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Defending Mortgage Foreclosures: Seeking a Role for Equity

By David A. Super

David A. Super
Professor of Law

University of Maryland School of Law
500 W. Baltimore St.
Baltimore, MD 21201
410.706.7365
dsuper@law.umaryland.edu

Equity came into existence to effectuate the policies underlying legal rules in situations where rigid application of those rules would not.[1] Here I argue that the creative application of equitable principles can mitigate the current foreclosure crisis to the benefit of beleaguered mortgagors, lenders, and the economy at large.

Three anomalies stand out in the current crisis. First, many current foreclosures are economically wasteful: those with interests in the property lose most of the value of those interests. The mortgagors' losses are obvious. Creditors may lose the value of their interests in a few ways. Creditors who reclaim homes that were mortgaged often end up with less value than if they had allowed the homeowner to remain in the home and make intermittent or reduced payments. Given a systemically glutted housing market, with credit for repurchasers all but unavailable, creditors reclaiming their collateral may see those homes linger on the market, perhaps for months. Foreclosing creditors also may never regain money spent to maintain the vacant property until housing conditions recover enough to make it marketable.

Second, the highly fractured ownership of mortgages makes extrajudicial settlement impossible. One entity may hold the rights to interest payments, while another has a claim on principal payments and still another, the late fees. Some arrangements even divide these interests further by year. With interests so fractured, gaining the consent of all parties to workouts is extremely difficult. Moreover, the compensation arrangements for mortgage servicing companies and agents—the point people in any negotiation or foreclosure—produce strong disincentives to negotiate. Thus most delinquent mortgages move like so many lemmings past stopping points that could produce more value for all parties and into the abyss of pointless foreclosure.

Third, many foreclosures stem from credit extensions, a device that prior public policy clearly declared undesirable. In some cases, mortgage originators may have defrauded mortgagors; in others, downstream purchasers or insurers of the mortgages may have been the victims; in many cases, both the originators and downstream groups suffered. Even where no actual fraud or other legal violations occurred, consumers' inability to understand the terms of adjustable rate mortgages (ARMs) and other complex financing schemes led consumers to make decisions that were not in their own interests or in that of the economy as a whole. The widespread promotion of credit on complex terms to naïve consumers was clearly inconsistent with the goals of numerous consumer protection statutes as well as evolving common-law doctrines such as unconscionability.

[1]See generally William Q. de Funiak, Handbook of Modern Equity (2d ed. 1956).

These three problems are precisely the sort that equity has moved to remedy in the past. Drawing analogies from existing equitable jurisprudence, courts can fashion new equitable defenses or, where state law allows nonjudicial foreclosure, grant injunctions to address each of these conditions. Equity is not some all-purpose elixir that can remedy all of the wrongs in our legal system, but in many cases it can make a crucial difference.

I. The Rise of Equity Jurisprudence

Equity took on recognizable form in fifteenth-century England as a response to problems that the increasingly rigid common-law system could not resolve. At that time the law courts viewed common law's clarity and rigidity as its great virtues. An example of that rigidity was the willingness to deny meritorious claims or defenses because of procedural missteps. The law courts were loathe to sacrifice that absolutism, leaving those who made innocent procedural errors subject to unconscionable abuses.[2] By contrast, the chancellor and his assistants who presided over equitable proceedings saw themselves as "making sure justice was done in cases where shortcomings in the regular procedure, or human failings, rendered its attainment [through the law courts] unlikely."[3] Freedom from the law courts' procedural limitations "enabled the chancellor to provide swift and inexpensive justice for the poor and oppressed.... He could enforce the dictates of conscience, and protect the foolish" without changing the usual rules of law.[4] Where a statute or the common law has a gap or produces an improvident result, equity may intervene.[5]

A. Equity and Mortgage Foreclosures

In the early seventeenth century equity courts came to determine that mortgagees were required to reconvey property back to defaulting mortgagors who had made the required payments late, that is, after the contractual deadline.[6] Initially the chancellor compelled mortgagees to honor this "equity of redemption" only in cases raising traditional equitable concerns such as fraud, mistake, and unconscionability.[7] By the end of the century, however, equity's traditional abhorrence of forfeitures caused it conclusively to presume unequal bargaining power in all mortgages: the threat of forfeiture of the mortgaged property "puts the borrower too much in the power of the lender, who, being distressed at the time, is too inclinable to submit to any terms proposed on the part of the lender."[8] Equity thus made redemption available without any special showing, declaring that the "right of redemption could not be clogged or fettered in any way; any agreement which had this effect was void."[9]

The modern foreclosure action arose to give mortgagees the means to cut off this equity of redemption.[10] In effect, foreclosure confirms that the mortgagor was not the victim of the mortgagee's superior bargaining power and that the mortgagor had received sufficient time to make the required payments—beyond that specified in the mortgage—to justify cutting off the mortgagor's interest in the property. In modern practice, the original purpose of certifying the propriety of the dealings underlying the mortgage is all too often forgotten. The additional time

[2] *Id.* at 87–88.

