

RESIDENTIAL MORTGAGE DEFAULT AND THE CONSTRAINTS OF JUNIOR LIENS

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I. INTRODUCTION

When a residential mortgage borrower becomes delinquent in payments and is unable to cure the default, there are two general courses of action available to the loan's servicer.¹ First, the servicer may agree with the borrower on a "workout"—usually in the form of a modification of the loan to reduce the monthly payments, grant a moratorium on some payments, change the interest rate or maturity date, or otherwise make it easier for the borrower to cure the delinquency and return the loan to performing status.² Second, the servicer may determine that a workout is not feasible,³ or that

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¹ Because most residential mortgage loans are either sold on the secondary market or securitized, the original mortgage lender is rarely the party with whom the borrower must deal when a default occurs. Secondary market purchasers and securitizers nearly always contract with mortgage servicers, who act as agents for loan holders in relationships with borrowers. The servicers' duties include receiving and accounting for loan payments, changing payment amounts as necessary for adjustable rate loans, maintaining escrow accounts for property taxes and casualty insurance premiums, making the actual payments for taxes and insurance when due, making collection efforts if the borrower defaults, negotiating "workouts" or loan modifications if feasible, and foreclosing the mortgage or otherwise liquidating the property or obtaining title for the loan's holder. See *Making Payments to Your Mortgage Servicer*, FED. TRADE COMM'N, <https://www.consumer.ftc.gov/articles/0190-making-payments-your-mortgage-servicer> (last updated June 2010); see also Adam J. Levitin & Tara Twomey, *Mortgage Servicing*, 28 YALE J. REG. 1 (2011). Because the role of mortgage servicers is so pervasive, this Article will generally use the term "servicer" when referring to the party representing the loan's holder.

² See BAXTER DUNAWAY, LAW OF DISTRESSED REAL ESTATE § 4:5 (2017); Larry Cordell, Karen Dynan, Andreas Lehnert, Nellie Liang & Eileen Mauskopf, *Designing Loan Modifications to Address the Mortgage Crisis and the Making Home Affordable Program*, 42 UCC L.J. 1 (2009).

³ See Manuel Adelino, Kristopher Gerardi & Paul S. Willen, *Why Don't Lenders Renegotiate More Home Mortgages? Redefaults, Self-Cures and Securitization*, NAT'L BUREAU OF ECON. RES. (July 2009), https://www.fhfa.gov/PolicyProgramsResearch/Research/PaperDocuments/WHY-DONT-LENDERS-RENEGOTIATE-MORE-HOME-MORTGAGES_N508.pdf; Diane E. Thompson, *Why Servicers*

one has already been tried and failed. Now the servicer's objective is to foreclose the mortgage or otherwise arrange a transfer of title to the real estate to the holder of the loan, or to approve a "short sale"⁴ that will liquidate the property and return to the holder an acceptable sum as a payment of the loan.

Whichever course the servicer follows, the existence of subordinate liens on the property can have a drastic impact in inhibiting the servicer's actions. We explain below why existing legal rules make this so. These inhibitions are generally detrimental to borrowers, because they limit the servicer's flexibility in making potentially attractive arrangements with borrowers. There is an irony in this, at least when the junior lien in question is a mortgage. When the borrower placed the junior mortgage on the property, its purpose was to raise cash for desirable purposes—to pay for goods or services needed or wanted by the borrower. But when the first mortgage loan is in default, the very presence of a junior mortgage may tie the servicer's hands in trying to make a mutually beneficial deal with the defaulting borrower.

Our purpose in this Article is to show how and why junior liens impose these constraints on the process of resolving residential mortgage loan defaults, and to suggest some changes in the law that can restore a measure of desirable flexibility for borrowers and servicers in negotiating default resolutions. At the same time, these suggestions take into account, as they must, the need for fairness in respecting the legitimate rights of junior lienholders.

In Part II, we provide some important background on American mortgage law and the ways in which the structure of American law has favored and facilitated the creation of junior lien financing on residential real estate.⁵ In Part III, we describe the standard techniques open to a servicer when faced with an uncured default by a borrower—either in the case where the servicer seeks to save the loan and keep the borrower in the house,⁶ or where the servicer instead determines that the loan cannot be saved, and that foreclosure or one of its alternatives is necessary.⁷ In Part IV, we explain how the

Foreclose When They Should Modify and Other Puzzles of Servicer Behavior, NAT'L CONSUMER L. CTR. v–viii, 1–3 (Oct. 2009), <https://www.nclc.org/images/pdf/pr-reports/report-servicers-modify.pdf>.

⁴ A "short sale" involves an agreement whereby the mortgagor sells the mortgaged property for an amount that is below (or "short") of the outstanding balance of the mortgage debt, but where the mortgagee nonetheless releases the mortgage lien so that the buyer will receive marketable title. See Philip J. Vacco, *Surviving a Short Sale: Guidelines for a Rewarding Short Sale Experience*, 27 PROB. & PROP. MAG., Mar.–Apr. 2013, at 40; Calvin Zhang, *A Shortage of Short Sales: Explaining the Under-Utilization of a Foreclosure Alternative* 7 (Apr. 2, 2018), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3050600.

⁵ See *infra* notes 12–73 and accompanying text.

⁶ See *infra* notes 74–117 and accompanying text.

⁷ See *infra* notes 118–58 and accompanying text.

presence of junior liens can inhibit or needlessly complicate the use of these techniques, particularly where the servicer wants to use a deed in lieu of foreclosure or a short sale to avoid the time and expense delays attendant to foreclosure.⁸ In Part V, we describe and consider the benefits of the Model Negotiated Alternative to Foreclosure Act, recently promulgated by the Uniform Law Commission (ULC). This Act, which borrows from the Uniform Commercial Code (UCC) Article 9's strict foreclosure process, seeks to mitigate some of the inefficiencies imposed by junior liens by permitting a deed in lieu of foreclosure that would have the title-clearing benefits that a lender could obtain only through foreclosure under current law.⁹ Finally, in Part VI, we compare mortgage law's treatment of junior liens with their corresponding status under Article 9,¹⁰ and offer our observations with respect to whether other Article 9-inspired reforms may be useful to address some or all of the problems posed by junior liens.¹¹

II. HOW AMERICAN LAW FAVORS JUNIOR FINANCING

In several ways, the American legal system favors and facilitates the creation of junior lien financing on residential real estate. We consider below whether this is desirable, but begin by outlining the ways current law implements this favoritism.

We start with the premise that senior lenders strongly dislike the creation of junior financing, and will usually prohibit or restrict it if they can.¹² There are several reasons for this antipathy, some obvious and some more subtle. Perhaps the most evident reason is that junior mortgage financing represents an additional cash flow burden for residential borrowers, increasing their potential financial stress and escalating the probability of a default in payment of the senior mortgage.¹³ Of course, second mortgage debt is not the only way this can occur; households can also take on auto loans, education debt, or any other form of consumer debt, secured or unsecured. Nonetheless, second mortgage debt is a clear harbinger of increased risk of default, and one that first mortgage lenders would generally like to avoid if they can.

⁸ See *infra* notes 159–83 and accompanying text.

⁹ See *infra* notes 184–246 and accompanying text.

¹⁰ See *infra* notes 247–56 and accompanying text.

¹¹ See *infra* notes 257–303 and accompanying text.

¹² See Joshua Stein, *Subordinate Mortgage Financing: The Perils of the Senior Lender*, 27 REAL EST. REV. Fall 1997, at 3.

¹³ Andrew Leventis, *The Relationship Between Second Liens, First Mortgage Outcomes, and Borrower Credit: 1996–2010* 3–4 (Fed. Hous. Fin. Agency, Working Paper 14–3, Sept. 2014), https://www.fhfa.gov/PolicyProgramsResearch/Research/PaperDocuments/WP_14-3_Second_Liens.pdf.

Second mortgage debt has a further negative impact that other types of debt do not; it decreases the borrower's equity in the property, giving the borrower less to protect and less to lose in a subsequent foreclosure.¹⁴ Thus, the borrower's incentive to avoid default on the first mortgage is weakened by junior mortgage financing.

In addition, the creation of junior mortgage debt deprives a first mortgage lender of significant control of the property.¹⁵ For example, the junior lender may put the borrower into bankruptcy or may foreclose its mortgage, with the result that the property's title may pass into the hands of a person regarded by the first mortgage lender as an undesirable risk. Further, as we will see below,¹⁶ the presence of a junior lien vastly complicates the process of first mortgage loan modification or workout, as well as the taking of a deed in lieu of foreclosure or the approval of a short sale. It is easy to see why first mortgage lenders dislike subordinate financing.

A. Due-on-encumbrance Clauses and the Garn Act

Suppose a first mortgage lender is determined to discourage or prohibit junior financing on the property. What tools are available to do so? Traditionally, lenders have turned to the "due-on-encumbrance" clause for this purpose.¹⁷ Such a clause provides, in essence, that if the borrower imposes further mortgages or other liens on the property without the first lender's consent, the first lender may accelerate the debt, declaring it due and payable in full, and may foreclose if payment is not made.¹⁸ Due-on-encumbrance clauses are usually combined with "due-on-sale" clauses that permit acceleration of the senior debt if the borrower transfers the property without lender approval. Indeed, the same language can often be easily read to allow acceleration for either reason—a transfer of title or the imposition of a junior lien. Here is a typical example:

If all or any part of the Property or any interest in it is sold or transferred . . . without Lender's prior written consent, Lender may require

¹⁴ *Id.*

¹⁵ *See id.* at 4.

¹⁶ *See infra* notes 159–83 and accompanying text.

¹⁷ Alternatively, the lender might simply cause the borrower to covenant not to impose any additional liens on the property; a violation of such a clause would constitute a default under the mortgage. *See, e.g.,* RCH Mortg. Fund IV, LLC v. Byrd, LLC, No. A12–1379, 2013 WL 1788528, at *3 (Minn. Ct. App. Apr. 29, 2013) (enforcing such a clause). Clauses of this type are sometimes used in commercial mortgages, but virtually never in residential mortgages.

¹⁸ *See id.*

immediate payment in full of all sums secured by this Security Instrument.¹⁹

Without doubt, the creation of a junior lien comprises a “transfer” of an “interest” in the property.²⁰ This language, standing alone, thus functions equally well both as a due-on-sale and a due-on-encumbrance clause. On its face, the clause gives the first lender full control over whether the borrower can place junior financing on the property.

However, this analysis is too simple. To understand why, one must have some appreciation for the controversy that surrounded due-on-sale and due-on-encumbrance clauses in the late 1970s and early 1980s. As a consequence of national economic conditions—and in some part a reaction (or overreaction) to the Federal Reserve Board’s monetary policies in the early 1970s²¹—interest rates during the late 1970s rose to unprecedented high levels.²² This placed mortgage lenders, and particularly depository financial institutions, at a great disadvantage; their costs of funds borrowed from their depositors increased drastically, while the average interest yield on their portfolios—consisting almost entirely of fixed-rate mortgage loans—grew only slowly. By 1980, many of them were operating their mortgage lending programs at a loss, with their costs of funds exceeding their mortgage portfolio earnings.²³

To try to forestall this result, virtually all mortgage lenders were using due-on-sale clauses by this period.²⁴ If these clauses had been fully

¹⁹ *Security Instruments*, FREDDIE MAC, <http://www.freddiemac.com/uniform/unifsecurity.html> (last visited Aug. 5, 2018) (Clause 18 of the uniform mortgage instrument of each state contains this language).

²⁰ See, e.g., *Bank Midwest v. Lipetzky*, 674 N.W.2d 176, 179–81 (Minn. 2004) (creation of security interest in installment land contract triggered prohibition on transfer); *Phillips v. Phillips*, No. A13–0699, 2014 WL 902683, at *3–4 (Minn. Ct. App. Mar. 10, 2014) (creation of security interest was a transfer of an interest in personal property); *Egbert v. Freedom Fed. Sav. & Loan Ass’n*, 440 N.E.2d 22, 25 (Mass. App. Ct. 1982) (creation of junior mortgage was within clause covering “any change in . . . the [m]ortgagor’s present legal . . . title or interest”). Cf. *City of Chicago v. Elm State Prop. LLC*, 69 N.E.3d 390, 402 (Ill. App. Ct. 2016) (mortgage was not a transfer of a “beneficial interest” for purposes of transfer tax statute).

²¹ Many have argued that the extreme inflation seen during this period was a result of policy errors by the Federal Reserve Board. See, e.g., Fabrice Collard & Harris Dellas, *The Great Inflation of the 1970s* (Bd. of Governors of the Fed. Res. Sys., Int’l Fin. Discussion Paper No. 799, 2004), <https://www.federalreserve.gov/pubs/ifdp/2004/799/ifdp799.pdf>; John Keefe, *What Causes Inflation? Lessons from the 1970s, Vol. 3*, CBS NEWS: MONEYWATCH (May 22, 2009), <http://www.cbsnews.com/news/what-causes-inflation-lessons-from-the-1970s-vol-3/>.

²² The Freddie Mac index of 30-year fixed-rate mortgage interest rates rose above 10% in November 1978 and did not fall below 10% again until April 1986. The index peaked in October 1981 at 18.45%. See *Average 30 Year Fixed Mortgage Rates*, MORTGAGE NEWS DAILY, <http://www.mortgagenewsdaily.com/data/30-year-mortgage-rates.aspx> (last visited Feb. 18, 2019).

²³ See R. Dan Brumbaugh, Jr. & Andrew S. Carron, *Thrift Industry Crisis: Causes and Solutions*, 2 BROOKINGS PAPERS ON ECON. ACTIVITY 349, 349, 351, 354 (1987).

²⁴ One of the authors began practicing real estate law in Los Angeles in 1967, shortly after the first

enforceable, the lenders would have been able to accelerate their loans and demand payoff when borrowers sold their houses, or would have been able to exact “assumption fees” or interest rate increases in return for agreeing not to accelerate.²⁵ Few mortgage loans during this period carried adjustable rates, but lenders viewed the due-on-sale clause as a sort of poor man’s adjustable rate clause, albeit with a rate that could be adjusted only when the borrower sold the property rather than on a prearranged schedule.²⁶ It was not a perfect solution for institutional lenders, but it was far better than having no power at all to adjust rates upward toward current market levels on loans held in portfolio.

Unfortunately for these lenders, borrowers in a number of states successfully sued to stop these upward rate adjustments.²⁷ The suits were usually based on the theory that the due-on-sale clause discouraged the sale of the property and hence was an unreasonable restraint on alienation.²⁸ Plaintiffs generally conceded that it would be permissible for the lender to accelerate the loan if the proposed transferee of the property had poor credit, but argued that a lender should not be allowed to assert the clause for the purpose of raising the interest rate on the loan.²⁹ Decisions in about a dozen states agreeing with this view had appeared by the early 1980s.³⁰ Depository mortgage lenders were extremely frustrated by this development, and they aggressively pressured Congress for a federal solution to their problem.

Congress finally responded by adopting Section 341 of the Garn-St. Germain Depository Institutions Act of 1982 (Garn Act).³¹ This section’s

uptick in mortgage interest rates of the postwar period. The rise in rates was a frequent topic of discussion among real estate lawyers and lenders, and it prompted many lenders to begin using due-on-sale clauses for the first time. The clause gained popularity during the late 1960s, and was incorporated in the original Freddie Mac uniform residential mortgage form, published in 1972. Fannie Mae subsequently adopted the clause as well, and the 1975 version published by both entities included it. Since that time, the clause has been well-nigh universally found in residential mortgages. See Julia Patterson Forrester, *Fannie Mae/Freddie Mac Uniform Mortgage Instruments: The Forgotten Benefit to Homeowners*, 72 MO. L. REV. 1077, 1085 (2007).

²⁵ See 1 GRANT S. NELSON, DALE A. WHITMAN, ANN M. BURKHART & R. WILSON FREYERMUTH, REAL ESTATE FINANCE LAW § 5:21 (6th ed. 2014); Richard J. Hayden, *The “Due-On-Sale” Clause in Washington after De La Cuesta and Garn: Has Washington Been Left a Loan?*, 20 GONZ. L. REV. 511, 514 (1985); Samuel J. Wilner, *Due on Sale and Due on Encumbrance Clauses in California*, 7 LOY. L.A. L. REV. 306, 306–07 (1974).

²⁶ See *Wellenkamp v. Bank of Am.*, 582 P.2d 970 (Cal. 1978).

²⁷ See Hayden, *supra* note 25, at 529–38; Wilner, *supra* note 25, at 311–13.

²⁸ See *Wellenkamp*, 582 P.2d 970; see also Hayden, *supra* note 25, at 548–50; Wilner, *supra* note 25, at 308–13.

²⁹ See *Wellenkamp*, 582 P.2d 970; see also Hayden, *supra* note 25, at 528–30; Wilner, *supra* note 25, at 311–13.

³⁰ Perhaps the most famous (or infamous) decision was *Wellenkamp*, 582 P.2d 970.

³¹ 12 U.S.C. § 1701j–3 (2018). See NELSON, WHITMAN, BURKHART & FREYERMUTH, *supra* note 25,

core was language approving the lenders' power to enforce their due-on-sale clauses, even when enforcement was for the purpose of increasing the interest yield on a loan.³² This language was preemptive of any contrary state law.³³ It thus provided the relief from the adverse court decisions that the lending community had sought—although by this time rates had begun to subside and much damage had already been done to the industry.³⁴ While it is by no means certain that fully enforceable due-on-sale clauses during the steep rise in interest rates would have “saved” the savings and loan industry, they would clearly have mitigated the industry's losses to a significant extent.

Prior to the Garn Act's preemption of state limitations on due-on-sale clauses, the Fannie Mae/Freddie Mac uniform residential mortgage form's version of the due-on-sale clause contained eight exemptions—that is, it listed eight situations in which the holder of the mortgage was *not* authorized to accelerate the loan.³⁵ Most of these situations involved involuntary or intra-family transfers, such as transfers at death or divorce, transfers to the owner's spouse or children, and short-term leases.³⁶ These exemptions were evidently created as a matter of fairness to borrowers who, it was thought, should not be subject to mortgage acceleration because they divorced, made gifts of the property to their children, or made other transfers that were not outright sales.³⁷ For our purposes, the exemption of greatest interest was the first one listed in the form, which provided that the lender could not accelerate the loan on account of “the creation of a lien or other encumbrances subordinate to the lender's security instrument which does not relate to a transfer of rights of occupancy in the property.”³⁸ When Congress

§§ 5:21–26; John C. Murray, *Enforceability of Mortgage Due-On-Sale Clauses – An Update*, AM. BAR ASS'N (2015), https://www.americanbar.org/content/dam/aba/publishing/rpte_report/2015/2-March/enforceability_of_mortgage_authcheckdam.pdf.

³² See 12 U.S.C. § 1701j–3 (2018); NELSON, WHITMAN, BURKHART & FREYERMUTH, *supra* note 25, § 5:24, at 339–40.

³³ The Garn Act's provisions apply “[n]otwithstanding any provision of the constitution or laws (including the judicial decisions) of any State to the contrary.” 12 U.S.C. § 1701j–3(b)(1) (2018).

³⁴ Of the approximately 4,700 savings and loan associations existing in 1979, about 1,500 had been closed or merged due to insolvency by 1983. See David L. Mason, *Savings and Loan Industry (U.S.)*, ECON. HIST. ASS'N (Feb. 1, 2010), <https://web.archive.org/web/20131020002106/http://eh.net/encyclopedia/article/mason.savings.loan.industry.us>; see also FED. DEPOSIT INSURANCE CORP., FED. HOME LOAN BANK BD. & NAT'L CREDIT UNION ADMIN. BD., A REPORT TO CONGRESS ON FEDERAL DEPOSIT INSURANCE, S. Pet. 98-65, at 328 (1st Sess. 1983) (recounting the effects of the extremely high interest rates during this period).

³⁵ See generally 12 U.S.C. § 1701j–3 (2018).

³⁶ See generally *id.*

³⁷ See generally *id.*

³⁸ *Id.* § 1701j–3(d)(1). It might be thought that Fannie Mae and Freddie Mac placed lenders in an odd position with this language. A first mortgage lender might strictly prohibit a borrower from imposing a second mortgage on his or her property at the time they obtain the first mortgage loan, but that same first

passed the Garn Act, it incorporated these exemptions virtually verbatim into the statute.³⁹ Because the Act preempted conflicting state law, its effect was to deprive first mortgage lenders of any power to control borrowers who wished to place junior mortgage financing on their property. Those in the second mortgage lending business must have been pleased indeed that their customers would not need to get their first mortgage lenders' consent to impose second mortgages on their properties.

However, commercial mortgage lenders deeply objected to this state of affairs.⁴⁰ They were accustomed to imposing detailed, highly restrictive due-on-encumbrance clauses on their borrowers. Now they found that such clauses had been made unenforceable by federal law, and they complained vigorously to Congress. As a result of their lobbying efforts, the Garn Act was amended by Section 473 of the Urban Rural Recovery Act of 1983 so that the list of exempt situations applied only "in the case of real property loans secured by liens on residential property containing less than five (5) dwelling units."⁴¹ The result was that commercial lenders could enforce due-on-encumbrance clauses on their borrowers, but residential lenders could not and still cannot.⁴² Thus, the Garn Act has been highly advantageous to home equity line of credit (HELOC) and other residential second mortgage lenders, eliminating what would otherwise have been a major roadblock to their business models. It has been correspondingly detrimental to residential first mortgage lenders, because it gives every homeowner the option to take an action that may materially increase the risk of default on his or her first mortgage.⁴³

mortgage lender would have no control at all over the placing of a second mortgage a week or a month later.

³⁹ See *id.*

⁴⁰ NELSON, WHITMAN, BURKHART & FREYERMUTH, *supra* note 25, § 5:24, at 344–45.

⁴¹ 12 U.S.C. § 1701j–3(d) (2018).

⁴² See *Blitz v. Marino*, 786 P.2d 490, 492 (Colo. Ct. App. 1989) (because by the terms of the mortgage the creation of a junior lien was excluded from the operation of the due-on-sale clause, the foreclosure of a junior lien would likewise not trigger the clause); *In re Ruepp*, 321 S.E.2d 517, 519 (N.C. Ct. App. 1984) (holding the same). Oddly, Fannie Mae and Freddie Mac then revised their uniform mortgage instruments to remove the detailed list of exempt situations; instead, the current form simply incorporates the language of the statute, providing, "However, this option [acceleration] shall not be exercised by Lender if such exercise is prohibited by Applicable Law." *Security Instruments*, FREDDIE MAC, <http://www.freddiemac.com/uniform/unifsecurity.html> (last visited Aug. 5, 2018) (Clause 19 of the uniform mortgage instrument of each state contains this language).

⁴³ See Leventis, *supra* note 13, at 3–4; Adam J. Levitin & Susan M. Wachter, *Second Liens and the Leverage Option*, 68 VAND. L. REV. 1243, 1282 (2015).

B. Future Advances and Future Advance Priority

A second way in which junior mortgage holders may or may not have the protection of the legal system lies in the system's treatment of future advances by senior lenders. If a first mortgage lender can make a further advance on its loan, and if that advance will have the priority of the original mortgage, the impact on a junior lienholder could obviously be devastating. A junior lienholder who had made a loan that it expected to be secured by the mortgagor's equity in the home—the home's value over the senior mortgage debt—could see that equity disappear if the senior lender could readily “soak up” the excess value through future advances to the mortgagor.

Under the common law, whether a future advance will retain the original mortgage's priority depends on whether the advance is obligatory, meaning that the mortgagee has a contractual duty to make it,⁴⁴ or optional. If the mortgagee is contractually obligated to make the advance in question, it will be senior to any intervening lien, i.e., the mortgagee will have the same priority for the future advance as it did for the original advance. On the other hand, if the future advance is optional, meaning that the mortgagor has no contractual right to demand it, and if the mortgagee has notice of an intervening lien at the time the advance is made, the priority for the advance will date only from the time of the advance. Thus, that advance will lose priority to the intervening lien.⁴⁵

The purpose of this seemingly bizarre rule is not to benefit second mortgage lenders by giving them an unexpected promotion in priority, although it obviously can have that effect in some cases. Rather, its objective is to help the borrower by avoiding a situation in which he or she is unable to obtain further secured financing from any source.⁴⁶ In theory, if the mortgagor cannot convince the first mortgagee to make additional advances and has no legal right to demand them, the rule enables the borrower to approach a second mortgagee, explain the situation, and borrow additional funds. The junior lender would, it is presumed, be entirely willing to lend; the optional advance rule would supposedly assure the junior that its security position would not be impaired by any subsequent advances by the senior

⁴⁴ See, e.g., *In re Qualstan Corp.*, 302 B.R. 575 (Bankr. S.D. Ohio 2003) (where there was no contractual duty on part of mortgagee to make advance, advance was optional and lost priority).

⁴⁵ See generally *Rosenthal & Rosenthal, Inc. v. Behun*, 140 A.3d 547 (N.J. 2016) (holding that the common law rule was incorporated in statute in New Jersey, and declining to abrogate it despite recognition of its critics); NELSON, WHITMAN, BURKHART & FREYERMUTH, *supra* note 25, § 12:7. The rule seems to have originated with *Hopkinson v. Rolt*, 9 H. of L. 514 (1861). See Gerald L. Blackburn, *Mortgages to Secure Future Advances*, 21 MO. L. REV. 209, 209–11 (1956).

⁴⁶ See Blackburn, *supra* note 45, at 209–10.

lender. Thus, the purpose of the rule is to protect the mortgagor's ability to obtain credit, and in this way, it facilitates the market for junior mortgage lending.⁴⁷

Unfortunately, the common law rule has proved to be spectacularly confusing in practice. Its application is fraught with problems.⁴⁸ There has been seemingly endless litigation about applying the distinction between optional and obligatory advances, particularly in the context of construction lending.⁴⁹ More litigation has arisen over the sort of knowledge or notice on the part of the senior lender that is sufficient to cause a loss of priority for the advance. Is actual knowledge required or is constructive notice from the public records enough?⁵⁰ If the intervening lien was a mechanic's lien, what sort of knowledge about the lien would result in loss of priority?⁵¹ Indeed,

⁴⁷ See *LaCholla Grp., Inc. v. Timm*, 844 P.2d 657, 659–60 (Ariz. Ct. App. 1992); NELSON, WHITMAN, BURKHART & FREYERMUTH, *supra* note 25, § 12:7, at 1096. The rule is not limited to situations involving junior mortgages; it has also been applied, perhaps illogically, to mechanic's liens, see *Shaw Acquisition Co. v. Bank of Elk River*, 639 N.W.2d 873 (Minn. 2002), to judgment liens, and to a trustee in bankruptcy under the "strong-arm" powers, see *In re Stanton*, 285 F.3d 888 (9th Cir. 2002) (Washington law).

⁴⁸ For detailed discussion and criticism of the common law, see Robert Kratovil & Raymond J. Werner, *Mortgages for Construction and the Lien Priorities Problem: The "Unobligatory" Advance*, 41 TENN. L. REV. 311, 321–22 (1974); Grant S. Nelson & Dale A. Whitman, *Rethinking Future Advance Mortgages: A Brief for the Restatement Approach*, 44 DUKE L.J. 657, 668–84 (1995) (discussing the common law response); Larry Skipworth, *Should Construction Lenders Lose Out on Voluntary Advances If a Loan Turns Sour?*, 5 REAL EST. L.J. 221 (1977); Craig D. Tindall, *The Obligatory Advance Rule in the Construction Lending Context*, 12 CONSTR. LAW. 13 (1992).

⁴⁹ Compare *Nat'l Bank v. Equity Inv'rs*, 506 P.2d 20 (Wash. 1973) (conditions in construction loan agreement made advances optional, resulting in loss of priority), with *Dempsey v. McGowan*, 722 S.W.2d 848 (Ark. 1987) (similar conditions did not make advances optional); compare *J. I. Kislak Mortg. Corp. v. William Matthews Builder, Inc.*, 287 A.2d 686 (Del. Super. Ct. 1972), *aff'd* 303 A.2d 648 (Del. 1973) (where construction loan agreement required borrower to submit certain documentation to support each draw on construction loan, and lender made advances without obtaining such documentation, advances were optional and lost priority), with *Home Lumber Co. v. Kopfman Homes, Inc.*, 535 N.W.2d 302 (Minn. 1995) (waiver of conditions by construction lender did not make advances optional).

