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The Subprime Trump Card: Standing up to the Banks

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"If the American people ever allow private banks to control the issue of their currency, first by inflation, then by deflation, the banks and corporations that will grow up around them will deprive the people of all property until their children wake up homeless on the continent their fathers conquered. The issuing power should be taken from the banks and restored to the people, to whom it properly belongs."

> – Thomas Jefferson, Letter to Treasury Secretary Albert Gallatin (1802)

Jefferson had it right. More than 1.5 million homeowners are expected to enter foreclosure this year, and about half of them are expected to have their homes repossessed. If the dire consequences Jefferson warned of 200 years ago have been slow in coming, it is because they have been concealed by what Jerome a Paris calls the *Anglo Disease* – "the highly unequal economy whereby the rich and the financial sector . . . capture most of the income but hide it by providing cheap debt to the middle classes so that they can continue to spend." He calls "finance" the "cannibalistic" sector in today's economy. Writing in The European Tribune this month, he states:

"[O]ne of the more attractive features of the financial world, for its promoters, is its ability to concentrate huge fortunes in a small number of hands, and promote this as a good thing (these people are said to be *creating* wealth, rather than *capturing* it). . . . [O]f course, the reality is that such wealth concentration is created by squeezing the rest, as is obvious in the stagnation of incomes for most in the middle and lower rungs of society. This is not so much wealth creation as wealth redistribution, from the many to the few. But what has made this unequality . . . tolerable is that the financial world itself was able to provide a convenient smokescreen, in the form of cheap debt, provided in abundance to all. The wealthy used it to grab real assets in funny money, and the rest were kindly allowed to keep on spending by tapping their future income rather than their insufficient current one; in a nutshell, *the debt bubble hid the class warfare waged by the rich against everybody else* . . . ."1

Now the debt bubble is bursting, with the anticipated real estate crash, banking crisis, foreclosures, and inevitable recession. "The income capture mechanisms set up during the bubble have not been reversed, so the pain is falling disproportionately on the poorest," writes Jerome a Paris. Meanwhile, finance is being bailed out. What's to be done? "[T]he financiers . . . will say that more 'reform' and 'deregulation' and tax cuts are needed," he says, but "maybe it's time to stop listening to what is highly self-interested drivel, and take

back what they grabbed: it's not theirs."

Good idea, but how? The financiers own the media, and their massively funded lobbies control Congress. How can we the people get enough clout to take on the giant financial and corporate giants? What can we do that will make politicians sit up and take notice?

How about swarming the courts? *New case law indicates that a majority of the 750,000 homeowners expected to lose their homes this year could have a valid defense to foreclosure*. As much as *$2 trillion* in real estate may be vulnerable to this defense, providing a very big stick for a lobby of motivated debtors. Mobilizing that group, in turn, could light a fire under the investors in mortgage-backed securities — the pension funds, money market funds and insurance companies holding these "orphan" mortgages. These investors also wield a very big stick, in the form of major law firms on retainer. When the embattled banks demand a bailout because they are "too big to fail," the taxpayers can respond, "You have already failed. It is time to try something new."

The Legal Trump Card: Make Them Produce the Note

A basic principle of contract law is that a plaintiff suing on a written contract must produce the signed contract proving he is entitled to relief. If there is no signed mortgage note or recorded assignment, foreclosure is barred. The defendant must normally raise this defense, and most defaulting homeowners, unaware of legal procedure and concerned about the expense of hiring an attorney, just let their homes go uncontested. But when the plaintiffs bringing subprime foreclosure actions *have* been challenged, in most cases they haven't been able to produce the notes.

Why not? It appears to be more than just sloppy paperwork. The banks that originally entered into these risky subprime arrangements generally did so because they had no intention of holding the loans on their books. The mortgages were immediately sliced and diced, bundled up as mortgage-backed securities (MBS), and sold off to investors. Loan originators sold the mortgages to financial institutions or other banks, which then sold the rights to the monthly mortgage payment income to investors, while transferring the responsibility to collect these payments to specialized mortgage servicing companies. The result has been to slice up the mortgage contract, with no party really having ownership of the original paperwork. When foreclosure has been initiated, the servicer or trustee acting as plaintiff now has trouble proving that it originated the mortgage or owned the loan. In order for a second bank or financial institution to have standing to bring a foreclosure lawsuit in court, it must have been assigned the mortgage; and with the collapse of the housing market, many of the subprime lenders have gone out of business, making it impossible to contact the originating mortgage company. Other paperwork has just been lost in the shuffle.2

Why weren't the mortgage notes assigned to the MBS holders when they were first sold? Apparently because the investors aren't even matched up with specific properties until *after* default. Here is how the MBS scheme works: when the mortgages are first bundled by the banks, all of the subprime mortgages go into the same pool. The bundled mortgages are chopped into "securities" that are sold to many investors — banks, hedge funds, money market funds, pension funds — with different "tranches" or levels of risk. The first mortgages to default are then assigned to the high-risk "BBB-" tranche of investors. As

defaults increase, later defaulting mortgages are assigned down the chain of risk to the supposedly more secure tranches.3 That means the investors get the mortgages only *after* the defendants breached the agreement to pay.

It also means the investors weren't a party to the agreement when it was breached, making it hard to prove they were injured by the breach.