[3] J.H. Baker, An Introduction to English Legal History 87 (2d ed. 1979).

[4] de Funiak, *supra* note 1, at 88–89.

[5] Baker, *supra* note 3, at 90; de Funiak, *supra* note 1, § 2 at 2–3.

[6] de Funiak, *supra* note 1, § 2.3(3) at 79–80.

[7] 12 Thompson on Real Property § 101.01(a) at 366–67 (1998).

[8] *Id.* at 367 (quoting *Toomes v. Conset*, 26 Eng. Rep. 952, 952–53 (Ch.) (1745)).

[9] *Id.*; 1 Dan B. Dobbs, Dobbs Law of Remedies § 2.3(3), at 80 (2d ed. 1993).

[10] Dobbs, *supra* note 9; Debra Pogrund Stark, *Foreclosing on the American Dream: An Evaluation of State and Federal Foreclosure Laws*, 51 Oklahoma Law Review 229, 231 (1998).

that foreclosure proceedings allow is the *minimum* due the mortgagor in cases where conscience and public policy have no quarrel with the underlying transaction. Modern mortgage foreclosure proceedings are no substitute, however, for a remedy that takes into consideration particular equitable concerns.

Courts recognize that foreclosure is "peculiarly an equitable action" and that courts "may entertain such questions as are necessary to be determined in order that *complete justice may be done*."[11] Because the consequences of foreclosure are so severe for the mortgagor, equity is uncommonly wary of enforcing technical rules and will deny a foreclosure where there has been "an inadvertent, inconsequential default in order to prevent unconscionably overreaching conduct by a mortgagee."[12] The trial court has the discretion to balance the equities and determine what is equitable in a particular case.[13] Equitable defenses to foreclosure may "address the making, validity, or enforcement of the mortgage, note or both.... Where the plaintiff's conduct is inequitable, a court may withhold foreclosure on equitable considerations and principles."[14] Even in states that have by statute converted foreclosure to a legal proceeding, equitable defenses remain available.[15]

That the present holder of the note and mortgage did not engage in the challenged conduct may not matter because an action to foreclose the equity of redemption seeks affirmative relief against the mortgagor. The court need not grant relief (i.e., allow foreclosure) against good conscience even if the present mortgagee acquired the note and mortgage under circumstances that would immunize it from direct liability. Moreover, vindicating some kinds of equitable claims requires that the claims apply against any assignee.[16]

B. Established Equitable Defenses to Foreclosure

Mortgagors often have an array of closely intertwined legal and equitable defenses.[17] For example, adequate notice to the mortgagor may be required both by law—by statute or the terms of the contract—and as a matter of equity.[18]

Courts recognize a wide range of equitable defenses to foreclosure actions. A Connecticut state court, for example, stated: "If the mortgagor is prevented by accident, mistake or fraud from fulfilling a condition of the mortgage, foreclosure cannot be had."[19] Other recognized equitable defenses to foreclosure actions include unconscionability, abandonment of security, usury, equitable estoppel, laches, breach of the implied covenant of good faith and fair dealing, refusal to agree to a favorable sale to a third party, violation of consumer protection laws, conspiracy, and other legally sufficient defenses dealing with the making, validity, or enforcement of the mortgage

[11] *Morgera v. Chiappardi*, 813 A.2d 89, 98 (2003). See also *New Alliance Bank v. Win Holdings International*, No. KNLCV075002721S, 2008 Conn. Super. LEXIS 481, at *16 (Conn. Super. Ct. Feb. 27, 2008); *CSFB 1998-C2 Park Mill Run Limited Liability Company v. Garden Ridge Hilliard Delaware Business Trust*, No. 05AP-746, 2006 Ohio App. LEXIS 1398, at *10 (Ohio Ct. App. March 30, 2006); *Manufacturers Hanover v. Snell*, 370 N.W.2d 401, 404 (Mich. Ct. App. 1985); *First Federal Savings and Loan Association v. Lockwood*, 385 So. 2d 156, 160 (Fla. Dist. Ct. App. 1980), overruled on other grounds, *Weiman v. McHaffie*, 470 So. 2d 682 (Fla. 1985); *Graf v. Hope Building Corporation*, 171 N.E. 884 (N.Y. 1930).

[12] *Karas v. Wasserman*, 458 N.Y.S.2d 280, 282 (N.Y. App. Div. 1982).

[13] *Ameriquest Mortgage Company v. McCorkle*, No. CV020279718S, 2003 Conn. Super. LEXIS 2087, at *4–5 (Conn. Super. Ct. July 16, 2003).

[14] *Bank of New York v. Conway*, 916 A.2d 130, 136 (Conn. Super. Ct. 2006).

[15] *Union National Bank v. Cobbs*, 567 A.2d 719, 721 (Pa. Super. Ct. 1989).

[16] *Miranda v. Universal Financial Group*, 459 F. Supp. 2d 760, 764 (N.D. Ill. 2006).

[17] *In re Brown*, 56 B.R. 487 (Bankr. D. Md. 1985).

