 745–46 (11th Cir. 1988) (quoting Ultracashmere House, Ltd. v. Meyer, 664 F.2d 1176, 1179 (11th Cir. 1981)); *see also* Booth v. Hume Publ'g, Inc., 902 F.2d 925, 932 (11th Cir. 1990).

revocation of any contract.'"[180] Thus, generally applicable contract defenses such as fraud, duress, or unconscionability could invalidate an arbitration agreement despite the general preemptive effect of FAA § 2.[181] However, a state cannot decide that any agreement to arbitrate a particular type of dispute is unenforceable:

> States may regulate contracts, including arbitration clauses, under general contract law principles and they may invalidate an arbitration clause "upon such grounds as exist at law or in equity for the revocation of *any* contract." . . . What States may not do is decide that a contract is fair enough to enforce all its basic terms (price, service, credit), but not fair enough to enforce its arbitration clause. The Act makes any such state policy unlawful, for that kind of policy would place arbitration clauses on an unequal "footing," directly contrary to the Act's language and Congress' intent.[182]

Within this framework, is there a substantial risk that a carefully-drafted pre-dispute foreclosure-by-arbitration clause would be invalidated as unconscionable? The most likely answer appears to be no.

As Professor Jeff Stempel has noted in discussing FAA § 2, all contract authorities, including the Uniform Commercial Code (UCC), recognize unconscionability as an element of contract law; however, neither the UCC nor leading judicial decisions define the term with any precision, and courts vary substantially in their enthusiasm for its use as a means of policing contract enforcement.[183] Perhaps the most familiar treatment of unconscionability comes from Professor Arthur Leff in his renowned article *Unconscionability and the Code—The Emperor's New Clause*,[184] in which he describes unconscionability as having both a procedural component (how the contract was formed) and a substantive component (the contract's inherent fairness).[185] Professor Jeff Stempel has argued that procedural and substantive unconscionability are "analytically distinct" and that each can

180. Doctor's Assocs., Inc. v. Casarotto, 517 U.S. 681, 681 (quoting FAA § 2).

181. *Id.* at 682.

182. Allied-Bruce Terminix Cos. v. Dobson, 513 U.S. 265, 281 (1995) (citation omitted).

183. Jeffrey W. Stempel, *Arbitration, Unconscionability, and Equilibrium: The Return of Unconscionability Analysis as a Counterweight to Arbitration Formalism*, 19 OHIO ST. J. ON DISP. RESOL. 757, 793–94 (2004).

184. Arthur Allen Leff, *Unconscionability and the New Code—The Emperor's New* Clause, 115 U. PA. L. REV. 485 (1967).

185. *Id.* at 487.

provide a legitimate basis for invalidating an arbitration provision.[186] The weight of authority, however, suggests that courts will invalidate an agreement to arbitrate as unconscionable only if it is both procedurally and substantively unconscionable.[187]

1. Procedural Unconscionability

Procedural unconscionability focuses upon the relative bargaining power between the parties and the extent to which the contract clearly discloses its terms.[188] The typical argument that a mortgagor might raise would be that the arbitration agreement is a product of adhesion rather than bargaining and thus procedurally unconscionable for that reason. Indeed, there is fairly substantial recent authority to this effect in California judicial decisions, which have treated some arbitration agreements as procedurally unconscionable if they were offered by the drafter on a "take it or leave it" basis.[189] This argument, however, seems both strained and out of step with the weight of authority. First, there is nothing about a pre-dispute arbitration agreement that is *inherently* procedurally unconscionable, particularly if the agreement is labeled and appears in text no smaller than other provisions of the underlying contract. Second, in standard form transactions, there is typically no negotiation of *any* of the standard contract terms, whether those terms involve agreements to arbitrate, attorney fee shifting clauses, or provisions governing warranties or remedies. Every day, California mortgage lenders make mortgage loans containing powers of sale on a "take it or leave it" basis, with no negotiation over whether the mortgagor can

186. Stempel, *supra* note 183, at 795–98 (cataloguing cases in which courts have held arbitration provisions unconscionable based upon the presence of only procedural or substantive problems).

187. Richard Craswell, *Property Rules and Liability Rules in Unconscionability and Related Doctrines*, 60 U. CHI. L. REV. 1, 17 (1993) (concluding that most courts have required both procedural and substantive unconscionability to exist before refusing to enforce an unambiguous contract term); Russell Korobkin, *Bounded Rationality, Standard Form Contracts, and Unconscionability*, 70 U. CHI. L. REV. 1203, 1256 (2003). There is also recognition in the case law, particularly in California, of a "sliding scale" in making this unconscionability determination: while both substantive and procedural unconscionability are required, the greater the substantive oppression reflected in the agreement, the less evidence of procedural unconscionability is necessary to invalidate the agreement. *See* Nagrampa v. MailCoups, Inc., 469 F.3d 1257, 1284 (9th Cir. 2006).

188. *See* Leff, *supra* note 184, at 487.

189. *See* Nagrampa, 469 F.3d at 1284 (finding an arbitration agreement procedurally unconscionable, even if only minimally so, where one party "had overwhelming bargaining power, drafted the contract, and presented it to [the other party] on a take-it-or-leave-it basis"); Aral v. EarthLink, Inc., 36 Cal. Rptr. 3d 229, 238 (2005) (finding "quintessential procedural unconscionability" where "the terms of the [arbitration] agreement were presented on a 'take it or leave it' basis . . . with no opportunity to opt out"); Flores v. Transamerica HomeFirst, Inc., 113 Cal. Rptr. 2d 376, 381 (2001) (holding that the standards for procedural unconscionability are satisfied by finding that an arbitration provision was presented on a take-it-or-leave-it basis and that it was oppressive due to "an inequality of bargaining power that result[ed] in no real negotiation and an absence of meaningful choice").

instead have a clause requiring judicial foreclosure. But this lack of bargaining, by itself, cannot render the mortgage (or the power of sale) procedurally unconscionable. Finally, courts in most states have not treated arbitration agreements in standard form contracts as inherently suspect on procedural unconscionability grounds.[190] Instead, the more common approach is reflected in Judge Easterbrook's opinion in *Oblix, Inc. v. Winiecki*:

> Standard-form agreements are a fact of life, and given § 2 of the Federal Arbitration Act, 9 U.S.C. § 2, arbitration provisions in these contracts must be enforced unless states would refuse to enforce all off-the-shelf package deals. . . . California routinely enforces limited warranties and other terms found in form contracts. . . . If a state treats arbitration differently, and imposes on form arbitration clauses more or different requirements from those imposed on other clauses, then its approach is preempted by § 2 of the Federal Arbitration Act. . . . It is in the end irrelevant whether the Supreme Court of California wants to treat arbitration less favorably than other promises in form contracts; no state can apply to arbitration (when governed by the Federal Arbitration Act) any novel rule. Under normal rules of contract, the promises Winiecki made in order to be hired and paid are enforceable. Thus she must arbitrate.[191]

2. Substantive Unconscionability

Even if one indulged the assumption that standard form contracting is inherently procedurally unconscionable, most courts would still enforce a pre-dispute mandatory arbitration agreement unless it was also substantively unconscionable.[192] Substantive unconscionability concerns the terms of the agreement and whether those terms are "so one-sided as to shock the conscience."[193] In this regard, a court would have to examine the particular

190. *E.g.*, Oblix, Inc. v. Winiecki, 374 F.3d 488 (7th Cir. 2004) (arbitration clause in employment contract not procedurally unconscionable because it was presented as "take it or leave it"); Fleetwood Enters., Inc. v. Gaskamp, 280 F.3d 1069 (5th Cir. 2002) (arbitration clause in manufactured home financing contract not procedurally unconscionable due to relative imbalance in sophistication of the parties); Harris v. Green Tree Fin. Corp., 183 F.3d 173 (3d Cir. 1999) (arbitration clause in home improvement financing contract not procedurally unconscionable).

