# ANALYSIS OF CONSTITUTIONAL ISSUES RELATED TO FORECLOSURE CRISIS-DRIVEN STATE RELIEF LAWS

**By**

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## I. STATES HAVE BROAD AUTHORITY TO REGULATE FORECLOSURES UNDER MODERN INTERPRETATIONS OF THE CONTRACTS CLAUSE

### A. Depression Era Foreclosure Legislation by the States - Background

During a period of about eighteen months in 1933 and 1934, twenty-seven states enacted statutes designed to mitigate the effects of the mortgage foreclosure epidemic that was sweeping the country.[1] In February and March 1933 Iowa and Minnesota passed the first such laws shortly after several thousand farmers had stormed into the opening legislative sessions in each state, disrupted proceedings, and demanded immediate foreclosure relief.[2] Before enactment of the Minnesota law, the state's governor had threatened to impose martial law over the deteriorating foreclosure climate and issued an executive order to sheriffs statewide to cease conducting foreclosure sales and evictions. One commentator who was involved in drafting legislation at the Minnesota capitol at the time described the climate in the legislature as a "flood of bills" poured in:

> It was proposed, for example: that the courts be closed to all mortgage foreclosure proceedings for two years; that the power to foreclose by advertisement be abolished; that sheriffs be given the power to postpone foreclosure sales at their discretion; that the courts be given the power to continue all foreclosure proceedings for two years upon such terms as should appear to them to be appropriate; that the period of redemption be extended arbitrarily one year, or two; and that henceforth there would be no personal liability upon any note or debt secured by a mortgage after the mortgage had been foreclosed.[3]

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[1] *Osborne on Mortgages* § 331 (2d ed. 1979). *See generally* Poteat, *State Legislative Relief for the Mortgage Debtor during the Depression*, 5 Law and Contemporary Problems, 517 (1938); Feller, *Moratory Legislation: A Comparative Study*, 46 Harvard L. Rev. 1061 (1933); G. Glenn, *Mortgages*, Vol. II §§ 150 to 167 (1943); *Powell on Real Property* § 37.49 (1968 ed.).
[2] Benton, *Iowa's Mortgage Moratorium Statute, A Constitutional Analysis*, 33 Drake L. Rev. 303 (1983-84); Prosser, *The Minnesota Mortgage Moratorium*, 7 So. Cal. L. Rev. (1934).
[3] Prosser, *supra* at p. 356.

During 1933 and 1934 many states enacted statutes that actually achieved most of these objectives. State legislatures drafted these laws with care in hopes of surviving constitutional challenges. The statutes authorized stays of foreclosure proceedings and extensions of post sale redemption periods, often lasting for several years. Borrowers were given powers to turn non judicial foreclosures into judicial foreclosures. State legislation provided tools for courts to restrict the harshness of deficiency judgments.[4] Some prominent examples of these laws will be discussed below.

1. *Moratorium/Stay of Proceedings in Depression Era legislation.*

Moratorium laws enacted during the thirties applied to both non judicial and judicial foreclosures. Yet, for the most part these statutes were drafted carefully to incorporate judicial supervision over any stay of foreclosure. Almost uniformly the laws imposed some form of payment obligation upon borrowers as a condition to the continuation of a stay. Several types of statutory schemes were typical. Most moratorium statutes followed the examples of the four state statutes discussed below:

**The Iowa Moratorium Statute.** Iowa was and remains a judicial foreclosure state. Its initial moratorium statute enacted in February 1933 authorized a borrower to apply to a court for an order continuing a pending foreclosure action until March 1, 1935. The Act gave courts the authority to prohibit entry of a foreclosure judgment while the stay remained in effect. The borrower had the right to remain in possession of the property during the stay period. However, the statute created a procedure for the courts to require the borrower to pay rents, income and profits generated by the property to the lender while the stay remained in effect. A similar process applied to cases in which a foreclosure judgment had already been entered. In these cases the statute extended the state's post judgment redemption period for a two year period subject to similar payment conditions. The Act applied to pending cases and to mortgages entered into before the enactment of the statute.

Under the Iowa statute the borrower's initial eligibility for the moratorium was automatic. The lender had the burden of proof of showing that the borrower made the application in bad faith. In a later reenactment of the statute, this burden of proof changed and the law required that the borrower establish good faith as a condition to obtaining the stay.[5]

**The New York Moratorium Statute.** New York was another judicial foreclosure state that enacted a foreclosure moratorium statute during the thirties. New York's law also barred foreclosure of mortgages in default, but required the borrower to continue payment of interest and taxes. The law provided that a court would review income and expenses related to the property every six months. At its

[4] Feller, *supra*; Poteat, *supra*; Clifford C. Hynning, *Constitutionality of Moratory Legislation*, 12 Chicago-Kent L. Rev. 182 1934).
[5] Benton, *supra*, at pp. 309-310.

discretion the court could require the borrower to pay the lender any surplus over and above what was needed to pay interest and taxes. Essentially, the statute provided for a moratorium only on the payment of the loan principal.[6] The law made the borrower's payment of interest, taxes, and insurance a condition to the suspension of foreclosure. The court was authorized to terminate the stay upon the borrower's nonpayment of any amounts the court at its discretion had ordered to be paid to the lender.[7]

In most cases the New York statute did not require that a court conduct any extensive evaluation of the borrower's income and expenses. The requirement to pay interest, taxes, and insurance focused on terms of the particular contract, and these amounts could be readily ascertained. A requirement that the borrower make payments to the lender out of surplus income left over after payment of interest, taxes, and insurance was adopted by later amendment to the statute. This requirement became a factor for income producing properties such as farms or buildings with rental units. The stay was granted automatically and continued upon compliance with payment terms. The New York statute did not incorporate any kind of "good faith" threshold for the borrower.

**The California Moratorium Statute.** Foreclosures in California during the thirties, as now, were primarily non judicial. California's moratorium statute functioned in much the same way as those in judicial foreclosure states. It authorized courts to stay judicial as well as non judicial foreclosures. The borrower petitioned a court for this postponement.[8] The petition for postponement could be filed at any time within 90 days after recordation of the notice of default. Also, at any time before expiration of the post-sale redemption periods, the borrower could file a petition to extend the redemption period.

Under the California law the courts exercised their equitable discretion in granting stays. Granting of a stay was not automatic, even upon compliance with set payment terms. The borrower's inability to pay was not in and of itself sufficient grounds for relief.[9] The burden of proof of showing a right to relief was on the borrower. The court had discretion to set amounts for payment to the lender as a condition to the granting and continuation of the stay. In setting a payment amount the court could consider the value of the property and the income derived from it. At a minimum the borrower was required to pay enough to meet obligations for upkeep, taxes and insurance. The post sale period of redemption could be extended on the same grounds and through a similar procedure. There were apparently few legal challenges to these exercises of the courts' traditional equitable discretion related to foreclosures. One commentator noted eight years after the statute's enactment that no

[6] *See Glenn on Mortgages, supra* § 154.1.
[7] New York eventually added a requirement that borrowers pay 1% per annum toward principal due as a condition to the stay. This percentage increased over later reauthorizations of the moratorium statute. M. Litton, *Suits for Interest Under the New York Mortgage Moratorium*, 25 Cornell Law Q. 401 (1940).
[8] *See Comment, Moratoria and Stay Laws: Mortgage Moratorium Legislation in California*, 30 Cal. L. Rev. 172 (1942).
[9] *Id* at p. 174.

trial court decisions related to granting, denial or termination of a stay had ever been set aside on appeal.[10]

**The Minnesota Moratorium Statute.** Minnesota, another non judicial foreclosure state, enacted moratorium legislation during 1933. One aspect of the statute, its extension of post-sale redemption periods, became the subject of the leading U.S. Supreme Court decision of the era upholding the constitutionality of state foreclosure moratorium legislation.[11] The Minnesota statute allowed a borrower to apply to a court for a stay of foreclosure for up to two years. As a condition to the stay the court could require the debtor to pay the income derived from the property, or else pay a fair rental value for the property. The court granting the stay reviewed and approved the amounts to be paid during the moratorium period. At a minimum the payments would have to cover taxes and insurance. The court could also require that any surplus income derived from the property be paid and applied to the debt.[12] The statute allowed courts to stay the redemption period following a sale for up to two years. All stays were granted on a case by case basis.

### 2. *Limitations on Deficiency Judgments through Depression Era Legislation*

Depression era state legislation protecting borrowers from the harsh effects of foreclosures was not limited to moratorium laws. During this period most states enacted some form of law limiting post foreclosure deficiency judgments. In much the same way they attacked the moratorium statutes, lenders challenged these anti-deficiency laws as unconstitutional impairments of their contract rights. Arguably the anti deficiency laws imposed more permanent and substantial modifications of lenders' contract rights than did the moratorium statutes. During the Depression, property values fell drastically and lenders could buy properties at foreclosure sales for nominal prices. Borrowers' liability for deficiency debts increased commensurately. Deficiency claims were thus a major source of contention for both borrowers and lenders.

**The New York Anti-Deficiency Statute.** In the early thirties, New York enacted a law that allowed courts to calculate deficiency debts based on the property's current fair market value rather than using the artificially low auction sale price. Crediting this higher figure against the deficiency typically produced a substantial reduction of the deficiency debt. The United States Supreme Court reviewed the New York anti-deficiency statute twice during the Depression era.

**The North Carolina Anti-Deficiency Statute.** North Carolina enacted a law similar to New York's, but applicable to non judicial foreclosure sales. The law applied to non judicial sales when the lender purchased the property. The limitation did not apply

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[10] *Id.*
[11] Home Building & Loan Ass'n v. Blaisdell, 290 U.S. 398 (1934).
[12] Amundson and Rotman, *supra*.

to sales after judicial foreclosures. Thus, lenders still had the option of pursuing a deficiency claim after a judicial foreclosure. Judicial foreclosures, however, were more time consuming than the non judicial procedures. In judicial foreclosures the courts also continued to perform their traditional role in refusing to confirm sales conducted under unfair circumstances. Thus, under either procedure lenders now found new obstacles in the way of their efforts to recover full deficiency judgments. The North Carolina statute was the first of the new anti-deficiency statutes to be tested before the United States Supreme Court.

Most states enacted some type of anti-deficiency law during the Depression decade, and many of these statutes remain on the books today. Twenty states now limit deficiency claims by requiring use of the property's fair market value rather than the bid price to calculate the borrower's debt. Eleven states now have laws that bar deficiency claims entirely in a significant portion of the state's home foreclosures.

## B. Constitutional Challenges to Depression Era State Foreclosure Relief Statutes.

### 1. *Background*

Lenders challenged the Depression era moratorium and anti deficiency laws as violative of the "Contracts Clause" of the United States Constitution. Article 1, Section 10 of the Constitution provides that "No state shall . . . pass any Law . . . impairing the Obligation of Contracts." The Constitutional Convention added this provision in reaction to a spate of debtor relief laws recently enacted by the states. The founders of the new national government perceived these state laws as inimical to the country's ability to build credit for its enterprises and compete as a growing commercial nation.[13]

During the nineteenth and early twentieth centuries the courts did not construe the contracts clause as setting an absolute bar to any state legislation that limited rights created under contracts. Rather, the courts developed a rule that "remedies" for default were distinct from the underlying contractual "obligation." State laws could regulate remedies but they could not modify contractual obligations.[14] For example, in 1880 the Supreme Court upheld a Rhode Island law which barred imprisonment for debt. In the court's view the state law limited only remedies for collection of the obligation and did not impair validity of the obligation itself.[15]

[13] *See generally*, Samuel L. Olken, *Charles Evans Hughes and the Blaisdell Decision: a Historical Study of Contract Clause Jurisprudence*, 72 Or. L. Rev. 513, 517-18 (1993).
[14] *Id*. at 522-536.
[15] Penniman's Case, 103 U.S. 714 (1880).

2. *Constitutional Challenges to the Depression era moratorium and stay statutes.*

Against this background of judicial interpretation the Minnesota foreclosure moratorium statute appeared before the Supreme Court in 1933. The case came in the form of an appeal involving the Blaisdells, a couple who owned a boarding home in Minneapolis. Following sale of their property through the state's non judicial sale procedure, and 14 days before the state's one year statutory post-sale redemption period was set to expire, the Blaisdells went before a Minnesota trial court and asked for a two year extension of their post sale redemption rights under the new state statute. The trial court granted the request. In doing so the court determined the rental value of the boarding home property to be $40.00 per month. The Blaisdells were ordered to pay this amount monthly to the lender as a condition to a continuing stay for up to two years.

The trial court did not set aside the foreclosure sale. By the court's order the Blaisdells were granted solely an extension of time to keep possession of the property and attempt to redeem. If they could refinance or otherwise come up with the money to pay off the foreclosure sale price during this time, they could set the sale aside and keep the property. The lender retained the right to claim full title to the home if the Blaisdells did not redeem. The trial court also noted that the property's value exceeded the debt. After paying the $40.00 monthly to the lender for two years the Blaisdells would owe about the same amount to the lender as they did when the stay was initially granted.