[18] *Chase Manhattan Bank v. Puppo*, No. 90-1743, 1991 U.S. Dist. LEXIS 5978, at *3 (E.D. Pa. May 1, 1991).

[19] *Norwest Mortgage Incorporated v. Clapper*, No. CV990060598S, 2002 Conn. Super. LEXIS 70, at *4–6 (Conn. Super. Ct. Jan. 4, 2002).

or the note.[20] The defense of breach of the implied covenant of good faith and fair dealing is valid "as long as it arises from the same transaction as the pending foreclosure proceeding."[21] Violations of the Truth in Lending Act may justify rescission of a mortgage provided that the mortgagor has not yet paid off or refinanced the mortgage.[22] Other consumer credit protection laws may similarly provide defenses.[23] Because ARMs are so easily misunderstood and misrepresented, they have been a frequent subject of fraud claims.[24] Ongoing relationships, unlike those typical between debtors and creditors, particularly relationships developed over several mortgages, may create a fiduciary relationship between the mortgagor and the bank "where the bank knows or has reason to know that the customer is placing his trust and confidence in the bank."[25]

Some equitable defenses apply only to a subset of mortgages. Where the U.S. Department of Housing and Urban Development (HUD) insures a mortgage, its regulations require mortgagees to take various steps before foreclosing.[26] Subject to limited exceptions, these requirements include sending a certified letter to the mortgagor by the end of the second month of delinquency, at least one face-to-face meeting with the mortgagor at the property, informing the mortgagor that the mortgagor may apply to HUD for foreclosure relief, and refraining from commencing proceedings until the mortgagor is at least three months' delinquent.[27] Other federal and state programs have broadly similar rules. Equity may bar foreclosure proceedings until the mortgagee complies with these rules.[28]

II. The Foreclosure Crisis and the Traditional Concerns of Equity

Equity seeks to steer law away from a few specific kinds of undesirable results. While "equitable defenses invite the court to consider only the plaintiff's ethical standing and to deny all remedies if the plaintiff does not meet equity's standards," courts will also balance the hardships that the parties, other affected persons, and the public would face under various possible outcomes.[29] Good-faith financial transactions and reasonable reliance strengthen hardship claims.[30] As part of balancing the equities, defendant's hardship is perhaps best considered when it "is not an inseparable part of plaintiff's right," when it or its cost far exceeds the benefit to the plaintiff, or when it "suggests that the plaintiff's right was unfairly acquired in the first place."[31]

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[20]*Id.*; *Hansford v. Bank of America*, No. 07-4761, 2008 U.S. Dist. LEXIS 65502 (E.D. Pa. Aug. 22, 2008); *U.S. Bank National Association v. Reynoso*, No. CV0705004312, 2008 Conn. Super. LEXIS 1807 (Conn. Super. Ct. July 17, 2008).

[21]See *PNC Bank National Association v. Slodowitz*, No. CV970137057S, 1999 Conn. Super. LEXIS 1907, at *11–12 (Conn. Super. Ct. July 19, 1999) (recognizing defense in general but finding plaintiff there had failed to make out its elements).

[22]Truth in Lending Act, 15 U.S.C. § 1635(a); see 12 C.F.R. § 226.23(b)(1) (2009) (requiring lender to disclose right to rescind). *Handy v. Anchor Mortgage Corporation*, 464 F.3d 760, 765–66 (7th Cir. 2006); *Barrett v. J.P. Morgan Chase Bank*, 445 F.3d 874, 881–82 (6th Cir. 2006). *King v. California*, 784 F.2d 910 (9th Cir. 1986); *Jenkins v. Mercantile Mortgage Company*, 231 F. Supp. 2d 737 (N.D. Ill. 2002).

[23]*Banco Popular North America v. Estate of Forrest L. Smith*, No. CV030196646S, 2004 Conn. Super. LEXIS 1751 (Conn. Super. Ct. June 29, 2004) (allowing defense under Equal Credit Opportunity Act).

[24]*Andrews v. Chevy Chase Bank Federal Savings Bank*, 240 F.R.D. 612 (E.D. Wis. 2007); *Greene v. Gibraltar Mortgage Investment Corporation*, 488 F. Supp. 177 (D.D.C. 1980).

[25]*Sussman v. Weintraub*, No. 06-20408, 2007 U.S. Dist. LEXIS 20485, at *14–16 (S.D. Fla. March 22, 2007).

[26]National Housing Act, 12 U.S.C. §§ 1708–1709 and regulations thereunder.

[27]24 C.F.R. §§ 203.602, 203.604, 203.651–.652, 203.606 (2009).

[28]*Countrywide Home Loans v. Wilkerson*, No. 03 C 50391, 2004 U.S. Dist. LEXIS 4034, at *2 (N.D. Ill. March 12, 2004); *Mortgage Associates Incorporated v. Smith*, No. 86 C 1, 1986 U.S. Dist. LEXIS 20384 (N.D. Ill. Sept. 15, 1986); *United States v. Trimble*, 86 F.R.D. 435, 436 (S.D. Fla. 1980); *Brown v. Lynn*, 392 F. Supp. 559 (N.D. Ill. 1975); *Fleet Real Estate Funding Corporation v. Smith*, 530 A.2d 919 (Pa. Super. Ct. 1987).