191. *Oblix, Inc.*, 374 F.3d at 491–92 (citations omitted).

192. *See, e.g., id.*

193. Circuit City Stores, Inc. v. Mantor, 335 F.3d 1101, 1107 (9th Cir. 2003); Ingle v. Circuit City

provisions of the arbitration agreement itself. For example, courts have found the following matters to be badges of substantive unconscionability: (i) a provision requiring an employee or consumer to arbitrate all claims against the employer or seller/service provider, but not requiring the employer or seller/service provider to arbitrate claims against the employee or consumer (a lack of "mutuality");[194] (ii) a provision requiring an employee to pay a filing fee to initiate an arbitration proceeding and vesting in the employer the unilateral discretion whether to waive the fee;[195] (iii) a provision limiting the nature of the remedies that the arbitrator could provide,[196] particularly for violations of federal statutory claims;[197] (iv) a provision allowing one party to modify the existence, scope, or terms of the arbitration agreement unilaterally and without notice;[198] and (v) a forum selection provision requiring arbitration in a forum "so gravely difficult and inconvenient that the resisting party will for all practical purposes be deprived of his day in court."[199]

Obviously, if a mortgage lender insisted upon including an arbitration clause that contained such one-sided provisions, it would open itself up to the risk that a court might deem the clause substantively unconscionable. For example, a foreclosure-by-arbitration clause in a mortgage on Florida land that purported to require arbitration in California would raise a serious substantive unconscionability concern, particularly in a residential transaction.[200] Likewise, serious doubt would arise if a clause purported to limit the defenses that the mortgagor could raise in arbitration (thus cutting off defenses that the mortgagor could have raised in a judicial foreclosure),

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Stores, Inc., 328 F.3d 1165, 1172 (9th Cir. 2003).

194. *Nagrampa*, 469 F.3d at 1285; *Ingle*, 328 F.3d at 1173; Iberia Credit Bureau, Inc. v. Cingular Wireless LLC, 379 F.3d 159 (5th Cir. 2004); Armendariz v. Found. Health Psychcare Servs., Inc., 24 Cal. 4th 83, 117 (2000). Not all courts, however, require that a pre-dispute arbitration clause has to be mutual, requiring both parties to submit their claims to arbitration. *See, e.g.*, *Harris*, 183 F.3d at 180 ; Doctor's Assocs., Inc. v. Distajo, 66 F.3d 438 (2d Cir. 1995); Becker Autoradio U.S.A., Inc. v. Becker Autoradiowerk GmbH, 585 F.2d 39 (3d Cir. 1978); Hannon v. Original Gunite Aquatech Pools, Inc., 434 N.E.2d 611 (Mass. 1982).

195. *Circuit City Stores*, 335 F.3d at 1107; *Ingle*, 328 F.3d at 1172.

196. One particularly troublesome issue has been whether an arbitration clause can effectively prohibit class action relief. Some decisions have held that a class action waiver is substantively unconscionable. *See, e.g.*, Discover Bank v. Superior Court, 36 Cal. 4th 148 (2005).

197. Paladino v. Avnet Computer Technologies, Inc., 134 F.3d 1054, 1060 (11th Cir. 1998) (finding that a clause limiting award of damages to breach of contract claims only and not Title VII claims "deprives the employee of any prospect for meaningful relief and is therefore unenforceable.").

198. Dumais v. Am. Golf Corp., 299 F.3d 1216 (10th Cir. 2002); Floss v. Ryan's Family Steak Houses, Inc., 211 F.3d 306 (6th Cir. 2000); Hooters of Am., Inc. v. Phillips, 173 F.3d 933 (4th Cir. 1999).

199. *Nagrampa*, 469 F.3d at 1287.

200. *See, e.g., id.* (holding unconscionable a provision requiring arbitration in a forum so inconvenient "that the resisting party will for all practical purposes be deprived of his day in court").

or to waive the anti-deficiency protection that the mortgagor would have under state law.

However, this risk can be avoided by thorough, balanced, and cautious drafting. If the mortgagee includes a provision that essentially replicates the same substantive rules and procedures that would apply in a judicial foreclosure—but on an accelerated timetable to permit the mortgagee to avoid the time delays attendant to state court litigation—such a provision appropriately could not be viewed as substantively unconscionable.

C. *What About Nonsignatories? A Foreclosure-by-Arbitration Agreement Could Be Enforced Against Junior Lienholders*

So far, this Part has focused on the mortgagor and the mortgagee who would have agreed to the mortgage containing the foreclosure-by-arbitration clause. But what about third parties? As noted previously, one of the primary functions served by the foreclosure process is the title-clearing function.[201] When conducted with proper authority, the foreclosure sale delivers to the buyer title to the land as it existed on the date the mortgagor granted the mortgage being foreclosed.[202] For this to happen, any interests that are junior to the mortgage lien being foreclosed, such as subsequent mortgage liens or judgment liens, must be extinguished by the foreclosure sale.[203]

Where foreclosure occurs by judicial process, due process of law requires that the foreclosing mortgagee join as a party to the foreclosure any person holding a junior encumbrance.[204] This joinder provides the junior encumbrancer with a full and fair opportunity to litigate the validity of the foreclosing mortgagee's lien and the mortgagee's right to foreclose that lien.[205] It also protects the junior encumbrancer's right to redeem his lien by paying off the balance of the senior mortgage debt, or alternatively, to protect his interest by bidding at the senior mortgagee's foreclosure sale.[206] As a result, if the mortgagee fails to join a junior lienholder as a party to a

201. *See supra* text accompanying note 169.

202. NELSON & WHITMAN, *supra* note 20, § 7.17, at 843 & n.17 (title acquired is the "entire interest and estate of mortgagor and mortgagee as it existed at the date of the mortgage").

203. *See supra* note 47 and accompanying text.

204. *See* NELSON & WHITMAN, *supra* note 20 § 7.12, at 808–15 (discussing need for foreclosing mortgagee to join "necessary" parties, such as those holding subordinate interests to be extinguished by the foreclosure).