After the Minnesota Supreme Court upheld the statute, the majority of the United States Supreme Court affirmed, holding that the law did not violate the Contracts Clause of the Constitution.[16] The Supreme Court emphasized that the state law did not fundamentally alter the lender's contract rights. Looking to prior interpretations of the contacts clause, the court construed the Minnesota statute as affecting primarily a remedy and not the underlying mortgage obligation. The law merely allowed a state court to extend a redemption deadline. State courts had traditionally played a role in setting terms of redemption under foreclosure laws, and the Minnesota statute allowed the courts to act consistently with that well established tradition.[17]

On the broader issue of the state's ability to alter contract rights, the *Blaisdell* court established a more significant principle. According to the court, under its police power a state could act to protect its citizens from economic harm as well as natural disasters. States could modify contract rights under this police power. The potential for states to act in this capacity had to be recognized as an implied condition to any contract: "[T]the reservation of the reasonable exercise of the protective power of the State is read into all contracts."[18] Protecting all citizens from an economic emergency was thus a permissible basis for limited impairment of private parties' contract obligations. Under the court's test, the pertinent question in assessing the validity of an exercise of the police power became "whether the legislation is addressed to a legitimate end and the measures

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[16] Home Building & Loan Ass'n v. Blaisdell, 290 U.S. 398 (1934).
[17] *Id*. 290 U.S. at 446-47.
[18] *Id*. 290 U.S. at 443-44.

taken are reasonable and appropriate to that end." [19] In the Blaisdells' case, the court found that the state's measures were reasonable, particularly because they included significant protections for the mortgagee. In addition, the existence of an emergency condition was undisputed and the legislature had proclaimed the law to be of limited duration.[20]

Summing up, in sustaining the Minnesota moratorium law, the *Blaisdell* court looked to five factors: (1) An emergency existed; (2) the legislation was addressed to a legitimate state end and not for the advantage of particular individuals; (3) The relief afforded was of a character appropriate to the emergency; (4) The conditions of the relief were reasonable in relation to the creditors' rights; and (5) The legislation was temporary in nature and limited to "the exigency which called it forth."[21]

In future application of the *Blaisdell* criteria, the major source of contention would be the fourth factor: whether the contract restriction imposed on the creditor was reasonable and appropriate in view of the emergency at hand. This is inherently a pragmatic and fact-based determination and one that does not lead to reliable predictability.[22] In *Blaisdell* the court majority repeatedly focused on the aspects of the Minnesota statute which left the most significant terms of the mortgagee's claim unimpaired:

> The statute does not impair the integrity of the mortgage indebtedness. The obligation for interest remains. The statute does not affect the validity of the sale or the right of a mortgagee-purchaser to title in fee, or his right to obtain a deficiency judgment, if the mortgagor fails to redeem within the prescribed period. Aside from the extension of time, the other conditions of redemption remain unaltered. While the mortgagor remains in possession he must pay the rental value.[23]

The year after its *Blaisdell* ruling, the Supreme Court in a unanimous decision in *W.B. Worthen v. Kavanaugh* invalidated an Arkansas statute that had recently been enacted to protect borrowers facing foreclosure.[24] Here again the court's approach was fact-based and emphasized what it considered unreasonable and inappropriate restrictions upon the mortgagees' contract rights. The overly burdensome restrictions included: (1) an increase in the minimum period after default before foreclosure could be initiated from

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[19] *Id*. 290 U.S. at 438.
[20] Despite its broader holding on the relation between local police power and the impairment of contracts, the majority's opinion in *Blaisdell* is less than direct in acknowledging that the Minnesota law actually impaired a contract obligation (as opposed to limiting a remedy). The dissenting opinion is clearer and more accurate in describing how the law impaired the underlying obligation under the contract, including the creditor's right to recover immediate possession of the property. In upholding the constitutionality of the statute below the Minnesota Supreme Court took as undisputed the fact that the statute impaired obligations of the contract. 189 Minn. 422, 424, 249 N.W. 334, 335 (1933).
[21] *Id*. 290 U.S. at 444-447.
[22] *See generally*, Olken, *supra* 591-602.
[23] *Id*. 209 U.S. at 425.
[24] W.B. Worthern Co. v. Kavanaugh, 295 U.S. 56 (1935).

sixty-five days to two and one half years; (2) a decrease in the statutorily allowed "default penalty" rate from 20 % to 3%; (3) suspension of the mortgagor's obligation to pay attorney fees and costs in connection with a foreclosure; and (4) a provision allowing the debtor to remain in possession of the property for four years after foreclosure with no interim protections for lenders. This latter provision applied to pending cases, and the statute as a whole applied retroactively to contracts entered into before its effective date.

The Supreme Court's final consideration of one of the Depression era moratorium statutes took place in 1945 with *East New York Savings Bank v. Hahn*.[25] At issue was the validity of the New York legislature's continuing extension of its 1933 foreclosure moratorium. As discussed above, the New York moratorium law provided limited relief to debtors in the form of delay of principal payments, and this stay was subject to extensive court review and potential payment conditions. The substantive terms of the New York statute were not at issue in this appeal, with the court noting that since *Blaisdell*, "there are left hardly any open spaces of controversy concerning the constitutional restrictions of the Contact Clause upon moratory legislation referable to the depression." [26] The New York statute, unlike the Arkansas law invalidated in *Worthen Co. v. Kavanaugh*, did not display a "studied indifference to the interests of the mortgagee or his appropriate protection."[27] With respect to the issue of the statute's extension well past the initial "emergency" that led to its enactment, the court expressed a strong inclination to defer to the judgment of the state legislature and the governor who had deemed the conditions in the state sufficient justification for a further extension of the moratorium law.[28]

3. *Challenges to Depression era anti-deficiency statutes.*

The Supreme Court upheld Depression era state laws that restricted mortgagees' deficiency claims on three different occasions.[29] The decisions involved recent enactments that applied prospectively and retroactively to existing mortgages. In *Richmond Mortgage & Loan Corp. v. Wachovia Bank & Trust Co.,*[30] the first of the three cases, the court rejected a challenge to North Carolina's fair market value limitation on deficiency judgments. The North Carolina legislation applied only to non judicial foreclosures in which the lender purchased the property at the sale. The law allowed the debtor to initiate a proceeding in which the court would reduce a deficiency claim by what the court determined the "true value" of the property to be. The statute did not limit the lender's ability to seek a full deficiency judgment if it agreed to forego the non judicial foreclosure process and use the state's alternative judicial foreclosure procedures.

[25] East New York Savings Bank v. Hahn, 326 U.S. 230 (1945).
[26] *Id*. 326 U.S. at 231.
[27] *Id*. 326 U.S. at 234 (quoting *Kavanaugh, supra*, 295 U.S. at 60).
[28] *Id.* 326 U.S. at 234 ("Appellant asks us to reject the judgment of the joint legislative committee, of the Governor, and of the Legislature, that the public welfare, in the circumstances of New York conditions, require the suspension of mortgage foreclosure for another year.")
[29] Richmond Mortgage & Loan Corp. v. Wachovia Bank & Trust Co., 300 U.S. 124 (1937); Honeyman v. Jacobs, 306 U.S. 124 (1937); Gelfert v. National City Bank of New York, 313 U.S. 221 (1941).
[30] 300 U.S. 124 (1937).

In upholding the North Carolina law the court emphasized that the lender's right to enforce a deficiency claim in a non judicial foreclosure had been created by the state legislature. Given that state legislation had created the non judicial foreclosure remedy, the parties had to have entered into their contracts with the knowledge that the state legislature could take those remedies away or alter them in the future. Limiting remedies available under the non judicial foreclosure statutes therefore did not violate any constitutionally protected contract right of the lenders. According to the court, "the particular remedy existing at the date of the contract may be altogether abrogated if another equally effective for the enforcement of the obligation remains or is substituted for the one taken away."[31] The equally effective remaining remedy for lenders in North Carolina existed under the state's judicial foreclosure proceedings, where subject to court scrutiny and albeit within the context of a more time consuming proceeding, the lender could still pursue its full monetary claim against the borrower.

In *Honeyman v. Jacobs*[32] the court applied its reasoning from *Richmond Mortgage* and reached a similar result in an appeal testing the constitutionality of the anti-deficiency provision recently added to the New York judicial foreclosure statutes. The court found New York's market value limitation on the scope of deficiency claims in judicial foreclosures was a reasonable extension of the equitable powers that courts traditionally exercised in judicial foreclosures.

By the time of the *Gelfert v. National City Bank of New York*[33] ruling in 1941 the court no longer felt bound to require findings of emergency to justify the limitation the State of New York imposed on deficiency claims in the exercise of its police power. Nor did the court require that there be a substantially similar alternative remedy through which the lender could recover its full deficiency claim. The court simply found that the state acted reasonably when it treated the lender's deficiency claim as a windfall rather than a constitutionally protected property right. A state could regulate foreclosures, including the imposition of limits on a deficiency claim, as long as it allowed the lender to be made whole through the foreclosure process. New York did this by allowing the lender to recover the indebtedness as reduced by the current market value of the security property. The New York legislation at issue did no more than codify basic equitable principles that courts traditionally applied in foreclosure actions.[34]

[31] 300 U.S. at 128-29.
[32] 306 U.S. 124 (1937).
[33] Gelfert v. National City Bank of New York, 313 U.S. 221 (1941).
[34] "But there is no constitutional reason why in lieu of the more restricted control by a court of equity the legislature cannot substitute a uniform comprehensive rule designed to reduce or to avoid in the run of cases the chance that the mortgagee will be paid more than once. . . . Certainly under this statute it cannot be said that more than that was attempted. The 'fair and reasonable market value' of the property has an obvious and direct relevancy to a determination of the amount of the mortgagee's prospective loss. In a given case the application of a specified criterion of value may not result in a determination of actual loss with mathematical certitude. But 'incidental individual inequality' is not fatal." 313 U.S. at 233-234.

### C. The Supreme Court's Current Contracts Clause Standard: The *Energy Reserves* Case

Contract Clause cases have not appeared frequently on the United States Supreme Court's docket over the past fifty years. It has been over thirty years since the court last struck down a state law on Contract Clause grounds.[35] The court's last significant articulation of Contact Clause standards came in the case of *Energy Reserves Group, Inc. v. Kansas Power & Light Co.,*[36]decided in 1983. Here, the court upheld a Kansas statute that set price caps on intrastate natural gas sales. The court reaffirmed its prior analysis from *Blaisdell* and focused on, among other factors, the extent of pre-existing state regulation of the subject matter in question -- the sale of natural gas. Under this standard, the more extensive the pre-existing state regulation of an industry when parties entered into their contract, the weaker would be a party's later argument that a substantial property right was impaired through a post contract regulatory change. According to the court, "state regulation that restricts a party to gains it reasonably expected from the contract does not necessarily constitute a substantial impairment."[37]

Consistently with prior contract clause decisions,[38] the *Energy Reserves* court did not require the finding of a temporary emergency to support the enactment of the statute. Instead, the question posed was a more general one: were the price ceilings a reasonable means to accomplish a legitimate end? Protecting consumers from unsettling fluctuations in gas prices was clearly a legitimate end. The court found it appropriate to give substantial deference to the state's selection of reasonable means to promote this end.

The currently operative "test" for Contract Clause validity, as articulated by the *Energy Reserves* court, builds upon the *Blaisdell* formulation. It asks the following questions:

1. Is there in fact a substantial impairment of the creditor's contractual rights?

2. If yes, the state must have a significant and legitimate public purpose behind the regulation, such as remedying of a broad and general social or economic problem.

3. If this is a significant and legitimate public purpose, the adjustment of the rights and responsibilities of the contracting parties must be based upon reasonable conditions and of a character appropriate to the public purpose supporting the legislation.[39]

Under this standard, if a law satisfies the second and third prongs of the test, a court will uphold the law despite a substantial impairment of contractual rights under the

[35] Allied Structural Steel Co. v. Spannaus, 438 U.S. 234 (1978) (striking down a Minnesota law mandating certain pension holdings by employers).
[36] 459 U.S. 400 (1983).
[37] 459 U.S. at 411.
[38] Gelfert, *supra*; Veix v. 6th Ward Bldg. and Loan Ass'n, 310 U.S. 32 ( 1940).
[39] *Energy Resources*, *supra* 456 U.S. at 411-412.

first prong.[40] The *Energy Resources* test thus steps back substantially from the "remedy" versus "obligation" dichotomy. It acknowledges that state laws may actually impair underlying obligations in a proper exercise of the police power. The courts in *Blaisdell* and *Honeyman* had struggled to pay lip service to the nineteenth century distinction between remedies and obligations, often characterizing the facts to fit within that analysis, while at the same time shaping legal principles that enunciated a much broader rule for future application.[41] The *Energy Resources* decision gives a more unreserved endorsement of the broad standards formulated in *Blaisdell* and the other Depression era Supreme Court decisions.

The existence of a temporary emergency and the limitation of the state law's reach to creditor remedies are no longer essential criteria in passing the Contracts Clause test. However, the imprint of the *Blaisdell* standards survives to a limited extent in the *Energy Resources* formulation. For example, a state law will certainly be more likely to satisfy the *Energy Resources* "significant and legitimate purpose" standard if a serious crisis compelled its enactment. The current mortgage foreclosure crisis, with its devastating impact on the entire economy, would clearly meet this second *Energy Resources* standard. Similarly, the "reasonable" and "appropriate" character of a state regulation under the third *Energy Resources* standard will be more easily satisfied the more the state law can be characterized as applying only to remedies rather than impairing the creditor's underlying contract rights.

For the past seventy-five years the Supreme Court's guidance on Contract Clause construction has, for better or for worse, been flexible. While better predictability might be desirable, the standard remains open to pragmatic, fact intensive, and creative arguments that a state has acted to meet a specific need for relief for debtors and that it has simultaneously provided reasonable protections for creditors.

### B. 1980s state foreclosure moratorium and mediation legislation- state appellate court rulings.

#### 1. *Introduction*

During the recession of the early 1980s unemployment and a faltering agricultural sector led to the reappearance of state legislation intended to protect borrowers from

[40] *Id*.

[41] In its *Blaisdell* decision the Minnesota Supreme Court also upheld the moratorium statute , but expressed no qualms about recognizing that the state law impaired contractual obligations.189 Minn. 422,424-25, 249 N.W. 334, 335. The Minnesota court considered the impairment to be justified as a reasonable exercise of the state's police power. Similarly, the *Blaisdell* dissent saw the state law as unambiguously allowing the impairment of contact obligations. 290 U.S. at 472-73, 482-83. In the dissent's view, under the existing contract the Minnesota lender had a present right to take possession of the security property, then sell it or do with the property as it chose. The new state law impaired that power in an unanticipated and drastic manner. With hindsight, the Minnesota Supreme Court and the U.S. Supreme Court dissent perhaps offered the more accurate characterization of the facts regarding the state law's effect on the creditor.

foreclosure.[42] Iowa, Minnesota, Kansas, North Dakota, and Oklahoma took action to limit farm foreclosures through various types of moratorium and stay legislation. Iowa, Minnesota, and South Dakota enacted mandatory mediation statutes which stayed foreclosure until and unless creditors complied with mediation requirements designed to explore alternatives to foreclosure. In addition, Connecticut enacted a moratorium program designed to protect unemployed homeowners. While the United States Supreme Court did not review any of these enactments, state appellate courts considered several of them under state and federal constitutional provisions. The new laws met with mixed results.

2. *The mandatory mediation statutes were upheld.*

In 1986 both Minnesota and Iowa enacted mandatory mediation statutes which required that lenders negotiate with borrowers and certify compliance with the mediation requirements before proceeding with foreclosures. Both statutes applied retroactively to existing mortgages. Lenders challenged the Minnesota law under the similar contracts clauses of the United States and Minnesota constitutions.