[29]Dobbs, *supra* note 9, § 2.4(5) at 108, 109; de Funiak, *supra* note 1, § 25 at 42–46.

[30]Dobbs, *supra* note 9, § 2.4(5) at 110–11.

[31]*Id.* at 111.

Applying equitable principles to foreclosure cases requires a sophisticated understanding of how equity differs from law. Equity is not just an elaborate means for cross-referencing one law to another—courts have come to read statutes *in pari materia* as a matter of course.[32] Instead equity provides relief from rules of law based on principles of conscience and public policy. Equity may draw guidance from other laws as to contemporary moral sensibilities and public policy, but, because equity is not a literalistic system, the textual limits of those laws have never constrained it.[33] Where a statute establishes that a type of conduct contravenes public policy, equity does not limit the victims of that conduct to the remedies the law prescribes:[34] "Concern over [the] risk of forfeiture is said to lie behind almost every major element of mortgage law."[35]

Equity requires the courts to consider new defenses because "[i]n an equitable proceeding, the trial court may examine all relevant factors to ensure that complete justice is done."[36] Of particular relevance to the present crisis, equity traditionally responds to the defenses of waste, value lost due to parties' failure to act in good faith, and the undermining of clearly accepted public policies.

A. Waste as a Consequence of the Bursting of the Housing Bubble

When the housing bubble burst, many homes plummeted in value, leaving their owners with negative equity, that is, owing more on their mortgages than the property is worth. The impaired value of the security—the property—makes it likely that foreclosing mortgagees will absorb substantial losses. In some of the areas hardest hit by the foreclosure crisis, the market is so glutted that a foreclosed home may have little or no present market value. When that occurs, the foreclosing mortgagee not only does not recoup the money lent but also may have to spend money to maintain and protect the home because unprotected homes may be vandalized, damaging the prospect of a sale. The most remunerative and economically efficient route for the mortgagee may well be to leave the defaulting mortgagors in possession—obviating the need for security and maintenance contracts—in exchange for whatever the mortgagors are in a position to pay. For the mortgagee to foreclose, on the other hand, would be the epitome of waste: the mortgagors bear moving costs and forfeit their emotional equity, the mortgagees lose most of their investment, and adjoining property values fall to the detriment of owners and local and state government.

Attacking just such waste is an important principle of equity.[37] The law categorizes waste as voluntary or permissive: the former is damage caused by the possessor's affirmative acts, while the latter is damage resulting from the possessor's neglect.[38] Equity would enjoin both.[39]

The mortgage foreclosure crisis resulted in significant part from mortgage servicing agents' fear of being charged with voluntary waste and responding to that fear by declining to act, thereby causing permissive waste. Mortgage securitization requires conscientious servicing agents to disentangle complex relationships among multiple future interest holders. Although servicing agents may

[32]See, e.g., *Lorillard v. Pons*, 434 U.S. 575 (1978) (applying remedies from one civil rights statute to others).

[33]Baker, *supra* note 3, at 90, 181; see *Flynn v. Korneffel*, 547 N.W.2d 249 (Mich. 1996) (recognizing that courts may go beyond the terms of a statute in unusual circumstances where equity so demands).

[34]*Peoples Trust and Savings Bank v. Humphrey*, 451 N.E.2d 1104 (Ind. Ct. App. 1983).

[35]Marshall E. Tracht, *Renegotiation and Secured Credit: Explaining the Equity of Redemption*, 52 Vanderbilt Law Review 599, 606 (1999).

[36]*Deutsche Bank National Trust Company v. McClardy*, No. CV076000497, 2008 Conn. Super. LEXIS 1337 (Conn. Super. Ct. May 22, 2008).

[37]de Funiak, *supra* note 1, §§ 26–27 at 47–51.

[38]Dobbs, *supra* note 9, § 5.2(8) at 737.

[39]*Id.* § 5.2(8) at 738–39.

wish to write down indebtedness to approximate more fairly the present value of a collateral home, such an action could appear to leave the servicing agent open to charges of voluntary waste. Yet allowing a property that is valuable, and capable of producing a stream of payments if left in the hands of the mortgagor, to fall into foreclosure—with little prospect of remunerative resale—may just as easily be understood as permissive waste, with the decay financial rather than physical. Permissive waste may be an even worthier subject for equitable relief than voluntary waste, for which, at least hypothetically, there is a greater chance of obtaining a damages remedy.[40]