205. *Id.*

206. *Id.*

judicial foreclosure proceeding, the junior lienholder is not bound by the court's judgment.[207] If the mortgagee nevertheless conducts a foreclosure sale, the purchaser will take the land subject to the interest of the unbound junior lienholder.[208] By contrast, if the mortgagee joins the holders of all junior interests as parties, then any foreclosure sale following judgment will extinguish those junior interests.[209]

Likewise, for foreclosure-by-arbitration to accomplish this title-clearing function, the mortgagee would have to join any junior lienholder as a party to the arbitration. FAA arbitration, however, is based upon an agreement to arbitrate.[210] In the typical case, a foreclosing mortgagee will not be in direct contractual privity with a junior lienholder. So can a foreclosing mortgagee compel a junior lienholder to arbitrate pursuant to an arbitration agreement contained in a mortgage to which the junior was not a signatory?

Existing authority demonstrates that a nonsignatory to an arbitration agreement may still enforce or be bound to that agreement under several accepted theories of agency or contract.[211] Recognized theories include agency, incorporation by reference, alter-ego, assumption, estoppel, third-party beneficiary, and successor-in-interest.[212] Several of these theories, including agency,[213] alter ego,[214] assumption,[215] estoppel,[216] and third-party

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207. *Id.*

208. For further discussion of the rights of the "omitted junior" encumbrancer and the foreclosure sale purchaser, see *id.* § 7.15, at 823–33.

209. *Id.* § 7.14.

210. 9 U.S.C. § 2 (2006).

211. *See infra* notes 212–22 and accompanying text.

212. *See infra* notes 213–22 and accompanying text.

213. When an agent negotiates a contract containing an arbitration provision on behalf of the principal, the principal may be bound to arbitrate even if the principal did not sign the contract. EDMONSON, *supra* note 63, § 13.2, at 13-5; OEHMKE, *supra* note 61, § 11.9, at 11-11. To bind a principal by its agent's acts, an adverse claimant must demonstrate that the agent was acting on behalf of the principal and that the cause of action arises out of that relationship. E.I. DuPont de Nemours & Co. v. Rhone Poulenc Fiber & Resin Intermediates, S.A.S., 269 F.3d 187, 198–99 (3d Cir. 2001). In the context of a mortgage foreclosure, such a relationship is unlikely to exist. At the time a mortgage is granted, there typically are no outstanding interests junior to that mortgage; the mortgagor can scarcely serve as an agent for a not-yet-in-existence principal. There is one situation where a junior encumbrance may already exist because of the priority the mortgage law accords to the purchase money mortgagee. Suppose, for example, that *X* buys land from *S* and grants *S* a purchase money mortgage to secure the unpaid balance of the purchase price. Suppose further that at the time of the purchase, *X* is already subject to a judgment in the amount of $200,000 in favor of *C*, and that under state law, the lien of that judgment attaches to the land as soon as *X* acquires title. Technically, *C*'s judgment lien against the land will arise either contemporaneously with (or very slightly prior to) *S*'s purchase money mortgage lien. Nevertheless, under mortgage law, *S*'s purchase money mortgage holds priority over *C*'s judgment lien. RESTATEMENT (THIRD) OF PROP.: MORTGAGES § 7.2(b) (1996); NELSON & WHITMAN, *supra* note 20, § 9.1, at 1107–17. However, there would be no reason to presume that a judgment creditor like *C* would have impliedly deputized *X* to bind *C* to an arbitration clause in any mortgage that *X* later granted on any land *X* subsequently acquired.

214. Courts have held that a nonparty may be bound to an arbitration agreement where the

beneficiary,[217] provide no support for binding a junior lienholder to a pre-dispute arbitration agreement contained in a senior mortgage. The

nonparty is merely the instrumentality or alter ego of a signatory to that agreement. EDMONSON, *supra* note 63, § 13.6, at 13-15; OEHMKE, *supra* note 61, § 11.11, at 11-13. Courts typically apply the alter ego theory in cases where "the alter ego so dominates and controls the affairs of the signatory such that the signatory cannot be said to have any independent existence or will of its own." EDMONSON, *supra* note 63, § 13.6, at 13-17; *see also* WorldCrisa Corp. v. Armstrong, 129 F.3d 71, 76 (2d Cir. 1997); *In re* Arbitration Between Keystone Shipping Co. and Texport Oil Co., 782 F. Supp. 28, 30–31 (S.D.N.Y. 1992); Menaker v. Padover, 427 N.Y.S.2d 495 (N.Y. App. Div. 1980). In the typical situation, there will be no such relationship between the mortgagor and a junior encumbrancer.

215. Courts have held that a nonparty can be bound to arbitrate if its conduct demonstrates that it has assumed the party's obligations under an agreement that contains an arbitration provision. *See* EDMONSON, *supra* note 63, § 13.7, at 13-18; OEHMKE, *supra* note 61, § 11:4, at 11-6. *See also* Gvozdenovic v. United Air Lines, Inc., 933 F.2d 1100, 1105 (2d Cir. 1991); *In re Arbitrartion Between Keystone Shipping*, 782 F. Supp. at 30; Petition of Transol Navegacao S.A., 782 F. Supp. 848, 851 (S.D.N.Y. 1991). It is possible that a junior encumbrancer could agree to assume the mortgagor's obligations under a senior mortgage, but such assumption agreements are extremely rare. In the typical case, a junior encumbrancer will simply have acquired its lien "subject to" the priority of the senior encumbrance, but will not have assumed any personal obligation to pay the senior debt or otherwise perform the personal obligations of the mortgagor on that debt. *See generally* NELSON & WHITMAN, *supra* note 20, § 5.3.

216. Courts have held that a nonsignatory can enforce an arbitration agreement against the signatory on estoppel grounds, particularly when the issues for resolution are intertwined with the underlying contract obligations and closely linked to a dispute that is subject to arbitration under the agreement. OEHMKE, *supra* note 61, § 11:6, at 11-7 and § 11:7, at 11-8. *See also* Sunkist Soft Drinks, Inc. v. Sunkist Growers, Inc., 10 F.3d 753, 757 (11th Cir. 1993); McBro Planning & Dev. Co. v. Triangle Elec. Constr. Co., 741 F.2d 342, 344 (11th Cir. 1984); Hughes Masonry Co., Inc. v. Greater Clark County School Bldg. Corp., 659 F.2d 836, 838 (7th Cir. 1981). However, courts have not allowed a signatory to compel a nonsignatory to arbitrate under this theory. *See, e.g.*, *E.I. DuPont de Nemours*, 269 F.3d at 199–202; MAG Portfolio Consultant, GMBH v. Merlin Biomed Group L.L.C., 268 F.3d 58, 64–65 (2d Cir. 2001). A nonsignatory can be equitably estopped from refusing to comply with an arbitration agreement if the nonsignatory receives a direct benefit from the contract containing that agreement. *See* Int'l Paper Co. v. Schwabedissen Maschinen & Anlagen GMBH, 206 F.3d 411, 418 (4th Cir. 2000); Am. Bureau of Shipping v. Tencara Shipyard S.P.A., 170 F.3d 349, 352–53 (2d Cir. 1999); OEHMKE, *supra* note 61, § 11:8, at 11-10. In the typical case, however, a junior encumbrance will arise only after the senior mortgage, and thus the junior encumbrancer has not received any direct benefit from the contract evidencing the senior encumbrance.