A state appellate court upheld the Minnesota mediation statute in *Laue v. Proctorville Credit.*[43] The Minnesota statute allowed a debtor to stop foreclosure proceedings for a period of 90 days or until a mediation could be concluded. Addressing the contract clause challenge, the court did not find the contractual impairment here any more significant than that found in the earlier Minnesota law upheld in *Blaisdell*. According to the *Laue* court, "The seriousness of the farm crisis and its orderly alleviation are legitimate public purposes for legislative action. By limiting the time for mediation, imposing obligations of good faith upon participating debtors and creditors, and repealing the Act effective July 1, 1988, the legislature has carefully tailored the means to protect the public purpose without unreasonably burdening creditors."[44]

The Iowa Supreme Court found the Iowa mediation statute to be similar to Minnesota's recently enacted law and, like the Minnesota law, applicable retrospectively to pending cases. However, the Iowa Supreme Court did not reach the constitutional issue directly.[45] After reversing the trial court on the issue of the statute's applicability to foreclosures pending at the time of enactment, the Iowa Supreme Court remanded the matter to the trial court.

Although the Minnesota mediation statute applied to non judicial foreclosures and the Iowa statute regulated judicial foreclosures, both laws provided for case by case court

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[42] *See generally* Robert M. Lawless, The American Response to Farm Crises: Procedural Debtor Relief, 1988 Univ. of Ill. L. Rev. 1037 (1988); Roland C. Amundson and Lewis J. Rotman, *Depression Jurisprudence Revisited: Minnesota's Moratorium on Mortgage Foreclosure*, 10 Wm. Mitchell L. Rev. 805 (1984); Timothy D. Benton, *Iowa's Mortgage Moratorium Statute: A Constitutional Analysis*, 33 Drake L. Rev. 303 (1983-84); Note, 12 Real Estate Law Journal 366 (1984).

[43] 390 N.W. 2d 823 (Minn. App. 1986).
[44] *Id*. 390 N.W.2d at 829.
[45] First National Bank v. Heimke, 407 N.W. 2d 344 (Iowa 1987)

supervision over the mediation process. Both statutes allowed the creditor to limit the stay by showing individualized hardship ("irreparable harm" under the Iowa statute and "bad faith" by the debtor under the Minnesota statute).

3. *Decisions invalidating 1980's state moratorium statutes.*

a. **The Oklahoma statute.** In 1986 Oklahoma enacted a Mortgage Foreclosure Moratorium Act. The Act prohibited the state's farm lending banks from initiating foreclosures for one year. The act did not provide for individualized proceedings under court supervision, but applied automatically to bar the agricultural banks from instituting foreclosures in their names. The Act did allow the agricultural banks to assign their loans to the state guaranty agency which insured the loans. The Act's stay provisions did not apply to the state guaranty agency. This agency had authority both to restructure loans and to foreclose when it deemed appropriate during the year when the stay would otherwise have barred the banks from foreclosing. Under the Act a court had no discretion to determine the length of the stay that applied to the banks currently holding the loans. There were no requirements for payment of interest, taxes or fair market rent during the stay period.

In a four to three split decision, the majority of the Oklahoma Supreme Court invalidated the 1986 Foreclosure Moratorium Act in *Federal Land Bank of Wichita v. Story*.[46] The court considered the limitation allowing only the guaranty agency to foreclose to be unreasonable: "State action which forces such a divestment to gain access to state court destroys the mortgagee's contractual rights. The statute denies all remedy to the mortgagee during the life of the Act. The alternative remedy is neither equally effective for the enforcement of the obligation nor does it substitute for the remedy taken away." [47] The three dissenting justices deferred to the legislative findings that the legislation was appropriate to the existing emergency and based upon reasonable conditions. The suspension of foreclosure was for a definite and reasonable time. Meanwhile, the mortgagee had the option of assigning the mortgage to a guarantor for foreclosure. According to the minority, the statute's restrictions were not as pervasive as the majority portrayed them: "The present legislation does not divest permanently mortgagees of the existing remedy of foreclosure nor temporarily of all remedy."[48]

b**. The Kansas statute.** The Kansas legislature enacted a "Family Farm Rehabilitation Act" in 1986, only to have the Kansas Supreme Court promptly strike it down as a violation of the Contracts Clause of the United States Constitution in *Federal Land Bank of Wichita v. Bott*.[49] The Kansas statute imposed a number of alterations on existing mortgagor/mortgagee relations. It allowed borrowers to apply for a stay of foreclosure lasting one year, with possible renewals for two more years. A court could

[46] 756 P.2d 588 (Okla. 1988).

[47] *Id*. 756 P.2d at 593.
[48] *Id* at p. 596.
[49] Federal Land Bank of Wichita v. Bott, 240 Kan. 624, 732 P.2d 710 (1987).

condition the stay upon the borrower's payment of insurance, prevention of waste, and allowance of inspections. The statute created a new redemption system which allowed the borrower to redeem after foreclosure by paying the fair market value of the property rather than the amount of the foreclosure judgment, which was typically higher. Upon redemption the borrower could acquire the property free and clear of the mortgage, and the lender would be "left without security for the difference between the redemption amount and the judgment amount."[50] The Act further retrospectively lowered the contract rate of interest accruing during the redemption period and created a new right of the borrower to redeem a part of the total acreage from foreclosure. The statute also prevented lenders from bidding at judicial sale or obtaining deficiency judgments.[51]

The Court in *Bott* considered whether the state had set "reasonable conditions" on the creditors' rights as required under *Blaisdell* and *Energy Reserves.*[52] The court compared the limitations described above to those found in *Blaisdell*:

> *Blaisdell* considered it essential that the integrity of the mortgage indebtedness not be impaired; that the interest pursuant to the contract continue to run; that the mortgagee have the right to title to the security or to obtain a deficiency judgment; that the conditions of redemption, if it occurs, stand as they were under the prior law; and that the mortgagor, if he retains possession during the extended redemption period, pay a reasonable rental.[53]

In light of this *Blaisdell* comparison, the court faulted the Kansas statute. The court considered the modification of the redemption payment to be an impairment of the mortgage debt; the lowering of the interest rate accruing during the redemption period was a change from the contract rate; the right to redeem in parcels affected the lender's substantive rights; and, in the court's view, the provisions for "adequate assurance" payments to be made during a stay period were not specific and were not mandatory.

The *Bott* court's view of the Contracts Clause was severely restrictive on several grounds. The deficiency limitations in the Kansas statute were not any more substantial than the prohibition on deficiencies upheld by the United States Supreme Court in *Gelfert.*[54] The provisions related to post judgment interest and partial redemption applied to post judgment remedies and did not "impair" the underlying obligation. The statute did require a court to set payment levels to apply during any stay. In the case on appeal the trial court had invalidated the statute on its face and never held a hearing to determine adequate assurance payments. Therefore, the record was unclear as to how this provision for ongoing payments would actually impact on the creditor in question.

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[50] *Id*. 732 P.2d at 717.
[51] Bott at p. 636.
[52] *Id*. 732 P.2d at 718.
[53] *Id.*
[54] The decision's discussion of the statute's treatment of deficiency claims is unclear. The opinion reports that the Kansas statute expressly preserved deficiency claims. 732 P.2d at 713. However, later the court faults the statute for preventing a mortgagee from obtaining a deficiency. 732 P.2d at 718.

c**. The Iowa redemption statute.** Iowa enacted legislation in 1987 that affected mortgage relations in two ways. The statute extended the redemption period for agricultural homesteads from one year to two years. It also allowed redemption by payment of the property's fair market value rather than the judgment amount. Lenders challenged the statute on a number of grounds, including a claim that these provisions violated their rights under the Contracts Clause of the United States Constitution. The Iowa Supreme court agreed with the lenders in *Federal Land Bank of Omaha v. Arnold*.[55] The *Arnold* court considered the Iowa statute in light of the United States Supreme Court's rulings in *Blaisdell* and *Worthen* and found the severity of the statute's restrictions placed it somewhere between the two.[56] Several aspects of the statute concerned the court. The use of the fair market value standard for redemption and the extension of the redemption period to two years had been imposed upon a creditor whose claim had already been reduced to judgment. It was the combination of these two retroactive changes that in the court's view went over the line and failed to leave "the integrity of the mortgage indebtedness unimpaired." [57] It appeared to be the particular combination of the two foreclosure restrictions at issue that concerned the court. Each of the limitations had been present in some of the state laws upheld by the U.S. Supreme Court's during the Depression era.

### D. Summary of Major Issues Addressed in Contracts Clause Foreclosure Rulings

**Payment of interest and income from property as a condition to relief from foreclosure.** What seems striking today in looking back at many of the Depression era statutes, particularly the moratorium laws, is the degree to which they were accommodating to lenders. Most of these statues set strict conditions for payment of certain basic charges as a condition to a stay of foreclosure. Often these payments went beyond simply taxes and insurance, and included interest and amounts which represented "income" from the property. This focus on the income producing capacity of the mortgaged property was likely a reflection of the significant number of farm homesteads involved. In the thirties the rates of homeownership were significantly lower than they are now, and farms made up a much larger portion of the owner occupied properties than they do today. While most family farmers were not producing any significant surplus income during the Depression, to the extent that surpluses did arise, the idea that lenders should be entitled to some portion of this income derived from use of the property during a stay certainly heightened the appearance of reasonableness and fairness to lenders. Similarly, the Blaisdells in Minnesota owned a fourteen room boarding house in which they also lived. Given the commercial use to which they put their home, it would be hard to argue that the Minnesota court acted harshly in requiring that the Blaisdells make monthly payments of $40.00 to the lender during the two year moratorium period allowed by the court pursuant to the statute.

[55] 426 N.W. 2d 153 (Iowa 1988).
[56] *Id* 426 N.W. 2d at 160.
[57] *Id*.

Compared to borrowers during the Depression era, today's homeowners are much less likely to be living in a property that produces a regular income. A provision requiring that homeowners pay interest as a condition to a moratorium on foreclosure would make the remedy useless for most homeowners facing foreclosure today. A large portion of the homeowners now in foreclosure took out the subject loans within the past five to eight years. Their payments consist almost entirely of interest and other non principal items such as taxes and insurance. Often the high interest rates themselves are a major cause of the foreclosure. Therefore, a moratorium that stayed only the obligation to pay toward principal, such as the New York law of the thirties, would provide no assistance for the homeowners most in need of help today.

Significant deflation in property values characterized the Depression era, as it does the housing market today. The effect of this deflation on prices bid at foreclosure sales was a major concern for legislators during the thirties. Much of the state remedial legislation was designed to alleviate the harsh effects of foreclosure sales which were producing only nominal bids. One significant purpose of the state moratorium legislation was to postpone sheriff sales to a time when market conditions would hopefully produce higher bids. A future improvement in real estate values would also allow homeowners to refinance or sell their properties so as to preserve or recoup equity. Similarly the limits placed on deficiency judgments were intended to alleviate the harsh effects of low bidding in the severely depressed real estate market.

**The role of the judiciary.** The Supreme Court decisions which upheld state legislation protecting borrowers during the Depression were uniform in their endorsement of provisions that allowed for close court supervision over foreclosure relief. The courts had always exercised a function of ensuring basic fairness in foreclosures. By focusing on the role of state courts in monitoring relief on a case by case basis, the Supreme Court was able to characterize this new legislation as merely an extension of centuries-old judicial practices.

**The role of lender misconduct.** Deflated property values and low bids at foreclosure sales are common during the current foreclosure crisis, as they were in the thirties. However, issues related to lender misconduct are an added element present today and not encountered so frequently during the Depression. Much more so than in the past, the lending industry itself has played a significant role in creating the current financial crisis. Today, legislative responses to the foreclosure crisis will fall short to the extent they fail to take this new development into account.

## E. Selected Constitutional Issues Relevant to Contemporary State and Local Mandatory Mediation Programs.

The mandatory mediation programs that have been initiated through state legislatures and by state and local court systems beginning in 2008 fit well within the types of borrower protections that can withstand contract clause challenges. The

Minnesota appellate court decision in *Laue v. Proctorville Credit*[58] addressed the basic contact clause issues likely to arise in any similar challenge. As the court noted, mediation procedures do not affect the underlying obligation of the mortgage, but fit well within the state's authority to fashion remedies for default.

Since the *Laue* decision, the general use of mediation in connection with nearly all types of judicial proceedings has become more prevalent. When foreclosure mediation systems are implemented within the existing framework and rules for a court system's mediation program, it will be difficult to raise serious objections to the practice.

The judicial or non judicial nature of a state's foreclosure system should make little difference in terms of the constitutional validity of a mediation program. As the Supreme Court noted in *Richmond Savings & Loan Corp. v. Wachovia Bank & Trust Co.,*[59] lenders have no constitutionally protected interest in the maintenance of a non judicial foreclosure system. State legislatures are free to modify or remove such systems entirely. In their place, states can require lenders to pursue the alternative judicial foreclosure remedies available under the laws of all states. Much of the Depression era legislation, like the 1986 Minnesota moratorium statute, simply gave borrowers the option to convert a non judicial foreclosure to a proceeding that became in whole or in part a judicial foreclosure. The lenders received all the benefits as well as the burdens of the judicial foreclosure system in pursuing their claims.

Issues related to the validity of mediation programs are more likely to arise in two particular areas. First, mediation systems that require consideration of a particular substantive test may face constitutional questions on Contract Clause or Takings Clause grounds. Second, to the extent that local government entities rather than state legislatures and courts create the programs, there may be questions as to the effect of the separation of powers doctrine and preemption under state general law.

### 1. Can state and local mediation programs impose substantive obligations on lenders to participate in good faith and modify loans in appropriate circumstances?

Mediation as a means to stem the rampant tide of foreclosures has a distinct appeal. Few would argue with the basic principle that it helps to have authorized representatives of lenders sit down with borrowers and their representatives to consider loss mitigation options. Achieving a mutually agreed upon settlement that is acceptable to all parties is always the most desirable resolution. Unfortunately, a problem that can appear along with solutions that sound enticing is the tendency for political leaders to showboat over the issue. Mediation systems with no enforceability attached to them can turn out to be little more than window dressing. While a requirement for good faith

[58] 390 N.W. 2d 823 (Minn. App. 1986).
[59] 300 U.S. 124, 131 (1937).

participation by all parties is essential to an effective mediation program,[60] some further accountability must follow as a consequence of participation. Through their equitable powers to supervise the conduct of foreclosures, courts must be able to enforce standards of good faith participation in mediation. If lenders reject loss mitigation options that are clearly appropriate for the borrower and that do not substantially impair the lenders' recovery under the obligation, the court should bar foreclosure.

