INCENTIVIZING DEEDS-IN-LIEU OF FORECLOSURE: AN ARGUMENT FOR THE EXPANSION OF THE HOME AFFORDABLE FORECLOSURE ALTERNATIVES (“HAFA”) PROGRAM

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I. INTRODUCTION

In light of the recent and ongoing economic crisis, which has led to a surge in defaulted mortgages, as well as the recent controversy over the foreclosure practices of large mortgage holders, this comment will examine an alternative device to foreclosure: the deed-in-lieu of foreclosure (“DIL”). In particular, this comment will address the potential benefits and pitfalls of using the DIL device to mortgagees, mortgagors, and broader communities, as well as the economy generally. The comment will then examine the government’s current incentive program, the Home Affordable Foreclosure Alternatives Program (“HAFA”), and the use of DIL transactions as part of that program. Finally, the comment proposes changes to make HAFA more effective and consistent with its stated goals.

II. BACKGROUND

With the recent rise in mortgage defaults and resulting foreclosures, there has been substantial scholarship discussing the faults of, and potential cures for, foreclosure law.¹ In order to address the issue of whether the DIL device can serve as a potential safety valve to the current system of foreclosure law, as well as better understand the nature of how DILs could serve that purpose, it is necessary to give brief background information regarding: (1) the foreclosure law of the United States as it stands currently; (2) the economic and sub-prime mortgage crises; and (3) the

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¹ See generally Melissa Jacoby, The Value(s) of Foreclosure Law Reform, 37 PEPP. L. REV. 511 (2010) (discussing various recent proposals for foreclosure law reform).
recent foreclosure controversy affecting large mortgage lenders.

A. Foreclosure Law

Although the law of foreclosure is very state-specific, there are two broad categories of procedures that foreclosures in the United States fall into: (1) judicial foreclosure; and (2) non-judicial foreclosure under a power of sale.2

Judicial foreclosure is available in every state, but is the primary method used in approximately forty percent of states.3 As the name suggests, judicial foreclosure requires a property to be sold through a court proceeding.4 The proceeding allows for procedural and substantive defenses to be considered by the court.5 If the court ultimately determines that the lender has the legal right to foreclose, then the court will grant a decree of foreclosure.6 Ordinarily, a sheriff or other public official who has been appointed by the court then conducts the actual sale.7

Non-judicial foreclosure under a power of sale is the other main foreclosure method and is allowed in approximately sixty percent of states.8 Under this method, once a mortgagor has defaulted, a mortgagee, after satisfying state-specific notice requirements, is entitled to exercise the “power of sale” clause contained in the mortgage (or deed of trust, as the security instrument is styled in many states).9 Once notice is provided, an auctioneer, a sheriff, or other public official generally conducts the foreclosure sale.10 A hearing is almost never provided in a power of sale foreclosure, unless the mortgagor files an affirmative action for an injunction.11

As is likely apparent from its description, judicial foreclosure allows for an in-depth review prior to a foreclosure sale, and ensures strong protection for a borrower. The flip side of this protection, however, is that

5. Id.
6. Id.
7. Id.
8. NELSON & WHITMAN, supra note 3, § 7.19.
9. RAO, supra note 4, § 4.2.3.
10. Id.
11. See, e.g., NELSON & WHITMAN, supra note 3, § 7.19; RAO, supra note 4, § 4.2.3 (stating that “to contest a foreclosure by power of sale, the homeowner must file an affirmative action and request an injunction to stop the sale.”).
judicial foreclosure is “complicated, costly and time-consuming.”\textsuperscript{12} Non-judicial foreclosure can also suffer from those same defects, though certainly to a lesser extent. In particular, non-judicial foreclosure can sometimes require substantial fees, lengthy delays, and redemption periods that are statutorily mandated.\textsuperscript{13}

B. Mortgage Default and Foreclosure Crisis

The home mortgage default and foreclosure crisis, which began in 2007, has resulted in billions, if not trillions, of dollars in total losses to borrowers, lenders, communities, and the broader economy.\textsuperscript{14} The federal government has enacted a variety of measures to help assuage the damage from the crisis, as well as the pain felt by many individuals.\textsuperscript{15}

The effects of the crisis continue to be felt in this country, with still high rates of foreclosure and depressed housing markets.\textsuperscript{16} Further, there is little indication that the number of foreclosures will be returning to normal rates any time soon.\textsuperscript{17} This comment looks at whether DILs can serve to mitigate some of the ongoing negative effects of this crisis.