217. Under third-party beneficiary analysis, a nonsignatory may compel arbitration if the signatories to the contract containing the arbitration clause agreed to confer upon the nonsignatory the benefits of the contract. MS Dealer Serv. Corp. v. Franklin, 177 F.3d 942, 947-48 (11th Cir. 1999); OEHMKE, *supra* note 61, § 11:5, at 11-6. In turn, courts will compel a nonsignatory to a contract containing an arbitration clause to arbitrate if the nonsignatory is a third-party beneficiary who has accepted the benefits of the contract. *Int'l Paper Co.*, 206 F.3d at 418; *Am. Bureau of Shipping*, 170 F.3d at 352–53; OEHMKE, *supra* note 61, § 11:8, at 11-10. In the typical case, however, a junior encumbrance will arise only after the senior mortgage, and thus the junior encumbrancer cannot be said to have been an intended beneficiary of the contract evidencing the senior encumbrance.

incorporation by reference and successor-in-interest theories, however, bear further study.

Courts have held that a nonparty may be bound to an arbitration agreement if there is a separate agreement between the signatory and the nonparty which incorporates the arbitration agreement by reference.[218] For example, most courts have enforced arbitration agreements against nonparty guarantors or sureties where the arbitration agreements were incorporated by reference into guaranties or performance bonds.[219]

Because a junior mortgagee takes its interest in the mortgaged premises subject to all interests of which it has constructive notice, a senior mortgagee might argue that an arbitration clause contained in a properly recorded senior mortgage should be deemed incorporated into the junior mortgage by reference. However, such an argument is weak. First, even if a junior lien is evidenced by a written agreement between the mortgagor and the junior lienholder (e.g., a second mortgage), that agreement likely will not incorporate the terms of the senior mortgage by specific reference. Second, many junior liens (such as judgment liens arising out of tort claims) are not evidenced by any written agreement at all—with such liens, there is no agreement into which the arbitration agreement could be incorporated, by reference or otherwise. Finally, no court decisions have extended the incorporation-by-reference theory to include this type of "constructive notice" argument.

Instead, the constructive notice argument more naturally fits within the "successor-in-interest" theory. In certain circumstances, a successor to a person that is a party to a contract containing an arbitration agreement is bound by that arbitration agreement. Where a successor expressly takes on all rights and obligations of another party under a contract containing an arbitration clause, a court will compel the successor to arbitrate if the assignment was sufficiently broad to cover the obligation to arbitrate.[220] By itself, however, the assumption principle is not sufficient to establish the enforceability of an arbitration clause in a senior mortgage against a junior

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218. EDMONSON, *supra* note 63, § 13.4, at 13-10; OEHMKE, *supra* note 61, § 11:3, at 11-6.

219. U.S. Fid. & Guar. Co. v. W. Point Constr. Co., 837 F.2d 1507, 1508 (11th Cir. 1988); EDMONSON, *supra* note 63, § 13:5, at 13-11. According to the Domke treatise:

> Originally, the trend towards the enforcement of arbitration provisions incorporated in performance bonds or guaranties was fueled by federal circuit courts which exhibited a stronger tendency to enforce arbitration between owners and sureties on performance bonds where the performance bonds incorporated, by a specific reference, a contract containing an arbitration clause . . . governed by the [FAA].
>
> A majority of state courts have followed suit in compelling sureties to arbitrate where the bond incorporates an agreement containing an arbitration provision. However, a minority continues to hold that a party must expressly agree to arbitrate before it will be compelled to arbitrate.

EDMONSON, *supra* note 63, § 13:5, at 13-11 to -12 (footnotes omitted).

220. EDMONSON, *supra* note 63, § 13.13, at 13-26.

encumbrancer. Under mortgage law generally, a transferee of mortgaged property is deemed to take that property subject to the terms of existing mortgages, but does not assume the mortgagor's personal obligations under the existing mortgage absent an express assumption of those obligations.[221]

But what if the senior mortgage expressly provided that the arbitration clause was binding upon the mortgagor *and the mortgagor's heirs, successors, and assigns*? In other words, what if the senior mortgage provided that the arbitration clause was a covenant that would run with the land? Would this be sufficient to turn the arbitration agreement into a covenant binding a junior encumbrancer as a successor to the mortgagor's interest? Under both the weight of common law authority and the position expressed in the new Restatement (Third) of Property: Servitudes, the answer appears to be yes.[222]

1. The Common Law: Does an Arbitration Agreement "Touch and Concern" Land?

Under the traditional common law rules, a signatory seeking to enforce an arbitration clause against a successor-in-interest would have to show that (1) the clause was intended to run with the land to bind successors, (2) the clause "touched and concerned" the land, and (3) the successor took its interest with notice of the clause.[223] If the clause by its express terms bound the original parties and their heirs, successors, and assigns, this would demonstrate the intent of the original parties for the clause to run to bind successors.[224] Likewise, assuming the clause appeared in an instrument recorded within the chain of title to the land, the successor would take with constructive notice of the clause.[225] Thus, the enforceability of the covenant against a successor would come down to whether the covenant requiring arbitration of disputes "touched and concerned" the land in question.

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221. NELSON & WHITMAN, *supra* note 20, § 5.3, at 394.

222. *See* Restatement (Third) of Prop.: Servitudes (2000).

223. HERBERT HOVENKAMP & SHELDON F. KURTZ, PRINCIPLES OF PROPERTY LAW § 10.3, at 342 (6th ed. 2005); WILLIAM B. STOEBUCK & DALE A. WHITMAN, THE LAW OF PROPERTY § 8.22, at 493 (3d ed. 2000). Because the covenantee would be seeking an equitable remedy (i.e., specific performance of the arbitration agreement) he would not have to establish privity of estate between the parties as traditionally required for a covenant to run with the land at law. HOVENKAMP, *supra*, § 10.3, at 343.

224. STOEBUCK, *supra* note 223, § 8.16, at 481 ("Obviously the use of the word 'assigns' is highly persuasive of an intent to bind successors.").