It is possible that mortgage holders would challenge a state or local law mandating reasonable consideration of loss mitigation options as a violation of the Contracts Clause. Can such a law authorize courts to deny foreclosure relief to lenders who have rejected a loan modification option that was shown through mediation to be affordable for the homeowner and more beneficial to investors than the likely results of foreclosure? This question becomes particularly pertinent today given the more effective tools for evaluating the potential effects of a loan modification. In 2008 the FDIC released its model loan modification program.[61] This program calculates an affordable modified loan and compares the value of this modified loan under a "net present value" test with the value the lender will receive if it proceeds with foreclosure. An acceptable loan modification is one that is both affordable to the borrower and allows the lender to recover more than it would likely receive if it acquired the property through foreclosure.

There has been little legislative activity along these lines to date, although various federally related loan programs, including the FHA insured, Rural Housing, and Veterans Administration programs have for many years required participating lenders to consider loss mitigation options before foreclosing. Courts exercising their equitable powers have refused to allow lenders participating in these government insured programs to foreclose when they had failed to consider the alternatives to foreclosure available under the programs.[62]

Finally, a Connecticut law enacted in 1983 allows an unemployed or "underemployed" homeowner against whom a foreclosure action has been brought to apply to the court for an order restructuring a mortgage loan.[63] In addition to the loan restructuring, the court may also order reduced payments for a period of six months.[64] In directing a restructuring of a loan the court may add to the principal any earned but

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[60] *See e.g.* Minn. Stat. Ann. § 583.27 (good faith participation requirement under 1986 Minnesota Farm mediation law); *But cf.* Obermoller v. Federal Land Bank, 409 N.W. 2d 229 (Minn. App. 1987) (declining to find bad faith in lender's participation in mediation while voicing objection to any requirement that it appear at all).

[61] http://www.fdic.gov/consumers/loans/loanmod/loanmodguide.html

[62] *See e.g.* Ghervescu v. Wells Fargo Home Mortgage, 2008 WL 660248 (Cal. Ct. App. Mar. 13, 2008); Wells Fargo Home Loan Mortgage v. Neal, 922 A.2d 538 (Md. 2007); United States v. Shields, 733 F. Supp. 776 (D. Vt. 1989); Fleet Real Estate Funding Corp. v. Smith, 530 A.2d 919 (Pa. Super. 1987); FNMA v. Moore, 609 F. Supp. 194 (D.C. Ill. 1985); Associated East Mortgage Co. v. Young, 394 A.2d 899 (N.J. Super. 1978); FNMA v. Ricks, 372 N.Y.S. 2d 485 (1975).

[63] Conn. Gen. Stat. Ann. § 49-31d to § 49-31i. The "protection from foreclosure" under the statute is defined as "a court ordered restructuring of a mortgage debt designed to eliminate an arrearage in payments on such debt and to provide a period not to exceed six months during which foreclosure is stayed." § 49-31d(4). *See also* §49-31d(6) (defining "underemployed person").

[64] Conn. Gen. Stat. Ann. § 49-31(h).

unpaid interest, taxes, and foreclosure costs and fees.[65] The court may also establish a new "composite interest rate" based on a weighted combination of the original note rate and a "prevailing interest rate" for the debt added to the loan principal.[66] There are significant limitations on the relief available under this provision. It authorizes a court to restructure mortgage debt only for homeowners who meet criteria for reduced household income and the statute limits loan to value ratio of the restructured loan.[67] The court retains discretion to consider the likelihood the homeowner can afford the modified payments and must also consider the prejudice the lender from restructuring.[68]

### 2. Does a state law that denies foreclosure to a lender who rejects a reasonable loan modification violate the contracts clause?

The basic definition of a loan modification is an agreement to permanently change one or more terms of an original obligation, such as changing the interest rate or repayment term A modification may include the lender's forbearance or waiver of some portion of the principal. The agreement is typically made in order to resolve a default or to settle litigation between the parties.

In holding that the Minnesota moratorium statute did not violate the contract clause in 1934, the Supreme Court expressly found that the statute did not "impair the integrity of the mortgage indebtedness."[69] In fact, the court carefully noted that the operation of the state law did not alter the interest rate, impair the lender's right to claim a deficiency, or affect the outcome of the foreclosure sale other than by extending the time to redeem.

A state law that limited a lender's discretion to reject a reasonable loan modification initially appears to be precisely the type of law that a court looking to *Blaisdell* for guidance would feel compelled to invalidate. However, this type of legislation must be placed in its contemporary context. A loan modification program such as the one developed by the FDIC in 2008 was not a factor to be considered in 1934. The FDIC can now use a sophisticated computer model to evaluate the actual costs and benefits from foreclosure for a particular lender and a particular type of loan. Essentially, the tool places a reliable monetary estimate on the degree of impairment of the underlying obligation and calls for modification only when accepting the impairment is more beneficial to the lender's investment than foreclosure. Second, as has been noted above, the loan modification remedy is particularly appropriate in view of the needs of borrowers and lenders in this current foreclosure crisis. Unlike the situation in the Great Depression, lender activities such as widespread extensions of credit to borrowers unable to pay and grants of credit based on inflated appraisals have been fundamental causes of

[65] Conn. Gen. Stat. Ann. § 49-31i(a).
[66] Conn Gen. Stat. § 49-31i( c ). The statute delegates to the state Banking Commissioner the setting of the composite interest rate. § 49-31j.
[67] Conn. Gen. Stat. Ann. § § 49-31d(6) and 49-31f(b) (income criteria) and §§ 49-31(b) (restructured loan principal cannot exceed either 90% of current appraised value of the property or the original principal amount).
[68] Conn. Gen. Stat. Ann. § 49-31f(d).
[69] 209 U.S. at 425.

this crisis. Loan modifications address the issues of borrower's ability to pay and the need to adjust property valuations, corrections needed now due to the pervasive misconduct of lenders in recent years. In this context the state regulation of this correction is highly appropriate, as is the ability of courts to ensure that fairness applies on a case by case basis in foreclosures.

A state's current preference for non judicial foreclosures should not affect the validity of a statute authorizing the courts of the state to evaluate a lender's loss mitigation record. As the Supreme Court noted in *Richmond Bank*, "The particular remedy existing at the date of the contract may be altogether abrogated if another equally effective for the enforcement of the obligation remains or is substituted for the one taken away."[70] Thus, states may always modify statutorily created non judicial foreclosure systems to divert foreclosures to a judicial system without implicating any constitutional concerns.

The Supreme Court's treatment of the states' anti deficiency laws under a Contracts Clause analysis during the thirties' is instructive in anticipating how a court might analyze contract impairment claims related to a state law requirement for consideration of loan modifications. In *Richmond Bank* the court held that the North Carolina anti deficiency statute did not violate the Contracts Clause because the state preserved the lender's right to pursue a deficiency claim though judicial foreclosure. However, the Court's next two considerations of anti deficiency laws had more significant implications. In *Honeyman v. Jacobs*[71] and *Gelfert v. City Bank of New York,*[72] the court reviewed New York's law. New York, unlike North Carolina, did not allow for an alternative method for lenders to pursue deficiency claims. The New York law applied in judicial foreclosures and the state had no other applicable foreclosure system. Therefore, the New York laws subjected all lenders' deficiency claims to a significant reduction based on the statute's imposition of the fair market value standard. Unlike the Minnesota statute upheld in *Blaisdell*, which extended a post sale redemption period while compensating the lender for the delay, the New York deficiency statute authorized a fundamental and permanent diminution of the lender's underlying contract claim. Under the mortgage contacts they had prepared with New York properties as security, lenders had the right to sue borrowers for the full amount of any deficiency - the difference between the foreclosure sale price and the debt. The subsequently enacted New York statute unquestionably took this right away to the extent of a property's current market value and did not replace this lost value with anything else.

In *Gelfert* the court noted that it had previously held in *Honeyman v. Jacobs* that the contract clause protected the lender's right to "no more than payment in full." However, what constituted "payment in full" did not necessarily equal the most advantageous recovery the lender could obtain through foreclosure. Rather, in the context of mortgage foreclosures, the payment to which a lender was entitled had much to do with what the courts perceived fairness to dictate in a given case. Given this history

[70] 300 U.S. at 128-29.
[71] 306 U.S. 539 (1939).
[72] 313 U.S. 221 (1941).

of judicial limitations imposed on creditors' claims through application of equitable standards of fairness, it was appropriate for the legislature to set general guidelines by statute that incorporated these judicial principles. As the *Gelfert* court stated,

> Mortgagees are constitutionally entitled to no more than payment in full [citing *Honeyman v. Jacobs*]. They cannot be heard to complain on constitutional grounds if the legislature takes steps to see to it that they get no more than that. As we have seen, equity will intervene in individual cases where it is palpably apparent that gross unfairness is imminent. That is the law in New York. [citations omitted]. But there is no constitutional reason why in lieu of the more restricted control by a court of equity the legislature cannot substitute a uniform comprehensive rule designed to reduce or to avoid in the run of cases the chance that the mortgagee will be paid more than once.[73]

Under New York's prior law, the lender had the right to resell a property it foreclosed upon and purchased at sale, typically recovering a price much greater than the auction bid. At the same time, the lender could pursue the borrower for the full difference between any foreclosure sale price and the full indebtedness. The lenders viewed the right to pursue a full recovery as an essential aspect of their contracts. The *Honeyman* court disagreed,"[T]o hold that the mortgagees are entitled under the contract clause to retain the advantages of a forced sale would be to dignify into a constitutionally protected property right their chance to get more than the amount of their contract."[74] In the court's view, retaining the advantages of a forced sale (i.e., a full deficiency judgment) was getting more than the amount fairly owed under the contract. This was another way of saying that in certain circumstances a lender's claim for strictly what the contract allowed was inequitable: a court of equity would not allow such a recovery, and therefore the state legislature could impose similar equitable limits generally in foreclosures.

The three Depression era deficiency decisions refer repeatedly to the traditional role of courts of equity in foreclosures.[75] The *Gelfert* court summed up this tradition as follows:

> We mention these matters here because they indicate that for about two centuries there has been a rather continuous effort through general rule or by appeal to the chancellor in specific cases to prevent the machinery of judicial sales from becoming an instrument of oppression. And so far as mortgage foreclosures are concerned, numerous devices have been

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[73] 313 U.S. at 233.
[74] 313 U.S. at 233-34.
[75] *See* Richmond Mortgage Corporation v. Wachovia Bank, 300 U.S. 124, 129-130 (1937) Honeyman v. Jacobs, 306 U.S. 539, 543-44 (1939); Gelfert v. National City Bank of New York, 313 U.S. 221, 231-33 (1941).

> employed to safeguard mortgagors from sales which will or may result in mortgagees collecting more than their due.[76]

Turning to the loan modification issue, the questions will likely arise: is the lender who refuses the reasonable loan modification developed in the course of mediation similar to the lender who insisted on the full deficiency claim? Are both seeking something more than a court of equity would consider "payment in full?" Should the creditors' monetary recovery be limited by consideration of the value of the property? Is the pursuit of a demonstrably unwise financial option a constitutionally protected property right? The decisions in *Honeyman v. Jacobs* and *Gelfert* support the position that courts in foreclosure actions may enforce reasonable limits on recovery in such cases. If courts may do so as part of their traditional role, state legislatures may draft laws that incorporate these standards as well.

### 3. Other Constitutional Issues: The Takings Clause.

Lenders may argue that state legislation which limits foreclosure when a lender unreasonably refuses to modify a loan contravenes the Takings Clause of the Fourteenth amendment.[77] This provision most often comes into play when a governmental entity takes physical possession of property for some public purpose.[78] However, state action that falls short of an outright physical taking and instead places significant limits upon an owner's use of property may fall within the scope of the Takings Clause's scrutiny of "regulatory" takings.[79] In assessing the propriety of a regulatory impairment under the Takings Clause, the courts look at two factors (1) the degree to which the governmental action interferes with distinct "investment backed expectations" of the owner, and (2) the character of the government action, including the purpose served"[80] Like the rule for the Contracts Clause, a standard of reasonableness applies: is the goal of the state regulation reasonable and are the regulatory burdens imposed to meet that goal reasonable?

A loan modification model such as the one developed by the FDIC authorizes a forbearance of payment of principal when necessary to make loan repayment affordable for the borrower. This feature should deflect any serious challenge under the takings clause to use of the model's results as a factor in limiting foreclosures. In *Wright v.*

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[76] 313 U.S. at 232-233.

[77] [N]or shall private property be taken for public use, without just compensation." U.S. Const. Amdt. 5, made applicable to the states by the Fourteenth Amendment.

[78] *See e.g.* Kelo v. City of New London, 546 U.S. 469 (2005) (municipality's action to acquire private property for transfer to private entities as part of planned community redevelopment program was for a public use and permissible under takings clause). Lucas v. South Carolina Coastal Council, 505 U.S. 1003 (1992) (environmental regulation that essentially deprives real property owner of all economically viable use of land can amount to the same as a physical appropriation of the land under takings clause).

[79] *See* Brown v. Legal Foundation of Washington, 538 U.S. 216, 233 (2003) (noting distinction between analytical standards for regulatory as opposed to physical takings); Palazzolo v. Rhode Island, 533 U.S. 606, 617-18 (2001) (same).

[80] Penn Central Transportation Co. v. City of New York, 438 U.S. 104, 130-134 (1978); *see generally* Palazzolo v. Rhode Island, *supra*, 533 U.S. at 633-34 (O'Connor concurring).

*Vinton Branch of Mountain Trust Bank of Roanoke, Virginia*[81] the Supreme Court held that two provisions of a recently enacted bankruptcy statute allowing debtors to modify mortgages saved the law from being invalidated as violative of the Takings Clause. The mitigating features were that the statute did not destroy the mortgagee's lien, although it reduced the lien to the value of the property, and that the mortgagee retained the right to pursue a foreclosure sale if the borrower defaulted on the modified obligation. The court had recently stricken a similar bankruptcy statute that it viewed as lacking these creditor protections.[82] Under the FDIC modification model, bifurcation of the principal into an interest bearing portion and a deferred non amortizing portion allows the mortgagee to gain the benefit of later appreciation of the property. The mortgagee's essential property interest therefore remains intact.