Equity may demand that parties amend or abandon entirely a legally valid claim if that claim has unjustifiably destructive ends.[41] In the mortgage foreclosure context, this might mean that a court will decline to grant a foreclosure after assessing the economic implications of the foreclosure: "The balancing of public interest and third person rights is … the traditional door which admits a modicum of economic analysis into the equity case."[42] Mortgage foreclosures often destroy much of the economic value of all ownership interests. Only the nonowner servicing agent, who is paid to bring the foreclosure but not necessarily paid to negotiate a workout, may benefit. Courts using their equitable powers can fashion a workout that benefits both the mortgagor and the collective interests of the class of mortgagees. More generally, courts expand, restrict, or redesign their remedies to conform to the hardships or equities that the parties before them face.[43]

B. Mortgage Securitization and the Obligation to Bargain in Good Faith

Mortgage securitization so splits ownership interests in a mortgage that all parties with ownership interests in the mortgage are highly unlikely to consent to a workout. Although mortgage securitization is new, the problem of fractured ownership is not. Fractured ownership has caused a host of problems that first law and then equity have attacked. The venerable Statute of Quia Emptores in 1290 ended the practice of making new possessors subtenants of their predecessors; this had left each past possessor of land with an ongoing connection to that land.[44] Transferring ownership to the new possessor allowed the crown to deal with only one person. Similarly the Statute of Uses in 1536 sought to rein in artificial transfers and divisions of interests in land.[45] Ambivalence about split ownership extended to the common law: although many people simultaneously could have present and future interests in land, it treated only one person at a time as having the highest form of title, seisin.[46]

Despite these efforts, present and future interests in realty often remained divided. As a consequence, those with remainders or executory interests could block life tenants from putting property to its best use, thereby wasting valuable economic resources. To prevent this, equity developed its own doctrine of waste separate from whatever damages the law courts might offer.[47] Similarly, when coowners could not agree on how to use property, equity forced partition to put the property back into useful commerce.[48]

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[40] *Id.*

[41] E.g., if you managed to get me to deed you Blackacre through fraud, you have a perfectly good legal action for ejectment. Law courts will grant you possession in such an action. But equity courts will recognize that this is unjust and will order you not to pursue your legally valid ejectment action. If I pursue the ejectment claim, the law court may well throw me off the land, but the equity court will throw you into jail.

[42] Dobbs, *supra* note 9, § 2.4(6) at 112.

[43] *Id.* at 113.

[44] S.F.C. Milsom, Historical Foundations of the Common Law 113–14 (2d ed. 1981).

[45] *Id.* at 218–19.

[46] *Id.* at 119–22.

[47] William B. Stoebuck & Dale A. Whitman, The Law of Property § 4.5, at 161–64 (3d ed. 2000).

[48] *Id.* § 5.11 at 215–17.

A court hearing a mortgage foreclosure action or weighing whether to enjoin one can resolve the analogous obstruction to mortgagee decision making by ordering partition of the exotic coownership arrangements that securitization has yielded. Alternatively it can establish principles of waste that immunize mortgage-servicing agents from actions by those holding interests in the mortgage so long as the servicing agent does not compromise the mortgage to a level substantially below the current market value of the security. Equity has a particular interest in supervising fiduciaries.

Court interventions to promote negotiated workouts of mortgage foreclosures are consistent with public policies that pervade our legal system. That system has become increasingly dependent on giving parties incentives to negotiate arrangements out of court in lieu of litigating.[49] The rule requiring even winning parties to bear their own attorney fees in most cases is an incentive to negotiate. The legal system also imposes affirmative duties to negotiate.

Nowhere is this norm clearer than in Section 8(d) of the National Labor Relations Act, which requires employers and unions to "meet at reasonable times and confer in good faith" over terms of employment and to reduce any agreements reached to a written contract.[50] Section 8(d) cautions that it "does not compel either party to agree to a proposal or require the making of a concession," but it nonetheless represents an affirmative norm against allowing the parties to settle their affairs in the first instance with economic brute force. Section 8(d) has reined in a wide range of obstructionist tactics.[51] The appearance of negotiating will not do; the law prohibits either side from managing its bargaining in a way that is unlikely to result in an agreement. For example, if an individual on a negotiating team cannot reasonably be expected to reach an amicable agreement, labor law recognizes the futility of bargaining.[52]

The use of alternative dispute resolution and settlement as negotiation tools has spread far more widely. The Alternative Dispute Resolution Act of 1998 declares extrajudicial resolution of disputes at the district and even appellate court levels to be a public policy priority.[53] Federal judges may require that a party with authority to deal participate in pretrial conferences.[54] These conferences may include mandatory settlement negotiations.[55] Contract law imposes a duty to bargain in good faith once two parties voluntarily link their fates together.[56] Many jurisdictions require parents in custody disputes to attempt to mediate before they may appear before a judge. Indeed, prior to securitization, the parties in mortgage foreclosures commonly negotiated workouts for mortgagors in distress.[57]

To promote a workout where securitization is involved, a court can refuse to allow foreclosure until the servicing agent gives convincing evidence of having negotiated in good faith with the mortgagor. If necessary, the court can reform the servicing agent's contract, setting

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[49]Indeed, this dependence on settlement and prelitigation resolutions has reached the point that some commentators worry that the "disappearing trial" will leave the legal system without sufficient benchmarks to assess the value of various legal rights (see, e.g., Owen Fiss, *Against Settlement*, 93 Yale Law Journal 1073 (1984)).