The investors have another problem: the delay in assigning particular mortgages to particular investors means there was no "true sale" of the security (the home) at the time of securitization. A true sale of the collateral is a legal requirement for forming a valid security (a secured interest in the property as opposed to simply a debt obligation backed by collateral). As a result, the investors may have trouble proving they have *any* interest in the property, secured or unsecured.4

The Dog-Ate-My-Note Defense

When the securitizing banks acting as trustees for the investors are unable to present written proof of ownership at a time that would entitle them to foreclose, they typically file what's called a lost-note affidavit. April Charney is a Florida legal aid attorney well versed in these issues, having gotten foreclosure proceedings dismissed or postponed for 300 clients in the past year. In a February 2008 Bloomberg article, she was quoted as saying that about *80 percent* of these cases involved lost-note affidavits. "Lost-note affidavits are pattern and practice in the industry," she said. "They are not exceptions. They are the rule."3

In the past, judges have let these foreclosures proceed; but in October 2007, an intrepid federal judge in Cleveland put a halt to the practice. U.S. District Court Judge Christopher Boyko ruled that Deutsche Bank had not filed the proper paperwork to establish its right to foreclose on fourteen homes it was suing to repossess.4 That started the ball rolling, and by February 2008, judges in at least five states had followed suit. In Los Angeles in January, U.S. Bankruptcy Judge Samuel L. Bufford issued a notice warning plaintiffs in foreclosure cases to bring the mortgage notes to court and not submit copies. In Ohio, where foreclosures were up by a reported *88 percent* in 2007, Attorney General Marc Dann was reported to be challenging ownership of mortgage notes in forty foreclosure cases.5

Few defendants, however, are lucky enough to have advocates like Charney and Dann in their corner, and most defaulting debtors just let their homes go. A simple challenge can be filed to the complaint even without an attorney, and some subprime borrowers have successfully defended their own foreclosure actions; but retaining an attorney is strongly recommended. People representing themselves are often not taken seriously, and they are likely to miss local rule requirements. With that warning, here is some general information on challenging standing to foreclose:

Some states are judicial foreclosure states and some are non-judicial foreclosure states. In a judicial foreclosure state (meaning the matter is heard before a judge), if a promissory note or recorded assignment naming the plaintiff is not attached to the complaint, the defendant can file a response stating the plaintiff has failed to state a claim. This can be followed with a motion called a demurrer to the complaint. Different forms of demurrers can be found in legal form books in most law libraries. In essence the demurrer states that even if everything in the complaint were true, the complaint would lack substance because it fails

to set out a copy of the note, and it should therefore be dismissed. Ordinarily there is no need to cite much in the way of statutes or case law other than the authority reciting the necessity of showing the note proving the plaintiff is entitled to relief.

In a non-judicial foreclosure state such as California, foreclosure is done by a trustee without a court hearing, so the procedure is a bit trickier; but standing to foreclose can still be challenged. If the homeowner has filed for bankruptcy, the proceedings are automatically stayed, requiring the lender to bring a motion for relief from stay before going forward. The debtor can then challenge the lender's right to the security (the house) by demanding proof of a legal or equitable interest in it.6 A homeowner facing foreclosure can also get the matter before a court without filing for bankruptcy by filing a complaint and preliminary injunction staying the proceedings pending proof of standing to foreclose. A judge would then have to rule on the merits. A complaint for declaratory relief might also be brought against the trustee, seeking to have its rights declared invalid.7

An Equitable Settlement for Everyone

These defenses can help people who are about to lose their homes, but there is another class of victims in the sub-prime mortgage crisis: investors in MBS, including the pension funds and 401Ks on which many people depend for their retirement. If the trustees representing the investors cannot foreclose, the lucky debtors may be able to stay in their homes without paying. However, the hapless investors will be left holding the bag. If the investors manage to shift liability back to the banks, on the other hand, the banks could go down and take the economy with them. How can these tricky issues be resolved in a way that is equitable for all? That question will be addressed in a followup article. Stay tuned.

NOTES

1. Jerome a Paris, "Countdown to $200 Oil Meets Anglo Disease," European Tribune (June 7, 2008).

2 "Contesting a Foreclosure Lawsuit: Who Owns the Mortgage?", ForeclosureFish.com (April 22, 2008).

3. CNBC, "Subprime Derivatives," youtube.com/watch?v=0YNyn1XGyWg (June 2007).

4 Vinod Kothari, "The True Sale Question," vindkothari.com.

3. Bob Ivry, "Banks Lose to Deadbeat Homeowners as Loans Sold in Bonds Vanish," Bloomberg.com (February 22, 2008).

4. Judge Christopher A. Boyko, Opinion and Order, In re Foreclosure Cases, Case 1:07-cv-02282-CAB, U.S. District Court, Northern District of Ohio, Eastern Division, filed 10/31/2007.

5. B. Ivry, op. cit.; Jimmy Higgins, "Judge Boyko's Snowball Starts Rolling Downhill," Fire on the Mountain (blogspot) (February 26, 2008); Wendy Davis, "Finding It Hard to Be a Loan," ABA Journal (March 2008).

6. "More Trouble for Mortgage Securitizers?", http://bigpicture.typepad.com (December 9,

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7. Aaron Krowne, et al., “True Sale, False Securitizations,” iamfacingforeclosure.com (November)

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