⁵⁰ Requiring actual knowledge: see *Mobley v. Brundidge Banking Co.*, 347 So.2d 1347 (Ala. 1977); *Idaho First Nat'l Bank v. Wells*, 596 P.2d 429 (Idaho 1979); *Hous. Mortg. Corp. v. Allied Constr., Inc.*, 97 A.2d 802 (Pa. 1953); *McMillen Feed Mills, Inc. v. Mayer*, 220 S.E.2d 221 (S.C. 1975); *Bank of Ephraim v. Davis*, 559 P.2d 538 (Utah 1977); *Union Nat'l Bank v. First State Bank*, 697 S.W.2d 940 (Ark. Ct. App. 1985); *Central Pa. Sav. Ass'n v. Carpenters of Pa.*, 444 A.2d 755 (Pa. Super. Ct. 1982); *Home Fed. Bank, FSB v. First Nat'l Bank*, 110 S.W.3d 433, 439 (Tenn. Ct. App. 2002) (based on TENN. CODE ANN. § 47–28–103(c) (2018)); *First Interstate Bank v. Heritage Bank*, 480 N.W.2d 555 (Wis. Ct. App. 1992). Finding constructive notice sufficient to deny priority: see *Rosenthal & Rosenthal, Inc. v. Benun*, 140 A.3d 547 (N.J. 2016); *People's Sav. Bank v. Champlin Lumber Co.*, 258 A.2d 82 (R.I. 1969); *Briarwood Towers 85th Co. v. Guterman*, 523 N.Y.S.2d 98 (N.Y. App. Div. 1988) ("actual or constructive notice"); *Tyler v. Butcher*, 734 P.2d 1382 (Or. Ct. App. 1987). Several states, by statute, have defined notice in this context to include only notice sent to the senior lender in writing; see, e.g., ME. STAT. tit. 9–B, § 436(1)(B) (2018); NEB. REV. STAT. § 76–238.01(3)(b)(ii) (2018); OHIO REV. CODE § 5301.232(B) (2018), *applied in* *Kent v. Huntington Nat'l Bank*, 764 N.E.2d 480 (Ohio Ct. App. 2001); VT. STAT. ANN. tit. 27, § 410(b)(3)(B) (2018), *applied in* *Daniels v. Elks Club of Hartford*, 58 A.3d 925 (2012).

⁵¹ See, e.g., *Grider v. Mut. Fed. Sav. & Loan Ass'n*, 565 S.W.2d 647 (Ky. Ct. App. 1978) (knowledge

since the purpose of the doctrine is to facilitate junior mortgage borrowing, should it even apply to mechanics liens? In sum, there is sufficient uncertainty about how and when the common law rule is to be applied that only the rare junior lender would be willing to rely upon it.

The common law rule continues to be in effect without change in about one-third of the states,⁵² but there has been widespread recognition that it is ineffective for its intended purpose⁵³ and that tinkering with the definitions of “obligatory” and “notice” are not adequate solutions. Numerous state legislatures have adopted replacements for the common law. Mostly adopted in the 1980s and 1990s, these replacements generally follow one of two basic models.

The first is based on an ingenious statute adopted in Missouri in 1981.⁵⁴ Its purpose is the same as the common law rule: to create an environment in which a borrower can obtain secondary financing despite the presence of a future advance clause in the first mortgage. This type of legislation, which now exists in at least fifteen states, achieves its objective through adoption of the concept of the “cutoff notice.”⁵⁵ Under these statutes, all future advances, whether obligatory or optional, take the priority of the original mortgage and are senior to any intervening liens up to some maximum amount, which must be stated in the mortgage.⁵⁶ However, in order to facilitate the borrower’s obtaining of junior mortgage loans, these statutes permit the borrower to issue

that “the [mortgagor] is unable to pay such claims or that the claimant intends to file a lien”); *First Nat’l Bank v. Worthley*, 714 P.2d 1044 (Okla. Civ. App. 1985) (knowledge that subcontractors have not been paid).

⁵² See, e.g., *Rosenthal & Rosenthal, Inc. v. Benun*, 140 A.3d 547, 561 (N.J. 2016); *Countrywide Home Loans, Inc. v. Bankfirst*, 264 P.3d 1262 (Okla. Civ. App. 2011). See generally NELSON, WHITMAN, BURKHART & FREYERMUTH, *supra* note 25, § 12:7.

⁵³ See *supra* note 48.

⁵⁴ See Rita C. Edwards, *Future Advances in Missouri*, 49 MO. L. REV. 103 (1984).

⁵⁵ MO. REV. STAT. § 443.055 (2018). See *Golden Delta Enters., L.L.C. v. U.S. Bank*, 213 S.W.3d 171 (Mo. Ct. App. 2007) (discussing application of the statute). Other statutes adopting this “cutoff notice” approach, at least for some types of loans, include CONN. GEN. STAT. § 49-2 (2018) (“open-end mortgages”); FLA. STAT. ANN. § 697.04 (2018); KY. REV. STAT. § 382.520 (2018); ME. REV. STAT. tit. 9-B, § 436 (2018); MONT. CODE ANN. § 71-1-206 (2017); NEB. REV. STAT. § 76-238.01 (2018); NEV. REV. STAT. § 106.380(1) (2017); N.C. GEN. STAT. ANN. §§ 45-67 to 45-74 (2017); OHIO REV. CODE ANN. § 5301.232 (2018); OR. REV. STAT. ANN. § 86.155 (2018); 42 PA. CONS. STAT. ANN. § 8143 (2018) (“open-end mortgages”); 34 R.I. GEN. LAWS §§ 25-8 to 25-14 (2018); TENN. CODE ANN. §§ 47-28-101 to 47-28-110 (2018); VA. CODE ANN. §§ 55-58.2, -59 (2018).

⁵⁶ The statutes typically require that the mortgage or loan agreement state a maximum amount that may be advanced, and limit their protection to that figure. See, e.g., MO. REV. STAT. § 443.055(2) (2018) (“[T]he security instrument shall state the face amount . . . [T]he total principal amount of the obligations secured at any given time may not exceed the face amount stated in the security instrument.”); *Id.* § 443.055(6)(1) (“The total debts so secured after receipt of such notice shall be limited in principal amount to the amount stated by the lender in its recorded notice, by which statement the lender shall be irrevocably bound . . .”).

a notice to the future advance lender that freezes priority advances at their current level, cutting off the possibility that any further advances could obtain the same priority as the original loan. The cutoff notice, in effect, ensures that any further advances will be subordinate to any intervening liens, but only prospectively. A borrower who has this power to freeze advances has no need of the optional/obligatory distinction. If the borrower needs additional financing, cannot get it on satisfactory terms from the existing mortgagee, and wishes to pursue borrowing opportunities with other lenders, he or she needs simply to issue a cutoff notice. The mortgagee is thus informed that no further advances will be secured by the mortgage's original priority; the future advance provision of the loan is terminated. Other lenders may then safely take junior mortgages on the property, knowing that no further advances by the senior lender can eat into the borrower's equity to the detriment of the junior mortgage.

The drafters of the Mortgages Restatement were attracted to this concept, and wrote it into the Restatement as if it were a court-made rule.⁵⁷ In reality, when the Restatement was adopted, no courts had adopted its approach without prior legislation. This remains true today. A few courts have discussed the Restatement approach with apparent approval, but none have felt comfortable adopting it in the absence of a supporting statute.⁵⁸

The second model for state legislation on future advances simply declares that all advances up to some maximum amount stated in the mortgage will have full priority against intervening liens. At least seventeen states have such statutes, although some are limited to specific types of loans.⁵⁹ The approach is simpler, of course, but it disregards the borrower's

⁵⁷ RESTATEMENT (THIRD) OF PROP.: MORTG. § 2.1 (AM. LAW INST. 1997).

⁵⁸ See, e.g., *Barclays Invs., Inc. v. St. Croix Estates*, 399 F.3d 570, 580 (3d Cir. 2005) (concluding that the Virgin Islands would adopt the Restatement approach, but that it was inapplicable because the parties to the mortgage had not agreed that it would secure future advances); *Shutze v. Credithrift, Inc.*, 607 So. 2d 55, 63 (Miss. 1992) (dictum); *Rosenthal & Rosenthal, Inc. v. Benun*, 140 A.3d 547, 561 (N.J. 2016) (court could not depart from common law because it had been adopted by statute in New Jersey).

⁵⁹ Some of these statutes are limited to particular types of future advance mortgages, such as open-end mortgages or construction loans. See ALASKA STAT. § 34.35.060 (2018); CAL. CIV. CODE § 8456 (2018) (advances "used for construction costs"); CONN. GEN. STAT. ANN. § 49-3 (2018) (construction loans only); DEL. CODE ANN. tit. 25, § 2118 (2018); FLA. STAT. ANN. § 697.04(2) (2018); HAW. REV. STAT. § 506-1 (2018); IND. CODE ANN. § 32-29-1-10 (2018), *applied in* *The Money Store Inv. Corp. v. Summers*, 822 N.E.2d 223 (Ind. Ct. App. 2005); KAN. STAT. ANN. § 58-2336 (2018), *construed in* *Fidelity Sav. Ass'n v. Witt*, 665 P.2d 1108 (1983); LA. CIV. CODE ANN. art. 3298 (2018); MD. CODE ANN., REAL PROP. § 7-102 (2018); MICH. COMP. LAWS ANN. § 565.902 (2018) (apparently applicable to all types of mortgages), *discussed in* *Deutsche Bank Tr. Co. Ams. v. Spot Realty, Inc.*, 714 N.W.2d 409 (Mich. Ct. App. 2005); N.H. REV. STAT. ANN. § 479:3 (2018) (financial institutions only); N.J. STAT. ANN. §§ 46:9-8.1 to 46:9-8.4 (2018) (inapplicable to construction loans); N.M. STAT. ANN. § 48-7-9 (2018); N.Y. REAL PROP. LAW § 281 (2018) ("credit line" mortgage only; inapplicable to construction loans); N.C. GEN. STAT. § 45-70 (2018), *applied in* *Perry v. Carolina Builders Corp.*, 493 S.E.2d 814 (N.C. Ct. App. 1997);

ability to obtain junior financing. In this legal environment, the only practical stance a second mortgage lender can take is to assume that advances up to the stated maximum might be made by the first lender, and to consider only the property's value in excess of that maximum as being available to secure a second mortgage loan. The result is that a very substantial portion of the borrower's equity in the real estate may go unused for borrowing purposes if the first lender refuses to make further advances on its security, while potential second mortgage lenders treat the additional equity as having already been encumbered by the first lender. These statutes get rid of the common law's annoying optional/obligatory distinction, but do so at considerable cost to borrowers who seek additional financing.⁶⁰

It is difficult to summarize the national picture with respect to the priority of future advances in a succinct and accurate way simply because many of the adopted statutory variations apply only to specific types of loans. Nonetheless, a rough approximation looks something like this. The common law optional/obligatory rule continues to prevail, unchanged by statute, in about one-third of the states. In nearly another one-third, future advances are given priority over intervening liens, but can be "cut off" if the borrower decides to seek junior financing elsewhere. The Restatement agrees with this approach. Both of these rules are intended to facilitate the market for secondary financing although the common law rule, because of its ambiguities, probably does so ineffectively. In the remaining one-third of the states, the law gives all future advances priority and provides no method for the borrower to cut off further advances. This approach disfavors the borrower's efforts to obtain subordinate financing. Hence, overall legislative reform efforts have been about equally divided between those that seek to facilitate second mortgage financing and those that pay no heed to it.

OR. REV. STAT. § 86.155(2) (2018), *construed in In re Lane*, No. 06-32879-ELP7, 2007 WL 1723502, at *6 (Bankr. D. Or. June 11, 2007) (statute provides a safe harbor for achieving priority for future advances, but common law method of obtaining priority remains available); S.D. CODIFIED LAWS § 44-8-26 (2019) (applicable only if mortgage refers to statute); WASH. REV. CODE ANN. § 60.04.226 (2018), *overruling Nat'l Bank v. Equity Inv'rs.*, 506 P.2d 20 (Wash. 1973), and not requiring a statement of the maximum amount to be advanced), *applied in Pac. Cont'l Bank v. Soundview 90, LLC*, 273 P.3d 1009, 1013 (Wash. Ct. App. 2012); WIS. STAT. ANN. § 706.11(1) (2018) (mortgages to state or national banks), *applied in Marine Bank Appleton v. Hietpas, Inc.*, 439 N.W.2d 604 (Wis. Ct. App. 1989) (statute covers, but is not limited to, construction loans). Texas has no statute, but case law appears to give priority to all advances if the mortgage contains a future advance and the advances are within the scope of the clause. There seem to be few modern cases: *see F. Groos & Co. v. Chittim*, 100 S.W. 1006 (Tex. Ct. Civ. App. 1907); *Coke Lumber & Mfg. Co. v. First Nat'l Bank in Dallas*, 529 S.W.2d 612, 615 (Tex. Ct. Civ. App. 1975).

⁶⁰ *See* THOMAS E. BAYNES, JR., *FLORIDA MORTGAGES* § 5-6 (2016).

C. Statutory Redemption and Junior Lien Revival

A third way in which mortgage law favors lending on the security of junior liens is statutory redemption. Statutory redemption is available only after foreclosure of a mortgage has been completed, and should not be confused, although it often is, with equitable redemption.⁶¹ Every state's common law recognizes equitable redemption, which is a right held by any and all parties subordinate to the mortgage being foreclosed, including the mortgagor and junior lienors.⁶² If a junior lienor redeems by paying the balance due on the senior loan, it is subrogated to the rights of the mortgagee from whom redemption is made. Hence, the junior lienor exercising equitable redemption does not obtain title to the real estate, but is entitled to an assignment by operation of law of the mortgage being redeemed.⁶³ A junior lienholder who redeems from the senior mortgagee can thereby stop the foreclosure of the senior lien from taking place, and can regain control of the situation.

Statutory redemption is completely different. It was not a feature of the common law, and exists by statute in only about twenty-three states.⁶⁴ It is available only after foreclosure, and only for a statutorily fixed period (commonly three months to one year). In most states, statutory redemption is made by paying to the foreclosure sale purchaser the amount that the purchaser bid at the sale plus interest and, in some states, certain of the purchaser's out-of-pocket expenses on the property.⁶⁵ One who exercises

⁶¹ For an in-depth treatment of the distinction between equitable and statutory redemption, see NELSON, WHITMAN, BURKHART & FREYERMUTH, *supra* note 25, §§ 7:1–2.

⁶² Catherine A. Gnatek, Note, *The New Mortgage Foreclosure Law: Redemption and Reinstatement*, U. ILL. L. REV. 471, 475 (1989).

⁶³ See, e.g., Fed. Deposit Ins. Corp. v. Bracero & Rivera, Inc., 895 F.2d 824, 828 (1st Cir. 1990); Davis v. Cole, 747 N.Y.S.2d 722, 729 (N.Y. Sup. Ct. 2002); Home & City Sav. Bank v. Sperrazza, 612 N.Y.S.2d 259, 260 (N.Y. App. Div. 1994). See generally RESTATEMENT (THIRD) OF PROP.: MORTG. § 6.4(e) (AM. LAW INST. 1997).

⁶⁴ ALA. CODE §§ 6–5–248, –253 (2018), *construed in* 600, L.L.C. v. Virani, 88 So. 3d 831 (Ala. 2012) (foreclosure price, not price obtained by sale purchaser on resale, is the redemption amount); ALASKA STAT. §§ 09.45.190, .35.250 (2018); ARIZ. REV. STAT. § 12–1282 (2018); ARK. CODE ANN. § 16–66–502 (2018); CAL. CIV. CODE §§ 729.010–.090, 726(e) (2018); COLO. REV. STAT. ANN. § 38–38–302 (2018); 735 ILL. COMP. STAT. 5/12–122 (2018); IOWA CODE ANN. §§ 628.28, .3 (2018); KAN. STAT. ANN. § 60–2414 (2018); KY. REV. STAT. ANN. § 426.220 (2018); ME. REV. STAT. ANN. tit. 14, § 6313 (2018); MICH. COMP. LAWS ANN. § 600.3140 (2018); MINN. STAT. ANN. §§ 580.23, .24 (2018); MO. REV. STAT. § 443.410 (2018); MONT. CODE ANN. 1947, § 25–13–802 (2017); N.M. STAT. ANN. § 39–5–18 (2018); N.D. CENT. CODE § 32–19–18 (2017); OR. REV. STAT. ANN. § 18–962 (2018); S.D. CODIFIED LAWS § 21–52–1 (2018); TENN. CODE ANN. §§ 66–8–101, –102 (2018); Utah Code Ann. § 78B–6–906 (2018); WASH. REV. CODE ANN. §§ 6.23.010, .020 (2018); WYO. STAT. ANN. § 1–18–103 (2018). See NELSON, WHITMAN, BURKHART & FREYERMUTH, *supra* note 25, §§ 7:1, 8:4–7.

⁶⁵ Depending on the particular statute, these expenses may include property taxes, insurance costs, and even improvements made to the property prior to the redemption. See, e.g., ALA. CODE § 6–5–253

statutory redemption receives the rights of the foreclosure purchaser—in other words, title to the land itself.⁶⁶ Thus, in effect, the redemptioner is buying the property back from the foreclosure sale purchaser.⁶⁷

Who can redeem under these statutes? All of the states that have adopted them agree that the mortgagor (or a successor owner of the property) can do so.⁶⁸ But in nearly half of the states having statutory redemption, holders of junior liens can redeem as well.⁶⁹ The importance of this right of junior lienors is relatively limited. If the mortgagor (or a successor owner of the real estate) redeems, the right of junior lienors to redeem is generally nullified. In addition, where there is more than one junior lienor seeking to redeem, complicated statutory provisions exist to determine which of them will have priority over the others.⁷⁰ Thus, in a practical case the right to redeem may or

(2018) (redemptioner must pay interest, taxes, insurance, and permanent improvements). Minnesota is among the most thorough of states, requiring the redemptioner to reimburse the purchaser for interest at 6%, property taxes and assessments, hazard insurance premiums, appraisal or valuation fees, attorneys' fees, payments on superior mortgages, recording fees, and (if the property has been abandoned by the mortgagor) expenses for installing or changing locks and other costs of protecting the property from vandalism and the elements. See MINN. STAT. §§ 580.23, 582.03 (2018).

⁶⁶ Illinois is an exception; there, a redeeming junior lienholder is simply entitled to a cancellation of the foreclosure sale and a revival of the junior lien. See 735 ILL. COMP. STAT. ANN. 5/12–132 (2018); *Crowder v. Scott State Bank of Bethany*, 5 N.E.2d 387, 388 (Ill. 1936); *Lamb v. Richards*, 43 Ill. 312, 316–17 (1867).

⁶⁷ See *Metcalf v. Phoenix Title & Tr. Co.*, 261 P. 633, 636 (Ariz. 1927); Annotation, *Creditor or Encumbrancer Redeeming from Mortgage Sale as Acquiring Title and Rights of Sale Purchaser*, 135 A.L.R. 196 (1941).

⁶⁸ 5 TIFFANY REAL PROPERTY § 1530 (3d ed. 2017).

⁶⁹ ALA. CODE § 6–5–248 (2018), *applied in* *Ross v. Rogers*, 25 So. 3d 1160, 1168–69 (Ala. Ct. Civ. App. 2009); ARIZ. REV. STAT. ANN. § 12–1281 (2018); COLO. REV. STAT. § 38–38–306 (2018), *applied in* *WYSE Fin. Servs., Inc. v. Nat'l Real Estate Inv., LLC*, 92 P.3d 918, 922 (Colo. 2004) (en banc); IDAHO CODE ANN. § 11–402 (2018); IOWA CODE ANN. § 628.8 (2018); KAN. STAT. ANN. § 60–2414(c) (2018), *applied in* *Alliance Mortg. Co. v. Pastine*, 104 P.3d 405, 413 (Kan. Ct. App. 2005); MINN. STAT. ANN. § 580.24 (2018), *applied in* *TCM Proprs., LLC v. Gunderson*, 720 N.W.2d 344, 350–51 (Minn. Ct. App. 2006); MONT. CODE ANN. § 25–13–801 (2017), *applied in* *Savoy v. Cascade Cty. Sheriff's Dep't*, 887 P.2d 160, 165 (Mont. 1994); S.D. CODIFIED LAWS § 21–49–33 (2018), *applied in* *Bank of Am. v. Driggs*, 669 N.W.2d 721, 724 (S.D. 2003); WASH. REV. CODE § 6.23.010 (2018), *applied in* *Capital Inv. Corp. v. King Cty.*, 47 P.3d 161, 164–65 (Wash. Ct. App. 2002).

⁷⁰ Two main systems exist. The “strict priority” approach allows a fixed time for redemption by the mortgagor; if that period expires without redemption, each junior lienor, in descending order of priority, has the right to redeem for a brief period (e.g., five days). If any junior lienor redeems, a lower-priority lienor (when its turn comes) may redeem by paying the amount bid at the foreclosure sale plus the amount necessary to buy out the liens of higher-priority lienors who previously redeemed. Under the “scramble” method, there is no exclusive redemption period for the mortgagor. Rather, redemption may be made by both the mortgagor and junior lienholders, although if redemption is ever made by the mortgagor, the redemption period ends. As among the junior lienholders, each may redeem at any time irrespective of their priority, but any lienor who redeems must pay the amount bid at the sale and in addition must buy out the amount owed to any other lienor with a higher priority who has already redeemed. For a detailed explanation with examples, see NELSON, WHITMAN, BURKHART & FREYERMUTH, *supra* note 25, § 8:7.

may not accrue to a particular lienholder. Nonetheless, in some cases the privilege of redeeming under the statute may prove to be of considerable value to a junior lienor—particularly if the successful bid at the foreclosure sale was substantially below the property's value, so that there is significant equity in the property that the junior may capture by redeeming.

Holders of junior liens have one additional advantage in the statutory redemption scheme. There is a considerable body of case law holding that if the mortgagor or a successor owner of the property exercises the right of statutory redemption and thereby reacquires the property, the junior liens will revive and reattach to the property.⁷¹ The obvious policy behind this rule is to prevent the mortgagor from unfairly cleansing the property of junior liens by running it through a possibly collusive foreclosure. Whatever one may think of the merits of the rule,⁷² it is obviously advantageous to junior lienholders, giving them a renewed (and probably quite unexpected) opportunity to collect their debts out of the property.

The right of statutory redemption, unlike the Garn Act and the future advance rules, is not designed to facilitate the market in origination of junior mortgage loans. Instead, its ostensible purpose is to provide an incentive for foreclosure purchasers to bid something close to the property's fair value, so that there will be little or no reason for anyone to redeem the property.⁷³ Nonetheless, it can prove highly useful to subordinate lienholders in the right

⁷¹ See, e.g., *Mihoover v. Walker*, 164 P. 504, 505 (Colo. 1917); *Franklin v. Spencer*, 789 P.2d 643, 645 (Or. 1990); *Rist v. Andersen*, 19 N.W.2d 833, 835 (S.D. 1945); *Newman v. Am. Nat'l Bank*, 780 P.2d 336, 340 (Wyo. 1989); *Scott v. Scott*, 534 N.E.2d 174, 176 (Ill. App. Ct. 1989); *Feldman v. M. J. Assocs.*, 324 N.W.2d 496, 498 (Mich. Ct. App. 1982). At the opposite extreme are states like California, where the statute expressly provides that the junior liens do not revive. CAL. CIV. PROC. CODE § 729.080(e) (2018). Many states also allow revival of junior liens in the analogous situations in which the mortgagor is the successful bidder at the senior foreclosure sale, or even when the mortgagor buys the property later from the foreclosure sale purchaser. See RESTATEMENT (THIRD) OF PROP.: MORTG. § 4.9 cmt. b (AM. LAW INST. 1997); NELSON, WHITMAN, BURKHART & FREYERMUTH, *supra* note 25, § 8:6 (statutory redemption by mortgagor). By way of contrast, when a mortgagor engages in *equitable* redemption of a first mortgage (i.e., pays it off), the first mortgage is cancelled but any junior liens simply remain attached to the property. The mortgagor may not, for example, claim to be subrogated to the rights of the first mortgagee and then re-foreclose the first mortgage to wipe out the juniors, since this would present an obvious case of unjust enrichment. See *id.* § 6:6.

⁷² See, e.g., *Newman*, 780 P.2d at 340 (“The potential for a mortgagor to eliminate junior mortgages by allowing a foreclosure by the senior mortgagee and then [redeeming from the senior mortgagee] is a solid basis for such public policy.” The Restatement agrees in the analogous situation in which the mortgagor buys at the foreclosure sale or buys later from the foreclosure purchaser, unless the latter is a bona fide purchaser. See RESTATEMENT (THIRD) OF PROP.: MORTG. § 4.9 cmt. b (AM. LAW INST. 1997).

⁷³ The statutes are likely ineffective in achieving this objective. For a thorough analysis and critique of statutory redemption, see *United States v. Stadium Apts., Inc.*, 425 F.2d 358, 365–73 (9th Cir. 1970) (particularly the dissent of Judge Ely).

circumstances, and to some extent makes junior liens more valuable than they would otherwise be.

III. METHODS OF RESOLVING MORTGAGE DEFAULT

When a residential mortgage servicer is faced with a default that the borrower is unable or unwilling to cure, there are two general approaches available to the servicer. The first might be called a “workout” or a “loan modification,” and involves changing the terms of payment in order to improve the borrower’s chances of curing the default and becoming current.⁷⁴ Several federally sponsored programs have been aimed at encouraging servicers to pursue this option.⁷⁵ The other approach is to terminate the loan and realize on the security provided by the real estate mortgage, typically (but not always, as explained below) by mortgage foreclosure.⁷⁶ The servicer may take this approach if the borrower appears to be so financially weak that loan modification is unlikely to be successful, or is unable to meet the guidelines of the applicable federal programs. It may also do so if a loan modification has been tried and failed.

The discussion in Part III focuses on the approaches available to the servicer with a particular focus on how the presence of one or more junior liens on the property affects the legal posture of the servicer in pursuing these approaches. In Part III.A, we deal with various forms and types of loan modification when the objective is to keep the mortgagor in the home. In Part

⁷⁴ See *supra* note 2.

⁷⁵ Under the Home Affordable Refinance Program (HARP), borrowers whose loans are held by Fannie Mae or Freddie Mac may be able to refinance at lower interest rates. The program has been extended through September 2017 at this writing. See *Making Homes Affordable: Home Affordable Modification Program*, U.S. DEP’T OF THE TREASURY, <https://www.treasury.gov/initiatives/financial-stability/TARP-Programs/housing/mha/Pages/hamp.aspx> (last updated Jan. 30, 2017, 3:14 PM); see also *About HARP*, HOME AFFORDABLE REFINANCE PROGRAM, <https://www.harp.gov/About> (last visited Aug. 12, 2018). The Home Affordable Mortgage Program (HAMP) provided mortgage modifications, usually in the form of interest rate reductions or loan term extensions. See *MAKING HOME AFFORDABLE*, <https://www.makinghomeaffordable.gov> (last visited Aug. 12, 2018). No new applications were accepted after the end of 2016. The Home Affordable Foreclosure Alternatives (HAFA) program, offered by some servicers, was designed to facilitate short sales or deeds in lieu of foreclosure by borrowers whose applications for the HAMP program were rejected. It was likewise terminated at the end of 2016. See *Bank of America Home Affordable Foreclosure Alternative (HAFA) Matrix*, *MAKING HOME AFFORDABLE*, https://www.makinghomeaffordable.gov/Documents/HAFA/HAFA-policies_Bank-of-America.pdf (last visited Aug. 12, 2018), for a typical explanation of eligibility under HAFA. In general, these programs have been controversial and their results disappointing. See *Wigod v. Wells Fargo Bank*, 673 F.3d 547, 555 (7th Cir. 2012) (there is no private right of action under HAMP); Nelson D. Schwartz, *Some Doubt a Settlement Will End Mortgage Ills*, N.Y. TIMES (Feb. 20, 2012), <http://www.nytimes.com/2012/02/21/business/some-doubt-a-settlement-will-end-mortgage-ills.html>.

⁷⁶ See RESTATEMENT (THIRD) OF PROP.: MORTG. § 8.2 (AM. LAW INST. 1997).

III.B, we discuss resolutions of distressed mortgages that result in the mortgagor's loss of the home, beginning with foreclosure and then discussing foreclosure alternatives (e.g., deeds in lieu of foreclosure and short sales). In a later section,⁷⁷ we discuss in detail the ways that holders of junior liens can impede the resolution of the mortgage default, but in this section, we simply address whether and to what extent such liens will acquire priority over the first mortgage.

A. Resolving Distressed Loans Through Modification

We begin with consensual loan modification,⁷⁸ the object of which is to make it easier for the borrower to comply with the loan's payment terms. The

⁷⁷ See *infra* Part IV.