[50]National Labor Relations Act, 29 U.S.C. § 158(d).

[51]Robert A. Gorman, Basic Text on Labor Law, ch. 20, at 399–495 (1976).

[52]*NLRB v. Kentucky Utility Company*, 182 F.2d 810 (6th Cir. 1950).

[53]Alternative Dispute Resolution Act of 1998, 28 U.S.C. §§ 651–658.

[54]Fed. R. Civ. P. 16(c)(1).

[55]Fed. R. Civ. P. 16(a)(5), (c)(2)(A) & (I).

[56]*Cyberchron Corporation. v. Calldata Systems Development*, 47 F.3d 39, 45 (2d Cir. 1995); *Hoffmann v. Red Owl Stores*, 133 N.W.2d 267 (Wis. 1965); E. Allan Farnsworth, Contracts § 3.26 at 196–99 (4th ed. 2004).

[57]4 Powell on Real Property § 37.35 (Michael Allan Wolf ed., 2008).

compensation at a level that reduces any disincentive to pursue the collective best interests of all those holding interests in the mortgage.

C. Public Policies Against Credit Abuses

Federal and state laws have long taken firm positions against predatory lending. But legal rules alone are not enough to prevent some of the mortgage practices that led to the mortgage foreclosure crisis. A significant cause of the foreclosure crisis was buyers with mortgages they had little chance of repaying.

Many people are not financially literate in even the most basic terms of mortgage documents. The proliferation of increasingly complex mortgage instruments in the last few years left consumers with little chance of understanding their mortgages. Some did not understand that their ARMs had artificially low initial interest rates that obscured the typical (higher) interest rate that applied over the life of the mortgage.[58] They failed to appreciate that their payments would soon rise to unaffordable levels.[59] Lenders compounded this confusion by refinancing the mortgages, with new deeply discounted rates, before the full interest rate became apparent, collecting a new set of fees each time. Some lenders deliberately or recklessly gave buyers mortgages for which they did not qualify; other buyers suffered the reverse problem, getting high-cost subprime mortgages when they qualified for more affordable standard arrangements. Some kinds of ARMs are in practice little more than grants of unilateral authority for creditors to impose terms.[60] Even when they do not give creditors unilateral authority, ARMs "put the entire risk of increased interest rates on the borrower."[61] Time lags may shift some of this risk back to the lender, but that delay is unlikely to benefit a borrower with a fixed or largely constrained income.[62]

The Federal Debt Collection Practices Act and many state laws on unfair and deceptive acts and practices prohibit the collection of charges not authorized by law.[63] The Act prohibits the misrepresentation of the character, amount, or legal status of a debt. Efforts to collect interest not properly disclosed to the borrower are prohibited.[64] Likewise, the practice by some credit companies of refinancing mortgages several times with the same mortgagors may be seen as collecting on prior debts while arranging new debts and fall within the Act's prohibitions.[65] The Act reaches foreclosure actions, among others, regulating the conduct of lawyers litigating those actions.[66] The Truth in Lending Act regulates the granting of credit.[67] Although perhaps best known for its notice requirements, the Truth in Lending Act also imposes substantive duties of fairness.[68]

The details of these and other laws protecting consumers and the integrity of the banking system are beyond my scope

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[58]*Id.* § 37.16[2][d].

[59]*Id.*

[60]*Id.* § 37.16[1][a].

[61]*Id.* § 37.16[3][a].

[62]*Id.*

[63]Federal Debt Collection Practices Act, 15 U.S.C. §§ 1692–1692p, 1692f(1). See generally National Consumer Law Center, Fair Debt Collection § 1.5.3 at 38–39 (4th ed. 2000).

[64]Federal Debt Collection Practices Act, 15 U.S.C. § 1692e(2)(A), (5); see *Patzka v. Viterbo College*, 917 F. Supp. 654 (W.D. Wis. 1996).

[65]See National Consumer Law Center, *supra* note 63, § 4.4.2.1 at 128–29.

[66]*Heintz v. Jenkins*, 514 U.S. 291 (1995).

[67]Truth in Lending Act, 15 U.S.C. §§ 1601-1681t.

[68]*Id.* § 1602(h).

here.[69] In some cases the laws provide on their own terms an adequate remedy. In others, however, rigid application of legal rules frustrate those laws' purposes, perhaps because the lender persuades the mortgagor to refinance the original suspect loan or because the deceptively low introductory rate in an ARM takes the borrower beyond a statute-of-limitations period. These are precisely the kinds of situations in which equity traditionally intervenes.