C. Foreclosure Controversy

Beginning in early October 2010, large mortgage lenders such as GMAC, Bank of America, and JPMorgan Chase, halted foreclosures in states where judicial foreclosure proceedings are required.\textsuperscript{18} The freeze was a result of the revelation that large mortgage lenders were not properly filing and certifying documents in foreclosure proceedings. In particular, at the heart of the controversy, is the use of “robo-signers” to sign affidavits and other documents that are necessary in foreclosure proceedings.\textsuperscript{19} The robo-signers—individuals whose sole job is to sign documents—would

\textsuperscript{12} Nelson & Whitman, supra note 3, § 7.11.

\textsuperscript{13} Cost and Time Factors in Foreclosure of Mortgages, supra note 2, at 414.


\textsuperscript{15} See infra Part IV.


\textsuperscript{17} See id. (indicating the continually increasing number of completed foreclosures through September 2010).


\textsuperscript{19} Id.
sign documents stating that they had personally reviewed the details of each case.\textsuperscript{20} These assertions, however, have ultimately turned out to be largely untrue.\textsuperscript{21} In fact, it would seem virtually impossible that a robo-signer would be able to actually verify and review the details of each document, as some have stated that they sign in excess of 10,000 documents per month.\textsuperscript{22}

While the mortgage foreclosure freeze that took place in October 2010 was largely self-imposed by large mortgage lenders,\textsuperscript{23} there remains a looming likelihood that state courts will impose further restrictions.\textsuperscript{24} The use of robo-signers is a cost-saving method by large mortgage holders to decrease the administrative cost of foreclosure, particularly in judicial foreclosure states where costs are high.\textsuperscript{25} If state courts were to halt foreclosure proceedings or at least force reform of the current system used by large mortgage lenders, likely raising the costs of foreclosure, foreclosure alternatives would become more attractive to lenders. The question then becomes whether the use of DILs, as an alternative device, should be further incentivized to make them a more widely used alternative to foreclosure, a question that will be addressed in a later section.

An additional consideration that should be addressed is the impact of a foreclosure freeze on the wider economy. While such a freeze may be the most sound method to protect consumers who received mortgages from these large lenders, the impact of the freeze would certainly have a substantial effect on the economy beyond any particular bank’s bottom line.\textsuperscript{26} Furthermore, the very uncertainty of a freeze (whether there will be one, how long one might last, and so on), in itself, could have negative economic ramifications.\textsuperscript{27} Such potential negative economic consequences strengthen the argument for the wide use of a robust foreclosure alternative such as DILs.


\textsuperscript{21} \textit{Id.}

\textsuperscript{22} \textit{Id.}


\textsuperscript{24} \textit{See New Jersey Court May Order Foreclosure Freeze}, \textit{N.Y. Times}, Dec. 20, 2010, at B6 (describing a possible foreclosure freeze imposed by the Supreme Court of New Jersey).

\textsuperscript{25} \textit{See supra} Part II.A.

\textsuperscript{26} Mark Gongloff, \textit{Foreclosure Crisis Slams Into Banks}, \textit{Wall St. J.}, Oct. 15, 2010, at A1–A2 (outlining the broader economic effects of a foreclosure freeze, including the effect on the stock market).

\textsuperscript{27} \textit{See id.} (discussing the negative economic impacts of uncertainty in the mortgage market).
III. DEEDS-IN-LIEU

Simply put, a deed-in-lieu of foreclosure is a device whereby a delinquent borrower will give a deed to a lender in exchange for the lender extinguishing all personal liability or for some other consideration.\(^{28}\) There are significant advantages to the borrower, the lender, the local court system, and the economy at large, from the consummation of this transaction, as opposed to proceeding through the foreclosure process. There is, however, potential for abuse that needs to be considered. These issues will be discussed, in turn, below.

A. Advantages to Lender

The advantages to lenders who use the DIL device instead of a foreclosure proceeding fall into three categories. The first relates to the economic value of the home secured by the loan; the second relates to the administrative costs of the proceedings; and the third relates to the negative publicity of foreclosure proceedings. Relating to the first category, with a DIL transaction, the lender can take control of the property immediately, and thus maintain the economic value of the property.\(^{29}\) With a foreclosure proceeding, there is potential for the property to be abandoned by the borrower at some point during the months-long (or, in some cases, years-long) foreclosure process and, as a result, the property may decrease in value. For the second category, the lender can quickly negotiate and consummate the transaction, saving the lender the high cost of foreclosure, which has been estimated at $50,000 per home (including the lender’s out of pocket costs and economic losses).\(^{30}\) Finally, for the third category, the lender can avoid the potential negative publicity of the foreclosure process.\(^{31}\) The reputation of foreclosing on peoples’ homes is naturally not good exposure for large lenders, and avoiding such a negative image is valuable.