⁷⁸ See generally NELSON, WHITMAN, BURKHART & FREYERMUTH, *supra* note 25, § 7.3. In theory, federal bankruptcy law could also provide a nonconsensual basis for modification of a home mortgage. At present, however, the Bankruptcy Code (Code) provides only very limited assistance to the financially distressed homeowner. In a Chapter 7 liquidation, a borrower whose mortgage is in default can obtain a discharge of its personal liability on the mortgage debt, thereby obtaining protection against the risk of a deficiency judgment that the borrower might otherwise face under state law. *Id.* § 8:17, at 804, 807. The mortgage lien itself "rides through" the bankruptcy, however, and remains valid against the property as an in rem obligation capable of being enforced by the mortgagee through foreclosure once the automatic stay is no longer in effect. JEFF FERRIELL & EDWARD J. JANGER, UNDERSTANDING BANKRUPTCY § 13.01, at 466 (2d ed. 2007) ("[D]ischarge provides debtors with relief from their in personam liability but does not affect creditors' in rem rights against a debtor's property."). Section 506(d) of the Code invalidates a lien to the extent it "secures a claim against the debtor that is not an allowed secured claim." 11 U.S.C. § 506(d) (2018). Read literally, this would appear to permit a Chapter 7 debtor to obtain principal reduction if the debt exceeded the value of the mortgaged property—i.e., to "strip-down" the principal amount secured by the lien to the property's then-current value. A debtor could then redeem the property from the lien by payment of this reduced principal amount (and thereafter capture the benefit of any post-bankruptcy appreciation in the value of the home). In *Dewsnup v. Timm*, 502 U.S. 410 (1992), however, the Supreme Court rejected this reading of section 506(d) and held that the mortgagor could not use section 506(d) to strip-down an undersecured mortgage lien. While *Dewsnup* has been seriously criticized and is probably wrongly decided, see, e.g., Margaret Howard, *Secured Claims in Bankruptcy: An Essay on Missing the Point*, 23 CAP. U.L. REV. 313 (1994), the Court has recently reaffirmed it in *Bank of Am. v. Caulkett*, 135 S. Ct. 1995 (2015), in holding that section 506(d) did not invalidate a junior mortgage lien even though the junior lien was entirely unsupported by any equity. Chapters 11 and 13 of the Code generally permit a reorganizing debtor to modify secured claims through a plan of reorganization—even over the objection of the secured creditor—as long as the plan meets the necessary "cram-down" standards for confirmation of the plan. 11 U.S.C. §§ 1129(b)(1), (2)(A) (2018) (Chapter 11); *id.* § 1325(a)(5)(B) (Chapter 13). For a mortgage claim, this means that the mortgagor/debtor's plan must pay the mortgagee an amount which has a present value at least equal to the then-fair market value of the property. *Id.* §§ 1129(b)(1), (2)(A); *id.* § 1325(a)(5)(B). However, the power to modify a secured claim is not available if the claim is secured "only by a security interest in real property that is the debtor's principal residence . . ." *Id.* § 1123(b)(5) (Chapter 11); *id.* § 1322(b)(2) (Chapter 13). This "anti-modification rule" incentivizes home mortgage lending by protecting home lenders from the risk of principal reduction that other secured creditors might suffer in bankruptcy. See, e.g., Julia Patterson Forrester, *Mortgaging the American Dream: A Critical Evaluation of the Federal Government's Promotion of Home Equity Financing*, 69 TUL. L. REV. 373, 404–06 (1994). The anti-modification rule prevents the debtor from

changed terms might include a lower interest rate or a longer loan duration, either of which will result in lower monthly payments. They might also include a moratorium on or a reduction of payments for a short period. They might even involve a reduction of the loan's principal. Principal reductions may be permanent, or the reduction may be deferred, to be recovered in subsequent years of the loan. Likewise, accrued but unpaid interest on the loan, or any deferred interest, may be added to the principal loan balance (or "capitalized") with the expectation of its recovery by the servicer at the end of the loan term, or when the loan is paid off.⁷⁹

Of course, if there are existing subordinate mortgages on the property, the creditor does not want them to achieve priority over the first mortgage as a consequence of the modification. Fortunately, there are legal doctrines that provide at least some protection against that risk. We examine them here under three headings, corresponding to three variations on the loan modification scenario. The first is a refinancing, in which the same lender makes a new loan (typically with more lenient payment terms) to pay off the existing first mortgage.⁸⁰ The second is simply an agreement between borrower and lender to amend the terms of the promissory note secured by the existing first mortgage while leaving it in place.⁸¹ The third is a refinancing by a different lender than the one that made the original loan.⁸²

confirming a plan that would modify the home mortgagee's claim in any respect without the home mortgagee's consent—unless the mortgagee loses the benefit of the anti-modification rule by taking additional collateral to secure the debt. *See, e.g., NELSON, WHITMAN, BURKHART & FREYERMUTH, supra* note 25, § 8:18. Under the overwhelming weight of authority, the anti-modification rule also applies to claims held by junior lienholders such as home equity lenders. *See Forrester, supra*, at 423–25 (noting some court decisions critical of this result as inconsistent with the apparent purpose of the rule to facilitate long-term mortgage financing). However, the rule applies only as long as the junior lien is supported by any equity. If the home's value is less than the balance due on senior liens, the strong weight of authority holds that the junior claim is not "secured" and may be "stripped-off" so that it does not survive the bankruptcy. *NELSON, WHITMAN, BURKHART & FREYERMUTH, supra* note 25, § 8:18, at 818, 821 (collecting cases). Thus, bankruptcy may provide a means for the insolvent mortgagor to extinguish fully underwater junior liens on the mortgagor's home—and thus potentially to benefit from any future market appreciation that would have redounded to the benefit of junior lienholders outside of bankruptcy.

⁷⁹ *See* Kirk Haverkamp, *Loan Modification Types & Options, Loan Mod Information & Plans*, MORTGAGELOAN.COM (Nov. 23, 2009), <https://www.mortgageloan.com/mortgage-loan-modification/types>. *See also OCC Mortgage Metrics Report*, OFFICE OF THE COMPTROLLER OF THE CURRENCY 9 (Sept. 2016), <https://www.occ.gov/publications/publications-by-type/other-publications-reports/mortgage-metrics/metrics-q2-2016.pdf> (Table One). This table, which compiles data on the volume of mortgage modifications completed on first-lien residential mortgages serviced by seven national banks (Bank of America, Citibank, HSBC, JPMorgan Chase, PNC, U.S. Bank, and Wells Fargo), characterize modifications into seven categories: (1) capitalization; (2) rate reduction or freeze; (3) term extension; (4) principal reductions; (5) principal deferral; (6) combination; or (7) other/not reported.

⁸⁰ *See infra* notes 83–101 and accompanying text.

⁸¹ *See infra* notes 102–05 and accompanying text.

⁸² *See infra* notes 106–17 and accompanying text.

1. Refinancing and the Replacement Mortgage Doctrine

Refinancing, when done by the same lender who made the original loan, involves a payoff of the loan and a discharge of the mortgage recorded in the public records, followed immediately by the execution of a new promissory note and mortgage and the recording of the new mortgage. The original balance on the new loan must be sufficient to pay off the old loan in full (unless the servicer has agreed to a principal reduction).

Suppose there is a junior lien, such as a second mortgage, a HELOC, or a judgment lien on the property. The ordinary operation of the first-in-time principle and the recording system would dictate that the junior lien, having been executed and recorded first,⁸³ would take priority over the refinance mortgage. But that outcome would, of course, be entirely unacceptable to the first lender, who expects to maintain its first lien status. Furthermore, the first lender could have chosen to modify the existing mortgage—thereby retaining its temporal first-in-time position—rather than replacing it with an entirely new mortgage document and releasing the original mortgage.⁸⁴ Thus, it would make little sense to take a strict temporal approach and promote the junior lien into a senior position over the refinance mortgage.

Fortunately, a common law rule known as the replacement mortgage doctrine will come to the lender's aid. As the Restatement of Mortgages explains:

If a senior mortgage is released of record and, as part of the same transaction, is replaced with a new mortgage, the latter mortgage retains the same priority as its predecessor, except to the extent that any change in the terms of the mortgage or the obligation it secures is materially prejudicial to the holder of a junior interest in the real estate.⁸⁵

⁸³ Cf. *Strong v. Stoneham Coop. Bank*, 310 N.E.2d 607, 608 (Mass. Ct. App. 1974) (the court rather bizarrely held that first mortgagee was not held to constructive notice of junior lien, despite fact that it was recorded at time first mortgage loan was modified).

⁸⁴ As discussed, the modified mortgage would retain its priority over an intervening junior lienholder except to the extent that the modification resulted in material prejudice to the intervening junior. *See infra* notes 102–05 and accompanying text.

⁸⁵ RESTATEMENT (THIRD) OF PROP.: MORTG. § 7.3 (AM. LAW INST. 1997). *See Houston Lumber Co. v. Skaggs*, 613 P.2d 416, 417 (N.M. 1980); *Union Bank v. Thrall*, 872 N.E.2d 542, 548 (Ill. App. Ct. 2007); *CitiMortgage, Inc. v. Mortg. Elec. Registration Sys., Inc.*, 813 N.W.2d 332, 335 (Mich. Ct. App. 2011); *Sovereign Bank v. Gillis*, 74 A.3d 1, 9 (N.J. Super. Ct. App. Div. 2013) (remanding case to trial court for consideration of the amount of “material prejudice”); *Fleet Bank v. Cty. of Monroe Indus. Dev. Agency*, 637 N.Y.S.2d 870, 871 (N.Y. App. Div. 1996); *Sheppard v. Interbay Funding, LLC*, 305 S.W.3d 102, 108–09 (Tex. App. 2009). *See generally* Carol Vento, Annotation, *Discharge of Mortgage and Taking Back of New Mortgage as Affecting Lien Intervening Between Old and New Mortgages*, 43

Thus, the refinanced senior mortgage is protected against loss of priority to junior liens unless the changes in loan terms would be materially prejudicial to them. Even a prejudicial change will keep priority, of course, if the junior lienholder consents to the changes or subordinates its lien to the new mortgage.⁸⁶

The replacement mortgage doctrine makes perfect sense. At the time the junior lienholder obtained its junior position, it knew or should have known—by virtue of the recording of the original mortgage—that it was in a junior position and would remain in a junior position until the original mortgagee was paid in full. While the refinance may involve a new promissory note and the cancellation of the old note, the debt to the mortgagee is not really being “paid in full,” but merely restructured. As such, a rule according the refinance mortgage with the priority of the original mortgage is fully consistent with the expectations of both the refinancing mortgagee and the intervening junior lienholder.

The difficulty in applying the replacement mortgage doctrine is in determining what types of changes are materially prejudicial to junior lienors.⁸⁷ The prejudicial effect of some changes is obvious. For example, if the new mortgage secures a larger principal amount than the balance owing on the old mortgage at the time of the refinancing, the prejudice to a junior lienor is clear, and the senior lender will suffer a loss of priority to the extent of the increased balance.⁸⁸

A.L.R.5th 519 (1996). Louisiana has rejected the doctrine on the basis of strict construction of Louisiana’s “race” recording statute. *See Pelican Homestead & Sav. Ass’n. v. Sec. First Nat’l Bank*, 532 So. 2d 397, 400 (La. Ct. App. 1988). *See also Hilco, Inc. v. Lenentine*, 698 A.2d 1254, 1256–57 (N.H. 1997). The release of the old mortgage and recording of the new mortgage must be part of the same transaction. *See United States v. Tolin*, 827 F.3d 809, 814 (8th Cir. 2016) (where more than two months elapsed between release of old mortgage and recording of new mortgage, court refused to protect the new mortgage with the old mortgage’s priority).

⁸⁶ *See, e.g., Burney v. McLaughlin*, 63 S.W.3d 223, 229–32 (Mo. Ct. App. 2001).

⁸⁷ *See id.* at 231–32.

⁸⁸ *See U.S. Bank v. JPMorgan Chase Bank*, 398 P.3d 118, 122 (Ariz. Ct. App. 2017) (where replacement mortgage had larger balance than original mortgage, creditor was entitled to retain priority only to the extent of the original mortgage’s balance); *Bowling Green Sports Ctr., Inc. v. G.A.G. LLC*, 77 N.E.3d 728, 732 (Ill. App. Ct. 2017) (junior lienor gained priority to the extent of \$51,000 advanced in loan modification); *Nationstar Mortg., L.L.C. v. Bowman*, 889 N.W.2d 243 (Iowa Ct. App. 2016); *Wells Fargo Bank v. SBC IV REO, LLC*, 896 N.W.2d 821, 837, 844 (Mich. Ct. App. 2016) (new mortgage lost priority to intervening lien to the extent its balance was larger than balance on old mortgage); *Golden Delta Enters., L.L.C. v. US Bank*, 213 S.W.3d 171, 176 (Mo. Ct. App. 2007) (case remanded for further findings as to whether increased balance was materially prejudicial to junior lienor); *Sheppard v. Interbay Funding, LLC*, 305 S.W.3d 102, 107 (Tex. App. 2009) (new mortgage was entitled to priority of old mortgage to the extent of balance paid off); *Nature’s Sunshine Prods., Inc. v. Watson*, 174 P.3d 647, 652–53 (Utah Ct. App. 2007) (new mortgage was sixteen times larger than obligation on initial mortgage sixteen years earlier and was materially prejudicial to intervening lienholder). *See also* N.J. STAT. ANN. § 46:9–8.2 (2018), which expressly preserves the priority of a modified mortgage except to the extent of

A little further analysis of the “increased balance” problem may be helpful here. Consider the following factual variations, which are based on these assumptions: (1) the senior mortgage debt bears a rate of 5% per annum simple interest; (2) the senior debt has a principal balance of \$200,000 prior to the given modification; (3) the senior mortgage does not cover future advances (or the particular future advance involved would not qualify for the priority of the original loan under the applicable legal rules); (4) the terms of the senior mortgage are consistent with the provisions of the Fannie Mae/Freddie Mac uniform single-family mortgage instrument; (5) there is only one junior lien at the time of the modification; and (6) the junior lienholder did not consent to the modification. The conclusions expressed below represent our understanding of the concept of “material prejudice.”

Example 1. Borrower is current at the time of the modification. In the modification, the senior lender advances \$10,000 in cash to the borrower, increasing the principal balance to \$210,000. *Result:* In this case, the increase in the principal balance of the loan is materially prejudicial to the junior lienholder. Thus, the senior lender’s lien now has a “split” priority; while it retains first priority to the extent of the \$200,000 principal balance prior to modification, it is subordinated to the extent of the additional \$10,000 loan.

Example 2. Borrower is current at the time of the modification. In the modification, the senior lender advances \$10,000 in cash to the borrower, increasing the principal balance to \$210,000. However, the borrower makes no payments on the loan over the next year, by which time the senior mortgage now has a total balance of \$220,500 (\$210,000 principal plus accrued but unpaid interest of \$10,500). *Result:* As in Example 1, the junior suffers material prejudice to the extent of the additional \$10,000 advance. In addition, the junior suffers material prejudice to the extent of the additional interest that accrued on that \$10,000 during the past year but was not paid ($\$10,000 \times 5\% = \500). Thus, the senior lender’s lien now has a split priority.

“any balance due in excess of the maximum specified principal amount which is secured by the mortgage, plus accrued interest, payments for taxes and insurance, and other payments made by the mortgagee pursuant to the terms of the mortgage.” See *Rosenthal & Rosenthal, Inc. v. Benun*, 140 A.3d 547, 557 (N.J. 2016) (statute does not protect optional future advances from loss of priority). Occasionally a court will hold that a modification that is prejudicial to a junior lienor results in a complete reversal of priorities, giving the junior lien a first position for its full balance. See generally *Citizens & S. Nat’l Bank v. Smith*, 284 S.E.2d 770, 772 (S.C. 1981) (priorities completely reversed on account of senior mortgagee granting a one-year time extension); *Gluskin v. Atl. Sav. & Loan Ass’n*, 108 Cal. Rptr. 318, 323 (Cal. Ct. App. 1973). But the better and much more common view is that the reversal of priorities is only *pro tanto*, to the extent of the prejudice suffered. See *Shane v. Winter Hill Fed. Sav. & Loan Ass’n*, 492 N.E.2d 92, 96–97 (Mass. 1986) (junior lienor not subordinate to increased interest rate on senior loan, but still subordinate to original interest rate). Further, the holding in *Gluskin* is severely undercut by *Friery v. Sutter Buttes Sav. Bank*, 72 Cal. Rptr. 2d 32, 38–39 (Cal. Ct. App. 1998) (finding no prejudice to the junior lienor from the shortening of the senior loan’s term).

It retains first priority to the extent of \$210,000 (the \$200,000 principal balance prior to modification and the \$10,000 of interest that accrued on that amount but was unpaid); however, it is subordinated to the extent of the additional \$10,000 loan and to the \$500 of interest that accrued but was unpaid on that portion.

Example 3. At the time of the modification, borrower is in default, with \$10,000 in interest having accrued but being unpaid. In the modification, the senior lender agrees to capitalize the accrued but unpaid interest, thus increasing the principal balance to \$210,000. *Result:* At this point, the junior lienholder has not suffered material prejudice due to the modification. Prior to the modification, the junior was in a subordinate position to the senior with respect to both the \$200,000 unpaid principal balance and any accrued but unpaid interest on that amount. The modification (capitalization of the accrued but unpaid interest) increases the principal, but it has not increased the total amount of the debt and thus the junior has as yet suffered no prejudice. The senior lender retains its priority to the full extent of the \$210,000 modified balance.

Example 4. At the time of the modification, borrower is in default, with \$10,000 in interest having accrued but being unpaid. In the modification, the senior lender agrees to capitalize the accrued but unpaid interest,⁸⁹ thus increasing the principal balance to \$210,000. However, the borrower makes no payments on the loan over the next year, by which time the senior debt now has a total balance of \$220,500. *Result:* As in Example 3, the mere capitalization of accrued but unpaid interest did not by itself materially prejudice the junior. However, over the ensuing year, the modified balance of \$210,000 accrued more interest ($\$210,000 \times 5\% = \$10,500$) than would have accrued on the loan if it had not been modified ($\$200,000 \times 5\% = \$10,000$). The junior thus does suffer material prejudice to the extent of the extra \$500 of interest accrued. The senior lender thus retains its priority to the extent of \$220,000 (the \$210,000 principal balance plus the \$10,000 in accrued but unpaid interest that would have accrued on the unmodified loan), but is subordinated to the junior with respect to the additional \$500 in interest accrued.

Example 5. At the time of the modification, borrower is in default, and the senior lender has expended \$10,000 for weatherproofing the property, providing security to prevent vandalism, payment of delinquent insurance

⁸⁹ Most residential mortgage loan documents, such as the Fannie Mae/Freddie Mac Uniform Note, do not provide that accrued but unpaid interest is capitalized automatically. Likewise, they do not provide that amounts of unpaid interest will accrue additional interest (i.e., there is no “interest on interest”). Thus, in a modification, if the lender is not willing to forgive unpaid interest or further delay its collection, the lender may insist that accrued but unpaid interest be capitalized (added to the unpaid principal balance).

premiums, and attorney's fees in efforts to collect the loan. In the modification, this \$10,000 is added to the loan balance, increasing the principal balance to \$210,000. *Result*: The junior lienholder suffers no material prejudice by virtue of the modification. All of the senior's expenditures are within the scope of the original mortgage, which permits the senior to add those expenses to the debt, and thus the junior knew (or should have known) it was at risk of being subordinate to the extent of such expenses. The senior lienholder retains priority to the full extent of the debt as modified.

Other changes may be obviously nonprejudicial. If the senior lowers the interest rate or reduces the balance on the refinanced loan, any junior lienors are better off, not worse.⁹⁰ By contrast, an increased interest rate is very likely to be held prejudicial.⁹¹ An extension of the loan term is more debatable. On the one hand, if the term extension lowers the monthly payments (as it would on an amortizing loan), this would make the loan easier for the borrower to repay and reduce the risk of default, which is beneficial to the junior. On the other hand, if the loan is held to maturity (perhaps not likely, but certainly possible), the result is that the junior lienor will be subordinate for a longer period of time (assuming that the junior is not already paid off), which is a detrimental result. Further, the property's security value might diminish during the extension period. The opposite arguments can be made, of course, if the modification shortens the loan term and monthly payments rise as a result, increasing the risk of the mortgagor's default.⁹² As a practical matter, courts have usually viewed term extensions as benign and refused to treat

⁹⁰ See generally *Big Land Inv. Corp. v. Lomas & Nettleton Fin. Corp.*, 657 P.2d 837, 840-41 (Alaska 1983) (interest rate reduction was not prejudicial to junior lien holder); *Ocwen Loan Servs., LLC v. Quinn*, No. A-2668-14T3, 2016 WL 6156209, at *3 (N.J. Super. Ct. App. Div. Oct. 24, 2016) (change of interest rate from potential 9.700% adjustable to 6.625% fixed was beneficial to junior interest holders).

⁹¹ See, e.g., *Shultis v. Woodstock Land Dev. Assocs.*, 594 N.Y.S.2d 890, 893 (N.Y. App. Div. 1993); RESTATEMENT (THIRD) OF PROP.: MORTG. § 7.3 cmt. a (AM. LAW INST. 1997) (increased interest rate prejudicial by placing additional strain on mortgagor's financial capacity, leading to greater probability of default).

⁹² In the analogous situation of financing by a different lender, see *Am. Sterling Bank v. Johnny Mgmt. LV, Inc.*, 245 P.3d 535, 541 (Nev. 2010) (where original loan matured in fifteen years and refinance loan matured in six months, with large increase in monthly payments, court found material prejudice to junior lienor). But see *Friery v. Sutter Buttes Sav. Bank*, 72 Cal. Rptr. 2d 32, 38 (Cal. Ct. App. 1998) (refusing to find prejudice to the junior lienor from a shortening of the senior loan's term).

them as causing a loss of the senior's priority.⁹³ There is little specific authority dealing with term reductions.⁹⁴

Of course, there are also other less common modifications. What about a change from fixed rate to adjustable rate or vice versa? A change in the index for rate adjustments? A change in the caps for future rate changes? Or suppose the modification includes a cross-collateralization clause, so that the new mortgage also secures obligations that the original mortgage did not?⁹⁵ Suppose the modification releases one of the co-borrowers from liability or adds a new guarantor? There is little or no judicial authority on these points, and for the most part, it is anyone's guess whether a court will hold a junior lien to be promoted in priority on account of them.

A further confounding factor is the possible presence of a clause in the senior mortgage reserving the right to modify the loan against junior lienors. The standard Fannie Mae/Freddie Mac residential mortgage, perhaps surprisingly, does not contain such a clause.⁹⁶ The Restatement approves the use of such clauses and provides that if a modification falls within the scope of such a clause, the senior mortgage will retain its priority even if the change is prejudicial to a junior lienor.⁹⁷ That is a plausible position and is probably correct, but there is no significant case authority addressing it.⁹⁸ Moreover,

⁹³ Cases holding that loan term extensions were not materially prejudicial and caused no loss of priority include: *Resolution Tr. Corp. v. BVS Dev., Inc.*, 42 F.3d 1206, 1215 (9th Cir. 1994) (five-month extension, based on California law); *St. Agatha Fed. Credit Union v. Ouellette*, 722 A.2d 858, 861–62 (Me. 1998) (three-year extension, accompanied by decreased interest rate and monthly payment); *Guleserian v. Fields*, 218 N.E.2d 397, 402–03 (Mass. 1966) (two-year extension); *Ocwen Loan Servs., LLC v. Quinn*, No. A–2668–14T3, 2016 WL 6156209 (N.J. Super. Ct. App. Div. Oct. 24, 2016) (two-year extension); *Burney v. McLaughlin*, 63 S.W.3d 223, 234 (Mo. Ct. App. 2001) (note extended from six months to six years). The Restatement agrees. See *RESTATEMENT (THIRD) OF PROP.: MORTG.* § 7.3 cmt. c (AM. LAW INST. 1997) (“Extensions of maturity generally reduce the likelihood of foreclosure of the senior mortgage, and thus are beneficial, rather than prejudicial, to the interest of junior lienors.”).

⁹⁴ See *Burney v. McLaughlin*, 63 S.W.3d 223, 230 (Mo. Ct. App. 2001).

⁹⁵ In *Burney*, 63 S.W.3d at 233–34, the court was willing to disregard such changes and uphold the original mortgagee's priority, but it is unclear whether other courts would do so.

⁹⁶ In Clause 12, the Uniform Instrument does provide that a forbearance, time extension, or alteration of the amortization schedule will not operate to release the borrower or the borrower's successors, but it says nothing about the effect of these actions on junior liens. See *Security Instruments*, FREDDIE MAC, <http://www.freddiemac.com/uniform/unifsecurity.html> (last visited Aug. 12, 2018).

⁹⁷ *RESTATEMENT (THIRD) OF PROP.: MORTG.* § 7.3(c) (AM. LAW INST. 1997). The Restatement also recognizes the right of the mortgagor to “cut off” the effect of such a clause by notice to the mortgagee, for the purposes of freeing up the property for future junior financing. *Id.* § 7.4.

⁹⁸ In a recent case, *Wells Fargo Bank v. SBC IV REO, LLC*, 896 N.W.2d 821, 838–44 (Mich. Ct. App. 2016), Wells Fargo claimed that it retained senior priority to the full extent of a cash-out modification, arguing that Michigan had adopted Restatement § 7.3(c) and that the original mortgage provided that “[t]his Security Instrument may be modified or amended . . . by an agreement in writing signed by Borrower and Lender.” The Michigan Court of Appeals rejected this argument and, based on material prejudice, denied Wells Fargo the priority of the original loan to the extent of the cash-out portion of the refinancing loan. The court reasoned that while a prior Michigan decision had adopted other portions of

such clauses can be complex and tricky, and debates can arise about whether a particular modification falls within the clause or not.⁹⁹

In sum, although the replacement mortgage doctrine is designed to protect senior lenders from loss of priority when they refinance their own loans, reliance upon the doctrine alone involves some risk. Except in the case of the most benign and innocuous changes of terms, such as a lowered interest rate or a reduction of principal balance, the consequences of any change are to some extent debatable, and there is some risk that they will result in at least a partial loss of priority vis-à-vis intervening liens. Even the presence in the original mortgage of a clause reserving the right to modify, while certainly helpful, is no guarantee of protection.¹⁰⁰ The only way for the refinance lender to eliminate this sort of risk entirely is to obtain a written consent or a subordination agreement from each junior lienholder. It is this fact that gives such lienors the leverage to “blow up” the proposed modification or make it much more costly, as explained below,¹⁰¹ and this leverage exists even if the junior lien has little or no actual value.

Restatement § 7.3, it was “not clear” that the court had adopted § 7.3(c). The court also reasoned that in any event, § 7.3(c) did not apply, as the refinancing loan “did not entail a mere modification of the original mortgage; rather, it was a true replacement mortgage, resulting in the satisfaction, discharge, and cancellation of the original mortgage in its entirety.” *Id.* at 839. This latter argument is breathtakingly formalistic, if not stupid. In terms of priority, the end result should be the same whether the parties proceed by replacement of the original mortgage or modification of it. The court’s distinction would essentially force the refinancing lender that wants the advantage of § 7.3(c) into a modification of the original loan documents rather than a replacement—even if the execution of new loan documents may well be easier for the parties and involve lower transaction costs for the borrower. The court’s reasoning, however, may mask a general reluctance by courts to embrace the more senior-friendly approach reflected in § 7.3(c). *Cf.* Robert Kratovil & Raymond J. Werner, *Mortgage Extensions and Modifications*, 8 CREIGHTON L. REV. 595, 610 (1975) (expressing doubt about the enforceability of a modification clause in the original mortgage). An enforceable future advance clause in the original mortgage may have a similar effect, provided that the modification is in the nature of an additional advance and is within the scope of the clause. On the enforceability of future advance clauses, see RESTATEMENT (THIRD) OF PROP.: MORTG. § 2.1 (AM. LAW INST. 1997); NELSON, WHITMAN, BURKHART & FREYERMUTH, *supra* note 25, § 12:7. Under such a clause, the mortgage may be immunized from loss of priority even if the advance is deemed prejudicial to junior liens. *See, e.g.,* Wells Fargo Fin. Ky., Inc. v. Thomer, 315 S.W.3d 335, 341 (Ky. Ct. App. 2010).

⁹⁹ *See, e.g.,* First Fed. Sav. & Loan Ass’n v. Arena, 406 N.E.2d 1279, 1284–85 (Ind. Ct. App. 1980) (clause held ineffective where original mortgage reserved the right to forbear, to sue, or extend the time for payment, but did not mention increasing the interest rate as modification actually did).