Takings clause claims have been raised along with contract clause challenges in a number of areas involving state and local regulation of property, including rent control. Rent control laws impose significant limits on the contract rights of property owners. They not only thwart owners' expectations that they will collect full market rents for their properties, but many rent control laws also limit the owners' rights to recover possession of their properties from existing tenants by simply terminating leases at the end of their scheduled terms. For example, ordinances may preclude landlords from terminating a lease or taking a rental property off the market when the result could be an attempt to rent the property to a new tenant at a higher rent. State laws and local ordinances restricting conversion of rental properties to condominiums have come under similar takings clause challenges.[83] Because rent control and use conversion laws have an effect on property rights similar to foreclosure restrictions, both as to delay in recovering property and a permanent denial of the full economic benefit of the property, it is useful to consider how these types of laws have fared under constitutional takings clause challenges.

The United States Supreme Court rejected takings clause and contract clause challenges to post World War I rent control ordinances of New York City and the District of Columbia in three significant decisions.[84] The court found the controls on rents and evictions to be justified by the acute post-war housing shortage. When the Minnesota legislature drafted its mortgage moratorium law in 1933, the drafters modeled their statute after the post World War I New York rent control laws in hopes of warding off the expected constitutional challenges.[85] In its *Blaisdell* decision sustaining the Minnesota statute, the Supreme Court referred to the court's earlier rent control cases as clear precedent in support of the expansive exercise of the state's emergency police powers to restrict the literal enforcement of private parties' contract rights.[86]

More recently the Supreme Court has rejected challenges that sought to overturn local rent control laws based on a number of constitutional grounds, including the

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[81] 304 U.S. 502 (1938).
[82] Louisville Joint Stock Land Bank v. Radford, 295 U.S. 555 (1935).
[83] *See e.g.* Griffin Development Co. v. City of Oxnard, 39 Cal.3d 256, 703 P.3d 339 (1975).
[84] Block v. Hirsh, 256 U.S. 135 (1921); Marcus Brown Holding Co. v. Feldman, 256 U.S. 170 (1921); Edgar A. Levy Leasing Co. v. Siegel, 258 U.S. 342 (1922).
[85] William I. Prosser, *The Minnesota Mortgage Moratorium*, 7 S. Cal. L. Rev. 353, 359-60 (1934).
[86] *Blaisdell*, *supra* 290 U.S. at 440-441.

Takings Clause.[87] Lower federal courts and state appellate courts have for the most part upheld rent control laws and similar landlord tenant regulations against property owners' claims that the laws worked as confiscatory takings of their property rights.[88] Generally the courts have allowed flexibility to governmental bodies in setting formula for a fair return on the property owners' investment.[89] In a few cases courts invalidated the laws as confiscatory, overly burdensome, or unreasonable based on particular procedures and formulas the laws used for calculating fair returns on investment.[90] Loan modifications using net present value calculations, as the FDIC model does, are well designed to demonstrate the fairness to investors of the restructured obligation.

## II. STATE CONSTITUTIONAL ISSUES RELATED TO MANDATORY MEDIATION PROGRAMS.

### A. Introduction

There is no question that a state can enact laws which impose substantial control over a lender's exercise of mortgage foreclosure remedies. A state can require mediation as a pre-condition to a lender's exercise of a right to foreclose, just as it can require mediation before allowing any creditor to exercise any other contractual or property rights. It is well settled that in an economic crisis or other emergency states can order delays of the exercise of foreclosure remedies in the exercise of their police power.

In the context of the current foreclosure crisis, state and local governments, as well as the courts, are again fashioning much-needed protections to assist homeowners facing loss of their homes through foreclosure. The Depression era rulings such as *Blaisdell* still provide the underlying constitutional support for these exercises of the states' police power.

Yet while *Blaisdell* continues to provide a rebuttal to many Contracts Clause challenges, some innovative local responses to the crisis are raising novel legal questions. These questions extend well beyond application of the contracts clause. For example, is ordering mediation of residential foreclosures a proper function of the executive, the legislative, or the judicial branch of state government? Where foreclosures in a particular

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[87] *Yee v. City of Escondido*, 503 U.S. 519 (1992); *Pennell v. City of San Jose*, 485 U.S. 1 (1988).

[88] Chicago Board of Realtors v. City of Chicago, 819 F.2d 732 (7th Cir. 1987)(ordinance regulating charges and other obligations imposed on landlords did not violate contracts clause and other constitutional provisions); Troy Ltd. v. Renna, 727 F.2d 287 (3d Cir. 1984) (limits on lease termination can be enforced as reasonable standard); Help Hoboken Housing v. City of Hoboken, 650 F. Supp. (D.N.J. 1986) (sustaining ordinance which imposed penalties for not renting properties); Griffin Development Co. v. City of Oxnard, 39 Cal. 3d 256, 703 P.3d 339 (1985) (sustaining ordinance restricting conversion of rental units to condominiums).

[89] *See e.g.* San Marcos Mobilehome Park Owners' Assn. v. City of San Marcos, 192 Cal App. 3d 1492, 238 Cal. Rptr. 290 (1987); Hutton Park gardens v. Town Council of Town of West Orange, 68 N.J. 543, 350 A.2d 1 (1975).

[90] Hall v. City of Santa Barbara, 797 F.2d 1493 (9th Cir. 1986); Ross v. City of Berkeley, 655 F. Supp. 820 (N.D. Cal. 1987).

state proceed through privately conducted non judicial sales, which branches of state government have authority to set conditions upon lenders' use of these procedures? And what about the power of local government in this area? Can a mayor, a county commissioner, a city council, a president judge of a county court, or a county sheriff implement a moratorium or mediation program and stay foreclosure sales pending mediation? Can local officials enforce such a program?

### B. Regulating Foreclosures at the State Level - separation of powers issues.

**Judicial vs. legislative control over foreclosure procedures**. State constitutions incorporate their own separation of power principles similar to those of the federal constitution. Under these standards, the judicial branch of each state's government exercises primary authority over matters related to court rules and the scheduling of judicial events. Typically the supreme court of a state exercises rulemaking authority over the lower courts of the state's judicial system. For example, state supreme courts often promulgate rules detailing when mediation will be required for certain categories of cases. Many state courts have adopted procedures modeled after Federal Rule of Civil Procedure 16, which mandates mediation of most civil cases filed in the federal court system.

In states with judicial foreclosure systems, legislatures enacting laws related to foreclosures must pay attention to the separation of powers doctrine. For example, if a state supreme court in a judicial foreclosure state has promulgated a rule that specifically excludes all foreclosure cases from mandatory mediation, a bill that proposes to require mediation in all judicial foreclosures might tread impermissibly into an area over which the judiciary has exclusive authority.

Case law on separation of powers issues related to mediation and judicial proceedings has produced mixed results. For example, the Tennessee legislature recently enacted a statute that mandated mediation in all workers compensation cases. Claimants challenged the statute on the ground that it was a legislative intrusion into exclusively judicial matters. However, the state supreme court found no separation of powers problem with the statute because it left intact all judicial remedies related to workers compensation and did no more than set up a procedure to supplement those remedies.[91]

A state constitutional provision that vests authority over judicial matters "exclusively" with the courts does not necessarily preclude the legislature from establishing quasi judicial procedures which must be exhausted as administrative remedies before a potential litigant may proceed to court.[92] The legislature can enlarge upon what are otherwise exclusive judicial functions without impairing them in violation of separation of powers doctrine.[93] For example, a number of state legislatures recently

[91] Lynch v. City of Jellico, 205 S.W. 3d 384,393 (Tenn. 2006).
[92] Lynn v. Simmons, 95 P.3d 99 (Kan. App. 2003).
[93] Pools by Murphy & Sons, Inc. v. Dept. of Consumer Protection, 841 A.2d 293 (Conn. Super. 2003) (upholding legislation creating state panel to assess administrative penalties in consumer protection matters).

enacted statutory requirements that litigants obtain a "certificate of merit" from an expert before filing certain malpractice actions in the state courts. Appellate courts have generally held that these statutes supplemented expert disclosure requirements under existing court rules and did not conflict with them.[94]

While there have not been any significant decisions on separation of powers issues related to legislative modification of judicial foreclosure procedures, the past treatment of landlord and tenant eviction cases presents some useful analogies. A court will invalidate state legislative enactments related to evictions to the extent that they conflict with specific court rules governing the same subject. However, the fate of the enactment will depend on the degree of imposition it creates. For example, a New York court declined to strike down a state statute that directed when courts could stay evictions or continue eviction hearings.[95] Similarly, in the view of a Florida court a state statute that established a requirement that commercial borrowers pay interest during foreclosure proceedings affected both substantive and procedural rights of parties and therefore did not impinge upon areas of exclusive judicial concern.[96]

Some general principles apply to these separation of powers rulings. To the extent that a legislative enactment merely supplements rather than directly conflicts with an established court rule, the less likely it will be vulnerable to challenges on separation of powers grounds. To the extent that legislation conflicts with specific time frames and detailed procedural rules already contained in court rules, the greater will be the likelihood of conflict.

Adding mediation requirements to non judicial foreclosures presents fewer separation of powers concerns than to do so for judicial foreclosures. Because courts do not play a significant role in conducting non judicial foreclosures, the potential for conflicts with specific court rules is remote. Legislation related to judicial foreclosures may raise possible separation of powers issues. However, the terms of state constitutions vary in the degree to which the legislature is allowed to encroach into the making of court rules and procedures. Some states specifically allow the legislature to supersede or repeal formally promulgated court rules by legislation.[97]

### C. Recent Foreclosure Mediation Action at the State Level.

In the current foreclosure crisis states have responded with the development of mediation programs through legislation and through court rules. A summary of 2008-2009 state actions to create foreclosure mediation systems is attached to this memorandum as Appendix 1. Several developments will be mentioned briefly here.

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[94] *See e.g* Bertelson v. Sacks & Tierney, P.A., 60 P.3d 703, 708 (Ariz. App. 2002).
[95] Lang v. Pataki, 707 N.Y.S. 2d 90 (N.Y. App. 2000).
[96] Caple v. Design Builders, 753 So.2d 49, 54 (Fla. 2000).
[97] *See e.g.* Taylor v. State, 969 So.2d 583, 584 (Fla. App. 2007) (Fla. Constitution Art. V § 2 gives state supreme court exclusive authority to promulgate rules for judicial proceedings, but legislature may repeal court rule through two-thirds vote).

*1. Recent Developments - Actions by State Supreme Courts*

During 2008 the chief justices of the supreme courts of Ohio, New Jersey, and New York promulgated rules that authorized or directed local courts to develop foreclosure mediation programs. These state supreme courts fashioned model programs that included recommended forms and procedures which local courts can adopt or modify as they see fit. As these are judicial foreclosure states the chief justices acted well within their roles as the ultimate authorities for fashioning rules for various types of court proceedings, including mortgage foreclosures. The justices adjusted existing mediation systems to respond to the dramatic increase in foreclosure filings in their jurisdictions.

*2. Recent Developments - Actions by State Legislatures*

In Connecticut, also a judicial foreclosure state, the state legislature enacted a statute that directs the state's court administrator to fashion a plan for foreclosure mediation.[98] The legislation sets basic parameters and goals for the court to implement. In California, where non judicial procedures are the most common form of foreclosure, the legislature enacted a new law that temporarily stayed lenders' ability to start new non judicial foreclosures.[99] The legislation required a thirty day delay before the lender may file a notice of default. During this time the lender must contact the homeowner and offer to meet to discuss alternatives to foreclosure, including workout agreements and loan modification. The California legislation effected this change through an amendment to the notice provision of the state's power of sale statute. Under the amended statute,

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[98] Conn. Gen. Stat. Ann. § 8-265ee. Subsection (a) of the statute provides: "On and after July 1, 2008, a mortgagee who desires to foreclose upon a mortgage which satisfies the standards contained in subdivisions (1), (3), (10) and (12) of subsection (d) of section 8-265ff, shall give notice to the mortgagor by registered, or certified mail, postage prepaid at the address of the property which is secured by the mortgage. No such mortgagee may commence a foreclosure of a mortgage prior to mailing such notice. Such notice shall advise the mortgagor of his delinquency or other default under the mortgage and shall state that the mortgagor has sixty days from the date of such notice in which to (1) have a face-to-face meeting, telephone or other conference acceptable to the authority with the mortgagee or a face-to-face meeting with a consumer credit counseling agency to attempt to resolve the delinquency or default by restructuring the loan payment schedule or otherwise, and (2) contact the authority, at an address and phone number contained in the notice, to obtain information and apply for emergency mortgage assistance payments if the mortgagor and mortgagee are unable to resolve the delinquency or default.

[99] Cal. Civ. Code § 2923.5. Subsection (a)(2) of the statute provides, "A mortgagee, beneficiary, or authorized agent shall contact the borrower in person or by telephone in order to assess the borrower's financial situation and explore options for the borrower to avoid foreclosure. During the initial contact, the mortgagee, beneficiary, or authorized agent shall advise the borrower that he or she has the right to request a subsequent meeting and, if requested, the mortgagee, beneficiary, or authorized agent shall schedule the meeting to occur within 14 days. The assessment of the borrower's financial situation and discussion of options may occur during the first contact, or at the subsequent meeting scheduled for that purpose. In either case, the borrower shall be provided the toll-free telephone number made available by the United States Department of Housing and Urban Development (HUD) to find a HUD-certified housing counseling agency. Any meeting may occur telephonically.

when a lender proceeds with the non judicial foreclosure it must file a certification along with its filing of the notice of sale that it complied with the requirement to offer to meet with the homeowner.

New York enacted a statute in August 2008 which will require holders of certain high cost loans to participate in mandatory mediation to consider loss mitigation options.[100] Finally, in December 2008 the New Jersey legislature enacted the Mortgage Stabilization and Relief Act.[101] This law provides funding to refinance loans in default into affordable mortgages. Lenders who agree to modify loans are eligible for participation. While the statute does not mandate mediation over loss mitigation issues, it does require lenders to report to state agencies regarding the status of loss mitigation efforts.