Securitization of mortgages has made the assignment of mortgagees' interests quite routine. Although "[t]he general rule of assignments is that the transferee has the same rights as the transferor," mortgage purchasers are likely to seek to defeat many defenses mortgagors might have under the "holder in due course" doctrine.[70] Courts already hold third parties, such as mortgage insurers, answerable for fraud in securing a mortgage where the mortgage was anomalous under market conditions.[71] The same rule should apply to purchasers of mortgages and where the abuses were violations of statutes rather than traditional fraud. Allowing third-party purchasers to foreclose without regard to the circumstances under which the loans were let would protect most ARMs from suit. ARMs were designed in large part to facilitate secondary mortgage markets and hence usually change hands almost immediately, making them a form of mortgage most vulnerable to lenders' abuses.[72] More generally, courts have limited the "holder in due course" doctrine to prevent the assignment of ARMs from eviscerating many consumer protection statutes.[73]

In analyzing the complex web of transactions that ultimately led to a foreclosure action, a court is not, of course, bound by the parties' characterization of payments. Where, for example, the lender's business model relies significantly on regular refinancing of its mortgages, the fees associated with that refinancing become de facto periodic payments equivalent to interest. A court applying equitable defenses based on fraud, usury, or violations of consumer protection statutes could determine that equity demands treating those payments as interest, making the effective interest rate considerably higher than the documents might suggest.

III. Limitations on Equitable Defenses to Mortgage Foreclosures

Courts recognize a few limitations on equitable claims and defenses. These seem unlikely to hamper seriously mortgagors' invocation of the defenses discussed above. Although "accident and mistake will often be inadequate to supply a basis for the granting or withholding of equitable remedies where the consequences to be corrected might have been avoided if the victim of the misfortune had ordered his affairs with reasonable diligence," it is also true that "always the gravity of the fault must be compared with the gravity of the hardship."[74]

Some courts require that any equitable defenses arise out of the same transaction as the mortgage itself.[75] Most mortgagors' defenses meet this requirement. Even in those cases where they do not, a court may, considering the equities, withhold foreclosure where the mortgagee's con-

[69]In particular, the National Consumer Law Center has a series of authoritative, thoroughly footnoted, and highly accessible manuals covering many consumer protection laws.

[70]Powell on Real Property, *supra* note 57, § 37.27[5]. The "holder in due course" doctrine promotes markets for securities by protecting subsequent purchasers from many kinds of defenses that might have been asserted against the original issuer of that security.

[71]*M & T Mortgage Corporation v. White*, No. 04-CV-44775, 2006 U.S. Dist. LEXIS 1903 (E.D.N.Y. Jan. 9, 2006).

[72]Powell on Real Property, *supra* note 57, § 37.16[2][f].

[73]*Id.* § 37.27[5][b].

[74]*Graf v. Hope Building Corporation*, 171 N.E. 884 (N.Y. 1930) (Cardozo, J., dissenting).

[75]*Klehm v. Grecian Chalet Limited*, 518 N.E.2d 187 (Ill. App. Ct. 1988).

duct has been inequitable.[76] Moreover, defenses against the note or lien may survive the packaging of the mortgage for resale on the secondary market.[77]

The "clean hands doctrine" estops someone without clean hands from invoking the powers of equity:

> It is a fundamental principle of equity jurisprudence that for a complainant to show that he is entitled to the benefit of equity, he must establish that he comes into court with clean hands.... The clean hands doctrine is applied not for the protection of the parties, but for the protection of the court.... It is applied not by way of punishment, but on considerations that make for advancement of right and justice. The doctrine of unclean hands expresses the principle that where a plaintiff seeks equitable relief, he must show that his conduct has been fair, equitable and honest as to the particular controversy in issue.[78]

Thus a mortgagee may seek to estop a mortgagor from seeking equity relief. But "[e]stoppel cannot be used to uphold a fraud. It is an equitable doctrine, and as such can only be used to protect the innocent. One who seeks equity must do equity...."[79]

One court held that a party seeking to escape liability under a usurious contract must demonstrate "clean hands" by tendering payment at the legal interest rate.[80] Few other courts seem likely to follow this view. The court focused on the amount of the debt, not its validity, and failed to appreciate that insolvency is not on the same moral plane as fraud. Although justice and equity demand that we show our willingness to pay our legitimate debts, they speak much more strongly that we should not perpetrate or benefit from fraud. Mortgagors' hands are not unclean by virtue of falling behind on their mortgages. If that were so, mortgagors would have no equity of redemption and there would be no action to foreclose that equity. Unless a party's "conduct is of such a character as to be condemned and pronounced wrongful by honest and fair-minded people, the doctrine of unclean hands does not apply."[81] Courts consider the broader public interest in determining whether parties' hands are unclean.[82] The "clean hands" doctrine has little applicability to equitable defenses other than usury.

Some theories that may be time-barred in affirmative suits may be available as equitable defenses or counterclaims.[83] Where, as is commonly the case for mortgagors facing foreclosure in the current crisis, the mortgagee's servicing agent has induced the mortgagor to refinance repeatedly, a court may consider the series of mortgages to be an ongoing pattern of conduct and run limitations periods for claims or defenses relating to any of those mortgages from the most recent of them. Alternatively, when a mortgagor discovers the true nature of the mortgage years after its initiation, when the rates have been adjusted upward, a court could, as is done in tort, run any limitations period from the time of discovery rather than from the time the mortgage was initiated. To do otherwise would reward lenders for designing ARMs so that the

[76] *New Century Mortgage Corporation v. Reynolds*, No. CV054002848, 2006 Conn. Super. LEXIS 306, at *11 (Conn. Super. Ct. Jan. 26, 2006).