¹⁰⁰ *See* Robert P. Giesen, “Routine” Mortgage Modifications: Lenders Beware, 17 REAL EST. L.J. 22 (1989).

¹⁰¹ *See infra* Part IV.

2. Amendment of the Original First Mortgage Loan Documents

Instead of paying off the first mortgage with the proceeds of a new loan, the servicer may make a simpler type of modification—an amendment to the existing promissory note restating the terms of payment.¹⁰² A careful servicer will probably have the borrower execute (and will record) an amendment to the mortgage as well, which indicates that the mortgage now secures the amended note.¹⁰³ In this situation, the law is essentially identical to the process of a replacement mortgage, which was previously discussed above. As the Restatement of Mortgages explains:

If a senior mortgage or the obligation it secures is modified by the parties, the mortgage as modified retains priority as against junior interests in the real estate, except to the extent that the modification is materially prejudicial to the holders of such interests.¹⁰⁴

Thus the “materially prejudicial” standard discussed above applies here as well, and the foregoing discussion is equally applicable when the mortgage and note are amended rather than refinanced by a replacement mortgage.¹⁰⁵

3. Refinancing by a Different Lender; Assignment or Subrogation

A third way in which a defaulting borrower may be able to retain title to the property is by refinancing with a different lender. Such transactions do not occur often, because a borrower who is already in default is obviously a credit risk and will likely have an impaired credit score.¹⁰⁶ Nonetheless, the borrower may find a willing lender. If one or more junior liens have attached to the property since the original loan was made, the refinancing lender would like to be able to “inherit” the priority of the original mortgage.¹⁰⁷

¹⁰² See generally *In re Payne*, 523 B.R. 560, 574–75 (Bankr. E.D. Tenn. 2014).

¹⁰³ But see *id.* at 574 (holding amendment of mortgage unnecessary if it contained a dragnet clause and modification consisted of an additional advance).

¹⁰⁴ RESTATEMENT (THIRD) OF PROP.: MORTG. § 7.3(b) (AM. LAW INST. 1997).

¹⁰⁵ See, e.g., *In re White*, 514 B.R. 365, 369 (Bankr. E.D.N.Y. 2014) (modification that reduced interest rate and monthly payments and deferred a portion of principal until maturity, did not materially prejudice junior lienor); *Acorn 420 Broadway LLC v. New England Phoenix Co.*, No. 13 MISC 478331, 2015 WL 2345641, at *8 (Mass. Land Ct. May 18, 2015) (material prejudice standard applies on a *pro tanto* basis, resulting in loss of priority to the extent of the prejudice).

¹⁰⁶ More commonly, the new lender is refinancing an original mortgage loan that is current at the time of the refinancing.

¹⁰⁷ See generally Philip Bond et al., *Does Junior Inherit? Refinancing and the Blocking Power of Second Mortgages*, 30 REV. FIN. STUD. 211, 213 (2017).

One way in which the refinancing lender could inherit the priority of the original mortgage is by taking a direct assignment of the original mortgagee's position through an assignment of the original mortgage documents (rather than a release of that mortgage).¹⁰⁸ Even without direct assignment of the original mortgage, however, the new lender could inherit the priority of the original mortgage through the principle of equitable subrogation. As the Restatement explains:

(a) One who fully performs an obligation of another, secured by a mortgage, becomes by subrogation the owner of the obligation and the mortgage to the extent necessary to prevent unjust enrichment. Even though the performance would otherwise discharge the obligation and the mortgage, they are preserved and the mortgage retains its priority in the hands of the subrogee.

(b) By way of illustration, subrogation is appropriate to prevent unjust enrichment if the person seeking subrogation performs the obligation: . . .

(4) upon a request from the obligor or the obligor's successor to do so, if the person performing was promised repayment and reasonably expected to receive a security interest in the real estate with the priority of the mortgage being discharged, and if subrogation will not materially prejudice the holders of intervening interests in the real estate.¹⁰⁹

Thus under the Restatement's view, the refinancing lender will receive the priority of the mortgage that was paid off if it reasonably expected to do so, and if granting that priority will not "materially prejudice" the position of intervening lienors.¹¹⁰ Courts that follow the Restatement generally have no difficulty in finding the necessary "reasonable expectation" of priority in a refinance by a new lender; hence, the remaining issue is whether changes in the terms of the new loan, as compared to the old one, are materially prejudicial to juniors¹¹¹—precisely the same test discussed above in connection with refinances and loan amendments by the original mortgagee.

¹⁰⁸ In New York, for example, when a refinancing occurs, the refinancing lender has traditionally taken an assignment of the original mortgage, so as to permit the borrower to avoid having to pay the New York mortgage tax associated with the amount being refinanced. *See, e.g.,* Lisa Prevost, *Reducing Refinancing Expenses*, N.Y. TIMES (May 23, 2013), <https://www.nytimes.com/2013/05/26/realestate/reducing-refinancing-expenses.html>).

¹⁰⁹ RESTATEMENT (THIRD) OF PROP.: MORTG. § 7.6(b)(4) (AM. LAW INST. 1997).

¹¹⁰ *See id.*

¹¹¹ *Am. Sterling Bank v. Johnny Mgmt. LV, Inc.*, 245 P.3d 535, 541 (Nev. 2010) (where original loan matured in fifteen years and refinance loan matured in six months, with large increase in monthly payments, court found material prejudice to junior lienor); *Bel Air & Briney v. City of Kent*, 358 P.3d

Under the Restatement, the refinancing lender's knowledge or notice of intervening liens is irrelevant to the availability of subrogation, but not all decisions follow the Restatement. One line of cases takes the view that subrogation should be denied if the refinancing lender has actual knowledge of the intervening liens.¹¹² Another, more rigid doctrine holds that even constructive notice, deriving from the fact that the junior liens are recorded in the public records, is sufficient to warrant denying subrogation.¹¹³ While both of these views are waning¹¹⁴ and the Restatement has gained considerable ascendance¹¹⁵ and seems obviously preferable,¹¹⁶ it has not yet won the day in all jurisdictions.

This means that in addition to worrying about the vagaries of application of the "material prejudice" standard discussed above, a lender who refinances another lender's loan without taking a direct assignment of the original mortgage must, in a number of jurisdictions, worry about exactly what version of the doctrine of equitable subrogation the court will apply. The only way for the refinance lender to eliminate this uncertainty entirely is to obtain written consent from any junior lienor acknowledging its subordinate

1249, 1253 (Wash. Ct. App. 2015), *review denied*, 366 P.3d 1243 (Wash. 2016) (material prejudice standard applied).

¹¹² See, e.g., *Vogel v. Veneman*, 276 F.3d 729, 735 (5th Cir. 2002) (Texas law); *Fishman v. Murphy ex rel. Estate of Urban*, 72 A.3d 185, 198 (Md. 2013); *Highmark Fed. Credit Union v. Wells Fargo Fin. S.D., Inc.*, 814 N.W.2d 814, 817 (S.D. 2012); *Indep. Nat'l Bank v. Buncombe Prof'l Park, LLC*, 741 S.E.2d 572, 576 (S.C. Ct. App. 2013). See NELSON, WHITMAN, BURKHART & FREYERMUTH, *supra* note 25, § 10:1 n.29 (collecting cases).

¹¹³ See, e.g., *In re Beltramo*, 367 B.R. 825, 831 (Bankr. D. N.M. 2007) (New Mexico law); *Ex parte Lawson*, 6 So. 3d 7, 13 (Ala. 2008) (constructive notice of mechanics' liens from visible construction on the property); *Mill Creek Lumber & Supply Co. v. First United Bank & Tr. Co.*, 278 P.3d 12, 17 (Okla. Civ. App. 2012); *Falk v. Fannie Mae*, 738 S.E.2d 404, 411 (N.C. Ct. App. 2013); NELSON, WHITMAN, BURKHART & FREYERMUTH, *supra* note 25, § 10:1 n.30 (collecting cases).

¹¹⁴ See *Wells Fargo Bank v. Simpson*, 36 N.E.3d 266, 284, *appeal denied*, 39 N.E.3d 1012 (Ill. 2015) (seeming to take the application of subrogation for granted); NELSON, WHITMAN, BURKHART & FREYERMUTH, *supra* note 25, § 10:1, at 942–43. Virginia adopted the Restatement view by statute, but with limitations. If the property is a single dwelling unit, the new mortgage does not exceed the old mortgage's balance by more than \$5,000 and does not have a higher interest rate than the old mortgage, and the intervening lien is a mortgage with an original balance not exceeding \$150,000, the old mortgage's priority is preserved. VA. CODE ANN. § 55–58.3 (2017).

¹¹⁵ *Bank of Am. v. Citizens Bank*, No. 14–cv–455–PB, 2015 WL 9305653 (D.N.H. Dec. 21, 2015) (same); *Bank of N.Y. Mellon v. Citibank*, 214 Cal. Rptr. 3d 504, 517 (Cal. Ct. App. 2017) (citing Restatement and holding refinancing lender's constructive notice of intervening lien does not disqualify it for subrogation); *AJJ Enters., LLP v. Jean-Charles*, 125 A.3d 618, 636–37 (Conn. Ct. App. 2015) (constructive notice of the intervening lien could be disqualifying in some circumstances, but was not here). See also NELSON, WHITMAN, BURKHART & FREYERMUTH, *supra* note 25, § 10:1 n.28 (collecting cases).

¹¹⁶ See Grant S. Nelson & Dale A. Whitman, *Adopting Restatement Mortgage Principles: Saving Billions of Dollars for Refinancing Homeowners*, 2006 B.Y.U. L. REV. 305, 355–65 (2006).

position.¹¹⁷ In sum, no matter what form a loan modification takes—whether an amendment to the original loan documents or a refinancing by the same or a different lender—there is often plenty of uncertainty as to whether the resulting mortgage will maintain priority over junior liens.

B. Resolution Resulting in Mortgagor's Loss of the Mortgaged Property

1. Foreclosure

The prototypical action by mortgage servicers in the face of an uncured default is, of course, foreclosure of the mortgage. Foreclosure is an invention of the English courts of equity and has ancient roots.¹¹⁸ The term stems from the concept of the equity of redemption—the right of a borrower to pay off the mortgage debt and thereby to redeem title to the land from the mortgage, despite the fact that payment is delinquent.¹¹⁹ Once the equity courts had established this right, it was necessary to put some time limit on it, so that a mortgagee would not have to wait indefinitely to see if the mortgagor would redeem. To accomplish this, the equity courts began to fix an outside date on which the redemption would have to be carried out, and failing which, that right of redemption would terminate (or literally be “foreclosed”).

Originally, foreclosure was “strict,” which meant that if redemption was not carried out by the foreclosure date, the mortgagee simply retained title to the property free and clear of the mortgage.¹²⁰ However, when English mortgage law was transplanted to the United States, strict foreclosure was widely regarded as unduly harsh.¹²¹ Most American jurisdictions adopted and continue to require foreclosure by auction sale instead.¹²² In this form of foreclosure, the property is auctioned to the highest bidder rather than having its title simply vested in the mortgagee. The proceeds of the sale are then paid to the mortgagee insofar as necessary to discharge the secured debt. Foreclosure by sale has the advantage, from the borrower's viewpoint, that it is possible for the highest bid at the sale to exceed the balance owing on the mortgage debt. If there are no junior liens on the property, this surplus is paid

¹¹⁷ Obviously, the refinancing lender is not going to obtain a subordination agreement from the intervening junior if the refinancing lender does not know the intervening junior lien exists.

¹¹⁸ See NELSON, WHITMAN, BURKHART & FREYERMUTH, *supra* note 25, § 1:3, at 7.

¹¹⁹ See *id.* §§ 1:2, 1:3.

¹²⁰ See *id.* § 1:3, at 7.

¹²¹ Connecticut and Vermont continue to use strict foreclosure. See *id.* § 7:12, at 602.

¹²² *Id.* § 1:4.

to the borrower and represents a return of the borrower's "equity" in the property.¹²³

Traditionally, American foreclosure was a judicially-supervised process.¹²⁴ The mortgagee filed a bill in equity to foreclose the mortgage and the borrower was entitled to file an answer, just as in any other civil lawsuit. If the factual allegations in the complaint were contested, the court would conduct a hearing and resolve the dispute. If the court found a proper legal basis for foreclosure—i.e., that the debt was valid and delinquent, was held by the mortgagee, and that the mortgage properly secured the debt and encumbered the real estate—the court would order a judicial sale, typically conducted by the sheriff as an officer of the court. The sheriff would distribute the proceeds, disbursing them to the foreclosing mortgagee up to the amount of the delinquent debt, and allocating any surplus first to junior lienors (if any) in descending order of their priority, and finally to the borrower.¹²⁵

This process is obviously complex, costly, and time-consuming.¹²⁶ It continues to be available in all American states, and is the usual mode of foreclosure in about half of them. In the other half of states, a statutory process known as nonjudicial foreclosure has supplanted judicial foreclosure as a practical matter. The details of nonjudicial foreclosure vary among the states recognizing it, but it typically involves giving a notice of default and election to foreclose to the borrower (or current owner of the property) and, in some states, to the holders of junior interests in the property.¹²⁷ If the default continues uncured after some grace period—commonly in the range of thirty days to six months—a notice of sale is issued to the borrower, and again, perhaps to junior interest holders. Assuming no cure or redemption

¹²³ See generally *id.* § 7:32 (discussing distribution of surplus).

¹²⁴ See *id.* § 1:4, at 8.

¹²⁵ *Id.* §§ 7:12, 7:17.

¹²⁶ See generally *An Overview of the Home Foreclosure Process*, FED. HOUSING FIN. AGENCY, <https://www.fhfaig.gov/Content/Files/SAR%20Home%20Foreclosure%20Process.pdf> (last visited Aug. 5, 2018).

¹²⁷ About half of the states recognizing nonjudicial foreclosure do not require notice of foreclosure to subordinate interest-holders. They include Alabama, the District of Columbia, Georgia, Maine, Michigan, Minnesota (unless the junior interest-holder is in possession; MINN. STAT. ANN. § 580.03 (2003)), Missouri, Nevada, New Hampshire, Rhode Island, Tennessee, Texas, Utah (although notice posted on the property may come to the attention of junior interest-holders in possession; UTAH CODE ANN. § 57-1-25(1)(b) (2003)), West Virginia (unless the junior interest-holder has notified the foreclosing creditor of the interest; W. VA. CODE § 38-1-4 (2003)), and Wyoming. In some of the jurisdictions mentioned, the absence of required notice is mitigated by the statutory right of any person, including the holder of a subordinate interest, to record a request for notice of the foreclosure of a particular security interest and thereby become entitled to receive one.

occurs,¹²⁸ the auction sale is conducted, either by the mortgagee or a trustee designated by the mortgagee, and the proceeds distributed in the same manner as in judicial foreclosure.

Whichever mode of foreclosure the mortgagee uses, the process is not cheap or quick.¹²⁹ As noted above, the process is usually handled by a servicer acting as the agent of the debtholder. There are a variety of expenses initially paid by the servicer but ultimately borne by the creditor (although the mortgagor is often obligated for these costs under the loan documents). If judicial foreclosure is used, the servicer will nearly always need to retain legal counsel; if the foreclosure is nonjudicial, the servicer will need to pay the fee of the trustee, lawyer, or other individual who conducts the auction.¹³⁰ A title examination will be necessary to determine the identity of the holders of any junior liens or other subordinate interests and to establish whether the original mortgagor is still the owner of the property. Notices must be mailed, as indicated above, and in most states the notice of sale must also be published in a newspaper—usually at a nontrivial cost.

Whether judicial or nonjudicial, the process is likely to take several months at a minimum.¹³¹ If judicial process must be used and the courts are crowded with other foreclosures, as they were in many states at the height of mortgage crisis in 2007–2010, it may take a great deal longer. If the borrower raises defenses, further time may be occupied with hearings and discovery, even if the defenses are ultimately shown to have no merit and the mortgagee completes the foreclosure. Even worse, in some states, statutes also grant the mortgagor a right of statutory redemption that permits the mortgagor (and perhaps junior lienors) to redeem the property for some period even after the foreclosure sale.¹³² Where such a redemption right exists, and where the borrower has not validly waived that right, it further extends the time before the mortgagee can obtain a marketable title for and liquidate the property. A study by the Federal Housing Finance Agency (FHFA) in 2013 showed that the average total time to obtain marketable title to a vacant home through foreclosure ranged from a low of 240 days (in Alabama and Missouri, two of

¹²⁸ In some nonjudicial foreclosure states, the borrower need not redeem in order to stop the foreclosure process, but need only cure the existing default, even though the loan has been accelerated. See NELSON, WHITMAN, BURKHART & FREYERMUTH, *supra* note 25, § 7:7, at 585. Section 22 of the standard Fannie Mae/Freddie Mac Uniform Instrument provides a thirty-day cure period. See *Security Instruments, FREDDIE MAC*, <http://www.freddiemac.com/uniform/unifsecurity.html> (last visited Aug. 5, 2018).

¹²⁹ There is also a broad consensus that foreclosure auctions consistently produce sub-market prices. See Grant S. Nelson & Dale A. Whitman, *Reforming Foreclosure: The Uniform Nonjudicial Foreclosure Act*, 53 DUKE L. J. 1399, 1417–25 & nn.91–107 (2004).

¹³⁰ See generally *id.*

¹³¹ *Id.* at 1404.

¹³² See *supra* notes 61–73 and accompanying text.

the states with the most rapid nonjudicial foreclosure timetables) to a high of 850 days (in New York, a judicial foreclosure state), with a national weighted average of 438 days.¹³³

In this context, time is money to the creditor. The property will often be vacant, abandoned by the borrower, and the mortgagee will need to secure it against vandalism and the elements. The mortgagee must maintain casualty insurance, the cost of which is unlikely to be paid by the borrower. Interest will continue to accrue on the unpaid debt. Property taxes must be paid to protect the priority of the mortgagee's lien. The creditor will also incur legal expenses and costs of sale. In a 2013 report, the FHFA estimated these collective costs to range from 1.12 basis points per day (in Puerto Rico) to 2.37 basis points per day (in Texas).¹³⁴ In theory, the mortgagee can add these expenses (up to the foreclosure sale date) to the secured obligation and collect them out of the foreclosure sale proceeds,¹³⁵ or from the borrower directly where the mortgagee has recourse against the borrower. However, if the property's value is "underwater" as compared with the loan balance and the borrower is judgment-proof, the mortgagee will have little hope of recovering these added costs.

Moreover, the foreclosure period described above is only the middle portion of a much longer time sequence. Most likely, the servicer will already have spent several months in collection efforts with the delinquent borrower before instituting foreclosure. And at the other end of the process, the likely result of the foreclosure is the vesting of title to the property in the creditor, since in most cases the servicer, acting on the creditor's behalf, is the successful bidder at the sale. But now it is the servicer's task to liquidate the property, which typically involves listing it with a real estate agent (thus generating another fee to be paid) and hoping for a successful and quick marketing period. Sadly, if foreclosure rates are high, the market is likely to

¹³³ *State-Level Guarantee Fee Analysis*, FED. HOUSING FIN. AGENCY 20 (Dec. 9, 2013), https://www.fhfa.gov/AboutUs/Reports/ReportDocuments/20131209_StateLevelGfeeAnalysis_508.pdf (Table 2); see also Lisa Prevost, *Paying for Foreclosure Delays*, N.Y. TIMES (Jan. 2, 2014), <https://www.nytimes.com/2014/01/05/realestate/paying-for-foreclosure-delays.html>.

¹³⁴ FED. HOUSING FIN. AGENCY, *supra* note 133, at 20. See also Larry Cordell, Liang Geng, Laurie Goodman & Lidian Yang, *The Cost of Delay 1* (Fed. Res. Bank of Phila., Working Paper No. 13-15, 2013), <https://www.philadelphiafed.org/-/media/bank-resources/publications/presentations/the-cost-of-delay.pdf>. These authors summarize their findings as follows: "The cost of delay, estimated by comparing today's time-related costs to those before the start of the financial crisis, is eight percentage points, with enormous variation among states. While costs are estimated to be four percentage points higher in statutory foreclosure states, they are estimated to be 13 percentage points higher in judicial foreclosure states and 19 percentage points higher in the highest-cost state, New York." *Id.*

¹³⁵ See RESTATEMENT (THIRD) OF PROP.: MORTG., § 2.2 (AM. LAW INST. 1997) (permitting the mortgagee to recover from the proceeds of foreclosure any expenditures that were reasonably necessary to protect the security).

be crowded with other similar properties, and it may take a long time indeed to find a buyer.

This grim story shows why mortgage investors usually consider foreclosure a costly, cumbersome, and inefficient process. However, there is a silver lining. The existence of junior liens on the property presents little or no problem to the foreclosing creditor. It is true that they add some minor expenses. A title examination is necessary to identify them, but it would be required in any event to verify the current ownership of the property.¹³⁶ Notices must be sent to them, along with the notices sent to the property's owner.¹³⁷ But the beauty of foreclosure is that, if the notices are properly served, the interests of any junior lienholders will be wiped out by the foreclosure proceeding, and title will vest in the foreclosure sale purchaser free and clear of them.¹³⁸

Thus, with all of its warts, foreclosure represents a sort of "gold standard" from the mortgage creditor's viewpoint in its treatment of junior liens. The holders of those liens have little power to interfere with the foreclosure process. Indeed, the senior creditor may view their presence in foreclosure as beneficial, because any junior lienholder can redeem its lien from the holder of the first mortgage—paying it off in full and thereby having the first mortgage rights assigned to itself by operation of law.¹³⁹ Of course, if the property's value is underwater with respect to the first mortgage, redemption by a junior lienor would be foolish. But if a junior does in fact redeem, the first mortgage holder will ordinarily be delighted, for it will recover its debt in full without the need to take title to the property and market it—the best of all possible worlds.

This protection against disruption by junior lienholders is surely one of the reasons that conventional foreclosure is so widely used. As we will show below, there are several alternatives to foreclosure that hold the promise of greatly reduced time and expense, but they do not offer the same sort of protection for the first mortgage creditor against interference by junior lienors.

¹³⁶ See generally *An Overview of the Home Foreclosure Process*, FED. HOUSING FIN. AGENCY, <https://www.fhfa.gov/Content/Files/SAR%20Home%20Foreclosure%20Process.pdf> (last visited Aug. 5, 2018).

¹³⁷ *Id.* at 10.

¹³⁸ See NELSON, WHITMAN, BURKHART & FREYERMUTH, *supra* note 25, § 7:13.

¹³⁹ See *id.* § 7:2.

2. Deed in Lieu of Foreclosure

Arguably, if loss of the mortgaged property is inevitable for the defaulting borrower, there is little point in forcing the creditor to go through the cumbersome process of foreclosure. Because the ultimate outcome of a foreclosure is a virtual certainty, the only purpose it serves for the borrower is delay. In effect, foreclosure provides a residential borrower with a minimum of several months—and in extreme cases, a year or more—of rent-free housing. If the borrower can raise some sort of colorable defense to foreclosure, this period can be extended even further. This may be advantageous to the borrower in many cases,¹⁴⁰ but it is not necessarily so. If the borrower has already moved from the premises or abandoned the property, or expects to do so soon, the delay is useless. Moreover, a foreclosure is likely to have a disastrous impact on the borrower's credit score and may delay very significantly the time when the borrower can obtain another home loan in the future.¹⁴¹

Thus, in a substantial proportion of cases, it makes sense for the borrower to offer to deed the property to the creditor voluntarily in lieu of going through the foreclosure process. The deed's effect on the borrower's credit score is likely to be less detrimental than an actual foreclosure.¹⁴² If the borrower insists, she or he can usually negotiate an agreement that the transaction will fully discharge the mortgage debt, thus avoiding the risk of a deficiency judgment against the borrower that accompanies a foreclosure in most states.¹⁴³ Sometimes the process of negotiating a deed in lieu will

¹⁴⁰ There is little doubt that in places where foreclosure delay is longer, strategic default is a more attractive option to borrowers. See Shuang Zhu & R. Kelley Pace, *The Influence of Foreclosure Delays on Borrowers' Default Behavior*, 47 J. MONEY, CREDIT & BANKING 1205 (2015).

¹⁴¹ See *Real Estate Short Sale: What Is It and How Does It Effect My Credit*, PRACTICAL LIST, <http://practicallist.com/real-estate-short-sale> (last visited Aug. 5, 2018).

¹⁴² See *id.* (indicating that the impact on credit score is lessened if the borrower has been able to obtain a waiver of liability for the deficiency). The data in this source, provided by Fair Isaac Corp., suggest that the negative impact of a foreclosure on one's FICO score is typically about thirty-five points more severe than a short sale or deed in lieu. However, there are numerous credit scores in use in addition to FICO, and they may vary with respect to the impact of a foreclosure as compared to a deed in lieu or short sale.

¹⁴³ The cases are divided as to whether a deed in lieu will automatically bar the mortgage creditor from pursuing a deficiency judgment. Compare *In re Johnson*, 371 B.R. 336, 341 (Bankr. C.D. Ill. 2007) ("the acceptance of the deed in lieu of foreclosure does not extinguish the mortgage debt, but does bar the mortgagee from obtaining or enforcing a deficiency judgment"), and *Olney Tr. Bank v. Pitts*, 558 N.E.2d 398, 403–04 (Ill. App. Ct. 1990) (holding lender prohibited from pursuing an action for a deficiency judgment), with *Nash Finch Co. v. Corey Dev., Ltd.*, 669 N.W.2d 546 (Iowa 2003) (lender could obtain deficiency judgment after accepting deed in lieu), and *Morrison v. Christie*, 266 S.W.3d 89 (Tex. Ct. App. 2008) (same). A well-advised borrower will eliminate this issue by obtaining a cancellation of the promissory note or a covenant not to sue from the creditor.

even result in a modest payment from the lender to the borrower to help defray the borrower's costs of vacating the property.

From the creditor's viewpoint, the deed in lieu of foreclosure has advantages as well. It provides a much quicker way of obtaining title to the real estate than foreclosure with less uncertainty and lower legal expenses. Because the parties are dealing face-to-face in a collaborative mode and the time is shortened, the deed in lieu reduces the risk of the borrower neglecting the property, or of the borrower or third parties vandalizing it.¹⁴⁴

Thus, the deed in lieu of foreclosure seems to make good sense to both parties,¹⁴⁵ and it is perhaps surprising that it does not occur more frequently. During the mortgage crisis this was partly due to structural reasons; servicers often were not sufficiently knowledgeable and well-staffed to work out deeds in lieu with their borrowers. But there is also a legal reason that deeds in lieu are problematic: the presence of junior liens. If the property is subject to a lien subordinate to the mortgage that is in default, as a practical matter a deed in lieu will be accepted only if the junior lienholder consents.¹⁴⁶

Stated simply, a deed in lieu of foreclosure is not the equivalent of a foreclosure. As we have seen, a proper foreclosure sale has the effect of delivering to the foreclosure sale purchaser title of the same quality as existed on the date that the mortgagor granted the mortgage being foreclosed.¹⁴⁷ Thus, the proper foreclosure of a first priority lien will eliminate all junior liens and permit the foreclosure purchaser to take clear title to the property. By contrast, a deed in lieu of foreclosure has no such inherent title-clearing effect. A voluntary deed in lieu transfers to the mortgagee the mortgagor's title as it exists on the date the mortgagor delivers the deed in lieu.¹⁴⁸ Thus, the grantee of the deed in lieu takes title subject to the mortgagee's own lien as well as any junior liens then in existence, which continue to encumber the property.¹⁴⁹

¹⁴⁴ The lender may require the borrower to attempt to market the property by listing it with a real estate agent for several months before the lender will consider a deed in lieu; see *Deed in Lieu*, BANK OF AM., <https://homeloanhelp.bankofamerica.com/en/deed-in-lieu.html> (last visited Aug. 5, 2018), for Bank of America's requirements in this regard. The deed in lieu may be especially helpful if the mortgage cannot be foreclosed immediately—for example, because of the limitations of the Servicemembers' Civil Relief Act of 1940, 50 U.S.C. § 501 *et seq.* (2018), or because the mortgagor has died and his estate is not yet in administration.

¹⁴⁵ The deed must be a voluntary act of both parties; the borrower cannot force the creditor to accept a deed in lieu. See, e.g., *In re Phillips*, 368 B.R. 733 (Bankr. N.D. Ind. 2007); *Martin v. Uvalde Sav. & Loan Ass'n*, 773 S.W.2d 808 (Tex. Ct. App. 1989).

¹⁴⁶ NELSON, WHITMAN, BURKHART & FREYERMUTH, *supra* note 25, § 7:13.