### D. Summary: Responses at the State Level

In non judicial foreclosure states the legislatures have significant authority to modify foreclosure procedures. They may keep foreclosures as non judicial proceedings and exercise broad discretion to set up a mediation system. Legislatures in non judicial foreclosure states also have the option of directing their foreclosures into existing judicial foreclosure systems as they see fit and requiring mediation as part of those procedures. However, as their enactments affect judicial procedures the legislative bodies must be alert to certain judicial prerogatives. An option that minimizes potential conflicts is for the legislature to define certain parameters for judicial review of foreclosures and delegate the more detailed rulemaking to the state's supreme court.

## III. LOCAL REGULATION OF MORTGAGE FORECLOSURES

### A. Authority of local courts to stay judicial foreclosures and require mediation.

As discussed above, state supreme courts typically have the authority to promulgate the rules that govern court proceedings throughout a state. A state supreme court may also delegate authority to local courts to fashion local rules for adjucicating particular classes of cases. The recent actions of the New York, New Jersey, and Ohio Supreme courts authorizing local foreclosure moratorium programs in connection with judicial foreclosures fit within this standard framework of delegated authority from a state supreme court to local county or district courts.

As the current foreclosure crisis worsened, not all local courts waited for this type of express delegation of authority before adopting their own local procedures to respond to the crisis. For example, during 2008 local courts in Pennsylvania and Florida took matters into their own hands and put in place mandatory mediation programs applicable

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[100] S. Bill 8143, A/A No. 10817A. The legislation also implemented a new ninety day notice requirement prior to initiation of all foreclosures.
[101] S. Bill 1599.

to judicial foreclosures of homes. (Summaries of these programs are contained in the Appendix 1)

The local courts in Pennsylvania and Florida did not act under specific directives from their state supreme courts to develop local foreclosure mediation programs. Rather, the local courts' authority was grounded upon very general language found in state court rules. In both states long standing state court rules had delegated substantial discretion in scheduling and procedural matters for all types of cases to local president judges and administrative judges.

In April 2008, after the Philadelphia Sheriff initially exercised his own scheduling discretion to stay monthly foreclosure sales, the president judge and administrative judge of the Philadelphia Common Pleas Court promulgated a local court regulation that established a "Residential Mortgage Foreclosure Diversion Pilot Program." (Joint General Court Regulation No. 2008-01). This program mandated mediation sessions prior to allowing a lender to proceed with a sheriff's sale of a home. Under Pennsylvania Rules of Civil Procedure, as promulgated by the Pennsylvania Supreme Court, the chief administrative judge of a county common pleas court has authority to "supervise the judicial business of the court" and may "promulgate all administrative rules and regulations." [102] This rule gave the chief judge of the Philadelphia court ample authority to modify the scheduling of foreclosure cases. In January 2009 the President Judge of the Allegheny County (Pittsburgh) court began to implement a similar residential Mortgage Foreclosure mediation system.

Similarly, under Florida Rule of Judicial Administration No. 2.215(b)(2) the chief judge of a circuit court may issue administrative orders related to court procedures. These administrative orders can be issued at the discretion of the local chief judge, with an aggrieved party having the right to seek review of the order by the state supreme court. In late 2008 the chief judges of the 12th and 18th judicial circuits of Florida, comprising four counties, authorized mediation programs for their courts. These orders became effective at the beginning of December 2008.

The local administrative judges in Pennsylvania and Florida exercised authority that was similar to that of the state supreme court judges who authorized foreclosure mediation programs statewide in New York, New Jersey, and Ohio. Thus, in all five judicial foreclosure states local judges have authority, either from a specific supreme court directive related to foreclosures, or from a general authority delegated to them by a statewide court rule, to stay foreclosures and require mediation.

Not all local administrative judges in judicial foreclosure states will have the same delegated authority to create foreclosure mediation programs. Whether they do will depend primarily upon the language of state court rules. It will also depend upon how local judges choose to exercise their own discretion. For example in October 2008 the Mayor of Milwaukee, Wisconsin asked the local chief judge to initiate a foreclosure

[102] 42 Pa. C.S.A. § 325(e)(1). *See also* Pa. R. Civ. P. Nos. 3121(b)(2), 3183(b)(2) (allowing courts to stay execution of judgments for money and foreclosure on general equitable grounds).

moratorium and mediation program for the county. The presiding Milwaukee judge turned down the request, claiming that he lacked the authority under state court rules to modify foreclosure procedures across the board in his court.[103] Whether the judge's view of his authority was accurate or not, this incident highlights the limitations of relying upon local court officials to address urgent needs of homeowners in foreclosure.

### B. Actions by other local officials: mayors, city councils, county commissioners, sheriffs, and clerks.

#### 1. *Local regulation of judicial foreclosures – potential problems related to the separation of powers doctrine.*

In judicial foreclosure states, separation of powers issues may arise when local officials who are not part of the judiciary seek to regulate mortgage foreclosure procedures. The state's supreme court may possess the exclusive rule making power related to judicial foreclosures. Actions by local executive and legislative officials may run afoul of this authority, particularly if they create new local procedures that conflict with duly promulgated state court rules. Local officials may encounter the same separation of powers obstacles that state legislators face when they attempt to assert extensive control over established judicial procedures.

To the extent that judicial officials with the direct or delegated authority to do so have promulgated rules which set time frames and procedures for judicial foreclosures, local officials with no delegated judicial authority will not have the power to change the established rules.[104] The basic principle is that legislative bodies can enact the policies that courts must apply, but they may not mandate the procedures the courts must use to apply the policies. Municipal governments contemplating the creation of mediation systems that set conditions for access to existing statewide judicial proceedings will have to tread carefully so as not to upset the balance of power favoring judicial control over court proceedings.

#### 2. *The role of local government/ local officials in conditioning foreclosure upon participation in mediation.*

##### *a. Municipal authority under home rule charters*

[103] Milwaukee Wisconsin Journal Sentinel, October 31, 2008.
[104] *See e.g.* Village of Glenview v. Zwick, 826 N.E. 2d 1171 (Ill. App. 2005) (invalidating local ordinance providing for attorney's fee shifting in litigation against municipality as contrary to statewide judicial practice); Fifth Ave., Office Center Co. v. City of Mt. Vernon, 658 N.Y.S. 2d 217 (1997) (local government may not set limit on access to judicial review of tax assessments authorized under statewide procedure); City of Spokane v. J.R. Distributions, 585 P.2d 784 (Wash. 1978) (city by ordinance cannot mandate superior courts to follow certain procedures in nuisance abatement cases); Molitor v. City of Cedar Rapids, 360 N.W.2d 568 (Iowa 1985) (city did not have authority to provide for method of appeal from its housing board to the courts).

As a general principle, local governments (cities, counties, townships) have no inherent power to enact laws. Traditionally municipalities were treated as creatures of the state, exercising only the constitutional and statutory powers granted to them by a state. However, home rule charters authorize a different approach to local government sovereignty. Many state constitutions allow local governments to adopt charters that give them greater autonomy to create laws applicable within their boundaries. Adopting a home rule charter typically grants a local government the power to enact laws to the full extent that the state legislature can enact them.[105] There are two basic limitations on home rule powers. First, the local government cannot enact laws that conflict with a specific state statute or with the state constitution. Second, the local law can only apply within the geographic boundary of the local entity.[106]

*b. Pre-emption by the state – limits on home rule power.*

Enactments under home rule charters are presumed to be valid, and the burden to show a conflict with state law is upon the party alleging it. State preemption of laws passed under local home rule authority is not favored. Generally, in order for pre emption to occur, there must be an actual conflict between a state law and a local law. State legislatures must expressly and clearly preempt a particular field in order to preclude local enactments in the same area. Because local governments have broad authority to exercise their police power under home rule charters, preemption of a local exercise of the police power is not to be implied lightly.

There is little judicial precedent construing the extent of local government power to regulate foreclosures. In a somewhat related context, the authority of local government to enact ordinances regulating predatory lending recently produced a spate of decisions from the courts. Many state legislatures enacted "mini-HOEPA" statutes in order to regulate predatory lending practices. Typically these state statutes were more restrictive in regulating lender practices than the federal HOEPA law.[107] Contemporaneously with the enactment of these state laws, municipalities in New York, California, and Ohio enacted their own ordinances regulating predatory lending. Typically these ordinances set stricter interest rate limits, regulated other loan terms such as prepayment penalties more severely than the state statutes, and required counseling as a condition to granting of high cost loans. The Oakland, California ordinance abrogated the holder in due course rule for assignees of lenders.[108] The New York City ordinance prohibited the City from doing business with entities involved in predatory lending. The mortgage lending industry mounted immediate legal challenges to the ordinances of New York City,

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[105] *See generally,* Eugene McQuillan, *The Law of Municipal Corporations* § 10.15 (3d ed. Rev. 1993).
[106] *Id*.
[107] The Homeownership and Equity Protection Act, 15 U.S.C. § 1639, *et seq.*, amended the federal Truth in Lending Act to require additional disclosures and bar certain terms and practices related to high cost loans.
[108] *See* American Financial Services Association v. City of Oakland, 34 Cal. 4th 1239,1250, 104 P.3d 813, 819, 23 Cal. Rptr.3d 453 (2005).

Oakland, and three Ohio cities: Cleveland, Dayton, and Toledo. Ultimately, the industry prevailed in striking down all the local ordinances on state law preemption grounds.[109]

The decisions in these cases were not as monolithic as the final results may suggest. Intermediate appellate courts in California and Ohio upheld the validity of the Oakland, Cleveland, and Toledo ordinances against the pre-emption challenges. The California Supreme Court found preemption by a four to three decision, and two justices dissented from the Ohio Supreme Court ruling.[110] Thus, even on the issue of preemption related to state predatory lending statutes, the law cannot be considered settled for other jurisdictions and different statutory issues.

Some of the courts' discussions in the municipal predatory lending ordinance cases do, however, suggest ways in which arguments over foreclosure and mediation preemption might be framed. In California, Ohio, and New York the municipalities acted to regulate predatory lending locally at the same time the state legislature was enacting statewide regulation on the same subject. There were express declarations in each of the statewide mini-HOEPA statutes that strongly supported finding a legislative intent for statewide preemption of the regulation of predatory lending. The Ohio statute authorized the state to "*solely* . . . regulate the business of originating, granting, servicing, and collecting loans and other forms of credit in the state and the manner in which any such business is conducted . . . in lieu of all other regulation of such activities by any municipal corporation or other political subdivision." (Ohio R.C. § 1.63(A) (emphasis added). The Ohio Supreme Court found that the state legislature acted in accordance with this authority in enacting the state mini-HEOPA statute. The general New York state banking law at issue also provided for "uniform regulation of the residential mortgage lending process."[111]

The Ohio Supreme Court considered the general state statutes regulating the mortgage industry to be laws occupying the field of regulation of mortgage lending. However, under the majority's view, the express intent of the legislature to preempt local laws would not be sufficient to strike down a local ordinance unless the local ordinance actually conflicted with the general state statute.[112] Here, the court found that the

[109] American Financial Services Association v. City of Oakland, *supra*; American Financial Services Association v. City of Cleveland, 112 Ohio St. 3d 170, 858 N.E. 2d 776 (2006); American Financial Services Ass'n v. City of Toledo, 859 N.E. 2d 923 (Ohio Mem. 2006); Mayor of the City of New York v. Council of City of New York, 4 Misc. 3d 151, 780 N.Y.S. 2d 266 (2004). *See generally*, Jonathan L. Entin & Shadya Y. Yazback, *City Governments and Predatory Lending*, 34 Fordham Law Journal 757 (March 2007); Kimm Tynan, *Pennsylvania Welcomes Predatory Lenders: Pennsylvania's Act 55 Preempts Philadelphia's Tough Ordinance But Provides Little Protection for Vulnerable Borrowers*, 34 Rutgers Law Journal 837 (Spring 2003) (discussing lending industry's successful use of state legislation to override local initiative).

[110] *See* American Financial Services Ass'n v. City of Toledo, 830 N.E. 2d 1233 (Ohio Ct. App. 2005); American Financial Services v. City of Cleveland, 824 N.E. 2d 553 (Ohio Ct. App. 2004).

[111] Mayor of New York v. Council of New York, *supra*, 780 N.Y.S. 2d at 273-74 (quoting N.Y. Banking L. § 589)

[112] A concurring opinion would have found such a declaration of intent to preempt sufficient to block the local law and considered Ohio in line with seven other states in which state legislatures had preempted the

Cleveland ordinance prohibited forms of predatory lending that were permitted under the state statute, and this difference in treatment amounted to a conflict. The dissenting justices rejected the contention that more stringent local regulation intended to achieve the same goals as the state legislation amounted to a conflict. In addition, according to the dissent, the state lacked authority under the state constitution to prohibit local government from regulating an area of such vital local importance as predatory lending.[113]

The majority of the California Supreme Court found preemption by implication. The majority inferred the state's intent to occupy the field of regulation of predatory lending from viewing the state's historical role in regulating mortgage lending. The dissent strongly disagreed with the majority's finding of implied preemption and adhered to the well established rule that silence on the issue of preemption in state legislation should not be lightly ignored. With respect to the California mini-HOEPA statute, the legislature had actually considered, but declined to adopt a provision pre empting local initiatives.[114] The dissenters went on the describe how, regardless of the lack of local government involvement in the regulation of mortgage lending in the past, there was a sound rationale for this involvement today:

> Thus, despite the circumstances that mortgage regulation historically has occurred at the state rather than the local level, we must recognize the concerns implicated by the recent rapid escalation of predatory lending. In view of the documented evidence that predatory lending is especially pervasive in low-income and minority neighborhoods, it is beyond dispute that Oakland and other similarly situated localities have a more significant interest in regulating subprime lending than localities that, because of demographics and composition, are not targeted in similar ways. Local regulation thus is not only constitutionally valid, but practically vital to the affected communities. Although predatory lending certainly is a matter of statewide concern, the specific interest of the communities most affected by the banned practices make the regulation of this field particularly amenable to local variations.[115]

Local initiatives directed at mandatory mediation and loan modifications obviously raise issues that are distinct from those involved in the dueling mini-HOEPA disputes. The New York, California, and Ohio courts focused closely upon the parallel nature of the state and local laws both modeled after the same federal anti predatory

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field of mortgage lending regulation by general statutes. In the court's view, these states were: Arizona, California, Connecticut, North Carolina, Pennsylvania, Texas, and Washington. 858 N.E. 2d at 789.