225. HOVENKAMP, *supra* note 223, § 10.3, at 345; STOEBUCK, *supra* note 223, § 8.28, at 500.

Would a covenant to use arbitration to foreclose mortgaged land "touch and concern" that land? At first blush, one might argue that the answer would be no. Traditionally, courts were reluctant to enforce a covenant against successors unless both the benefit and the burden of the covenant touched and concerned the land; if the benefit of a covenant was "in gross," or personal to the covenantee, the burden of the covenant did not run to bind successors to the covenantor.[226] On the one hand, one might argue that a covenant regarding the manner of dispute resolution does not inherently benefit the land or enhance its use and enjoyment. Under this view, the benefits of such a covenant (i.e., the ostensible efficiency savings or autonomy benefits to be obtained from an arbitral adjudication) could be characterized as a personal benefit to the covenantee (in this context, the foreclosing mortgagee). On the other hand, the foreclosing mortgagee could argue that because the arbitration agreement reduces its potential enforcement costs, that agreement increases the value of its mortgage, and thus should be viewed as "touching and concerning" the mortgagee's interest in the mortgaged land. The latter analysis is more persuasive in that to the extent both parties have an interest in the mortgaged land, an agreement to arbitrate disputes regarding their respective interests benefits each of them as owners.[227]

There appear to be no reported cases addressing whether an arbitration clause in a mortgage would run with the land to bind successors. However, a number of cases have arisen in the contexts of other conveyances, and the weight of this authority holds that an arbitration agreement is a covenant that runs with the land to bind a successor.[228] Most of the case law involves leases, with the leading case being the Oregon Supreme Court's decision in *Abbott v. Bob's U-Drive*.[229] Abbott leased land to Thompson by virtue of a lease under which Thompson agreed to operate two auto leasing businesses

226. R. WILSON FREYERMUTH ET AL., PROPERTY AND LAWYERING 627 (2d ed. 2006); *see also* Caullett v. Stanley Stilwell & Sons, Inc., 170 A.2d 52 (N.J. Super. Ct. App. Div. 1961) (covenant obligating lot buyer to use covenantee's contracting firm to construct first residence did not "touch and concern" land); Bremmeyer Excavating, Inc. v. McKenna, 721 P.2d 567 (Wash. Ct. App. 1986) (covenantor's promise to use a particular company's excavating services on a particular parcel of land did not run to bind covenantor's successor).

227. This is perhaps more apparent by considering the example of a residential common interest community in which all lots are subject to a recorded declaration that includes a reciprocal restriction requiring lot owners to resolve certain types of disputes through arbitration. If the benefit of the arbitration agreement were viewed as personal, the burden of the arbitration agreement would not run to bind successors, and the arbitration agreement would thus become unenforceable as lots in the community "turned over." Instead, it is more appropriate to argue that the arbitration agreement plausibly benefits the value of each lot (and thus each lot owner as a lot owner) by providing a more expedient and efficient process for resolving neighborhood disputes.

228. *See, e.g.*, Abbott v. Bob's U-Drive, 352 P.2d 598 (Or. 1960).

229. *Id.*

(one for short-term leases and one for long-term leases).[230] The lease contained a provision requiring arbitration of any dispute arising under the lease.[231] Thompson incorporated two corporations—Bob's U-Drive (which engaged in short-term leasing) and Continental (which engaged in long-term leasing).[232] The following year, Thompson assigned all of his interest under the lease to Bob's U-Drive in writing.[233] No written assignment was made to Continental, although both corporations continued operating out of the premises.[234]

Four years into the lease term, a dispute arose over payment of rent.[235] Abbott filed a petition seeking to compel Bob's U-Drive and Continental to arbitrate regarding rent due under the lease.[236] Bob's U-Drive consented to arbitration but Continental did not, arguing that it was neither an assignee nor a signatory bound by the arbitration agreement.[237] The court concluded that Continental was an implied co-assignee of the lease along with Bob's U-Drive, based upon the fact that "both corporations were occupying portions of the leasehold premises and had been paying rent."[238] The court then addressed the question of whether the covenant to submit lease disputes to arbitration ran with the lease and concluded that the arbitration agreement was a covenant running with the land:

> A covenant to pay rent clearly 'touches and concerns' the land. It would seem to follow that a covenant to arbitrate a question with respect to rental payments should also be regarded as relating to the property interests of the original covenanting parties as lessor and lessee. As stated in Clark [on Covenants], "there would seem to be no reason for applying the rule of touching and concerning in an overtechnical manner, which is unreal from the standpoint of the parties themselves." Clark suggests the following as a practical test:
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> "Where the parties, as laymen and not as lawyers, would naturally regard the covenant as intimately bound up with the land,

230. *Id.* at 600.
231. *Id.* at 599–600.
232. *Id.* at 600.
233. *Id.*
234. *Id.*
235. *Id.*
236. *Id.*
237. *Id.*
238. *Id.* at 602.

aiding the promisee as landowner or hampering the promisor in similar capacity, the requirement should be held fulfilled."[239]

The court concluded that "the average person accepting the assignment of a lease containing a covenant to arbitrate questions relating to the terms of the lease would normally assume that he was bound by the covenant."[240] The court also noted that in previous decisions, courts had held that provisions for reappraisal and resetting of rent had been treated as running with the land.[241] The court thus concluded that the assignment was "sufficient to carry with it the covenant to arbitrate contained in the written lease."[242]

Likewise, the California Court of Appeal in *Kelly v. Tri-Cities Broadcasting, Inc,*[243] reached a similar result. *Kelly* involved a dispute arising out of the purchase by Tri-Cities Broadcasting, Inc. (Tri-Cities) of a radio business from Far West Broadcasting Corp. (Far West).[244] The business was operated on land leased from the father of Robert and Richard Kelly, and the lease obligated the lessee to provide five minutes of airtime daily to the lessor or its assignee for advertising purposes.[245] The lease also contained an arbitration agreement stated to be binding upon the parties and their assignees.[246] At the time of the sale of the business, Tri-Cities took an assignment of the lease.[247] Subsequently, Tri-Cities relocated its transmitter to another site and refused to provide airtime to the Kellys.[248] In response, the Kellys filed a complaint seeking to enforce against Tri-Cities the obligation to pay rent under the lease and to compel Tri-Cities to arbitrate the dispute under the arbitration agreement.[249] Tri-Cities argued that it was not bound by the agreement to arbitrate, but the court disagreed, concluding that the agreement ran with the land to bind Tri-Cities.[250] Noting that case authority was "sparse,"[251] the court relied upon the *Bob's U-Drive* decision in stating that "[t]he Oregon Supreme Court concluded a covenant to

239. *Id.* at 604 (citing CHARLES E. CLARK, COVENANTS AND INTERESTS RUNNING WITH LAND 99 (2d ed. 1947)).

240. *Id.*

241. *Id.*

242. *Id.* One judge dissented, noting that while a covenant to pay rent ran with the land, "a covenant to arbitrate is personal and does not run with the land." *Id.* at 606 (Duncan, J., dissenting).

243. 195 Cal. Rptr. 303 (Ct. App. 1983).

244. *Id.* at 304.

245. *Id.* at 304–05. The opinion does not clearly explain whether the lessee was to provide this air time in lieu of monetary rent or in addition to monetary rent stated elsewhere in the lease.