¹⁴⁷ *Id.* at 607–08.

¹⁴⁸ *Id.*

¹⁴⁹ *Id.* § 6:19, at 553 n.358.

Obviously most potential purchasers of the property from the lender have no desire to take it subject to such liens. Of course, the servicer or a later grantee can foreclose against the junior lienor in order to clear the title of the lien.¹⁵⁰ But the necessity of doing so defeats the whole purpose of using a deed in lieu in the first place in terms of speed and cost.

Overall, then, the existence of junior liens acts as a substantial impediment to the otherwise attractive practice of using deeds in lieu of foreclosure. American real property law provides no solution to this problem, although as discussed in Part V, a solution may become available by virtue of a new model act recently approved by the Uniform Law Commission.

3. Short Sale

A second technique for terminating a mortgage in default without the necessity of foreclosure is the short sale.¹⁵¹ In such a transaction, the mortgage creditor agrees to permit the borrower to sell the property and remit the proceeds to the creditor in full satisfaction of the debt, despite the fact that the sum remitted is less than a full payoff of the outstanding balance. The amount paid is “short” of the full balance, but is accepted as full payment.

¹⁵⁰ Unfortunately, a few cases have held that the delivery of the deed in lieu to the creditor causes a merger of the mortgage and the fee title, thus eliminating the mortgage as a separate entity and making foreclosure against the junior lien impossible. *See, e.g.,* Janus Props., Inc. v. First Fla. Bank, 546 So. 2d 785 (Fla. Ct. App. 1989) (where mortgagee recorded a satisfaction of the mortgage after accepting a deed in lieu, the mortgage could not thereafter be foreclosed); NELSON, WHITMAN, BURKHART & FREYERMUTH, *supra* note 25, § 6:19. But the great majority of modern cases reject the merger doctrine in this context, or accept it only if there is affirmative evidence that the mortgagee intended a merger. *See* F.D.I.C., as Liquidating Agent of New England Allbank for Sav. v. Holden, No. CIV. 92-455-JD, 1994 WL 263691, at *5 (D.N.H. Jan. 26, 1994) (merger will not be found where it would inequitably promote the priority of a junior lien); *In re* Estate of Ozier, 587 N.E.2d 77, 80 (Ill. App. Ct. 1992) (in absence of contrary evidence, an intent not to merge is presumed); Gruenzner v. Hickok, No. A12-0169, 2012 WL 3641354, at *4 (Minn. Ct. App. Aug. 27, 2012) (evidence both for and against an intent to merge; trial court’s finding of no merger upheld); Congregation Beth Medrosh of Monsey, Inc. v. Rolling Acres Chestnut Ridge, LLC, 956 N.Y.S.2d 95, 98 (N.Y. App. Div. 2012) (merger is disfavored and will not be found where it would unjustly enrich a junior lienor); Miller v. Martineau & Co., C.P.A., 983 P.2d 1107, 1113 (Utah Ct. App. 1999) (if intervening liens exist, no merger will be found absent contrary evidence); Ennis v. Finanz Und Kommerz-Union Etabl., 565 So. 2d 374, 375 (Fla. Dist. Ct. App. 1990) (“absent manifestations of an intention by [the mortgagee] that there be a merger, none occurs”). To avoid the merger problem, wise mortgagees always include anti-merger language in their deeds in lieu. For cases finding no merger in deference to such clauses, see PNC Bank v. Philben, Inc., No. CIV. A. 96L-02-005, 1997 WL 717786, at *1 (Del. Super. Ct. Oct. 1, 1997); Clark v. Fed. Land Bank, 423 N.W.2d 220, 222 (Mich. Ct. App. 1988); GBJ, Inc., II v. First Ave. Inv. Corp., 520 N.W.2d 508, 511 (Minn. Ct. App. 1994). In a few states, statutes expressly authorize the holder of a mortgage to foreclose against a junior lien after accepting a deed in lieu of foreclosure; *see* 735 ILL. COMP. STAT. § 5/15-1401 (2018); TEX. PROP. CODE ANN. § 51.006 (2017). But if the common law is properly understood, such statutes are unnecessary.

¹⁵¹ *See supra* note 4.

From the viewpoint of both borrowers and creditors, the advantages of a short sale are similar to those of a deed in lieu of foreclosure. The borrower can continue to occupy the property until the sale is completed. The process avoids the embarrassment of a foreclosure and carries less credit stigma.¹⁵² The lender benefits from a potentially speedier process as compared to foreclosure, has greater confidence that the borrower will maintain and care for the property in order to maximize the chances of the sale being consummated, and likely can expect a higher sale price through a short sale as contrasted with a foreclosure sale.¹⁵³

Short sales are finicky and can be challenging to arrange, as they require the concurrence of the seller, the buyer, the creditor, and any mortgage insurer.¹⁵⁴ The creditor may demand a Broker's Price Opinion (BPO) or an appraisal; the creditor is naturally concerned that the agreed price approximate the best possible price and does not wish to leave money "on the table."¹⁵⁵ The creditor is also concerned that the broker's commission and other closing costs be reasonable. As with the deed in lieu, a well-advised borrower will attempt to negotiate a release from liability for any deficiency.¹⁵⁶ It may require considerable effort on the part of all of the parties to reach agreement on these matters.

In one respect, the short sale is even better for the creditor than a deed in lieu or a foreclosure. Because the short sale provides liquid funds to the creditor, the creditor has no need to undertake any marketing effort, nor to pay the carrying costs of the property while waiting for it to sell. For this reason short sales, despite their challenges, can be very attractive to a creditor that wishes to avoid foreclosure.

However, like the deed in lieu of foreclosure, a short sale is not a foreclosure and does not eliminate subordinate liens.¹⁵⁷ A title examination is necessary to discover whether such liens exist. If they do, it is necessary to obtain their holders' consent or buy them out, even if they are valueless.¹⁵⁸

¹⁵² See Elizabeth Weintraub, *How a Foreclosure or Short Sale Affects Credit*, BALANCE (Sept. 10, 2017), <https://www.thebalance.com/how-a-short-sale-or-a-foreclosure-affects-credit-1798177>.

¹⁵³ See, e.g., Zhang, *supra* note 4 (finding that homes selling by short sale transact at 9.2–10.5% higher prices on average than those selling through foreclosure).

¹⁵⁴ See Vacco, *supra* note 4, at 40.

¹⁵⁵ *Id.*

¹⁵⁶ California, by statute, prohibits a deficiency judgment after a short sale. CAL. CIV. PROC. CODE § 580e (2011). An Arizona court assumed that the state's anti-deficiency statute would apply to short sales. See *Tanque Verde Anesthesiologists L.T.D. Profit Sharing Plan v. Proffer Grp., Inc.*, 836 P.2d 1021 (Ariz. Ct. App. 1992).

¹⁵⁷ See NELSON, WHITMAN, BURKHART & FREYERMUTH, *supra* note 25, §§ 6:20, :21.

¹⁵⁸ For example, Fannie Mae and Freddie Mac will approve up to \$6,000 in payments to buy out junior liens. See *Servicing Guide Announcement: Standard Short Sale/HAF A II and Deed-in-Lieu of Foreclosure Requirements*, FANNIE MAE 11 (Aug. 22, 2012),

Hence, junior liens can act as a serious hindrance to the implementation of a successful short sale.

IV. THE “JUNIOR LIEN PROBLEM”: JUNIOR LIEN AS AN IMPEDIMENT TO RESOLVING MORTGAGE DEFAULT OTHER THAN BY FORECLOSURE

As Part III noted, the presence of one or more junior liens complicates the ability of a senior lienholder to resolve mortgage default through a process other than foreclosure. The methods aimed at loan modification—an amendment to the promissory note, or the refinancing of the debt by the current loan’s holder or by a new lender—may not clearly preserve the senior mortgagee’s expected priority vis-à-vis junior liens. Given judicial uncertainty over the meaning of “material prejudice” and the circumstances under which material prejudice exists, the result is simply uncertain. To be certain of obtaining its expected security, the senior mortgagee must negotiate for and obtain the junior’s consent to the modification and an acknowledgment by the junior of the expected parameters of the senior’s priority. If the junior lienor is cooperative, the senior mortgagee may be able to obtain this agreement, but only after incurring transaction costs that the senior either has to absorb itself or pass through to the borrower. If the junior lienor is uncooperative, the senior mortgagee must decide whether to modify the loan anyway—and risk a potential loss of priority—or refuse, at which point the borrower loses the benefits of an otherwise desirable loan modification.

In the loan modification context, these disruption and transaction costs may be relatively modest (though they are not trivial).¹⁵⁹ In the context where the borrower gives up the home, however, the calculus changes dramatically. As Part III also noted, the presence of junior liens is the most common legal barrier to deeds in lieu and short sales, as such transactions do not have title-clearing effect without junior lienholder consent.¹⁶⁰ If the junior’s lien is supported by equity (i.e., if the unencumbered fair market value of the

<https://www.fanniemae.com/content/announcement/svc1219.pdf>. Likewise, under the HAFA program, the loan’s holder could allow up to \$12,000 from the home’s sale price to pay junior liens. See *Bank of America Home Affordable Foreclosure Alternative (HAFA) Matrix*, MAKING HOME AFFORDABLE, https://www.makinghomeaffordable.gov/Documents/HAFA/HAFA-policies_Bank-of-America.pdf (last visited Aug. 12, 2018).

¹⁵⁹ To be completely safe, a prudent refinancing or modifying lender would require an inter-creditor agreement with any intervening lienholders. At a minimum, the agreement would include the intervening lienholders’ agreement to subordinate their liens to the extent expected by the refinancing/modifying lender. Even in a residential transaction, the negotiation, preparation, and execution of such an agreement would involve transaction costs that ultimately will be borne by the borrower.

¹⁶⁰ See *supra* notes 140–58 and accompanying text.

mortgaged property exceeds the senior debt), it is entirely appropriate that the junior should have an effective veto power over a transaction that would extinguish its lien—other than a foreclosure by the senior, which the junior could easily avoid by paying off the senior debt.

During housing market declines like those experienced during the period between 2007 and 2010, however, it becomes more likely that the balance owed on a defaulted first mortgage will exceed the property's unencumbered fair market value. In this situation, a junior lien has no economic value. If the first mortgagee conducted a foreclosure sale, the sale proceeds would not be sufficient to pay off the first mortgage in full, much less to pay anything on account of the debt nominally secured by the junior lien.¹⁶¹ The economic worthlessness of the underwater junior lien demonstrates why the Bankruptcy Code permits a reorganizing debtor in Chapter 11 or Chapter 13 to invalidate any junior lien that is not supported by any value in excess of the balance due on prior encumbrances.¹⁶² This reflects that the benefits to be gained by the debtor's rehabilitation outweigh any benefit that might ordinarily attach to allowing a junior to assert the leverage offered by its lien. But in our modern system of mortgage foreclosure, as noted earlier, extinguishing an underwater junior lien takes significant time¹⁶³ and results in significant transaction costs.¹⁶⁴ A timely deed in lieu or short sale would permit the lender to mitigate many of these delay and transaction costs, either in full or in significant part. In this context, a junior lien that ought to be valueless instead acquires nontrivial nuisance or leverage value.¹⁶⁵

Consider an example typical of many distressed loans in the post-2007 era. Borrower owns a home subject to a first mortgage held by First Bank (securing a debt of \$300,000) and a second mortgage held by Second Bank (securing a debt of \$50,000). The home's value is only \$240,000, as reflected by a short sale proposal from Purchaser. Expenses of the proposed short sale (including Borrower's brokerage commission) will be \$15,000. First Bank

¹⁶¹ NELSON, WHITMAN, BURKHART & FREYERMUTH, *supra* note 25, § 7:32 (discussing distribution of sale proceeds).

¹⁶² *See supra* note 78.

¹⁶³ *See supra* note 133 and accompanying text.

¹⁶⁴ *See supra* note 134 and accompanying text.

¹⁶⁵ *See, e.g.*, Christopher J. Mayer, Edward R. Morrison & Tomasz Piskorski, *A New Proposal for Loan Modifications*, 26 YALE J. REG. 417, 419 (2009) (“[B]y delaying, the second-lien lender might convince the first-mortgage servicer to ‘buy out’ the second lien at a price above its true value. This is often called a ‘hold-up’ problem.”); Leventis, *supra* note 13, at 4 (noting junior lienors act as “roadblocks” to the handling of distressed loans); Donghooon Lee, Christopher J. Mayer & Joseph Tracy, *A New Look at Second Liens* 4 (Nat’l Bureau of Econ. Research, Working Paper No. 18269, 2012), <http://www.nber.org/papers/w18269> (noting second liens represent a serious public policy challenge to the extent that second lienholders block refinancing programs such as HARP by refusing to agree to re-subordinate to refinanced first lien).

agrees that it will release its lien and waive any deficiency claim against Borrower in exchange for payment of the \$225,000 of net sale proceeds. The home is in Florida, however, where the expected time to foreclosure is nearly two years—and during which time First Bank might incur \$20,000 or more in delay-associated costs (which it is unlikely to recover from either the home or Borrower).¹⁶⁶ As a result, when Borrower seeks a release from Second Bank to facilitate the short sale, Second Bank responds that it will release its lien only if Borrower agrees to pay Second Bank \$10,000 from the net sale proceeds. Borrower does not have an additional \$10,000 in cash to pay Second Bank's demanded ransom; Purchaser will not agree to pay an additional \$10,000 not justified by the home's market valuation; Broker will likely have no interest in reducing its commission by \$10,000; and First Bank—having already agreed to forgo a \$75,000 deficiency judgment to facilitate the sale at the current terms—will not agree to diminish its share of the sale proceeds further.¹⁶⁷ As a result, the short sale agreement fails, increasing the ultimate likelihood that Borrower will end up facing a foreclosure sale by First Bank (and, in many states, potential liability for a deficiency judgment).

Liens are property interests, so leverage is an intrinsic aspect of holding any lien. As others have noted, the junior lienholder in effect holds a type of option on the mortgaged property.¹⁶⁸ Even if a junior lien is underwater, as long as the lien remains effective, the value of the mortgaged property could increase in value to the point that the junior lien may once again meaningfully secure repayment of some or all of the unpaid debt. For this reason, Second Bank might argue that its conduct—demanding a \$10,000 ransom as a price for releasing its option, even though its lien presently has no market value—is both rational and normatively justified. In other words, Second Bank might say that there is no “junior lien problem.” There are several problems with this position, however.

First, as Part II explained, our existing residential mortgage market prevents a senior mortgage lender from contracting for protection against this risk. In a perfectly free market, the senior mortgagee could gain protection from this risk by including in the senior mortgage a due-on-encumbrance clause and enforcing that clause in the event that a junior lien arises without

¹⁶⁶ This estimate of delay and transaction costs derives from the FHFA's data. See *supra* notes 133–34 and accompanying text.

¹⁶⁷ Of course, in some individual cases one or more of the parties might make additional financial concessions, but it would be understandable and typical if all refused to do so.

¹⁶⁸ See Levitin & Wachter, *supra* note 43, at 1272–86; Vickie Been, Howell Jackson & Mark Willis, *Sticky Seconds—The Problems Second Liens Pose to the Resolution of Distressed Mortgages*, 9 N.Y.U. J.L. & Bus. 71, 98 (2012).

the senior's consent. It is true that an enforceable due-on-encumbrance clause in the senior mortgage would not avoid the risk of undesired junior liens completely; a junior lien could arise without the senior's consent involuntarily (e.g., another creditor obtains a judgment lien) or even voluntarily (e.g., the mortgagor and the junior mortgagee decide to take the risk that the nonconsenting senior will choose not to accelerate the debt and proceed to foreclosure).¹⁶⁹ Nevertheless, to the extent that a senior could bargain for and enforce a due-on-encumbrance clause, it would surely discourage lenders from voluntarily taking junior lien positions without the senior's consent. It would also increase the senior's leverage to obtain an inter-creditor agreement that could limit the junior's ability to exercise the leverage effect to the senior's detriment.¹⁷⁰ However, as Part II explained, the Garn Act prohibits the senior residential mortgagee from exercising a due-on-encumbrance clause.¹⁷¹ The Garn Act thus effectively permits the mortgagor to create a junior lien (and its associated leverage risk) without the consent of the senior mortgagee and without permitting the senior to protect itself against this risk contractually (other than by pricing that risk into the senior interest rate in the first instance).¹⁷²

Second, in a market where the junior lien is underwater, the junior's exercise of the leverage effect is extortionate because the costs of the foreclosure process in that instance are entirely external to the junior.¹⁷³ If the

¹⁶⁹ A senior mortgagee might attempt to prevent this through the use of a disabling restriction (under which any attempt by the mortgagor to create a junior lien is void) or a forfeiture restriction (under which any attempt by the mortgagor to create a junior lien would result in the forfeiture of the mortgagor's interest). However, while the Garn Act establishes the reasonableness and validity of a due-on-encumbrance clause, it does not validate either disabling or forfeiture restrictions, and courts might be more willing to characterize a disabling or forfeiture restraint as an unreasonable restraint on alienation and thus invalid. *See, e.g.*, RESTATEMENT (FIRST) OF PROP. § 405 (AM. LAW INST. 1944) ("Disabling restraints, other than those imposed on equitable interests under a trust, are invalid."); *Id.* § 406 (forfeiture restraint valid only if it is "qualified so as to permit alienation to some though not all possible alienees" and "is reasonable under the circumstances").

¹⁷⁰ To preserve its position, the junior either would have to enter into an inter-creditor agreement with the senior (and likely bear the cost of negotiating it) or redeem its position by paying off the balance of the senior debt. *See* Patrick Cleary, *Intercreditor Agreements*, ALEXANDER HOLBURN: BUS. L. BLOG (May 3, 2012), <http://businesslawblog.ahbl.ca/2012/05/03/intercreditor-agreements/>.

¹⁷¹ *See supra* notes 17–43 and accompanying text.

¹⁷² *See* 12 U.S.C. § 1701j–3 *et seq.* (2018). To the extent that the senior adjusts by pricing this into first mortgage interest rates, of course, it creates a potentially undesirable cross-subsidy in which homeowners without second mortgages are effectively subsidizing the debt service costs of homeowners with second mortgages.

¹⁷³ *See, e.g.*, Been, Jackson & Willis, *supra* note 168, at 97 ("The second lien holder may be more likely to underinvest in or block cooperative approaches to a modification or other efficient resolution of a distressed mortgage. Some of the costs of doing so—such as the consequences of foreclosure—are born by the first lien holder or by others who are not involved in the transaction, such as the neighbors of the property. On the other hand, the benefits of modifying a delinquent mortgage accrue to the borrower,

junior demands an excessive ransom that “craters” an otherwise beneficial deed in lieu or short sale and a foreclosure of the senior mortgage results, the additional costs associated with that foreclosure fall on the mortgagor (i.e., loss of the home and potentially continued deficiency risk),¹⁷⁴ the senior mortgagee (i.e., additional transaction and delay costs, unlikely to be recovered, and a likely foreclosure sale discount relative to a frustrated short sale),¹⁷⁵ neighboring landowners (i.e., property values that are diminished by proximity to the foreclosed property),¹⁷⁶ and the local community as a whole (i.e., diminished property tax collections resulting from reduced property values and other social costs associated with vacant housing).¹⁷⁷ The desire to avoid these costs explains why the federal government’s foreclosure

neighbors, and the economy as a whole, not necessarily the holder of a second lien.”)

¹⁷⁴ Julie Forrester has also argued that because bankruptcy law gives substantial protection to junior mortgage lenders, such as the potential benefit of the anti-modification rule discussed *supra* note 78, the presence of junior liens on home mortgages may inappropriately discourage deserving borrowers from seeking bankruptcy protection. Forrester, *supra* note 78, at 427–32 (discussing tendency of many homeowners to encumber their homes with junior liens to pay or consolidate unsecured debts rather than filing for bankruptcy).

¹⁷⁵ See Zhang, *supra* note 4, at 17 (noting a 9.2% transaction discount between homes selling in foreclosure sales and homes selling via short sales).

¹⁷⁶ As others have explained, housing prices are both spatially and serially correlated; a decline in the value of an inadequately maintained house will tend to reduce the value of neighboring houses. Because borrowers often cease maintaining mortgaged properties in foreclosure, foreclosures tend to have spillover effects on neighboring parcels, and these effects increase in neighborhoods with multiple foreclosed properties. See, e.g., Vicki Been, Jenny Schuetz & Ingrid Gould Ellen, *Neighborhood Effects of Concentrated Mortgage Foreclosures*, 17 J. HOUSING ECON. 306, 317 (2008); John Y. Campbell et al., *Forced Sales and House Prices*, 101 AM. ECON. REV. 2108, 2130 (2011); John P. Harding et al., *The Contagion Effect of Foreclosed Properties*, 66 J. URBAN ECON. 164, 177 (2009); Dan Immergluck & Geoff Smith, *The External Costs of Foreclosure: The Impact of Single-Family Mortgage Foreclosures on Property Values*, 17 HOUSING POL’Y DEBATE 57, 69 (2006); Zhengou Lin et al., *Spillover Effects of Foreclosures on Neighborhood Property Values*, 38 J. REAL EST. FIN. & ECON. 387, 388–89 (2009). See also Levitin & Wachter, *supra* note 43, at 1251–52 (“Several studies have found that home sale prices decline an average of 1% for each nearby foreclosure (usually within 0.1 miles).”); Zhang, *supra* note 4, at 19 (“Each foreclosure sale decreases nearby home prices by up to 0.6% after the foreclosure sale itself, and this negative foreclosure externality does not disappear even one and a half years after the foreclosure sale itself. On the other hand, the short sale externality is almost nonexistent.”).

¹⁷⁷ To the extent that foreclosures in an underwater market diminish the property values of other homeowners, then it likewise (as revaluation occurs) diminishes the local tax base and thus property tax collections. See, e.g., James Alm, Robert D. Buschman & David L. Sjoquist, *Foreclosures and Local Government Revenues from the Property Tax: The Case of Georgia School Districts*, 46 REGIONAL SCI. & URB. ECON. 1 (2014) (increase in home foreclosures from 2006–2011 caused 3% decrease in property tax base); Ann M. Burkhart, *Fixing Foreclosure*, 36 YALE L. & POL’Y REV. 315 (2018); Keith Ihlanfeldt & Tom Mayok, *Foreclosures and Local Government Budgets*, 53 REGIONAL SCI. & URB. ECON. 135, 145 (2015) (empirical study of foreclosures in fifty-five Florida counties; finding that foreclosures reduced tax base by 1.65% and diminished tax revenue by over \$5,000 for each foreclosure).

mitigation efforts include significant payment incentives to junior lienholders to facilitate short sales or deed in lieu transactions.¹⁷⁸

Finally, agency problems in the residential mortgage servicing market further compromise the efficient resolution of distressed mortgage loans other than by foreclosure. These agency problems take predominantly two forms. First, compensation schemes for the servicer of the first mortgage have tended to favor foreclosure of a defaulted mortgage rather than modification:

Servicers have no stake in the performance of mortgage loans, so they do not share investors' interest in maximizing the net present value of the loan. Instead, a servicer's decision whether to foreclose or modify a loan is based on its own cost and income structure, which is skewed toward foreclosure.¹⁷⁹

Thus, as Professor Been has noted, because second liens add to the transaction costs a servicer must bear to modify a first mortgage loan, "second liens exacerbate the gap between a servicer's own interests and the interests of the principal."¹⁸⁰ Second, and more significantly, the entity servicing the first mortgage is also frequently the same entity (or an affiliate of the same lender) holding the junior lien position.¹⁸¹ In this situation, the

¹⁷⁸ See *supra* note 121 (discussing governmental short sale and deed in lieu of foreclosure requirements). See also Levitin & Wachter, *supra* note 43, at 1265 n.49 (discussing 2MP Second Lien Modification Program); *Second Lien Modification Program (2MP): Overview*, HOME AFFORDABLE MODIFICATION PROGRAM, https://www.hmpadmin.com/portal/programs/second_lien.jsp (last visited Aug. 5, 2018). Some have posited that junior lienholders and junior lien servicers may have strategically refused to cooperate with deed in lieu and short sale proposals to increase the likelihood that government actors would introduce these subsidies for junior lienholder cooperation. See, e.g., Been, Jackson & Willis, *supra* note 168, at 98–99 (“[S]econd lien holders may hope the government will introduce programs that will require other parties (such as taxpayers) to bear some of the costs of any workout. That expectation may lead to moral hazard: a second lien holder will be more likely to take the risk that its delay in working with the first lien holder to reduce the borrower's distress will render the second lien worthless if it believes that delay may allow it to take advantage of subsidies that might become available.”); James Kwak, *Underwater Second Liens*, BASELINE SCENARIO (Mar. 13, 2010), <https://baselinescenario.com/2010/03/13/underwater-second-liens/> (“In practice, the second liens do have some small value, based on three things: (1) the hope that some borrowers will continue to make payments on second liens, even though would do better (financially) to walk away; (2) option value, since housing prices could rise enough to make the second liens worth something; and (3) the possibility that the government will start paying off second lienholders to stop blocking short sales.”).

¹⁷⁹ Levitin & Twomey, *supra* note 1, at 1; see also Been, Jackson & Willis, *supra* note 168, at 100 (“foreclosure allows the servicer to minimize its out of pocket costs and to recover quickly any advances it has to make to cover the shortfall to investors when a borrower is delinquent”); Diane E. Thompson, *Foreclosing Modifications: How Servicer Incentives Discourage Loan Modifications*, 86 WASH. L. REV. 755 (2011).

¹⁸⁰ Been, Jackson & Willis, *supra* note 168, at 100.

¹⁸¹ The phenomenon clearly exists, but its precise frequency is unclear. While some have asserted that

servicer's incentives are also skewed; for example, the servicer may urge modification of the senior debt so as to preserve its junior lien position when a deed in lieu or short sale might provide a more appropriate resolution.¹⁸² Alternatively, the servicer may refuse an otherwise appropriate modification of the senior debt so as to avoid any appearance of self-dealing.¹⁸³

As long as mortgage law continues to allow the creation of junior mortgages and disempowers the senior home mortgagee to protect itself contractually from a junior's inefficient exercise of its leverage, we will continue to have what we are calling "the junior lien problem," i.e., junior liens will continue to complicate resolution of distressed senior mortgages other than by foreclosure. What is needed—but what standard mortgage law has not previously provided—is a way for a borrower to deliver a deed in lieu or short sale deed that will wipe out the liens of underwater and uncooperative junior lienholders. We now turn to a new model law that would accomplish that result.

V. THE MODEL NEGOTIATED ALTERNATIVE TO FORECLOSURE ACT

The concept of a deed in lieu of foreclosure with title-clearing effect is not revolutionary. In fact, the concept has featured prominently in UCC Article 9's default remedies structure—where it is known as "strict foreclosure"—for more than five decades already.¹⁸⁴

A. *The Precursor: Article 9 Strict Foreclosure*

A strict foreclosure is a trade under which the secured party acquires the debtor's rights in the collateral without the normal foreclosure process¹⁸⁵ in

over half of all second liens are held by the servicer of the first lien, *see* Been, Jackson & Willis, *supra* note 168, at 100, this number seems quite high. In congressional testimony in 2010, then JPMorgan Chase Home Lending CEO David Lowman stated that "[a]bout 10 percent of Chase's total serviced portfolio of first lien mortgage loans has a Chase-owned second lien." *Second Liens and Other Barriers to Principal Reduction as an Effective Foreclosure Mitigation Program: Hearing Before the H. Comm. on Fin. Servs.*, 111th Cong. 5 (2010) (statement of David Lowman, Chief Executive Officer for Home Lending, JPMorgan Chase).

¹⁸² Sumit Agarwal, Gene Amromin, Itzhak Ben-David, Souphala Chomsisengphet & Yan Zhang, *Holdup by Junior Claimholders: Evidence from the Mortgage Market* (Nat'l Bureau of Econ. Research, Working Paper No. 20015, 2014), <https://www.nber.org/papers/w20015> ("We show that servicers are less likely to act on the first lien mortgage owned by investors when they themselves own the second lien claim secured by the same property. When they do act, such servicers' choices are skewed towards actions that maximize the value of their junior claims, favoring modification over liquidation and short sales and deeds-in-lieu over foreclosures.")

¹⁸³ Been, Jackson & Willis, *supra* note 168, at 96–97; Levitin & Wachter, *supra* note 43, at 1265.

¹⁸⁴ U.C.C. § 9–620(a), cmt. 2 (AM. LAW INST. & UNIF. LAW COMM'N 2010).