[77] See *U.S. Bank National Association v. Reynoso*, No. CV075004312, 2008 Conn. Super. LEXIS 1807 (Conn. Super. Ct. July 17, 2008) (allowing wide range of defenses in such a case).

[78] *Thompson v. Orcutt*, 777 A.2d 670, 676 (Conn. 2001); see DE FUNIAK, *supra* note 1, § 24 at 39–42 (applying "clean hands" rule).

[79] *Mahaffey v. Investor's National Security Company*, 747 P.2d 890, 892 (Nev. 1987).

[80] *Michigan Mobile Homeowners Association v. Bank of Commonwealth*, 223 N.W.2d 725, 729 (Mich. Ct. App. 1974).

[81] *Thompson v. Orcutt*, 777 A.2d 670, 676 (Conn. 2001).

[82] *Id.* at 679–80.

[83] *Campbell v. Machias Savings Bank*, 865 F. Supp. 26, 31–37 (D. Me. 1994).

abusive interest rates start only after the statute of limitations has run—an anathema to equity. Where the initial interest rate of an ARM is so low that it results in negative amortization, "the lender is in essence making a further loan to the borrower" each month.[84] That could continually renew the borrower's cause of action. Strong equitable considerations can overcome even such normally dispositive bars as res judicata.[85]

Courts should not, out of deference to the operation of the markets, hesitate to intervene in a mortgage action. Even in ordinary times, lenders and borrowers have highly asymmetrical information about macroeconomic changes and the likelihood that those changes could result in a loan default. This mismatch leads to economically inefficient mortgages and means that the market will not protect borrowers' interests without government intervention.[86] Moreover, the current crisis is fundamentally reshaping both the primary and secondary mortgage markets. Rigid enforcement of mortgages let during the housing boom will not preserve those market practices—even if that were desirable—because the crisis has swept those practices away. Preserving as much value as possible for all parties will best facilitate the future resuscitation of the housing and mortgage markets.

Some courts may feel tempted to punish mortgagors for borrowing too heavily or for the consumption that borrowing financed. This would be inappropriate. Equity does not seek to enforce wisdom or frugality; to do so would turn equity into a tool of the subjective will of a particular judge. Instead equity seeks to protect innocents from dishonesty and victimization by those with more sophistication. Few if any mortgagors were more sophisticated than their lenders. Their borrowing may have been unwise (assuming it was knowing), but it was not duplicitous.

Moreover, public policy set at the highest levels of the federal government encouraged this explosion of borrowing. Leading economic policymakers, including former Federal Reserve Board Chairman Alan Greenspan, supported homeowners' leveraging the equity in their homes into cash for consumption.[87] A wide array of government regulators overcame initial reservations to allow widespread marketing of ARMs.[88] The 1996 welfare law encouraged welfare recipients—whose incomes are far below the poverty line—to save for down payments on homes.[89] But welfare recipients, and those making wages typical of recent welfare leavers, could not possibly have saved enough for a conventional down payment, even on a very modest home, and would have faced mortgage payments consuming almost all of their disposable incomes. By any standard, these would be very high-risk mortgages.

■ ■ ■

No legal theory can come close to remedying a problem as massive and complex as the mortgage foreclosure crisis. The creative application of equity can, however, stave off further pointless destruction of value that further devastates vulnerable families and drives our economy still closer to the abyss. This is precisely the sort of rationalizing, conserving role that equity has performed with great effectiveness over the ages: "Let the hardship be strong enough, and equity will find a way through, though many a formula of inaction may seem to bar the path."[90]

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COMMENTS?

We invite you to fill out the comment form at http://tinyurl.com/JulyAugustSurvey. Thank you.

—The Editors

[84] Powell on Real Property, *supra* note 57, § 37.16[4][d].

[85] *In re Daniels*, 350 B.R. 619 (Bankr. D. Fla. 2006).

[86] Michael H. Schill, *An Economic Analysis of Mortgagor Protection Laws*, 77 Virginia Law Review 489, 521–22.

[87] James R. Hagerty & Ruth Simon, *Leveraging to the Limit*, Wall Street Journal, June 10, 2005, at A1; Catherine Burrough, *Valley Home Sales Still on Record Clip*, Arizona Republic, Oct. 20, 2002, at 1A.

[88] Powell on Real Property, *supra* note 57, § 37.16.

[89] The Personal Responsibility and Work Opportunity Reconciliation Act of 1996, 42 U.S.C. § 604(h)(2)(B)(ii).

[90] *Graf v. Hope Building Corporation*, 171 N.E. 884 (N.Y. 1930) (Cardozo, J., dissenting).

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