[113] American Financial Services v. City of Cleveland, *supra,* 858 N.E. 2d at 795-96 (noting that Cleveland had recently been named "the poorest large city in the United States" and observing, "[p]redatory lenders prey on the poor, and Cleveland is thus especially prone to predatory lending and its inevitable aftermath. Is it appropriate for the General Assembly to restrict the ability of municipalities to respond to the problems attendant to poverty?"

[114] American Financial Services Association v. City of Oakland, *supra,* 104 P.3d 830-31.

[115] *Id* 104 P.3d at 836.

lending statute. The simultaneous appearance of the state and local laws regulating the same area in much the same way clearly invited preemption attacks.

Local mediation and loan modification ordinances will likely bring state preemption challenges as well. The mortgage lending industry will focus on the general state regulation of their industry, and, more specifically on the state regulation of foreclosure procedures. The industry's claim will be that the state preempted the field, either expressly or by implication, by establishing judicial and non judicial means of foreclosure.

Local governments must respond to preemption arguments in different ways depending on whether the common method of foreclosure in their states is judicial or non judicial. In judicial foreclosure states, the local governments may wish to draft their ordinance as a directive to the courts to exercise their power and discretion within a framework set by an ordinance. The problem here may be the lack of authority of the local government over the state's judiciary. In particular, the state supreme court may be the only body with authority to modify court procedures.

Non judicial foreclosures present a different problem. A typical state power of sale or foreclosure by advertisement statute reads something like the following Michigan provision:

> Every mortgage of real estate, which contains a power of sale, upon default being made in any condition of such mortgage, may be foreclosed by advertisement, in the cases and in the manner specified in this chapter. However, the procedures set forth in this chapter shall not apply to mortgages of real estate held by the Michigan state housing development authority.[116]

The enactment of a local ordinance in Michigan that conditioned non judicial foreclosure upon compliance with mediation and loan modification obligations would likely be met by mortgage holders' arguments emphasizing that the state statute by its express terms applies to *every* mortgage in the state. The standard argument for pre-emption asserts that a local ordinance which prohibits what a state statute expressly permits is invalid. The Michigan statute appears to give mortgage holders an affirmative right to enforce contract terms allowing foreclosure by advertisement everywhere in the state. While a local law that excessively burdens this right may be preempted, one that imposes less restrictive obligations may not be. For example, an ordinance that channels non judicial foreclosures into a judicial or administrative system for mediation purposes might set thresholds for foreclosure, while not ultimately prohibiting use of the non judicial foreclosure remedies authorized by state statute.

In any preemption dispute involving state versus local foreclosure procedures, the precise language of the general state statutes will be critically important. The locality's own needs should play a role as well. Other factors may help in upholding an ordinance.

[116] Mich. Cons. Laws Ann. § 600.3201.

For example, a local ordinance will be more likely to withstand challenge if it is tied to an emergency situation that is clearly temporary. Given the unique nature of the current foreclosure crisis, including the changes in the mortgage market and the industry's development of new types of deceptive marketing practices, the past lack of involvement by local government in this area should not be a significant impediment.

Conflicts between general state laws regulating foreclosures and local ordinances covering the same area have not been the subject of litigation in the past. However, some types of laws regulating property rights have frequently seen preemption disputes. These include the areas of landlord and tenant eviction procedures, rent control, and condominium conversion. For example, in many instances states have enacted comprehensive statutory schemes to regulate landlord and tenant relations. At the same time local governments have also sought to regulate various aspects of these relations, ranging from ordinances dealing with property conditions, security deposits, discrimination in tenant selection, the amount of rent charged, forms of notice and procedures for eviction, and decisions to take rental properties off the market. The results of preemption litigation in these areas have not been uniform. The outcomes vary widely from state to state due to differences in the structure of home rule grants and in the degree to which the state legislature had expressly addressed the type of regulation. Therefore, a decision from one state will seldom carry much weight in another.

At one end of the spectrum is the case of *Ingamort v. Borough of Fort Lee*,[117] the landmark decision of the New Jersey Supreme Court upholding the Newark rent control ordinance against a preemption challenge. The Newark ordinance in question had been enacted in furtherance of the City's police power to respond to a shortage of affordable rental housing deemed to constitute an emergency. The court rejected arguments to the effect that regulating property interests differently in one part of the state was inappropriate. The court saw no compelling need for uniform statewide practices. Noting that the ability to meet local needs was part of the value of home rule legislation, the court stated:

> [T]he legislature may invest in local government the police power to devise measures tailored to the local scene. The Legislature may decide to do so for sundry reasons. A problem may exist in some municipalities and be trivial or nonexistent in others. And if the evil is of statewide concern, still practical considerations may warrant different or more detailed local treatment to meet varying conditions or to achieve the ultimate goal more effectively.[118]

The court went on to observe that this diversity could be particularly important where local government is "equipped to deal with matters of local concern which, if left to State action, might not be met expeditiously, or at all."[119] According to

[117] 62 N.J. 521, 303 A.2d 298 (1973).
[118] 62 N.J. at 528-529.
[119] *Id*. at 533.

the *Ingamort* court, the powers of local government were to be liberally construed under the home rule provisions. Most importantly, the court did not require a specific delegation of authority from the state to the local governments to enact rent control laws. The general authority to enact laws in furtherance of the police power was sufficient. As the court noted:

> That control of rent affects the exercise of the right to contract with respect to property is undeniable. But the right to contract is subject to the police power and no less so when the police power is exerted at [the] municipal level. [citations omitted] Whether an ordinance relates to zoning, or contains a housing code, or imposes upon the landlord duties relating to health, it necessarily limits the use of property or the right to contract with respect to it. That the ordinance imposes restraints which the State law does not, does not spell out a conflict between State and local law. On the contrary the absence of a statutory restraint is the very occasion for municipal initiative. The police power is vested in local government to the very end that the right of property may be restrained when it ought to be because of sufficient local need.[120]

The California Supreme Court adopted similar reasoning in upholding a local rent control law against a state preemption challenge in *Berkenfeld v. City of Berkeley.*[121] More recently, local legislation affecting property rights has been upheld against similar pre emption challenges.[122] At the other end of the spectrum, a number of appellate courts have invalidated ordinances regulating property as in conflict with statewide regulatory schemes.[123]

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[120] *Id.* at 538.

[121] 17 Cal. 3d 129, 550 P.2d 1001 (1976).

[122] *See* Zorn v. Howe, 716 N.Y.S. 2d 128 (2000) (upholding local ordinance that established ground for eviction based on drug related conduct that was not a ground for eviction under state law); Rental Property Owners of Kent v. City of Grand Rapids, 566 N.W. 2d 514 (Mich. 1997) (rejecting property owners' challenge to ordinance authorizing padlocking of rental properties under nuisance control rationale); Margola Associates v. City of Seattle, 854 P.2d 23 (Wash. 1993) (upholding ordinance requiring landlord registration); City of New York v. Park South Associates, 529 N.Y.S. 2d 261 (1988) (upholding local prohibition on certain unlawful evictions); People v. Little, 192 Cal. Rptr. 619 (1983) (upholding ordinance subjecting purchasers at foreclosure sale to local rent control law). *See also* Page v. City of Chicago, 701 N.E. 2d 218 (Ill. App. 1998) (general discussion of local police power in context of city human rights ordinance which added protections and remedies against certain types of discriminatory employer conduct beyond those in state statute).

[123] Action Apartments v. Santa Monica, 163 P.3d 89 (Cal. 2007) (statute authorizing tenants to sue landlords for bringing harassing litigation conflicted with state litigation privilege, thus preempted); Johnson v. City of San Francisco, 40 Cal. Rptr. 3d 8 (2006) (state statute authorizing removal of rental units from market conflicted with and preempted local ordinance requiring notices related to closing down rental units); Bohbut v. Santa Monica, 34 Cal. Rptr. 3d 827 (Cal. 2005) (striking down anti eviction and rent control ordinance as preempted by substantive provisions of state eviction statute that allowed prohibited practice); Channing Properties v. City of Berkeley, 14 Cal. Rptr. 2d 32 (1992) (State statute requiring 60 days notice to take rental property off market pre empted local ordinance requiring six months notice, emphasizing state's intent to regulate timing of evictions); Ba Mar, Inc. v. County of Rockland, 566 N.Y.S. 2d 298 (1996) (state mobile home park law preempted field of mobile park regulation; invalidating

### C. The Roles of Judges, Clerks, and Sheriffs

If state legislatures, state supreme courts, and local government entities will not act to encourage loss mitigation efforts before allowing homes to be sold in foreclosure, is there a role for local officials? Judicial and non judicial foreclosures raise similar, but also some distinct issues related to these questions.

#### *1. Judicial foreclosures*

In judicial foreclosures judges typically exercise authority over the entire conduct of the proceeding. Before they allow entry of a foreclosure judgment, judges can exercise their general equitable powers to consider the extent the mortgage holder exercised bad faith in refusing to consider loss mitigation.[124] After entry of a foreclosure judgment judges often retain some discretion in the scheduling of a sale. However, state statutes and statewide court rules may set time limits within which a sale must take place. These rules may require a sale within a fixed time or after or before a specific procedural event.[125] If such a limit applies, it is unlikely an individual judge will have authority to schedule sales outside of these limits. At the other end of the spectrum, as discussed above, state statutes and state supreme court rules may give local administrative judges significant authority over scheduling events at the local level.

If there are no express limits set by general court rule or statute, a judge presiding over a judicial foreclosure should be able to exercise discretion in scheduling the sale.[126] There are obviously limits on this discretion, and a judge cannot abuse these limits. In varying degrees certain courts have taken hardship and emergency conditions into account in deciding whether to allow a foreclosure to proceed.[127]

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county law restricting evictions from parks). *See also* Tartaglia v. McLaughlin, 77 N.Y.S. 2d 31 (1947)(invalidating on preemption grounds and as improper legislative interference with judicial procedures an ordinance requiring that temporary emergency rent commission must issue certificate authorizing eviction and imposing new limit on evictions in field pre empted by state eviction laws)[123] Fields v. Taylor, 80 N.Y.S. 2d 159 (1948) (municipality cannot regulate eviction proceedings by granting successive 60 day stays, creating conflict with state judicial procedures).

[124] *See e.g* Wells Fargo Home Mortgage, Inc. v. Neal, 398 Md. 705, 922 A.2d 538 (2007).

[125] *See e.g.* Central Trust v. Alison, 403 N.Y.S. 2d 396 (1978) (referee must schedule sale within time frame provided by statute); Federal Land Bank v. Blackshear, 38 S.W. 2d 30 (Ark. 1931) (statute required sale to be within six months or before end of current court term).

[126] *See e.g.* Union Guardian v. Building Sec. 273 N.W. 424 (Mich. 1937); Page v. Austern, 169 So. 826 (Miss. 1936); Federal Land Bank v. Wells, 172 S.E. 707 (S.C. 1934).

[127] *See e.g.*, Savarese v. Schoner, 464 So.2d 695 (Fla. App. 1985); Reynolds v. Ramos, 188 Conn. 316, 449 A.2d 182 (1982); Associated East Mortgage Co. v. Young, 163 N.J. Super 315, 384 A.2d 899 (N.J. Super. 1978); U.S. v. Loosley, 551 P.2d 506 (Utah 1976); Federal Home Loan Mortgage Corp. v. Taylor, 318 So.2d 203 (Fla. App. 1975); Bisno v. Sax, 175 Cal. App. 2d 714, 346 P.2d 814 (Ca. App. 1959); Murphy v. Fox, 278 P.2d 820 (Okla. 1955); Crane v. Bielski, 15 N.J. 342, 104 A.2d 651 (1954); Casper v. Anderson Apartments, 196 Misc. 555, 94 N.Y.S. 2d 521 (1949); Graf. v. Hope Bldg Corp., 254 N.Y.1, 171 N.E. 884 (N.Y. 1930) (Cardozo, C.J. *dissenting*); Germania Life Ins. Co. v. Potter, 109 N.Y.S. 435 (1908).

If the court does have discretion to take emergency conditions into account for individual cases and the same conditions affect a large number of pending foreclosures, a judge should have authority to extend stays for groups of similar cases pending in the same court. This form of general relief becomes particularly appropriate when there are alternatives still available that are financially in the mortgage holder's interest, such as loss mitigation options, and those alternatives have not been exhausted. Similarly, if homeownership can be preserved while awaiting the implementation of state or federal legislation that will offer relief to distressed homeowners, a judge's equitable powers should extend to granting stays in individual and multiple foreclosure cases to ensure that homeowners have the chance to benefit from these measures. Again, this exercise of power assumes there are not specific contrary limits set by state statute or general court rule.

2. *Non judicial foreclosures – ministerial and discretionary actors*

Non judicial foreclosures are typically characterized as proceedings by private parties to enforce private contracts. However, this is not always the case. To varying degrees public officials play roles in most non-judicial foreclosures. Examples are numerous. In Colorado the court approves the request for a sale and a public trustee conducts the sale. In North Carolina a court clerk must determine as a preliminary matter whether a sale may go ahead. In Georgia the court confirms the sale if the lender seeks a deficiency. In Maryland the person conducting the sale must file a report of sale with the court. In Massachusetts the lender must file Servicemembers Civil Relief Act information with the court before initiating foreclosure. In Michigan the sheriff distributes surplus proceeds from the sale. In Virginia the trustee files a report with the local commissioner of accounts who approves the distribution of any proceeds. A non judicial sale will not be complete or valid unless the public officials perform these tasks.

Public officials play a number of indirect but essential roles under many other non judicial foreclosure systems. Lenders must record a notice of default or "order to docket" with a local clerk before proceeding with a non judicial foreclosure sale in California, District of Columbia, Idaho, Maryland, Arkansas, Alaska, Nebraska, Nevada, Oregon, and Utah. In Massachusetts the lender must file a pre sale notice with various public officials. Lenders must record the notice of sale with public officials in Arizona, California, Idaho, Maryland, Texas, Washington State, Montana, and Utah. Public officials must conduct the non judicial foreclosure sales in Michigan and Minnesota. A sheriff signs off on the foreclosure sale deed in Maryland, Michigan, and Minnesota. In New Hampshire the record of the sale must be filed with the registry of deeds, and in Maryland with the court.