¹⁸⁵ WILLIAM H. LAWRENCE, WILLIAM H. HENNING & R. WILSON FREYERMUTH, UNDERSTANDING

exchange for (where the debtor is a consumer) satisfaction of the underlying debt.¹⁸⁶ The secured party is then free to use or dispose of the collateral as it wishes, without regard to the provisions that would govern an Article 9 foreclosure sale.

A secured party initiates a strict foreclosure by making a “proposal” that sets forth the terms on which the secured party will accept the collateral satisfaction of the debt,¹⁸⁷ and by providing notice of the proposal to all persons who would have been entitled to notification prior to an Article 9 foreclosure sale.¹⁸⁸ If the secured party receives a timely objection from anyone receiving the proposal or from a person holding a subordinate interest in the collateral, the secured party cannot use strict foreclosure.¹⁸⁹ If the secured party does not receive a timely objection, the debtor’s rights in the collateral become vested in the secured party, and the secured party’s interest—and any subordinate liens—are extinguished.¹⁹⁰ The strict foreclosure process thus permits the debtor and the secured party to accomplish the equivalent of a deed in lieu of foreclosure, but with all of the title-clearing benefits associated with foreclosure.

If the collateral’s value exceeds the debt owed to the secured party (plus expected costs of foreclosure), the debtor will object to the proposal and effectively force the secured party to conduct a foreclosure sale. The resulting sale should, if the debtor’s valuation is correct, generate surplus proceeds for the debtor.¹⁹¹ Likewise, because strict foreclosure will extinguish junior liens,

SECURED TRANSACTIONS § 18.04 (5th ed. 2012).

¹⁸⁶ Under the original Article 9, strict foreclosure always resulted in the complete satisfaction of the debtor’s obligation, as the Code did not authorize strict foreclosure in partial satisfaction of the debt. See U.C.C. § 9–505(2) (AM. LAW INST. & UNIF. LAW COMM’N 1972) (secured party may retain collateral “in satisfaction of the obligation”); *id.* § 9–505 cmt. 1 (strict foreclosure involves “abandoning any claim for a deficiency”). Critics argued that the parties should be free to stipulate to a “fair price” for the secured party to take title to the collateral in lieu of foreclosure (and thus to stipulate to a deficiency amount). Revised Article 9 now permits partial strict foreclosure, but only in non-consumer transactions. U.C.C. §§ 9–620(a), (g) (AM. LAW INST. & UNIF. LAW COMM’N 2010).

¹⁸⁷ *Id.* § 9–102(a)(66). The decision to seek strict foreclosure rests with the secured party; the debtor cannot force the secured party to use the procedure. LAWRENCE, HENNING & FREYERMUTH, *supra* note 185, at 450.

¹⁸⁸ U.C.C. § 9–621(a) (AM. LAW INST. & UNIF. LAW COMM’N 2010).

¹⁸⁹ *Id.* § 9–620(a)(2). A person entitled to notification of the proposal must notify the secured party of an objection within twenty days after notification of the proposal was sent. *Id.* § 9–620(d)(1). Any other person holding an interest in the collateral (such as a judgment lien) but not entitled to notification of the proposal must object within twenty days of the last notification given by the secured party or, if no notifications are given, before the debtor consents to the proposal.

¹⁹⁰ *Id.* § 9–622(a). Strict foreclosure extinguishes subordinate interests even if the secured party fails to comply with its notification requirements. *Id.* § 9–622(b). Any person that was entitled to notification, but did not receive it, may recover any damages caused by the secured party’s noncompliance. *Id.* § 9–625(b).

¹⁹¹ *Id.* § 9–615(d)(1) (debtor entitled to surplus following payment of expenses of sale and liens

juniors will also object if a normal disposition would be expected to produce a surplus that would be paid to the objecting junior.

B. The Model Negotiated Alternative to Foreclosure Act

In 2015, the Uniform Law Commission promulgated the Uniform Home Foreclosure Procedures Act (UHFP).¹⁹² UHFP is a substantial and complex act dealing with many aspects of mortgage foreclosure. It addresses who has standing to commence a foreclosure, notice of default and mortgagor's right to cure, sending and publication of notice of sale, sale procedures, remedies and defenses, and alternative dispute resolution processes which include a title-clearing deed in lieu of foreclosure called a "negotiated transfer."¹⁹³ The intent of the drafters was to provide an "overlay" to existing state law foreclosure processes.¹⁹⁴ In other words, while each state could continue to follow its traditional foreclosure practices (e.g., requiring judicial foreclosure rather than permitting nonjudicial foreclosure), UHFP would establish certain basic threshold procedures and protections.

No jurisdiction has enacted UHFP, and no jurisdiction is likely to enact it anytime soon. Though UHFP does reflect a thoughtful overall balance between the interests of borrowers and mortgage lenders, borrower and lender advocates each perceive that the present mélange of state foreclosure laws provides them with respective advantages in resolution of defaulted mortgage loans—advantages they are reluctant to compromise through comprehensive reform.¹⁹⁵ Further, major consumer advocacy groups refused to participate in the drafting process, and thus feel no stake in UHFP's enactment.¹⁹⁶

Nevertheless, some of the concepts reflected in individual segments of the UHFP are beginning to be reflected in piecemeal state-by-state foreclosure reform legislation. Even prior to UHFP, alternative dispute resolution procedures similar to those reflected in UHFP Article 3 had

extinguished by foreclosure).

¹⁹² UNIF. HOME FORECLOSURE PROCEDURES ACT (UNIF. LAW COMM'N 2015) [hereinafter UHFP].

¹⁹³ See generally *id.*

¹⁹⁴ See *id.* § 805 cmt. 2.

¹⁹⁵ *Legislative Fact Sheet—Home Foreclosure Procedures Act*, UNIFORM L. COMMISSION, <http://www.uniformlaws.org/LegislativeFactSheet.aspx?title=Home%20Foreclosure%20Procedures%20Act> (last visited Aug. 3, 2018).

¹⁹⁶ This is unfortunate, because some of UHFP's provisions, such as its limitations upon an assignee's ability to assert holder-in-due-course status as a defense to a borrower's claims of fraud or material misrepresentation in the origination of the loan, see UHFP, *supra* note 192, § 705, are quite borrower-favorable.

already been adopted in a number of states.¹⁹⁷ Further, several states have recently adopted “fast-track” foreclosure procedures for abandoned mortgaged property; some of which are comparable in substance to the provisions of UHFPA Article 6.¹⁹⁸

In our view, the most valuable innovation of UHFPA is the “negotiated transfer” authorized in UHFPA Article 5,¹⁹⁹ which would permit a title-clearing deed in lieu of foreclosure akin in important respects to Article 9 strict foreclosure. At its 2017 Annual Meeting, the ULC carved out the negotiated transfer provisions from UHFPA Article 5, placed them in a free-standing act labeled the Model Negotiated Alternative to Foreclosure Act (MNAFA), and approved MNAFA for enactment in the states.²⁰⁰ MNAFA is a targeted response to the problem of junior liens as a barrier to deeds in lieu and short sales. It authorizes the mortgagor and the mortgagee to negotiate a transfer of the mortgaged property to the mortgagee, and provides that “all . . . interests subordinate to the interest of the creditor that is a party to the proposed negotiated transfer are extinguished.”²⁰¹ Of course, wiping out junior liens in this fashion is justified only where those liens have no economic value. MNAFA accomplishes this ingeniously, effectively forcing the junior lienholder to decide for itself whether its lien is worth preserving. The remainder of Part V outlines MNAFA’s negotiated transfer procedures.

¹⁹⁷ See *id.* §§ 301–06, which provide what is essentially a court-supervised or agency-supervised mediation process (though UHFPA eschews the term “mediation” in favor of “foreclosure resolution”). The National Consumer Law Center maintains a page on its website identifying twenty-six states with foreclosure mediation programs. See *Foreclosure Mediation Programs by State*, NAT’L CONSUMER L. CTR., <https://www.nclc.org/issues/foreclosure-mediation-programs-by-state.html> (last visited Aug. 5, 2018).

¹⁹⁸ See UHFPA, *supra* note 192, § 601 (determination of abandonment in judicial foreclosure proceedings); *id.* § 602 (determination of abandonment in nonjudicial foreclosure proceedings); *id.* § 603 (when presumption of abandonment arises); *id.* § 604 (procedure for withdrawal of abandonment); *id.* § 605 (foreclosure procedures for abandoned property); *id.* § 606 (maintenance obligations with respect to abandoned property). As of 2014, states with specific procedures for foreclosure with respect to abandoned property existed in Indiana, Illinois, Kentucky, Michigan, Nevada, New Jersey, and Oklahoma. Geoffrey Walsh, *Fast Track Foreclosure Laws: Are They Headed in the Right Direction?*, NAT’L CONSUMER L. CTR. (Jan. 2014), <https://www.nclc.org/images/pdf/pr-reports/report-fast-track-foreclosure-laws.pdf>. Maryland enacted a fast-track foreclosure statute for vacant properties in 2017. See MD. CODE ANN., REAL PROP. §§ 7-105.1, .14 (2018).

¹⁹⁹ UHFPA, *supra* note 192, §§ 501–04.

²⁰⁰ See *generally* MODEL NEGOTIATED ALT. TO FORECLOSURE ACT (UNIF. LAW COMM’N 2017) [hereinafter MNAFA].

²⁰¹ *Id.* § 5(a).

C. The Mechanics and Scope of the MNAFA

1. Notification to Junior Lienholders

Because the consummation of a negotiated transfer will extinguish junior liens, MNAFA requires notification of the proposed transfer to junior lienholders. If there is a judicial foreclosure pending at the time of the negotiated transfer agreement, the homeowner and the mortgagee must request the court to send notice of the proposed transfer to all other parties to the action;²⁰² this would include any junior lienholders, who are necessary parties to a judicial foreclosure.²⁰³ If there is no judicial foreclosure pending at the time of the agreement,²⁰⁴ the mortgagee must send notification of the proposed transfer to junior lienholders of record and any other persons from whom the creditor has received notice of a claimed interest in the home.²⁰⁵

2. Objection and Redemption by Junior Lienholder

A junior lienor has twenty days from the date notice was sent to object to the proposed negotiated transfer.²⁰⁶ If the junior lienholder does not timely object, the parties can complete the transfer and the junior lien is extinguished.²⁰⁷ However, if a junior lienholder objects and wishes to prevent the negotiated transfer, the junior must redeem the property from the senior

²⁰² *Id.* § 4(a).

²⁰³ NELSON, WHITMAN, BURKHART & FREYERMUTH, *supra* note 25, § 7:13.

²⁰⁴ MNAFA, *supra* note 200, § 4(b). Section 4(b) would apply in a judicial-foreclosure-only state if the mortgagee has not yet filed a foreclosure action. This might occur either because mortgagor has defaulted but mortgagee has not yet determined to foreclose, or because the mortgagee has determined to foreclose but has not yet prepared and filed a complaint. Section 4(b) will always apply in a nonjudicial foreclosure state (except in the rare case in which the mortgagee has nevertheless filed a judicial foreclosure action), without regard to whether the mortgagee has taken the steps necessary to commence a nonjudicial foreclosure.

²⁰⁵ *Id.* (“If a homeowner and creditor propose a negotiated transfer when a judicial foreclosure is not pending, the creditor shall send notice of the proposed transfer to: (1) a person from which the creditor received, before the homeowner and creditor agreed to the proposed transfer, notice of a claimed interest in the mortgaged property; and (2) a person that, [10] days before the homeowner and creditor agreed to the proposed transfer, held a recorded interest in the property subordinate to the mortgage that is the subject of the proposed transfer.”).

²⁰⁶ *Id.* § 3(a)(4). The objection must be in a “record,” i.e., “inscribed on a tangible medium or [] stored in an electronic or other medium and [] retrievable in perceivable form.” *Id.* § 2(11).

²⁰⁷ *Id.* §§ 5(a), 6(a) (negotiated transfer “(1) discharges the obligation in full; (2) transfers to the creditor all of the homeowner’s rights in the property, except for a right of the homeowner to continue to occupy the property pursuant to an agreement between the homeowner and creditor which is incorporated in the negotiated-transfer agreement; (3) discharges the mortgage held by the creditor and any mortgage or other lien subordinate in priority to the mortgage held by the creditor; and (4) terminates any other subordinate interest except an interest protected from termination by law other than this [act].”).

mortgage lien by tendering the amount of the senior mortgage obligation.²⁰⁸ If the junior does redeem, the junior becomes “entitled to the benefit of the proposed transfer,” i.e., it obtains title to the property free of the redeemed lien and all subordinate interests.²⁰⁹ Obviously, a junior lienor will do so only if it believes the home’s expected value justifies the redemption price.

Due to the need for title clarity, MNAFA requires a judicial process to establish a redemption date if a junior lienholder objects.²¹⁰ If a judicial foreclosure is already pending, the court simply sets a date, not more than thirty days after the objection, by which the objecting junior lienor must pay off the senior lien.²¹¹ If the junior objects when no judicial proceeding is pending—as would typically be the case in a jurisdiction that uses nonjudicial foreclosure—the mortgagee must file a judicial proceeding and have the court set a redemption date for the objecting lienholder.²¹² In either case, if the junior lienor fails to tender the redemption amount by the date established by the court, its lien is extinguished.²¹³

Because a home could be subject to multiple junior liens, and all junior lienholders must receive notice of a proposed negotiated transfer, it is possible (though not likely) that two or more junior lienholders could file objections. In such a situation, MNAFA requires the court to establish a process for sequentially recognizing the juniors’ respective rights of redemption. To accomplish this, the court must establish the relative

²⁰⁸ *Id.* § 5(a) (objecting junior lienholder may “tender to the creditor that is a party to the transfer an amount equal to the obligation to be satisfied”). If a junior lienor makes such a tender, the mortgagee’s claim is paid in full and the redeeming junior lienholder steps into the position of the paid-off creditor. *Id.* (if junior timely redeems, junior “is entitled to the benefit of the proposed transfer, and all interests subordinate in priority to the interest of the creditor that is a party to the proposed transfer are extinguished effective on the date of tender”).

²⁰⁹ *Id.*

²¹⁰ *Id.*

²¹¹ *Id.* The MNAFA’s process is functionally the same as a junior lienholder would face under the law in Connecticut, which uses strict foreclosure. When a senior lienholder in Connecticut files a petition for strict foreclosure and the property is affected by a junior lien, the court would establish a date by which the junior lienholder would have to redeem its junior lien from the foreclosing senior or have that lien extinguished. See also 3 JOEL M. KAYE & WAYNE D. EFFRON, CONN. CIVIL PRACTICE FORMS, Form 707.1 (4th ed. 2018).

²¹² MNAFA, *supra* note 200, § 5(c) (“If a judicial proceeding is not pending and a creditor that sends a notice under Section 4(b) receives an objection from a person holding an interest in the mortgaged property which would be affected by the negotiated transfer, the negotiated transfer may not proceed unless the creditor initiates a judicial proceeding to allow the objecting person to tender the amount due to the creditor.”).

²¹³ *Id.* § 5(a) (“If the person does not tender the amount to the creditor on or before the date set by the court, the interest of the person objecting and all other interests subordinate to the interest of the creditor that is a party to the proposed negotiated transfer are extinguished, effective on the date set by the court by which the tender could have been made.”).

priorities of the objecting juniors²¹⁴ and then fix a series of redemption dates—assigning a redemption date to each objecting junior lienholder in the reverse order of their priority, with the most junior lienholder getting the earliest redemption date.²¹⁵ The most junior objecting lienholder must tender an amount equal to the total of the balances due on all debts secured by liens superior to its own.²¹⁶ If it does so in a timely manner, the tendering junior becomes the owner of the property free and clear of the redeemed liens and any subordinate interests.²¹⁷ If that junior fails to make a timely tender, its lien is extinguished and the next (i.e., the next more senior) lienholder is entitled to its turn.²¹⁸ This process continues until any objecting junior exercises timely redemption or until all objecting juniors have failed to do so.²¹⁹

This process is conceptually similar to the rights of junior lienholders in an ordinary foreclosure; all juniors are subject to being terminated by the foreclosure of a senior lien, but each has a common law right to redeem its lien from senior liens prior to the foreclosure sale. However, in an ordinary foreclosure, a junior who redeems from the senior lien acquires *only the senior's lien position*, not the mortgagor's equity of redemption.²²⁰ By contrast, under MNAFA—because the mortgagor has already agreed to

²¹⁴ *Id.* § 5(b) (if there are multiple objecting juniors, “the court promptly shall determine the relative priorities of the interests held by each person that filed an objection”).

²¹⁵ *Id.* (“The court shall set separate days by which each objecting person holding an interest in the mortgaged property may tender the amounts described in [Section 5(a)] to the creditor proposing the negotiated transfer and the amounts due to other persons holding [junior interests]. The court shall assign the days to the objecting parties in the reverse order of their priorities, with the objecting party holding the most junior interests receiving the first tender date.”).

²¹⁶ *Id.*

²¹⁷ *Id.* § 5(d) (“If an objecting person holding the most junior interest in the mortgaged property tenders the amounts described in subsection (b) on or before the date set by the court, the person is entitled to the benefit of the proposed negotiated transfer, and all interests junior in priority to the interest of the creditor that first proposed the negotiated transfer are extinguished effective on the date of tender.”).

²¹⁸ *Id.* § 5(e) (“If an objecting person holding the most junior interest in the mortgaged property does not tender the amounts described in subsection (b) on or before the date set by the court, the interests of the person that failed to tender are extinguished, and the objecting party with the next tender date is entitled to tender to all creditors that are senior in priority to the objecting party in the same manner described in subsection (b). This process continues until each objecting person has been paid in full or has its interest extinguished.”).

²¹⁹ *Id.*

²²⁰ NELSON, WHITMAN, BURKHART & FREYERMUTH, *supra* note 25, § 7:2, at 570 (“A junior lienholder’s equitable right to redeem is different than the redemption right of the mortgagor . . . [T]he mortgagor’s equitable redemption right is to pay off the mortgage in default and redeem *the land*. The mortgagor’s payment extinguishes the mortgage. In contrast, the junior lienor purchases the senior mortgage to prevent the senior mortgagee from foreclosing and thereby eliminating the junior lien.”) (emphasis in original).

transfer its equitable ownership—the junior is redeeming *the mortgaged property itself*.

3. MNAFA's Scope and General Provisions

As a threshold matter, a negotiated transfer under MNAFA is possible only for a mortgage on one-to-four-family residential property.²²¹ A negotiated transfer also requires express agreement between the mortgagor and the mortgagee entered into after default.²²² This agreement must state that it is made pursuant to Section 3 of MNAFA,²²³ and must “specify the date and time when the homeowner must surrender possession” to the mortgagee.²²⁴

Under this agreement, the mortgagee must accept the property in full satisfaction of the debt,²²⁵ in a negotiated transfer governed by MNAFA, the

²²¹ MNAFA, *supra* note 200, § 2(6) (“‘Mortgaged property’ means real property improved with not more than four dwelling units which is subject to a mortgage.”). The term includes an attached single-family unit such as a condominium or townhouse unit, a manufactured housing unit or time-share unit if that unit constitutes real estate under applicable state law, property on which four or fewer dwelling units are under construction, and a single-family unit in a common interest community. *Id.* The term does not include a home that “was used or intended to be used primarily for nonresidential purposes” at the time the mortgage was granted. *Id.* Under the UHFPA, from which MNAFA was excerpted, the drafters limited the act’s scope to residential property for two reasons: (1) it was residential foreclosures that clogged the courts and bogged down servicers during the mortgage crisis; (2) the drafters perhaps felt that enactment prospects for UHFPA would be improved if the support of commercial mortgage lenders was not required. Conceptually, of course, the principles of MNAFA could be applied equally well to nonresidential mortgage loans, and a state that enacted MNAFA could, if it wished, remove this scope restriction.

²²² *Id.* § 3(a)(1). In an Article 9 strict foreclosure, it is possible that strict foreclosure can occur based upon implied consent, i.e., where the secured party proposes strict foreclosure and the debtor fails to respond (which might occur because the debtor receives the proposal and does not object, or because the debtor never reads the proposal, or even because the debtor never received a proposal that was properly sent). By contrast, under MNAFA, implied consent from the mortgagor is not permissible; the homeowners and the mortgagee must agree to the transfer in a “record,” *id.*, which means a writing (“inscribed on a tangible medium”) or storage of the agreement “in an electronic or other medium . . . retrievable in perceivable form.” *Id.* § 2(11).

²²³ *Id.* § 3(a)(2). MNAFA does not preclude the mortgagor and mortgagee from entering into a deed in lieu agreement the terms of which would be governed by the applicable state’s prior common law. *See id.* § 6(f) (“This [act] does not prevent a homeowner and creditor from entering into an agreement other than a negotiated transfer, but the consequences of a negotiated transfer described in this section do not apply to an agreement that does not state it is made pursuant to Section 3.”). This requirement thus enables an interested person to distinguish between a negotiated transfer (which would have title-clearing effect under MNAFA) and a traditional deed in lieu (which would not).

²²⁴ *Id.* § 3(b). Where there are junior lienholders entitled to notice of the proposed agreement, the homeowner “is not obligated to surrender possession before the 20-day period” for junior lienholders to object to the agreement, even if the agreement provides to the contrary. *Id.*

²²⁵ *Id.* § 3(a) (“A homeowner and creditor may negotiate a transfer of mortgaged property to the creditor in full satisfaction of the obligation to the creditor secured by the mortgage . . .”) (emphasis

mortgagee cannot preserve the right to a deficiency judgment to any extent.²²⁶ This protects unsophisticated consumers from bad negotiated transfer deals, corresponds with the result most borrowers would expect,²²⁷ and is consistent with Article 9's analogous prohibition on partial strict foreclosure in consumer transactions.²²⁸ However, nothing in MNAFA prevents the mortgagee from agreeing to pay the mortgagor additional sums (e.g., "cash for keys") to help defray moving expenses and encourage the mortgagor's agreement.²²⁹ If there are multiple owners of the home, the choice to proceed under the Act is available only if all of the owners agree.²³⁰ However, obligors who are liable on the debt but have no interest in the real estate (e.g., guarantors) need not be parties to the negotiated transfer agreement, because a negotiated transfer extinguishes the obligation and thus such obligors have no down-side risk.²³¹

As noted above, MNAFA's procedures govern only if the parties choose to have MNAFA govern and state this intent in their agreement.²³² Thus, if a first mortgagee conducts a title examination and discovers no junior liens, the mortgagee and the homeowner may prefer to use a traditional deed in lieu of foreclosure, in which case the provisions of MNAFA do not apply.²³³

Finally, while MNAFA will be of greatest use to first mortgage lenders; it is equally available to junior mortgagees. However, MNAFA has no effect on mortgages or liens senior to the mortgage that is the subject of the negotiated transfer.²³⁴ Thus, for example, assume that Freyermuth's home is

added); *Id.* § 3(c) ("This section does not authorize a transfer of mortgaged property to a creditor in partial satisfaction of the obligation it secures.").

²²⁶ *Id.* § 6(d) ("Transfer of mortgaged property under Section 3 terminates any right of the creditor to obtain a personal judgment against the homeowner and any other person liable for the obligation secured by the property, including attorney's fees, costs, and other expenses.").

²²⁷ *Cf.* CAL. CIV. PROC. CODE § 580e (2018) (prohibiting deficiency judgment against mortgagor following short sale).

²²⁸ U.C.C. § 9-620(g) (AM. LAW INST. & UNIF. LAW COMM'N 2010) ("In a consumer transaction, a secured party may not accept collateral in partial satisfaction of the obligation it secures.").

²²⁹ See generally MNAFA, *supra* note 200.

²³⁰ *Id.* § 3(a)(1). See also *id.* § 3, cmt. 4 ("When there are multiple owners of the mortgaged property, all the owners need to consent to a negotiated transfer. The act does not authorize a forced transfer outside of foreclosure for a non-consenting co-owner.").

²³¹ *Id.* § 3, cmt. 5 ("Because the effect of a negotiated transfer under section 6(a)(1) is to completely discharge the obligation, this section does not require any consent from an obligor who is not also a homeowner.").

²³² *Id.* § 3(a)(2).

²³³ *Id.* § 6(f) ("This [act] does not prevent a homeowner and creditor from entering into an agreement other than a negotiated transfer, but the consequences of a negotiated transfer described in this section do not apply to an agreement that does not state it is made pursuant to Section 3.").

²³⁴ *Id.* § 3(d) ("A negotiated transfer does not affect the rights of a person holding an interest in mortgaged property, if the interest has priority over the interest of a creditor to whom title to the property is transferred under this section."); see also *id.* § 5 cmt. 3 ("persons that hold interests that have priority

subject to an unpaid property tax lien, which is superior in priority to Bank's otherwise first mortgage. If Freyermuth and Bank engaged in a negotiated transfer under MNAFA without paying the unpaid taxes, Bank would take title to the home subject to the tax lien (the same result as would occur in a conventional foreclosure).²³⁵

D. MNAFA and Short Sales

By its terms, MNAFA applies only to transfers by a homeowner to a mortgagee, i.e., the typical deed in lieu of foreclosure.²³⁶ It does not explicitly address a short sale transaction in which the homeowner proposes to transfer to a third person. MNAFA's provisions, nevertheless, can facilitate short sale agreements and short sale deeds. For example, the homeowner and mortgagee could structure the transaction so that the chain of title for the short sale passes through the mortgagee. For instance, suppose that Mortgagor owns a home subject to a \$300,000 mortgage held by First Bank and a \$50,000 mortgage held by Second Bank. Mortgagor proposes to sell the home to Purchaser for \$240,000 (slightly below its appraised fair market value of \$250,000), so long as Mortgagor can deliver marketable title free of the liens of First Bank and Second Bank. In this situation, the negotiated transfer agreement could be a three-party agreement between Mortgagor, Purchaser, and First Bank, in which First Bank agrees to take title pursuant to the agreement under MNAFA and in turn to deliver title to Purchaser once the negotiated transfer is complete. This would involve two deeds: one from Mortgagor to First Bank—which under MNAFA would extinguish the underwater Second Bank mortgage if, as is likely, Second Bank chooses not to satisfy the First Bank mortgage debt—and a second from First Bank to Purchaser conveying clear title. Presumably, First Bank would insist that the deed it delivers to Purchaser would be without general title warranties, but nothing in MNAFA requires such a warranty.

E. Negotiated Transfer, Article 9 Strict Foreclosure, and the Policy of MNAFA

To an extent, MNAFA provides the mortgagee with a remedy that is analogous to an Article 9 strict foreclosure as described above in Part V.A.

over the interest of the creditor who enters into the negotiated transfer with the homeowners—so-called 'senior interests'—would not be affected by the negotiated transfer, and the creditor taking title by negotiated transfer would take only what the transferee had").

²³⁵ See NELSON, WHITMAN, BURKHART & FREYERMUTH, *supra* note 25, § 7:13.

²³⁶ MNAFA, *supra* note 200, § 3(a).

However, the remedies are not precisely the same. Under Article 9 strict foreclosure, if a junior lienholder objects to the secured party's proposal, the junior lienholder need not pay off the senior debt. Instead, the senior receiving such an objection effectively must proceed with a foreclosure sale.²³⁷ By contrast, under MNAFA, once the mortgagor and the mortgagee send notice of the proposed negotiated transfer, the junior cannot simply object and insist on a foreclosure sale; a junior that wishes to protect its junior lien must redeem the property or see its lien extinguished by the negotiated transfer.²³⁸ Thus, while the Article 9 junior that believes there is equity in its position can insist upon having that equity tested at a foreclosure sale, MNAFA deprives the junior mortgagee of this option.

This policy distinction between MNAFA's procedure and Article 9 strict foreclosure is entirely appropriate. For personal property collateral, if the junior insists upon foreclosure, that foreclosure can occur in an arms-length private sale²³⁹ that can happen in as little as two or three weeks.²⁴⁰ Even a short reinvestment delay of a few weeks' time imposes some delay costs, and Article 9 sales do involve transaction costs. For this reason, Article 9 permits strict foreclosure to allow the secured party and the debtor to avoid these costs by mutual consent. But while these delay and transaction costs are external to the junior lienholder, they are relatively small enough that on balance, Article 9 justifiably permits a junior lienholder to decide to protect its potential equity in the collateral by insisting upon a foreclosure sale.