246. *Id.*at 306.

247. *Id.* at 304.

248. *Id.* at 305 n.1.

249. *Id.* at 306.

250. *Id.* at 306, 311.

251. *Id.* at 310.

arbitrate was a covenant running with the land. We agree and would treat it as similar to a covenant to pay rent upon which it rests for the conclusion that such a covenant 'touches and concerns the land.'"[252]

Subsequently, the California courts reaffirmed this view in *Melchor Investment Co. v. ROLM Systems*.[253] Melchor leased two buildings to ROLM Corporation (ROLM Corp.) for a term of twenty years under a lease containing an arbitration clause.[254] Ten years into the lease term, ROLM Corp. merged into IBM, which assumed ROLM Corp.'s obligations under the lease.[255] Two years later, IBM, with the consent of Melchor, subleased the buildings to ROLM Systems for a term of five years.[256] During the sublease, a dispute arose regarding the condition of the roof.[257] When ROLM Systems demanded arbitration, Melchor filed an action to enjoin arbitration on the grounds that it had no privity of contract with ROLM Systems.[258] The trial court denied the injunction and ordered arbitration,[259] and the California Court of Appeal dismissed Melchor's appeal:

> Lessor [Melchor] concedes that sublessor [IBM] can compel it to arbitrate pursuant to the lease. The parties here argue about whether sublessee expressly agreed to be bound by the arbitration provision in the lease, in other words, whether there is contractual privity between lessor [Melchor] and sublessee [ROLM Systems]. *Kelly v. Tri-Cities Broadcasting, Inc.* . . . demonstrates the irrelevance of this concern. Privity of estate, not privity of contract, is dispositive here. . . . *Kelly* concluded that a covenant to arbitrate, like a covenant to pay rent, touches and concerns and therefore runs with the land. . . . In this case since sublessee remains an occupant of the property, sublessee and lessor are bound to arbitrate by privity of estate even if sublessee did not expressly assume this obligation of sublessor.[260]

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252. *Id.* at 311.
253. 4 Cal. Rptr. 2d 343 (Ct. App. 1992).
254. *Id.* at 344–45.
255. *Id.* at 344.
256. *Id.*
257. *Id.* at 345.
258. *Id.*
259. *Id.*
260. *Id.* at 346–47 (citations omitted); *see also* Lansdale v. Marina Pacifica Homeowners' Ass'n, No. B192520, 2007 WL 2307043 (Cal. Ct. App. Aug. 14, 2007) (lease provision requiring appraisal was arbitration provision governed by California arbitration statute and was binding against

Courts have also held that a pre-dispute arbitration clause contained in an easement agreement "touches and concerns" land. In *Baker v. Conoco Pipeline Co.*,[261] Lawrence and Betty Baker sued Conoco for damages to trees and vegetation on their land due to Conoco's having mowed a fifty-foot strip of the Bakers' land.[262] This strip of land was located over a pipeline that Conoco maintained across the Baker land pursuant to a recorded easement granted by a predecessor of the Bakers.[263] Conoco sought a stay and an order compelling arbitration of the dispute, arguing that the easement agreement contained an arbitration clause.[264] The Bakers argued that the easement agreement was a personal contract binding only the original parties.[265] The court, however, held that the arbitration agreement was a covenant running with the land and thus bound the Bakers, who were in privity of estate with the original covenantor by virtue of their succession to ownership of the land.[266] Rejecting the Bakers' argument that the arbitration agreement was personal, the court noted:

> The second requirement for a successor to the covenantee's estate to compel the performance of the covenant is that the covenant's benefit must "touch and concern" the land. . . . This element is easily dispensed with in this case because the arbitration provision in the easement granting a right-of-way to lay pipelines provides the exclusive procedure for resolving disputes over damage to crops, fences, and timber, which clearly "touch and concern" the real property.[267]

The judge reached the identical determination in a companion case, *Cason v. Conoco Pipeline Co.*[268]

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successors to the original lease).

261. 280 F. Supp. 2d 1285 (N.D. Okla. 2003).

262. *Id.* at 1292.

263. *Id.* at 1291–92.

264. *Id.* at 1292.

265. *Id.* at 1295.

266. *Id.* at 1298. Because Conoco was seeking equitable relief (specific enforcement of an agreement to arbitrate), it is not clear why the *Baker* court felt it necessary or appropriate to evaluate whether the Bakers were in privity of estate with the prior landowner at the time the easement was created. Under the traditional approach, privity of estate was not required for the burden of a covenant to bind successors as a servitude in equity. Tulk v. Moxhay, (1848) 41 Eng. Rep. 1143, 1144 (Ch.); HOVENKAMP, *supra* note 223, § 10.3, at 343; STOEBUCK, *supra* note 223, § 8.26, at 498.

267. *Baker*, 280 F. Supp. 2d at 1297–98 (citation omitted).

268. 280 F. Supp. 2d 1309 (N.D. Okla. 2003).

2. The Restatement of Servitudes

The conclusion that an arbitration agreement would constitute a servitude running with the land to bind a successor would also follow if one analyzes the issue under the Restatement (Third) of Property: Servitudes. The new Restatement rejects the historical "touch and concern" standard as outmoded and unpredictable.[269] Instead, it provides that a servitude is valid unless it is "illegal or unconstitutional or violates public policy."[270] Adopting a strong freedom-of-contract approach to the creation of servitudes and their enforcement against successors, the Restatement "shift[s] to the party claiming invalidity of a servitude the burden to establish that it is illegal or unconstitutional, or violates public policy."[271] To defeat the enforcement of a covenant as a servitude, the successor must establish that the servitude (1) "is arbitrary, spiteful, or capricious;"[272] (2) "unreasonably burdens a fundamental constitutional right;"[273] (3) "imposes an unreasonable restraint on alienation;"[274] (4) "imposes an unreasonable restraint on trade or competition;"[275] or (5) "is unconscionable."[276]

A careful reading of the commentary to the Restatement leaves little doubt that a pre-dispute arbitration agreement in a mortgage would constitute a servitude binding against a successor such as a junior lienholder. While a pre-dispute arbitration agreement may constitute an indirect restraint on alienation, it is not arbitrary,[277] spiteful,[278] capricious,[279] or

269. RESTATEMENT (THIRD) OF PROP.: SERVITUDES § 3.2 (2000) ("Neither the burden nor the benefit of a covenant is required to touch or concern land in order for the covenant to be valid as a servitude.").

270. *Id.* § 3.1.

271. *Id.* § 3.1 cmt. a.

272. *Id.* § 3.1(1).

273. *Id.* § 3.1(2).

274. *Id.* §§ 3.1(3), 3.4, 3.5.

275. *Id.* §§ 3.1(4), 3.6.

276. *Id.* §§ 3.1(5), 3.7.