Use of public facilities is also built into many non judicial foreclosure statutes. Non judicial foreclosure sales must take place at the court house in Michigan, Texas, Alabama, Colorado, Montana and Utah. In Mississippi the notice of sale must be posted at the courthouse.

In these non judicial foreclosure jurisdictions, may a court clerk or town or county land records clerk refuse to accept filings from foreclosing lenders due to a local emergency created by a multitude of non judicial foreclosures? May local officials bar lenders from use of the local court house for posting notices or conducting sales?

The answer to these questions depends on the degree to which any of these local officials has authority to exercise discretion in carrying out their duties. In almost all cases, the answer will be no. For example, town recording officials can be subject to a mandamus action and compelled to perform their ministerial duties as defined by state statute.[128]

Finally, self help eviction is not allowed under any known system of non judicial foreclosures. In all jurisdictions the lenders or third parties who purchase homes at foreclosure sale must obtain court approval for an eviction. A sheriff, constable, or similar law enforcement official must execute the court order turning the house over to the purchaser at the sale. May courts refuse to issue process necessary to effectuate these orders for possession? May sheriffs act independently to delay or refuse to serve and execute the eviction orders?

Courts may have some discretion in refusing to grant judgments for possession in post sale ejectment or unlawful detainer actions. Ejectment actions, like foreclosures, are often subject to the court's equitable powers of review. A Michigan court, for example, has held that a court may deny ejectment relief to a lender following a non judicial foreclosure based on matters related to the conduct of the foreclosure sale.[129] Under this analysis a court should be able to deny ejectment relief to a lender if it failed to comply with procedural and substantive requirements related to a mediation program. Unless there is a statute grant them discretion in executing court judgments, it is unlikely that sheriffs or constables will have similar discretionary authority in deciding when and how to enforce an order for eviction.

## CONCLUSION

As a result of the courts' re-evaluation of the Contracts Clause which began in the 1930s, states now have significant latitude to act in fashioning responses to the ongoing foreclosure crisis. Beginning in the Depression era, state statutes enacted in response to severe upswings in home foreclosures relied heavily upon the inherent equitable powers of courts supervise foreclosures, and the courts have upheld these laws. Based on modern interpretations of the scope of the Contracts Clause, it is clear that state legislation may direct the courts' exercise of discretion in ways that will promote the preservation of homeownership, despite impairment of mortgage holders' existing contract rights. Restrictions on foreclosure that do not extinguish mortgage holders' liens

[128] *See e.g.* Mortgage Electronic Registration Systems, Inc. v. Romaine, 861 N.Y.S. 2d 81 (N.Y. 2006) (county recorder has no discretion to refuse to record mortgages and assignment under name of electronic data base system despite well founded belief that documents did not meet legal standards for filing).

[129] Manufacturers Hanover Mortgage Co. v. Snell, 142 Mich. App. 548, 370 N.W. 2d 401 (1985).

and preserve the ultimate remedy of a forced sale upon a future default should satisfy the basic protections for mortgage holders guaranteed by the Contracts Clause.

Local governments may also play an important role in prevention of foreclosures. However state law preemption may limit these local government powers in some instances. In the absence of clear state law preemption, local governments should have authority to regulate foreclosures equal to that of the states. In addition, local courts may have powers to regulate court proceedings under delegated authority from the State or the state's supreme court. The local courts may exercise this authority to regulate judicial foreclosures in a number of ways that will require accountability from mortgage holders who seek to use the court system to foreclose.

**APPENDIX 1 - SUMMARY OF STATE AND LOCAL FORECLOSURE MEDIATION PROGRAMS CREATED UNDER STATUTE OR COURT RULE 2008-2009 (DOES NOT INCLUDE PROPOSED PROGRAMS)**

## A. State Statutes

***California*** Effective September 6, 2008 mortgagee cannot file notice of default until 30 days after contacting borrower to explore options through which borrower can avoid foreclosure. (Notice of default precedes the notice of sale by 90 days). Mortgagee must advise homeowner of opportunity for conference with mortgagee and schedule conference within fourteen days of request. If notice of default is later filed, it must include a declaration from the mortgagee that it has contacted the borrower or tried with "due diligence" to contact the borrower to set up the conference. "Due diligence" is defined in subsection (g) to include a first class letter, three phone calls, and certified letter to the borrower. All parties may participate in the conference by phone. A housing counselor may be involved and can conduct the call on behalf of the homeowner. Information about loss mitigation options, contacts, and documentation needed for conference must be listed on mortgagee's website. There is no requirement for involvement of a mediator. The statute does not specify sanctions or other consequences from mortgagee's failure to comply. Statute applies to residential mortgages made from January 1, 2003 through December 31, 2007. Cal. Civ. Code § 2923.5.

Related statute enacted at same time provides that servicer acts in best interests of all parties to pooling and servicing agreement if implements loan modification or workout plan such that "[a]nticipated recovery under the loan modification or workout plan exceeds the anticipated recovery through foreclosure on a net present value basis." § 2923.6.
Database:

***Connecticut*** Statute directs Chief Court Administrator to implement statewide foreclosure mediation program, including development of forms and rules. Under program rules, notice to homeowner of mediation to be attached to front of the foreclosure complaint along with mediation request form. The homeowner must file the foreclosure mediation request form and appearance form not more than 15 days after the return date on the summons, unless extended by court. First session to be scheduled ten days after receipt of request. Period for mediation ends 90 (formerly 60) days after return date for summons and complaint. No judgment may be entered while mediation pending. Court may extend period, but not for more than ten days. Counsel for mortgagee must certify compliance with notice provisions before proceeding. Statue applies to one-to-four family, owner occupied residential properties in state. Participation is mandatory for counsel representing the mortgagee. Counsel for mortgagee must appear at mediation session and have authority to settle and mortgagee is available by phone or electronic means. At the initial session the mediator files a report with the court stating whether scheduling further sessions appears to appropriate. Additional sessions may be scheduled up to the 90 day time deadline. If the mediator at the initial sessions determines additional sessions unlikely to be productive, the process ends. Conn. Gen. Stat. Ann. § 8-265ee. , effective July 1, 2008 to July 1, 2010. For information and forms related to program see: www.jud.ct.gov and www.jud.state.ct.us/foreclsosure. Mediation program also allows homeowner to pursue application for financial assistance under related program for homeowners in distress. Conn Gen. Stat. Ann. § 8-265dd.

In report issued by Superior Court Judicial Operations Branch reviewing cases filed from July 1, 2008 through October 31, 2008, lists 7,063 foreclosure cases filed during period in state, 5513 eligible for mediation, 1553 defendants (28% of those eligible) sought mediation, 680 mediations completed. Breakdown of 680: "staying in home" 53%; "moving from home 17%; "not settled" 30%. Of the 680 cases mediated, reports loan modifications in 40%, or 270 cases." Report does not give information on nature of loan modifications.

## B. Statewide Judicial Directives:

***New Jersey*** On October 16, 2008 Chief Justice of New Jersey Supreme Court announced a program to require mediation in foreclosure cases. The program was to begin in selected counties with the intention to expand statewide. A request for mediation does not stay or otherwise delay a foreclosure action. Homeowner can request mediation up to time of sale, but homeowner must file motion with court to stay sale if time is inadequate to complete mediation. Homeowner can request mediation if did not file answer. Information and instructional material on mediation must be served on homeowner with summons and complaint. This information includes the notice of mediation availability, mediation financial worksheet, and HUD certified housing counselor information form and recommendation sheet. These documents must also be served on homeowner when mortgagee requests judgment. A further notice of availability of mediation must be given 60 days after the filing of the complaint. Mediation is not scheduled until complete financial packet, including tax returns, pay stubs, and bank statements, is returned along with housing counselor recommendation. Homeowner required to formulate proposal with housing counselor when counseling services are available. Requirements apply to 1-4 unit owner occupied properties. Mediation is to be "free." In January 2009 legislature appropriated $12 million to pay for mediations. Information, notices, and forms at www.judiciary.state.nj.us. Related legislation, Dec. 2008 creating Mortgage Stabilization program and Housing Assistance and Recovery Program appropriating $40 million for loan funds and mortgagee reporting requirements regarding loss mitigation efforts to Department of Banking.

***New York*** The Chief Judge of the New York State Unified Courts issued report in June 2008 establishing a Statewide Program for Residential Owner Occupied Foreclosures. The plan anticipates amending local court rules to include mediation procedures for foreclosures. The initial pilot program was to operate in Queens, then expand statewide. Under general guidelines, notice of availability of mediation to be served with complaint. Second notice to be sent by court, notifying homeowner that conference can be held within 60 days. In order to a schedule conference, homeowner is required to confirm by sending in a request for conference and indicating that he/she scheduled an appointment for legal assistance or with a housing counselor, or explain why this has not been done. The request for a conference does not relieve defendant of obligation to file an answer. Further case management scheduling will be made at the initial court conference. Defendant can request extension of time to complete mediation. Information available at www.courts.state.ny.us (under "What's New).

New York Civil Practice Rule 3408 effective September 1, 2008 requires mandatory settlement conferences for residential foreclosure actins involving high cost home loans created from January 1, 2003 through September 1, 2008 as well as certain subprime non traditional loans (including payment option adjustable rate mortgages) and loans defined by the Real Property Actions and Procedures Law (RPAPL) § 1304. Mortgagees are required to give 90 days notice to homeowners before filing a foreclosure action involving these types of loans. The conference must be scheduled within 60 days of service of the complaint or as continued by the court. At the conference the parties will review payment revisions and other options to avoid foreclosure. The court may appoint counsel for unrepresented defendants. The plaintiff must appear for the conference with an attorney authorized to settle and the mortgagee must be available by phone or video conference. For actions pending when Rule goes into effect, defendant may request conference if no judgment entered.

***Ohio*** In early 2008 the Chief Justice of Ohio Supreme Court announced a foreclosure mediation model for county common please to use as a basis for formulating their own foreclosure mediation programs. The Supreme Court promulgated general guidelines for the local programs in November 2008. These include recommended procedures and model forms. www.supremecourtofohio.gov/foreclosure. Several common pleas courts have adopted their own procedure under these guidelines. Local courts have some flexibility to craft programs to their own specifications..

Under the state program guidelines, the form for requesting mediation can be served with the complaint or the initial pleadings can include a notice to the defendant that forms for requesting mediation are available from the court. Upon receipt of borrower's request for mediation, the court sends the borrower and lender questionnaires. The borrower must complete and return the forms and provide financial documentation. The mortgagee must provide a payment history and provide evidence of its standing to proceed. The local court's mediation department monitors the collection of data needed to evaluate the case for mediation. A judge or magistrate may review the request for mediation and questionnaires. The court may decline to schedule the case for mediation based on the documentation. If mediation is ordered, it will follow the court's alternative dispute resolution procedures. There may be several sessions. The first session will review the status of documentation. Later sessions will review proposals and will require the mortgagee and its attorney to be present. There is no automatic stay of the homeowner's time to answer the complaint. The homeowner must request a stay by a routine motion.

Franklin County (Columbus), Clark County (Springfield) and Ashtabula County have or are currently implementing programs. Cuyahoga County has implemented a program and a description appears at: www.cp.cuyahogacounty.us/internet/CourtDocs/ForeclosureMediation.pdf.

## C. Local Court Initiatives:

***Florida*** During late 2008 the chief judges of several circuits, including the 12th judicial circuit (DeSoto, Manatee, Sarasota counties) and the 18th (Seminole County) judicial circuit of Florida authorized mediation for foreclosure cases in their courts. The chief administrative judge of a circuit may issue administrative orders related to court procedures under Florida Rule of Judicial Administration No. 2.215(b)(2).

The Twelfth Judicial Circuit order requires mortgage holders to attempt to set up a single phone conference without a mediator. He conference is to occur no later than 45 days after service of process. The parties can agree to a longer time frame for completion of discussion. Homeowner notified of availability of mediation with service of summons and complaint. Consideration of summary judgment is stayed pending lender's certification of completion of mediation. The conference may take place by phone. See www. 12circuit.state.fl.us

The Eighteenth Circuit requires referral through the court's formal mediation process, using certified court mediators. All foreclosure cases involving residential properties are referred to mediation. Plaintiff lenders shall bear the costs of 4200 paid in advance for a 1.5 hour session. Fees can be taxed as costs in a final judgment. Summary judgment will not be entered until mediation completed. Plaintiffs may enter defaults and waive mediation only upon filing a motion certifying there has been communication with the homeowners and the foreclosure is truly uncontested. The lender may appear by phone, with attorney present. See www.flcourts18.org/foreclosures.php

***<u>Pennsylvania</u>***

*Philadelphia* President Judge of Philadelphia County Common Pleas Court implemented Residential Mortgage Foreclosure Diversion Pilot Program by order of April 16, 2008. Under the order Sheriff sales are stayed pending completion of conciliation conferences. (Joint General Court Regulation No. 2008-01). Mortgagee must file certificate of completion of conciliation session before foreclosure sale can proceed. State law allows a county common please court to "supervise the judicial business of the court" and "promulgate all administrative rules and regulations." 42 Pa.C.S.A. § 325(e).

Foreclosing plaintiff lists on civil court cover sheet that property is owner-occupied and this designation triggers a case management order. Conciliation hearing notice is then served upon defendant along with the complaint. Conference should be set 30-45 days from filing complaint. Defendant expected to work with housing counselors and complete and share documents. Housing counseling agency to prepare assessment and proposal for review before conciliation conference. A Civil Case Manager appointed by the court conducts the session. So long as the homeowner follows the conciliation procedures, foreclosure proceedings, including entry of judgment and sheriff sale, are stayed until certification filed that conciliation concluded. If an agreement is not reached at the conference, an order issues setting an additional session or authorizing the mortgagee to proceed with the foreclosure. The order provides for termination of the program on December 31, 2009. Information at http://fjd.phila.gov/mfdp.

*Pittsburgh.* Residential Mortgage Foreclosure Program of Allegheny County Common Pleas Court implemented for new cases filed beginning January 12, 2009. Mortgagee must serve homeowner with pink notice with hotline number along with complaint. Through the housing counselors homeowner submits a certification of participation in mediation to the court. This filing stays foreclosure for up to ninety days.

Prior to the scheduled session, the counselor and homeowner submit financial information and proposals.  Mortgagee must respond prior to or at conciliation conference. Representative of mortgagee with authority to modify mortgage and enter into other agreements must be available in person or by phone for session.