²³⁷ This statement is not strictly correct, because Article 9 actually does not require the secured party to conduct a disposition of the collateral (except in limited circumstances not pertinent here). Article 9 says that a secured party "may" dispose of collateral after default. U.C.C. § 9-610(a) (AM. LAW INST. & UNIF. LAW COMM'N 2010). It does not say "shall dispose." See *id.* Thus, a secured party that received an objection to a strict foreclosure proposal could choose, consistent with the statute, not to conduct a disposition and instead just use the collateral in whatever way the secured party chose to. A secured party that did so, however, would still hold the collateral subject to the debtor's right of redemption, which can only be extinguished by disposition. *Id.* § 9-617(a)(1). Further, it would have the duties of a secured party in possession of collateral, which might well be breached by the secured party's use of the collateral without the debtor's consent. See *id.* § 9-207. Thus, as a practical matter, the secured party receiving an objection to a strict foreclosure proposal must dispose of the collateral (usually by sale).

²³⁸ MNAFA, *supra* note 200, § 6(a).

²³⁹ U.C.C. § 9-610(b) (AM. LAW INST. & UNIF. LAW COMM'N 2010) ("If commercially reasonable, a secured party may dispose of collateral by public or private proceedings, by one or more contracts, as a unit or in parcels, and at any time and place and on any terms.").

²⁴⁰ U.C.C. § 9-610(b) provides that except in the limited circumstances in which notice is excused, a secured party disposing of collateral must send a "reasonable" notice of disposition to the persons identified in § 9-610(c) (which include the debtor and junior lienholders). *Id.* What amount of notice is "reasonable" is a question of fact, but in non-consumer transactions, ten days prior notice is deemed to be "within a reasonable time." *Id.* §§ 9-612(a), (b).

By contrast, in the real estate context, the external cost calculus is more extreme. The real estate foreclosure must occur in a public auction,²⁴¹ which is likely to produce a lower recovery than what the mortgagee would receive through a deed in lieu or short sale.²⁴² Further, the real estate foreclosure would in most states take six months to two years or more to complete²⁴³—increasing the senior's likely reinvestment loss due to delay (including opportunity costs and possible vandalism or deterioration of the property) and additional transaction costs (particularly those associated with judicial foreclosure).²⁴⁴ Finally, the real estate foreclosure sale has spillover effects not present in the Article 9 context. If Whitman defaults on his home loan and the bank forecloses on Whitman's home, that foreclosure sale is more likely to reduce the value of Freyermuth's nearby home; by contrast, if Whitman defaults on his car loan and the bank repossesses and sells his car, that repossession and sale has no impact on the value of Freyermuth's car.²⁴⁵ The MNAFA justifiably requires the objecting junior that wants to retain its interest to internalize these costs—to “put its money where its mouth is.” This provides a fair, quick, and relatively inexpensive alternative form of resolution of the distressed mortgage loan.

One might argue requiring an objecting junior to redeem the senior debt is unfair to junior lienholders that have little or no access to capital. This argument holds no force for institutional lenders, who carry the majority of junior liens. The argument may carry somewhat more force as applied to an individual junior mortgagee (e.g., a home seller who takes a purchase money mortgage to secure a portion of the purchase price but subordinates to an institutional lender that provided financing to cover the balance of the price), certain junior statutory lienholders (e.g., a subcontractor or material supplier asserting a mechanic's lien), or judgment lienholders.²⁴⁶ On balance,

²⁴¹ NELSON, WHITMAN, BURKHART & FREYERMUTH, *supra* note 25, §§ 7:17 (judicial foreclosure), 7:20 (nonjudicial foreclosure).

²⁴² See *supra* notes 129, 140–58 and accompanying text.

²⁴³ See *supra* notes 129–39 and accompanying text.

²⁴⁴ See *supra* notes 134–35 and accompanying text. Judicial-foreclosure-only requirements magnify the foreclosing creditor's transaction costs, as do inefficient nonjudicial foreclosure requirements (such as the statutory requirement for repetitive newspaper publication of sale notice that typically provide little or no useful information about the property).

²⁴⁵ Levitin & Wachtel, *supra* note 43, at 1251 (“[M]ost asset classes have serially uncorrelated asset prices For example, if *your* car is damaged and declines in value, it does not affect the value of *my* car, even if we park them next to each other.”) (emphasis original).

²⁴⁶ One could simply exempt these more “sympathetic” junior lienors from the title-clearing effects of a statute like the MNAFA. The drafters of MNAFA chose not to do so, perhaps because the percentage of transactions in which one or more of such interests arises is likely nontrivial; exempting them altogether would create a significant gap in MNAFA's scope and utility. Alternatively, because MNAFA does contemplate some judicial process, one might allow these more sympathetic junior lienors to obtain a

however, we believe that the MNAFA approach creates the necessary mechanism to facilitate more efficient resolutions of distressed mortgage loans during the *next* real estate crisis.

VI. RETHINKING JUNIOR LIENS: IMPLICATIONS FOR FURTHER REFORM OF MORTGAGE LAW

As we explained in Part V, we believe that the enactment of MNAFA would provide a necessary and useful mechanism to facilitate certain resolutions of distressed mortgage loans, particularly in periods of declining real estate values. In Part VI, we take a step back and think more broadly about subordinate financing of residential real estate. How else might Article 9 inform potential reforms of American mortgage law so as to address the junior lien problem? We begin by describing the way the Article 9 system addresses junior liens, and then consider some ways in which state mortgage law might adopt Article 9-inspired reform approaches.²⁴⁷

A. Article 9 vs. Mortgage Law—The Junior Lender’s Calculus

As a threshold matter, UCC Article 9 and mortgage law provide parallel secured finance systems and share a common overall conceptual approach. Each system provides a set of rules governing the creation of a valid security interest (“attachment” in Article 9 parlance) and certain aspects of the pre-foreclosure relationship between the borrower and the creditor. Each system provides a set of rules governing the process by which a creditor can give notice of its security interest so as to make that interest enforceable against certain third parties—“perfection” under Article 9, and “recording” under real estate law. Each system provides a set of priority rules that rank-order liens where more than one creditor holds a lien against the same collateral.

foreclosure sale if they can “prove the value” of the mortgage property through a competent appraisal. This approach would, in some regards, be quite comparable to the existing strict foreclosure procedure used in Connecticut, in which the court has discretion to order a foreclosure sale if the mortgagor or a subordinate lienholder proves that the value of the mortgaged real estate exceeds the balance of the foreclosing party’s debt. *See* *Fidelity Tr. Co. v. Irick*, 538 A.2d 1027 (Conn. 1988); NELSON, WHITMAN, BURKHART & FREYERMUTH, *supra* note 25, § 7:11, at 602.

²⁴⁷ One might also attempt to facilitate the modification of distressed mortgages through reform of federal bankruptcy law so as to permit the mortgagor/debtor to obtain principal reduction. Professor Adam Levitin has made this argument elsewhere. *See* Adam J. Levitin, *Resolving the Foreclosure Crisis: Modification of Mortgages in Bankruptcy*, 2009 WIS. L. REV. 565 (2009) (arguing that mortgage lending markets are in fact indifferent to bankruptcy strip-down of underwater liens). Such a change may well be advisable. We have chosen here to focus more overtly on potential solutions based in state mortgage law.

And each provides a set of remedies to the creditor when faced with default by the borrower.

Junior liens can arise under both systems. However, because each system has different priority and enforcement rules, the systems diverge dramatically as to the prevalence and impact of junior liens. With respect to residential real property, junior liens are widely found; previous commentators have suggested that 20% of all homes are covered by junior mortgages.²⁴⁸ Voluntary junior liens against a home typically arise because a lender has made a conscious decision to advance credit to the borrower against the borrower's equity (the excess value of the home above the balance of the senior mortgage debt) in exchange for the junior lien. Further, as noted in Parts III and IV, the priority and foreclosure rules associated with mortgage law facilitate the ability of junior lienholders to exploit their leverage in a fashion that can impose unwarranted costs upon senior lienholders, borrowers, and even neighboring landowners.²⁴⁹

By contrast, under Article 9, there is no comparable "junior lien problem." As noted earlier, Article 9's more streamlined foreclosure procedures strongly temper the junior's leverage vis-à-vis the debtor and senior lienholders.²⁵⁰ But there is a more significant divergence. When a voluntary junior lien arises under Article 9, it is not because a lender has chosen to make a loan against the equity in machinery or other goods belonging to the debtor. When voluntary junior liens arise under Article 9, they arise in a very different way,²⁵¹ for two important reasons.

²⁴⁸ See, e.g., Been, Jackson & Willis, *supra* note 168, at 77–78 ("Robert Avery and his colleagues recently estimated that 13.2 million mortgages originated between 2004 and 2009 had a second mortgage. Given that there are almost 66 million home purchase and refinance loans originated over the same period, that estimate would suggest that some 20 percent of them had second liens. . . . Other estimates suggest a similar or slightly higher percentage. Industry sources have reported, for example, that second liens encumbered less than 18 percent of the loans held or guaranteed by Fannie Mae and Freddie Mac ("agency" mortgages). Laurie Goodman and her colleagues estimated that more than 50 percent of the mortgages in non-agency securities were accompanied by a second lien. Because the dollar volume of non-agency mortgage-backed securities outstanding in 2011 amounted to less than a fifth of that of agency mortgages, the weighted average of the 18 percent estimate for agency loans and the 50 percent estimate for non-agency mortgage backed securities yields an average in the low 20's."); *Second Liens and Other Barriers to Principal Reduction as an Effective Foreclosure Mitigation Program: Hearing Before the H. Comm. on Fin. Servs.*, 111th Cong. 5 (2010) (statement of David Lowman, Chief Executive Officer for Home Lending, JPMorgan Chase) (noting that 30% of Chase-held first mortgages were subject to junior liens, whether held by Chase or another lender). Junior liens could also arise involuntarily (e.g., judgment liens, mechanics liens, and tax liens), but reliable data on the prevalence of involuntary liens is not readily available.

²⁴⁹ See *supra* notes 74–183 and accompanying text.

²⁵⁰ See *supra* notes 237–44 and accompanying text.

²⁵¹ When voluntary junior liens arise under Article 9, they generally do not involve an extension of new credit by the junior. Instead, the typical scenario in which a voluntary junior lien arises under Article

First, there is a significant practical distinction between real property collateral and most forms of personal property collateral. Lenders generally expect that the value of real property will not decline (assuming proper maintenance of the realty). This expectation has facilitated the popular perception that one's home is a veritable ATM from which one can readily tap equity as needed.²⁵² By contrast, most forms of personal property collateral—even if properly maintained—have a shorter useful life and lose their value more rapidly, making junior lending against such property much less desirable.

Second, and more significantly, Article 9's priority rules structurally discourage voluntary junior lending. There certainly are forms of personal property that do not readily depreciate over time (e.g., artwork) or do so very slowly (e.g., a copyright or trademark). Yet there is no active market for second lien financing of these assets. This is because Article 9's perfection and priority rules are based upon the "first-to-file-or-perfect" rule,²⁵³ which precludes a creditor from presuming that the debtor's equity in personal property collateral is a reliable source of collateral.

To demonstrate, suppose Debtor wishes to borrow \$2 million from Bank; to be secured by a Picasso painting worth \$5 million that Debtor owns free of encumbrances. Bank searches the UCC records and finds no financing statement on file covering the Picasso. On February 1, Bank then files a financing statement covering the Picasso, Debtor signs a security agreement covering the Picasso, and Bank advances \$2 million to Debtor. Bank now has a perfected security interest in the Picasso to secure repayment of the \$2 million loan. Now assume that Debtor needs another \$1 million in credit and

9 is this: (1) Bank already holds an otherwise first-priority blanket lien on all of Debtor's machinery, presently-owned and after-acquired; and (2) Debtor acquires a new machine using credit obtained from Finance Company to which Debtor grants a purchase-money security interest. Bank obtains a perfected security interest in the new machine by virtue of the after-acquired property clause in its security agreement with Debtor, and if the first-to-file or perfect rule applied in this scenario, Bank's security interest in the new machine (acquired when Debtor acquired rights in the machine) would take priority over Finance Company's by virtue of Bank's prior-filed financing statement. However, in this scenario, Article 9 subordinates Bank's security interest in the new machine to Finance Company's purchase-money security interest in that machine, assuming that Finance Company takes sufficient action to perfect its security interest within twenty days after Debtor takes possession of the machine. See U.C.C. § 9-324(a) (AM. LAW INST. & UNIF. LAW COMM'N 2010).

²⁵² See, e.g., Gabriel Rico, *Think Twice Before Using Your House as an ATM, Experts in Tucson Advise*, ARIZ. DAILY STAR (July 9, 2016), https://tucson.com/business/tucson/think-twice-before-using-your-house-as-atm-experts-in/article_6d138236-1cb7-5255-9f3b-392cbf9988c6.html; Diana Olick, *Homes as ATMs: It's Starting Again*, CNBC (Oct. 5, 2015), <https://www.cnbc.com/2015/10/05/homes-as-atms-its-starting-again.html>; Nin-Hai Tseng, *The House That Was Your ATM Is Back*, FORTUNE (Nov. 27, 2013), <http://fortune.com/2013/11/27/the-house-that-was-your-atm-is-back/>.

²⁵³ U.C.C. § 9-322(a)(1) (AM. LAW INST. & UNIF. LAW COMM'N 2010) ("Conflicting perfected security interests . . . rank according to priority in time of filing or perfection.").

approaches Finance Company, which on March 1 files a financing statement covering the Picasso, loans Debtor \$1 million, and takes a second-priority security interest in the Picasso. Finally, on April 1, Debtor returns to Bank and borrows an additional \$3 million—increasing its total debt to Bank to \$5 million—and signs another security agreement granting Bank another security interest in the Picasso to secure repayment of the additional credit. Debtor later defaults to Bank, which repossesses and sells the Picasso for \$5 million.

In this situation, Finance Company (which is still owed \$1 million) might have expected that after Bank received payment of the original \$2 million loan, Finance Company's security interest would hold first priority (and thus that Finance Company would have the best claim against the next \$1 million in sale proceeds). But this conclusion by Finance Company would be wrong. Even though Finance Company's March 1 security interest in the painting may have attached prior to Bank's April 1 security interest (granted to secure the second loan) of \$3 million, Bank's security interest has priority because Bank was the first to file a financing statement covering the Picasso on February 1, and that financing statement remains in effect. Thus, Bank will recover the full amount of its \$5 million loan from the Picasso's sale proceeds, and Finance Company will be left with only an unsecured claim for repayment of its \$1 million loan.

Thus, even though Debtor may have had \$3 million in equity in the Picasso, Finance Company could not safely take a junior position because the first-to-file-or-perfect rule permits Debtor and Bank to enter into subsequent loan agreements that "soak up" or "consume" that equity. As a result, a creditor in the position of Finance Company that expected to have its desired priority has only three ways to achieve that priority:

- It could enter into an inter-creditor agreement with Bank, in which Bank agrees that while Bank will retain its priority as to the then-\$2 million outstanding principal balance and interest accrued thereon, Bank subordinates its priority position as to any future loans Bank might make to Debtor that are secured by the Picasso.²⁵⁴
- It could loan Debtor \$3 million, but direct \$2 million of the loan proceeds to pay off the existing debt to Bank and then require Bank to terminate its financing statement²⁵⁵—thereby preventing

²⁵⁴ *Id.* § 9-339 ("This article does not preclude subordination by agreement by a person entitled to priority.").

²⁵⁵ *Id.* § 9-513(c) (secured party must take steps to terminate financing statement within twenty days

a future Bank-Debtor secured loan transaction from qualifying for priority under first-to-file-or-perfect.

- It could “take out” the Bank’s position, paying Bank \$2 million and taking an assignment of Bank’s security interest and financing statement.²⁵⁶

If it makes the loan without taking one of these steps, however, Finance Company subjects itself to the risk that a future loan transaction between Debtor and Bank will consume the Debtor’s equity in the collateral. In effect, under Article 9 all subsequent loans by Bank that are secured by the same collateral take the priority of its original financing statement. This effectively prevents a debtor from using its equity in personal property collateral as a source of collateral without the consent or repayment of the first-priority secured party.

B. Possible Mortgage Law Reforms Informed by Article 9 (Beyond MNAFA)

Beyond the enactment of MNAFA as we recommended in Part V, what other useful mortgage law reforms might Article 9 inspire?

1. Comprehensive Codification of Mortgage Law

Without question, the most aggressive reform would be to codify all of mortgage law in a manner comparable to the way Article 9 codified the law governing personal property security interests. This approach would include a foreclosure process that allowed the mortgagee to complete a foreclosure and obtain marketable title (i.e., free and clear of junior liens and any rights of redemption) as quickly as that is possible for personal property collateral under Article 9. Such a system would protect the current expectations of borrowers that they can borrow against home equity and the current expectations of lenders that such lending is secure (at least absent declining

following authenticated demand by debtor, if “there is no obligation secured by the collateral . . . and no commitment to make an advance, incur an obligation, or otherwise give value . . .”).

²⁵⁶ In this situation, Article 9 would permit Finance Company to file an amendment of the Bank’s financing statement to indicate the assignment of the Bank’s security interest to Finance Company. *Id.* § 9-514(b). Such an amendment is not required, however; if Bank’s security interest was properly perfected, the security interest would remain perfected following its assignment to Finance Company as long as Bank’s financing statement remained effective, even if no amendment was made to reflect the assignment. *Id.* § 9-310(c) (“If a secured party assigns a perfected security interest or agricultural lien, a filing under this article is not required to continue the perfected status of the security interest against creditors of and transferees from the original debtor.”).

market values or circumstances involving waste). It would also permit a foreclosing senior to avoid the severe enforcement delay and unwarranted transaction costs that permit underwater junior lienholders to block otherwise efficient modifications, deeds in lieu, or short sales. This might be done by including provisions similar to MNAFA.

Of course, this approach has been tried and failed, would have no likelihood of being enacted if tried again, and thus is probably not worth trying again. Nearly half of the states require judicial foreclosure for land,²⁵⁷ and the fates of the 1985 Uniform Land Security Interest Act (ULSIA) and the 2002 Uniform Nonjudicial Foreclosure Act (UNFA)—both of which tried to encourage broader enactment of nonjudicial foreclosure—provide a cautionary tale about further efforts.²⁵⁸ The likelihood that Congress might federalize the foreclosure process seems even more remote.²⁵⁹

There is an intermediate solution that would ostensibly protect state prerogatives while protecting national interests. The FHFA could use its supervisory authority to direct Fannie Mae and Freddie Mac to purchase mortgage loans only in states which have laws permitting nonjudicial foreclosure processes that meet certain fairness and efficiency criteria. Such a move would undoubtedly encourage recalcitrant state legislatures to adopt nonjudicial foreclosure statutes like UNFA. However, the FHFA seems unlikely to take such a bold step in an area which customarily falls under the prerogative of state law.

²⁵⁷ See *supra* note 126 and accompanying text.

²⁵⁸ In 1985, the ULC promulgated the Uniform Land Security Interest Act (ULSIA), which attempted to codify a very substantial portion of mortgage law in a manner akin to UCC Article 9. See, e.g., Norman Geis, *Escape from the 15th Century: The Uniform Land Security Interest Act*, 30 REAL PROP., PROB. & TR. J. 289, 292 (1995) (ULSIA “holds the promise of accomplishing for the law of real estate mortgage security what the Uniform Commercial Code has already accomplished so well for commercial law.”). ULSIA received zero enactments. The ULC adopted UNFA in 2002. UNFA’s procedures were both fair relative to existing state nonjudicial foreclosure processes (some of which permitted foreclosure on unreasonable time frames and without required notice to certain creditors) and efficient relative to judicial foreclosure. UNFA even included provisions permitting the possibility of foreclosure by negotiated sale (e.g., one conducted by customary commercial methods used in the sale of real estate in arms-length settings, including the use of brokers and pictorial advertising). See Nelson & Whitman, *supra* note 48. But while UNFA provides the “state of the art” with respect to nonjudicial foreclosure, not a single state has enacted UNFA to date.

²⁵⁹ Our colleagues Grant Nelson and Bob Pushaw have previously argued that Congress could and should federalize real estate law given that the secondary market has transformed the historically-local mortgage market into a national one. See Grant S. Nelson & Robert J. Pushaw, *Rethinking the Commerce Clause: Applying First Principles to Uphold Federal Commercial Regulations but Preserve State Control Over Social Issues*, 85 IOWA L. REV. 1 (1999); see also 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 (2003).

2. Equating a Recorded Real Estate Mortgage with an Article 9 Financing Statement

A more modest, yet relatively aggressive reform would be for mortgage law to allow a recorded mortgage to have the same effect as an Article 9 financing statement. Under this approach, the recording of a senior mortgage would stake out the mortgagee's priority for *any* debts owed by the mortgagor to the mortgagee and secured by the land—even debts incurred later—for as long as the mortgage remained of record. Under this approach, as under Article 9, a creditor taking a junior lien against the mortgagor's equity in the property would be at risk that this equity would be "consumed" by future advances or other subsequent loans from the mortgagee to the mortgagor that are secured by the property.²⁶⁰

This approach holds significant potential advantages relative to mortgage law's status quo. First, it would provide the most comprehensive fix to the junior lien problem by creating the most optimal incentives. In the current market, it is common for one lender to hold a senior mortgage, a separate lender to hold a junior mortgage, and for there to be no inter-creditor agreement between them.²⁶¹ From a systems design perspective, this is particularly undesirable—perhaps the worst possible result. An inter-creditor agreement would be more likely to establish the respective priorities of the parties explicitly; it would more likely constrain the junior's ability to obstruct an efficient refinancing; and it would more likely prevent the junior from blocking the senior's ability to obtain an otherwise efficient modification or settlement of the senior mortgage. Mortgage law should encourage the existence of such agreements. But under the status quo, such

²⁶⁰ In fact, something similar to this approach is already available in some states, but remains unused in residential lending. As noted, statutes in about one-third of the states empower mortgage lenders to make future advances with the assurance that those advances will receive the priority of the original loan, subject only to two conditions: the mortgage must contain a clause authorizing future advances, and it must state a maximum amount for those advances. *See supra* notes 59–60 and accompanying text. Theoretically, the lender could insert a number into the mortgage that would stake out the lender's priority beyond any amount likely to be loaned against the home. In other words, even if the home has a value of only \$200,000, the lender might state that the mortgage could secure up to \$5 million. However, the Fannie Mae/Freddie Mac uniform residential mortgage form contains no future advance clause (and of course, no statement of the maximum amount to be advanced), and thus fails to take advantage of these statutes. Individual state adaptations of the uniform instrument (such as Missouri's) do have the necessary recitals of the future advance priority statute, but lenders do not routinely use them to "stake out" priority in an unlimited amount as described here. *See* THOMAS E. BAYNES, JR., FLORIDA MORTGAGES § 5–6 (Dec. 2016).

²⁶¹ *See* Rohit Kapuria et al., *What is an Inter-Creditor Agreement?*, EB5 DILIGENCE (June 5, 2015), <https://www.eb5diligence.com/articles/what-is-an-inter-creditor-agreement> (highlighting inter-creditor agreements as "not very favorable to a subordinate lender").

an inter-creditor agreement typically does not exist; the Garn Act prevents the senior home mortgagee from using the mortgage's due-on-encumbrance clause as leverage to compel such an agreement.²⁶²

By contrast, under this Article 9-informed approach, a creditor taking a voluntary junior lien could not be assured of having *any* priority against the equity in the mortgaged property unless the junior obtained an inter-creditor agreement establishing the agreed parameters of that priority. This approach would place the burden of obtaining such an agreement on the junior—*where that burden rightly belongs under a system ostensibly based on the prior-in-time concept*. Further, because the Garn Act does not affect state law perfection and priority rules, this approach accomplishes this result without any need for Congress to modify the Garn Act.²⁶³

Second, this approach would eliminate the need for a mortgage to contain provisions securing future advances,²⁶⁴ as well as all of the legal confusion associated with the existing future advance priority rules. Courts would no longer have to struggle with trying to articulate a meaningful and coherent distinction between optional and obligatory advances, decide whether or when the borrower had issued a stop notice, or if the borrower's issuance of a stop notice is enforceable (i.e., whether it would unreasonably jeopardize the senior's security for advances already made).²⁶⁵ This doctrine would become irrelevant and unnecessary.

Third, this approach would also eliminate any need for courts to determine whether a loan modification, replacement mortgage, or refinancing mortgage resulted in a "material prejudice" to the intervening junior;²⁶⁶ or

²⁶² See Garn-St Germain Depository Institutions Act of 1982, 12 U.S.C. § 1701j-3 (2018) (preemption of due-on-sale provisions).

²⁶³ Based in state law, this approach thus differs from the previous proposal by Professors Adam Levitin and Susan Wachter that Congress should modify the Garn Act to permit a senior to accelerate the senior debt if the borrower obtained a junior lien. See Levitin & Wachter, *supra* note 43, at 1287 ("We suggest that the Garn-St. Germain Act's prohibition on [due-on-sale] clause enforcement be modified, at least as applied to voluntary junior liens. A lender should be able to call its loan if the homeowner willingly encumbers the property with a junior lien.").

²⁶⁴ A mortgage could still have a future advances clause, and for efficiency purposes likely would. The presence of such a clause would obviate the need for the mortgagee to have the borrower execute yet another mortgage agreement at the time of later loans. But under this approach, a future advance clause would be significant only as between the borrower and the lender with regard to whether a lien exists to secure the later loan (i.e., for "attachment" purposes, in Article 9 terminology). The clause would, as under Article 9, have no significance for purposes of establishing priority vis-à-vis other creditors.

²⁶⁵ See, e.g., RESTATEMENT (THIRD) OF PROP.: MORTG. § 2.3(c)(1) (AM. LAW INST. 1997) (mortgagor's issuance of stop notice is ineffective if "a termination or subordination of future advances would unreasonably jeopardize the mortgagee's security for advances already made").

²⁶⁶ It is conceivable that a senior/junior inter-creditor agreement could incorporate a "material prejudice" standard in attempting to establish contractually how a subsequent modification of the senior debt would affect the parties' relative priorities. If so, we suppose, present case law regarding the

whether allowing equitable subrogation to a refinancing mortgagee would prevent “unjust enrichment.” If the existing senior mortgage remains of record and is sufficient to stake out the senior’s priority for future secured loans, a lender that makes a junior mortgage loan without obtaining an inter-creditor agreement establishing its expected priority would have no credible material prejudice argument. Likewise, under this approach, it would be irrelevant whether a refinance lender knew of an intervening junior lien or had constructive notice by virtue of the recording of the junior lien. Over the past three decades, an exceptionally large sum of attorneys’ fees has been spent litigating over the parameters of equitable subrogation in the refinancing context,²⁶⁷ which we believe was largely wasted. Implementing this approach would obviate the need for such litigation.

On the surface, this approach has one substantial apparent drawback: it disrupts the expectation of borrowers—encouraged by thirty-five years of experience under the Garn Act—that they can obtain junior financing against home equity in an unfettered market competition. By contrast, under this Article 9-informed approach, a mortgagor seeking to tap its home equity is to some extent “locked-in” to dealing with the existing senior mortgagee, which would have an implicit first refusal right to make further secured loans against the home while the senior mortgage remains of record. One might object that this approach could prevent the borrower from obtaining a home-equity loan altogether (if the senior mortgagee unreasonably refuses an additional loan) or could force the borrower to accept such financing at a higher rate. It could also subject them to other more onerous terms than the borrower could receive from competing lenders. In fact, this very concern—protecting the mortgagor’s access to credit—explains much of the present substance of mortgage law regarding future advance priority.²⁶⁸

At first blush, this concern would appear overstated. As Professors Levitin and Wachter have previously argued, the senior lender “does not in fact have an absolute bilateral monopoly” over the borrower’s access to credit.²⁶⁹ Consider the example of Borrower, who owns a home worth \$500,000 and subject to a first-priority mortgage held by First Bank securing an outstanding balance of \$250,000. Borrower wants to obtain an additional

existence of “material prejudice” could remain relevant.

²⁶⁷ See generally, John C. Murray, *Equitable Subrogation: Can a Refinancing Mortgagee Establish Priority over Intervening Liens?*, 45 REAL PROP. TR. & EST. L.J. 249 (2010) (discussion of unpredictability of equitable subrogation).

²⁶⁸ See, e.g., NELSON, WHITMAN, BURKHART & FREYERMUTH, *supra* note 25, § 12:7, at 1096 (common law’s optional vs. obligatory standard meant to protect “marketability of the mortgagor’s title, so that she can borrow from other lenders”); see *supra* notes 47–58 and accompanying text.

²⁶⁹ Levitin & Wachter, *supra* note 43, at 1289.