277. *Id.* § 3.1 cmt. g ("Arbitrary normally means that the purpose is not legitimate, or that the means adopted have no reasonable relationship to accomplishment of the purpose."). Given the fundamental pro-arbitration policy reflected in the FAA, the purpose of a pre-dispute arbitration agreement must be viewed as legitimate.

278. *Id.* ("Spiteful means that the primary purpose of the servitude was to cause harm to another, rather than to secure a benefit to the creating party or parties."). Given the efficiency benefits arbitration potentially provides, one could not reasonably conclude that a pre-dispute arbitration agreement was spiteful unless its content was so one-sided as to be substantively unconscionable.

279. *Id.* ("Capricious generally means that no legitimate purpose for creating the servitude is discernible."). Again, given the fundamental pro-arbitration policy articulated in the FAA, one could not conclude that a pre-dispute foreclosure-by-arbitration clause served no legitimate purpose.

unconscionable,[280] and it does not constitute an unreasonable restraint on alienation. Though the Restatement requires that a servitude imposing a direct restraint on alienation can be enforced only where enforcement is reasonable under the circumstances,[281] a servitude imposing an indirect restraint on alienation is enforceable as long as it is supported by a rational justification:[282]

> Many economic arrangements for spreading the purchase price of property over time and for allocating risk and sharing profit from property development can be attacked as indirect restraints on alienation. If such arrangements are not unconscionable and do not otherwise violate public policy, there is usually no reason to deny the parties freedom of contract. The parties are usually in a better position than judges to decide the economic trade-offs that will enable a transaction to go forward and enhance their overall value.[283]

Further, the comments to the Restatement leave little doubt that, at least in the context of a common interest development, a pre-dispute arbitration agreement in the declaration would be enforceable:

> 9. The declaration of covenants for the Seaside Property Owners Association requires that all disputes over the amount of assessments for required maintenance of common areas owned by the Association be resolved by arbitration. The declaration provides a method for selecting arbitrators, provides that their decision shall be final, and provides that property owners waive their rights to challenge maintenance assessments in a court of law. In the absence of other facts or circumstances, the conclusion would be justified that this provision is effective to deny current beneficiaries of the servitudes the right to sue over assessments.[284]

Finally, a pre-dispute arbitration agreement would have no meaningful impact upon trade or competition and, given the overwhelming pro-

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280. *See supra* notes 180–200 and accompanying text.

281. RESTATEMENT (THIRD) OF PROP.: SERVITUDES § 3.4 (2000) ("A servitude that imposes a direct restraint on alienation of the burdened estate is invalid if the restraint is unreasonable. Reasonableness is determined by weighing the utility of the restraint against the injurious consequences of enforcing the restraint.").

282. *Id.* § 3.5 ("An otherwise valid servitude is valid even if it indirectly restrains alienation by limiting the use that can be made of property, by reducing the amount realizable by the owner on sale or other transfer of the property, or by otherwise reducing the value of the property. . . . A servitude that lacks a rational justification is invalid.").

283. *Id.* § 3.5 cmt. a.

284. *Id.* § 8.1, cmt. d, illus. 9.

arbitration policy reflected in the FAA,[285] cannot be viewed as contrary to public policy. As a result, under the Restatement's analysis, a foreclosing mortgagee could enforce a pre-dispute foreclosure-by-arbitration covenant against a junior lienholder as a servitude.

IV. SOME CONCLUDING THOUGHTS

Part III demonstrates that there are no structural legal barriers preventing a mortgagor and mortgagee from agreeing to privatize the foreclosure process through an arbitration agreement, even in states where statutes purport to require judicial foreclosure.[286] Thus, if judicial foreclosure becomes too cumbersome and time-consuming, or if (as proposed by the National Consumer Law Center) some states take away power of sale foreclosure as an enforcement option for the mortgagee, mortgagees could choose to begin using pre-dispute arbitration agreements as a means to privatize and streamline the foreclosure process.

Before concluding, however, there are two remaining questions that deserve note (and perhaps further exploration outside of this article). The first question is whether there may be another explanation for why mortgagees have not incorporated foreclosure-by-arbitration clauses into mortgages. As noted previously, the most plausible explanations are the availability of power-of-sale foreclosure (in those states that authorize it)[287] and the lack of foreclosure-by-arbitration provisions in mortgage forms approved by secondary market purchasers (even in judicial-foreclosure-only states).[288] However, critics of arbitration often argue that its ostensible efficiency benefits are overrated, and that arbitration is often no more timely or inexpensive than litigation.[289] This implicates another possible explanation: if judicial foreclosure is in fact just as quick and inexpensive as arbitration in practice, it is predictable that parties would likely contract for judicial foreclosure rather than foreclosure-by-arbitration.[290] In this respect,

285. *See supra* notes 126–79 and accompanying text.

286. *See supra* notes 114–285 and accompanying text.

287. *See supra* notes 13–14 and accompanying text.

288. *See supra* notes 116–17 and accompanying text.

289. *See supra* note 104.

290. One empirical study of the contracting patterns of certain companies indicated that while over seventy-five percent of their consumer contracts contained mandatory pre-dispute arbitration clauses, less than ten percent of their negotiated commercial contracts contained such clauses, perhaps suggesting that companies may value or prefer litigation as a means of resolving business-to-business disputes. Theodore Eisenberg et al., *Arbitration's Summer Soldiers: An Empirical Study of Arbitration Clauses in Consumer and Nonconsumer Contracts*, 41 U. MICH. J.L. REFORM 871

the relative speed and cost of judicial foreclosure (as compared to a potential substitute arbitral process) is an empirical question on which more current data would be useful.[291] The ABA Real Property, Trust and Estate Section is currently updating its fifty-state survey on foreclosure, last published in 1995.[292] When available, the results of this project could provide some useful (albeit predominantly anecdotal) information on the timeliness of foreclosure in judicial-foreclosure-only states.

The second question is the normative one: *should* parties be allowed to contract for FAA arbitration as a substitute for judicial foreclosure? I have consciously not addressed this question in this article, in which I intended to focus in a descriptive way on whether foreclosure-by-arbitration was structurally feasible. As to the normative question, however, I will offer a few closing thoughts.

I can see no reason to prevent commercial lenders and borrowers from agreeing to privatize the foreclosure process through arbitration. The residential mortgage market presents a more complicated picture. Mandatory arbitration of consumer disputes is widespread,[293] and one can proffer a case that foreclosure-by-arbitration would offer efficiency gains versus judicial foreclosure that would benefit residential borrowers in reduced borrowing costs.[294] Nevertheless, I have some lingering doubts about whether sound policy should permit foreclosure-by-arbitration clauses in residential mortgages. First, given the influence of the modern secondary mortgage market and standardized mortgage forms, there is no meaningful negotiation over mortgage terms in the residential context.[295] Thus, the

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(2008).