\$50,000 loan to pay college tuition bills for Borrower's child. Second Bank would be willing to extend this credit at a competitive rate, but First Bank simply refuses to consent or to agree to subordinate to Second Bank with respect to any future advances to Borrower. This refusal does not mean that Borrower will be denied access to its home equity. If prudent underwriting justifies Second Bank's willingness to make Borrower a \$50,000 home equity loan, it would also justify Second Bank in making a \$300,000 loan that would be a first priority mortgage once Second Bank takes out First Bank's senior position and either compels the cancellation of First Bank's mortgage or an assignment of that mortgage to Second Bank.²⁷⁰ And knowing that Second Bank would happily make that loan, First Bank is less likely to act in a way that will exploit Borrower. Thus, the ready availability of refinancing ameliorates any risk that a creditworthy borrower could not obtain financing otherwise justified by the value of the borrower's home.

Concededly, this scenario does not work as well if market interest rates have risen significantly since the original mortgage loan. A refinancing of the balance due on the original (plus the additional "cash out" needed by the borrower) would likely be at the higher current rate, and the borrower might be quite unwilling to give up the benefit of the lower rate on the original loan. In turn, this might give the original lender considerable additional bargaining power in setting the terms of an additional advance,²⁷¹ and could result in higher aggregate interest rates to consumers in refinancing transactions.²⁷²

Further, the availability of refinancing as a *complete* answer to the bilateral monopoly problem assumes that the borrower can prepay the senior mortgage debt at any time. Under existing mortgage law, however, the default rule is "perfect tender in time"—unless the loan documents permit prepayment, the mortgagee can refuse prepayment and insist upon payment in strict accordance with the terms of the documents.²⁷³ As a result, if the

²⁷⁰ While such a take-out loan would involve transaction costs, so would any junior mortgage loan. *See id.* at 1290 ("To be sure, there are transaction costs for refinancing, but they are unlikely to exceed those for exercising the leverage option, which means borrowing for a separate second mortgage."). Moreover, the biggest transaction costs are loan origination fees, which would be entirely within the control of the second lender, and therefore could be minimized to a level comparable to those normally expected in the making of a free-standing junior mortgage loan.

²⁷¹ For example, suppose that First Bank's existing mortgage bears a rate of 5% and current mortgage interest rates are at 10%. Borrower clearly would like to maintain the benefit of the 5% rate, but First Bank—realizing that Borrower cannot "take out" First Bank without refinancing the full balance at 10%—may refuse to extend additional credit to Borrower unless Borrower agrees to modify the original loan to increase the interest rate above the now-suboptimal 5% rate.

²⁷² If legislators consider this risk to be unacceptable, one solution would be to require the original lender either to extend second mortgage credit on the same terms offered by a competing lender or to consent to the borrower obtaining the loan from the competing lender.

²⁷³ NELSON, WHITMAN, BURKHART & FREYERMUTH, *supra* note 25, § 6:1, at 481 ("Contrary to what

senior loan documents are silent, the senior could refuse to permit its loan to be taken out, which would complicate the borrower's ability to obtain refinancing.²⁷⁴

In practice, the perfect tender in time rule has not prevented access to refinancing because it is a default rule that the parties typically opt out of in the mortgage contract. In the home mortgage context, the Fannie Mae/Freddie Mac uniform notes have provided since 1975 that the borrower can prepay in whole or in part, at any time, without any prepayment fee.²⁷⁵ The "free prepayment" clause has contributed to the enormous volume of refinancing transactions the market has experienced during more than three decades of generally declining interest rates, and has shaped the expectation of most homeowners that the law readily permits them to refinance.²⁷⁶ As long as this clause remains in the archetypal home mortgage loan document, this would sufficiently protect the typical homeowner from being deprived of access to credit against the value of the home.²⁷⁷

In the modern political climate, however, the future of Fannie Mae and Freddie Mac are unclear—and in turn, perhaps also the future of the uniform instrument and its free-prepayment-at-any-time clause.²⁷⁸ To that extent, a legitimate concern remains and implementing this approach effectively would not only require state legislation to reject perfect tender in time as a default rule,²⁷⁹ but also to establish either a bar on prepayment fees on residential first mortgages or a statutory limit on the permissible amount of such a fee.

is probably the pervasive popular belief, in the absence of a specific provision in the note or mortgage so permitting, there is by the majority view no right to pay off a mortgage debt prior to its maturity.").

²⁷⁴ Even if the perfect tender in time rule applies and the senior can thus refuse prepayment, this would not necessarily preclude a refinancing. The refinancing transaction, however, would have to leave the existing senior mortgage in place, and thus would have to take the form of a wraparound mortgage. Use of a wraparound mortgage for refinancing purposes would certainly complicate the refinancing relative to conventional refinancing transactions. For a more thorough discussion of wraparound mortgages, see *id.* § 9:8.

²⁷⁵ See Forrester, *supra* note 24, at 1084–85.

²⁷⁶ *Id.* at 1089–90.

²⁷⁷ Of course, not all borrowers can satisfy the Fannie or Freddie underwriting requirements, and thus some end up with nonuniform loan documents that do not allow free prepayment. These loan documents do, however, customarily allow prepayment for a stated fee.

²⁷⁸ See generally Jeanine Skowronski, *Future of Fannie, Freddie Still Unclear*, STREET (Aug. 8, 2010), <https://www.thestreet.com/story/12807023/1/future-fannie-freddie-still-unclear.html>.

²⁷⁹ The Restatement of Mortgages already takes this approach, making the mortgage presumptively pre-payable without fee unless the mortgage provides otherwise. See RESTATEMENT (THIRD) OF PROP.: MORTG. § 6.1 (AM. LAW INST. 1997) ("In the absence of an agreement restricting or prohibiting payment of the mortgage obligation prior to maturity, the mortgagor has a right to make such payment in whole or in part.").

The other drawback to this approach is that its comprehensiveness would make its implementation too ambitious and disruptive. By contrast to Article 9, mortgage law does not exist as a uniform, codified whole, but as a body of common law rules with a level of statutory overlay that varies by state in its breadth and depth. For example, the perfect tender in time rule is, in most states, a common law principle rather than a statutory directive. The future advance priority rules vary by state as to their source: some states still follow the judicially-established optional/obligatory distinction, while others have codified their future advance priority rules but in a non-uniform manner. As noted above, this approach would require mortgage law to displace both the perfect tender in time rule and the existing rules on future advance priority. For lenders in an increasingly national mortgage market to adapt meaningfully, these changes could not occur via the case-by-case reform process of the common law; they would have to occur in a largely uniform statutory codification.

Is this approach practicable? There is room for substantial doubt. Congress seems unlikely to federalize mortgage law, and as noted earlier, prior efforts (such as ULSIA) to achieve comprehensive uniform codification of state mortgage law failed spectacularly. However, ULSIA's failure could have been a function of its over-comprehensiveness. In particular, ULSIA's adoption of nonjudicial foreclosure as the standard method of mortgage enforcement²⁸⁰ proved an insuperable political barrier—a lesson reinforced again when UNFA later achieved no enactments.²⁸¹ ULSIA tried to do too much, and could not overcome the resistance of accumulated years of doctrine and practice—and the expectations those years of doctrine and practice shaped in borrowers and lenders.²⁸²

By contrast, the approach described here would not codify mortgage law in a comprehensive fashion, a la Article 9. It is actually substantially more modest. Fixing the junior lien problem does not require that states adopt the same foreclosure method; judicial-foreclosure-only states could remain judicial-foreclosure-only states. States could continue to adopt different approaches with respect to the availability of a deficiency judgment, or whether the foreclosed borrower should be entitled to “fair value” protection,

²⁸⁰ See UNIF. LAND SEC. INTEREST ACT § 509 (UNIF. LAW COMM'N 1985). See Roger Bernhardt, *ULSIA's Remedies on Default—Worth the Effort?*, 24 CONN. L. REV. 1001, 1029–41 (1992).

²⁸¹ See *supra* note 258 and accompanying text.

²⁸² One might offer the same critique of ULSIA's predecessors, the Uniform Land Transactions Act (ULTA) and the Uniform Simplification of Land Transfers Act (USLTA). ULTA and USLTA were perceived to be too disruptive of existing state conveyancing practices and ultimately not necessary to facilitate the development of a national mortgage market. See, e.g., Marion W. Benfield, Jr., *Wasted Days and Wasted Nights: Why the Land Acts Failed*, 20 NOVA L. REV. 1037 (1996).

or whether an installment contract constitutes a mortgage or is instead governed by contract law. States could continue to differ in the standards by which courts should evaluate whether or not to appoint a receiver for mortgaged property. States could even innovate and attempt to implement foreclosure sale processes that attempted to shift the foreclosure system from a public auction-based model to one incorporating characteristics of market sales.²⁸³ In fact, this approach would entirely preserve state autonomy with regard to mortgage enforcement. Instead, it would more narrowly target the priority rules of mortgage law that contribute to or exacerbate the junior lien problem. Where the ULC's efforts to achieve statutory reform in real estate law at the state level have been more narrowly targeted, they have been more successful.²⁸⁴

Finally, there is substantial reason to believe that lenders can readily adapt to the changes this approach contemplates. The lending community has nearly sixty years of accumulated experience with Article 9's first-to-file-or-perfect rule and its implications for loan underwriting. While this approach would involve the need for some changes in standard mortgage documentation, these changes would likely be minor,²⁸⁵ and would not pose an insurmountable burden if a reform statute provided a suitably delayed effective date. Likewise, this approach would require no significant changes to the underwriting or servicing procedures of first mortgage home lenders or servicers. It would be disruptive of the expectations of second mortgage lenders, but that is the whole point. The approach does not forbid second mortgage lending, but places the burden on the second mortgage lender to obtain contractual protection for its expected priority—*again, exactly where*

²⁸³ See, e.g., Burkhardt, *supra* note 177.

²⁸⁴ Several ULC real property-related acts narrowly tailored to address particular market failures have been much more successful. See, e.g., UNIF. PARTITION OF HEIRS' PROP. ACT (UNIF. LAW COMM'N 2010) (11 enactments); UNIF. REAL PROP. ELEC. RECORDING ACT (UNIF. LAW COMM'N 2004) (34 enactments); UNIF. ENVTL. COVENANTS ACT (UNIF. LAW COMM'N 2003) (26 enactments).

²⁸⁵ For example, it is common in some states for a mortgage containing a future advance clause to specify the maximum principal amount that can be secured under the mortgage; in Missouri, for example, this recital is required by statute. See MO. REV. STAT. § 443.055(2) (2018). Under this approach, there would be no inherent limit on the amount that a mortgage could secure, and thus there would be no need for such a limit unless the parties themselves agreed to such a limit. But this is a minor tweak, and readily accomplished. As noted, under this approach, a mortgage would not even have to have a future advance clause; the recording of the mortgage would establish the lender's priority for both the amount of that mortgage loan and any future loans by the same lender that are secured by the same land. See *supra* note 260 and accompanying text. However, if the mortgage did have a future advance clause in it, the lender would not have to have the borrower execute a new mortgage agreement at the time of the subsequent loan; by contrast, if the original mortgage had no future advance clause, the borrower would have to execute a new mortgage agreement at the time of the subsequent loan.

that burden belongs in a priority system ostensibly based on the first-in-time concept.

The preceding discussion has not addressed the effects of this strong Article 9-like approach on nonconsensual junior lienholders such as judgment lien creditors, mechanics' lienors, and some types of tax lien holders (such as the United States in asserting a federal tax lien). Because these creditors would not have an opportunity to negotiate inter-creditor agreements with first mortgagees, one might argue that a system that permits additional loans by the first mortgagee to "soak up" the borrower's equity would operate unfairly by diminishing or eliminating the value of their liens. It is worth noting here that whether these nonconsensual junior liens have any value at all is largely a matter of luck. For example, consider judgment liens. At the time a judgment creditor obtains and perfects a lien, the debtor may or may not have fully encumbered his or her property with mortgages or other voluntary liens. If the real estate is already fully encumbered or over-encumbered, the judgment lien is worthless.²⁸⁶ Barring an unexpected and usually improbable increase in the property's value, the judgment is simply not worth enforcing; an execution sale would have no bidders. The same is true of mechanics' liens. In most states, mechanics' liens are subordinate to properly perfected construction loan mortgages.²⁸⁷ Hence, if the construction loan on a project already exceeds its value (a common occurrence with troubled projects), there is no practical value in an unpaid contractor or supplier enforcing its lien.

Assume, however, that the property is not fully encumbered. Any creditor that acquires an involuntary subordinate lien could choose to enforce that lien by foreclosure immediately; if it chooses not to do so, there is no inherent unfairness if a later loan to the borrower (which would typically extend new value to the borrower) increases the balance of the senior debt.²⁸⁸ As a result, we have no particular sympathy for the traditional judgment lien creditor who chooses to wait rather than enforce its lien immediately. On the other hand, there may be more sympathetic grounds for an exception that carves out an intervening priority for a mechanics' lien creditor, whose labor or materials will have contributed to or preserved the value of the mortgaged property. And state law, of course, has nothing to say about the priority of an intervening federal tax lien. Even under this suggested approach, the ability

²⁸⁶ NELSON, WHITMAN, BURKHART & FREYERMUTH, *supra* note 25, § 4:2.

²⁸⁷ *Id.* § 12:4.

²⁸⁸ Indeed, in the approximately one-third of the states that allow future advances to retain priority up to the amount stated in the senior mortgage, a judgment lien creditor that acquires a judgment lien but does not enforce it immediately already runs a comparable risk. *See supra* notes 59–60 and accompanying text.

of the senior mortgagee to obtain the priority of its original mortgage for future non-construction-related secured loans vis-à-vis an intervening federal tax lien would remain limited to advances made without actual knowledge of the tax lien and within the first forty-five days after the tax lien arises.²⁸⁹

3. Enhancing the Durability of a Mortgage in the Context of Modification or Refinancing

A more modest reform approach would not treat the mortgage as the equivalent of an Article 9 financing statement, but would instead enhance its durability in the event of a modification or refinancing. This approach would make explicit that a mortgage can remain of record until the mortgage debt is *actually satisfied*—i.e., repaid in full *by the borrower*, rather than through a refinance.

This approach is best demonstrated by considering the classic refinancing transaction. Suppose that Debtor owns a home that secures repayment of a mortgage loan from First Bank with a current balance of \$200,000. Debtor then decides to refinance with Second Bank (which is offering slightly better terms than First Bank). At the time of the Debtor's application for the refinancing loan, there is a \$100,000 outstanding judgment against Debtor in favor of Smith. Second Bank nevertheless makes the loan, expecting that it will have first priority. Second Bank then records its mortgage, and shortly thereafter the First Bank mortgage is cancelled.

As explained in Part III, the proper result in this circumstance is that Second Bank's mortgage should receive priority over Smith by virtue of equitable subrogation to the priority position previously held by First Bank. On the given facts, there is no credible argument that this result is prejudicial to Smith or in any way contravenes Smith's reasonable expectations. At the time Smith obtained the intervening lien, it was in a junior position to First Bank. Second Bank could have paid First Bank \$200,000, taken an assignment of the First Bank mortgage, and modified the note to conform to the terms of Second Bank's loan. If that had happened, Smith could not have prevented the assignment and unquestionably would have remained in the same junior position.²⁹⁰ This demonstrates that by allowing Second Bank to

²⁸⁹ 26 U.S.C. § 6323(d) (2018); NELSON, WHITMAN, BURKHART & FREYERMUTH, *supra* note 25, § 9:9.

²⁹⁰ This assumes, as is usually the case, that Second Bank's loan terms are in fact better for the borrower than the terms of the old First Bank loan, so that the new loan will be as easy or easier for the borrower to pay. This fact eliminates any argument an intervening junior lienor might make of material prejudice from the change of loan terms. Obviously, if Second Bank extends Debtor an additional \$50,000 of new credit in this transaction, thereby increasing the principal balance of the debt, Smith would be

take the existing priority position of First Bank, it does not unduly prejudice Smith. On the contrary, by promoting Smith in priority, it would enrich Smith by giving him first dibs at proceeds of sale of the home under circumstances where Smith had no reasonable assurance of that result when Smith obtained the judgment. Application of the equitable subrogation doctrine in this circumstance is efficient and appropriate because it accomplishes this result without requiring Second Bank to incur the additional transaction costs associated with an assignment of the mortgage from First Bank and a subordination agreement from Smith.

Likewise, it should be irrelevant whether Smith's junior lien was of record or whether Second Bank had actual knowledge of Smith's lien. By virtue of the refinancing, Second Bank expects to step into First Bank's position regardless, as it could have done through a direct assignment of the First Bank mortgage. Some courts have refused to apply equitable subrogation in this circumstance on the theory that this result is necessary to preserve the integrity of the state's recording statute, most notably *Countrywide Home Loans, Inc. v. First Nat'l Bank of Steamboat Springs* (based on Wyoming's race-notice statute)²⁹¹ and *Eastern Savings Bank, FSB v. CACH, LLC* (based on Delaware's pure race statute).²⁹² But these cases were wrongly decided, because they fundamentally misunderstood the purpose of recording statutes as a dispute resolution mechanism. The recording statute exists to protect the expectations of persons who acquire their interest in *reasonable reliance* upon the fact that the information in the recording system was misleading.²⁹³ Someone who takes a junior position (whether voluntarily or involuntarily) behind a recorded mortgage knows or should know that they have no guarantee or legitimate expectation of first priority until the senior debt has been satisfied, i.e., *paid in full by the debtor*. Because the later refinancing transaction does not trigger that result, the junior (in our hypothetical, the judgment creditor Smith) has no compelling reliance-based story to tell vis-à-vis the refinancing lender. Further, this is true regardless of whether the original refinanced mortgage document was cancelled or not.

The policies that underlie the recording act do become relevant to the priority of the junior's lien when the junior assigns that position, whether through sale or foreclosure of the junior lien. Returning to our previous example, suppose that after the refinancing transaction, Smith obtains an

materially prejudiced if Second Bank was to have its original priority for the newly-extended credit as well as the original refinanced principal balance. See *supra* Part III.A.1.

²⁹¹ 144 P.3d 1224, 1231 (Wyo. 2006).

²⁹² 124 A.3d 585, 592 (Del. 2015).

²⁹³ 25 DEL. CODE ANN. § 2106 (2018).

order for an execution sale of the home in satisfaction of Smith's judgment. At that sale, Henning buys the home, after doing a title search and concluding that: (1) the First Bank mortgage, having been cancelled, must have been satisfied; and (2) based on first-in-time, Smith's judgment lien has priority over Second Bank's mortgage, such that the sale will in fact deliver clear title to the home. Is Henning a bona fide purchaser (BFP) that takes free of Second Bank's lien? Or does Henning take subject to that lien on the basis that Second Bank was subrogated to the priority of the refinanced First Bank mortgage that was cancelled of record?

Second Bank will argue that equitable subrogation should still apply, and that a reasonable person in Henning's position was on constructive notice of this possibility even though the First Bank mortgage had been cancelled of record. This argument receives strong support from a recent Michigan decision, *Wells Fargo Bank, NA v. SBC IV REO, LLC*,²⁹⁴ which involved a dispute between a refinancing mortgagee (Wells Fargo) and the assignee/purchaser (SBC) of a mortgage loan that had been a junior mortgage when originally taken by that lender (Capitol). SBC argued that it was a bona fide purchaser—based on the recorded cancellation of the original refinanced mortgage—and thus had priority over Wells Fargo's later-recorded refinancing mortgage. The court rejected this view:

The bona-fide purchaser argument posed by SBC does not rely on a previously unrecorded conveyance that allegedly constituted a defect of which it had no notice.... Instead, SBC appears to be maintaining that it had no notice of the possibility of an equitable-subrogation claim. Essentially, SBC is equating an equitable-subrogation interest (a prospective claim of equitable subrogation) to a "previously unrecorded conveyance," which equitable-subrogation interest can be defeated if a subsequent mortgagee acquires a mortgage for a valuable consideration and records it absent notice of a viable claim for equitable subrogation.

Assuming for the sake of argument that the premise of SBC's theory is sound, . . . SBC cannot show that it was indeed a bona fide purchaser for value²⁹⁵

Noting that Michigan courts had embraced the Restatement's view of equitable subrogation two years prior to SBC's purchase of the Capitol mortgage, the court held that because the record showed the original (although cancelled) mortgage and the refinancing mortgage, SBC "should

²⁹⁴ 896 N.W.2d 821, 824–25 (Mich. Ct. App. 2016).

²⁹⁵ *Id.* at 842–43.

have been aware of an available claim of equitable subrogation” by Wells Fargo as the refinancing lender.²⁹⁶ Further, the court suggested that the very premise of SBC’s theory was unsound “considering that the whole purpose of the doctrine of equitable subrogation is to allow a mortgagee whose mortgage is the junior lien in the public record to attain senior lien status.”²⁹⁷

The court’s reasoning in *Wells Fargo v. SBC IVREO* makes perfect sense in its factual context. As a sophisticated commercial actor engaged in the purchasing of mortgage loans, SBC can be expected to appreciate the existence and operation of the equitable subrogation doctrine. Prior to its purchase, SBC could have (and should have) inquired of Wells Fargo, and inquiry would have revealed that the later-recorded refinancing mortgage would have the priority of the prior cancelled mortgage under equitable subrogation.

The decision may be a bit more unsettling in our hypothetical, where the person claiming BFP status is not a sophisticated investor but a consumer homebuyer. On the one hand, it seems less likely that a consumer homebuyer like Henning would know of the equitable subrogation doctrine or appreciate its application. Thus, one might expect some judges to be sympathetic to Henning in a dispute with a lender that could have structured its transaction differently. On the other hand, as the Michigan court noted, an equitable subrogation claim does not arise from an unrecorded document, and there are many circumstances in which purchasers who believe they are BFPs nonetheless take subject to unknown claims.²⁹⁸

A modest reform approach would address these issues in two ways. First, it would explicitly embrace the Restatement’s position on the replacement mortgage doctrine and equitable subrogation for refinancings. Fortunately, in an increasing number of states, this has happened through judicial adoption without legislative intervention. In states where it has not, legislation could codify the Restatement result by providing that when a refinancing occurs (i.e., where a third-party refinancing lender pays the outstanding balance to the original mortgagee), an assignment of the original mortgage to the refinancing mortgagee occurs by operation of law. In the replacement

²⁹⁶ *Id.* at 843.

²⁹⁷ *Id.* at 843 n.24.

²⁹⁸ The recording system does not communicate perfect information and does victimize some purchasers who might reasonably have thought themselves to be BFPs based on a record search. For example, Freyeremuth might purchase a home because a title search reveals that the only mortgage appearing in the record chain of title has been satisfied of record; unbeknownst to Freyeremuth, however, the recorded satisfaction piece was a masterful forgery and the mortgage loan remains unsatisfied. The forgery is void, and Freyeremuth takes title to the home subject to the lien of the unpaid mortgage. There is a reason for prudent buyers to buy title insurance!

mortgage context (where the lender is taking out its own position), legislation could codify the Restatement result by making explicit that the mortgagee has the same priority for the replacement mortgage as it did for the original mortgage, to the extent of the amount refinanced.²⁹⁹

Second, the refinancing or replacement mortgagee should be able to leave the original mortgage of record (i.e., without having to record a cancellation or satisfaction). This would provide a more effective signal to potential assignees of an intervening junior that they are stepping into a junior position. Ideally, perhaps, either through statutory codification or a change in documentary practice, the refinancing lender could likewise signal its intention to invoke the replacement mortgage doctrine or equitable subrogation (as appropriate) by labeling the new mortgage document as a “replacement mortgage” or “refinancing mortgage.”³⁰⁰ In some states, this approach may require a modification of mortgage satisfaction statutes, which in their present form may require the recording of a mortgage satisfaction even in cases in which the loan is simply being refinanced rather than truly paid off by the borrower.

4. Summary

We believe that mortgage law can and should address the junior lien problem through a lens informed by UCC Article 9. This should not take the form of a comprehensive codification of mortgage law in the style of Article 9, given the failure of similar previous efforts and the political commitment of more than twenty states to judicial foreclosure as the exclusive foreclosure method.³⁰¹ Instead, mortgage law might take one of two less comprehensive approaches. Under the first approach, a recorded mortgage would be given the same effect as a filed financing statement under Article 9, such that it would stake out the mortgagee’s priority not only for the contemporaneous loan, but for any subsequent loans made by the mortgagee that are secured by the mortgaged property. This approach would still permit junior mortgage lending, but the junior mortgagee could not enjoy an assured position in the lien priority stack without obtaining an agreement with the senior mortgagee

²⁹⁹ The Commonwealth of Virginia has such a statute, although it is subject to some limits. First, it is effective only against intervening mortgages not exceeding \$50,000 in amount. Second, the refinancing mortgage must contain a clause identifying the recording information for the original mortgage. Third, the balance on the refinancing mortgage must not exceed the balance paid on the original mortgage by more than \$5,000 and its interest rate must not be higher than that of the original mortgage. *See* VA. CODE ANN. § 55–58.3 (2018).

³⁰⁰ VA. CODE ANN. § 55–58.3 does this, and also requires the inclusion of the recording information for the mortgage being refinanced.

³⁰¹ *See supra* notes 257–59 and accompanying text.

sufficient to provide that assurance.³⁰² This approach would also obviate the need for courts to apply complex existing doctrines (such as future advances priority and equitable subrogation rules) to resolve senior versus junior priority disputes. Under the second, more modest approach, mortgage law could enhance the durability of a mortgage in the context of refinancing or modification transactions by making it explicit that a mortgage retains its priority and may remain of record until the mortgage debt is fully satisfied by the borrower (rather than through a modification or refinancing).³⁰³ Even this more modest approach, in combination with enactment of the MNAFA as discussed in Part V, would provide a largely complete solution to the efficiency problems posed by junior mortgage liens.

VII. CONCLUSION

Beginning in 2007, the United States real estate market endured a crisis more severe than any since the Great Depression of the 1930s.³⁰⁴ Today, signs of recovery are strong; land values in most areas now exceed pre-2007 levels, and Fannie Mae and Freddie Mac are returning substantial profits to the Treasury.³⁰⁵ Yet the crisis has reminded us that land values are not predestined to move in only one direction; land values remain subject to economic gravitational forces in the same way that the parcels to which those values relate are subject to physical gravitational forces. As Isaac Newton is alleged to have said—and as the band Blood Sweat & Tears definitively said—“What goes up, must come down.”³⁰⁶ We may not know when the next real estate crisis will occur, but it *will* occur.

During a November 2008 *Wall Street Journal* forum, former Chicago Mayor Rahm Emanuel noted, “You never want a serious crisis to go to waste.”³⁰⁷ The post-2007 real estate crisis exposed how present law permits junior lienholders to impose unwarranted barriers and costs that obstruct the efficient resolution of distressed mortgage loans. Now is the time for mortgage law to fix the junior lien problem prior to the next crisis. In the

³⁰² See *supra* notes 260–64 and accompanying text.

³⁰³ See *supra* notes 282–94 and accompanying text.

³⁰⁴ See Steve Hanke, *What Do The Great Depression And The Great Recession Have In Common?*, FORBES (Aug. 16, 2017), <https://www.forbes.com/sites/stevehanke/2017/08/16/what-do-the-great-depression-and-the-great-recession-have-in-common/#3fe2d094375d>.

³⁰⁵ See Cicley Wedgeworth, *10 Years After the Crash, the Boom Times Are Back in Real Estate—But Way Different*, REALTOR.COM (Nov. 13, 2017), <https://www.realtor.com/news/trends/10-years-recession-boom-times-back-real-estate>.

³⁰⁶ See BLOOD, SWEAT & TEARS, *Spinning Wheel*, on BLOOD, SWEAT & TEARS (Columbia 1968).

³⁰⁷ A video of Emanuel’s comments is available at Wall Street Journal, *Rahm Emanuel on the Opportunities of Crisis*, YOUTUBE (Nov. 19, 2008), https://www.youtube.com/watch?v=_mzcbXilTkk.

process, mortgage law can and should look to UCC Article 9 where appropriate for inspiration for the needed fixes. At a minimum, we encourage the adoption of the Model Negotiated Alternative to Foreclosure Act so as to permit a deed in lieu of foreclosure to have title-clearing effect and extinguish valueless junior liens. Further, if federal law is going to continue to prevent senior mortgagees from exercising due-on-acceleration clauses to discourage the creation of junior liens, then states should also consider modifying mortgage law to allow a recorded mortgage to stake out that mortgagee's priority for subsequent secured loans. This would effectively place on junior mortgage lenders the burden to obtain an inter-creditor agreement to assure the junior's expected place in the lien priority stack—exactly where that burden belongs in a system based upon the first-in-time principle. Alternatively, states might more modestly enhance the durability of a mortgage in the context of refinancing or modification by making it explicit that a refinancing mortgage retains the priority of the original mortgage (which may thus remain of record) until the refinanced debt is fully satisfied by payment by the borrower.