291. It is worth remembering, however, that the relevant comparison is not between the time and expense of judicial foreclosure versus the time and expense of arbitration generally. To ensure that foreclosure-by-arbitration provides the intended efficiency gains over judicial foreclosure, a foreclosure-by-arbitration agreement should (and presumably would) provide for an expedited process for pleading, hearing, and sale—one that would occur more quickly than judicial process in public courts (presumably, one that would occur on a timetable similar to foreclosures conducted under power of sale).

292. FORECLOSURE LAW & RELATED REMEDIES, *supra* note 44.

293. To this point, efforts to obtain federal legislation barring the use of pre-dispute arbitration agreements in home loan contracts have been unsuccessful, though the Arbitration Fairness Act of 2009, H.R. 1020, 111th Cong., 1st Sess., remains pending. Failed efforts include the proposed Predatory Lending Consumer Protection Act of 2003, S. 1928, 108th Cong. § 4; the proposed Save Our Homes Act, H.R. 3322, 108th Cong. § 3 (2003); the proposed Responsible Lending Act, H.R. 833, 108th Cong. (2003); and the proposed Predatory Mortgage Lending Practices Reduction Act, H.R. 1663, 108th Cong. (2003).

294. Professor Stephen Ware has offered this defense of mandatory consumer arbitration (though not specifically in the context of mortgage foreclosure). Stephen J. Ware, *Paying the Price of Process: Judicial Regulation of Consumer Arbitration Agreements*, 2001 J. DISP. RESOL. 89; Stephen J. Ware, *Consumer Arbitration as Exceptional Consumer Law*, 29 MCGEORGE L. REV. 195, 213 (1998) (arguing that consumers should have an alienable right "to get consideration for the right of government adjudication").

295. *See supra* notes 188–91 and accompanying text.

assumption of consumer consent to foreclosure by arbitration (or the notion that consumers could obtain meaningful "consideration" for waiving the right to judicial foreclosure) seems tenuous. Second, the cost of the arbitrator's fee—which one could easily dismiss as proportionally trivial in the context of a commercial transaction—could be disproportionately large in the context of a residential mortgage loan. If this fee were charged to the mortgagor (as would be the case under the language of the typical mortgage), it would consume an additional (and perhaps unwarranted) portion of the mortgagor's equity in the land, or increase the mortgagor's liability for a deficiency. Third, one of the ostensible benefits of arbitration—its privacy[296]—is one of its more noxious characteristics from the perspective of the public interest. In states requiring judicial foreclosure, foreclosure happens in the open sunlight of the public courts. In the past two years, this public process has exposed non-trivial levels of negligent, abusive, and/or fraudulent mortgage servicing, the details of which might have remained out of the public eye under a system that privatized foreclosure altogether. This concern almost certainly played a part in the decisions of Fannie Mae and Freddie Mac not to purchase mortgage loans containing pre-dispute arbitration agreements.[297] Finally, it is increasingly clear that dishonesty and fraud played and continues to play a nontrivial role in the residential mortgage crisis—from borrowers being taken advantage of by mortgage brokers and subprime lenders, to distressed homeowners now falling prey to foreclosure "rescue" scams.[298] If there were widespread use of foreclosure-by-arbitration, there is little doubt that new firms would develop to provide this particular service. But would such firms be sufficiently independent of foreclosing lenders for the firms to produce independent and unbiased decision making? The recent controversy about the National Arbitration Forum and its handling of consumer debt-collection cases[299] raise a cautionary warning, and has certainly provided wind in the sails of critics of mandatory consumer arbitration.

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296. *See supra* notes 96–98 and accompanying text.

297. *See supra* notes 118–21 and accompanying text.

298. Jessica Holzer, *U.S. Plans to Combat Mortgage Fraud, Rescue Scams*, WALL ST. J., Apr. 6, 2009, http://online.wsj.com/article/SB123902916166993009.html; Bob Tedeschi, *A Crackdown on Rescue Schemes*, N.Y. TIMES, June 19, 2009, http://www.nytimes.com/2009/06/21/realestate/21mort.html.

299. On July 14, 2009, Minnesota's Attorney General filed suit against the National Arbitration Forum, the nation's largest provider of arbitration for debt collection. This suit alleged that through various financial connections, the NAF was owned and controlled by entities that owned and controlled the three largest debt collection companies in the U.S., which filed over half the claims processed annually by the NAF. The suit also alleged that the NAF and these debt collection

As this article has suggested, foreclosure by arbitration is possible in the residential setting. If that is bad policy, state law cannot prevent it given the FAA's pre-emptive effect. As a result, Congress would have to act to prevent it, amending the FAA to make clear that it would not pre-empt state judicial-foreclosure-only laws (at least with respect to residential mortgage loans). If adopted, the proposed Arbitration Fairness Act of 2009 would do just that by carving out consumer disputes from the coverage of the FAA.[300]

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companies sought to conceal this financial relationship to maintain the appearance that the NAF was independent in its administration of the arbitrations filed by those companies. On July 17, 2009, the NAF entered into a settlement under which it agreed to discontinue all consumer arbitrations. The findings of an investigation of the NAF by the majority staff of the Domestic Policy Subcommittee of the House Oversight and Government Reform Committee included the following:

> 1. [Nearly] all NAF "consumer arbitrations" [were] debt collection actions brought by creditors or assignees (claim purchasers) . . . and [were] decided in the creditors' favor.
>
> . . . .
>
> 3. Arbitrators in most of claims ignored . . . evidence of whether . . . claims were brought within the statute of limitations.
>
> 4. Arbitrators in most of the claims ignored lack of specific evidence of who was actually served with the notice of the arbitration.
>
> . . . .
>
> 6. All arbitrators ignored evidence that should have resulted in dismissal of most of the claims.
>
> 7. One . . . arbitrator who did not ignore such evidence and did dismiss a lot of cases, ended up without any additional cases being assigned to him . . . .
>
> 8. The NAF . . . did not follow its own rules and sent claims to arbitrators despite the fact that those claims should have been dismissed for failure of the creditor to serve notice or [sic] the arbitration "promptly."
>
> 9. The NAF is violating California law by refusing to publish the results of many of its California arbitrations.

STAFF OF DOMESTIC POLICY SUBCOMMITEE MAJORITY, HOUSE OVERSIGHT AND GOVERNMENT REFORM COMMITTEE, 111TH CONG., REPORT ON ARBITRATION ABUSE: AN EXAMINATION OF CLAIMS FILES OF THE NATIONAL ARBITRATION FORUM 2, *available at* http://domesticpolicy.oversight.house.gov/documents/20090721154944.pdf.

300. The Arbitration Fairness Act of 2009, H.R. 1020, 111th Cong.,, would amend FAA § 2 to provide that "[n]o predispute arbitration agreement shall be valid or enforceable if it requires arbitration of (1) an employment, consumer, or franchise dispute." H.R. 1020, 111th Cong. § 4 (2009). Furthermore, the Act would establish that the validity or enforceability of a pre-dispute arbitration agreement would be determined by a court rather than the arbitrator. *Id.*