B. Advantages to Borrower

Like the advantages to the lender, where applicable, the borrower will have reciprocal advantages. Further, there are additional advantages to a

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29. Id. at 461.


31. Murray, supra note 28, at 461; see also NELSON & WHITMAN, supra note 3, § 6.18 (outlining reasons for using deeds-in-lieu of foreclosure).
borrower that are not shared by the lender. The borrower can obtain release of some or all of her personal liability under the mortgage indebtedness. The borrower, like the lender, can avoid the publicity, notoriety, time, and expense involved in foreclosure litigation that, on average, has been estimated to be $7200. Further, in some situations, the lender may agree to pay the transfer costs or make additional monetary payments to the borrower. Also, in some situations, the lender may grant the borrower some possessory interest in the property, such as the right to lease the property or the right to purchase it in the future. And finally, DIL “actions typically have less adverse impact than foreclosure on borrowers’ credit records.”

C. Advantages to Local Court System

With the sharp rise in foreclosures, court systems—particularly in judicial foreclosure states—have been inundated with foreclosure actions. This influx of foreclosure actions has strained court systems to the point where multiple states have felt the need to enact programs in order to alleviate some of the burden. One type of program that has been implemented is required mediation. Under such a regime, borrowers and lenders are forced to meet with a mediator in order to (ideally) have the lender and borrower agree to either a loan modification or a short sale. The success of these mediation programs, however, remains unclear.

32. Murray, supra note 28, at 462.
33. Id., see also Anna Moreno, Cost-Effectiveness of Mortgage Foreclosure Prevention 4 (1995).
34. Murray, supra note 28, at 462.
35. Id.
37. See, e.g., Greg Allen, Mediation Courts May Ease Foreclosure Backlog, NPR, Apr. 6, 2009 (describing the foreclosure problem as “a backlog that has overwhelmed the courts in many states”); see also David Streitfeld, New York Courts Vow Legal Aid in Housing, N.Y. TIMES, Feb. 15, 2011, at B4 (discussing New York’s rise in court foreclosure actions, particularly the 217% in the borough of Queens); Kimberly Miller, Foreclosure Mediators: Banks Pushed Us to Fail, PALM BEACH POST, Feb. 21, 2011 (“An estimated 350,615 foreclosures clog Florida courts.”).
39. Id.
40. See id.; see also Kimberly Miller, Florida Supreme Court Orders Mediators to be First Step in Foreclosure Cases, PALM BEACH POST, Dec. 28, 2009 (stating that the mediation program will be used to “discuss whether a loan modification or short sale is an option instead of foreclosure”).
In Florida, for instance, only six percent of the cases that have been referred to mediation have resulted in agreements, while the remaining ninety-four percent of cases have proceeded to court.\textsuperscript{42}

The advantage that the use of DIL transactions can serve in this situation is, of course, to remove foreclosure cases from the court system, allowing them to be resolved without draining the resources of state courts. Even assuming state mediation programs were successful, there would still be a strong argument for encouraging the use of DIL transactions in order to further alleviate the burden on the courts. However, as mentioned above, there is a strong indication that these programs have not proved to be as successful as their advocates might have hoped in alleviating the strain on state courts. This further bolsters the argument that an additional measure to alleviate the strain would be sound policy.

\textbf{D. Economic Advantages of DILs}

In one sense, the economic advantages of DILs can be considered through the lens of the economic disadvantages, and costs, of foreclosure. Foregoing foreclosure often avoids these negative economic consequences. With regard to the broader economy, a foreclosure can impose high costs on the local government where a house is located, as well as on the value of the other homes in a foreclosed home’s neighborhood.\textsuperscript{43} If a home is abandoned prior to foreclosure, a local government could potentially lose $20,000 in lost property taxes, unpaid utility bills, property upkeep, sewage, and maintenance.\textsuperscript{44} Furthermore, studies have shown that a single-family home foreclosure lowers the value of homes located within one-eighth of a mile by an average of 0.9\%.\textsuperscript{45} In addition to the monetary costs of foreclosure, there are also social costs. For instance, increased foreclosures have been found to contribute to higher levels of violent crimes.\textsuperscript{46}

The negative impact of foreclosure on neighborhoods and local economies might not, of course, be entirely reversed by using an alternative to foreclosure, such as DILs. Nevertheless, there are good reasons to believe that use of DILs would mitigate many of the negative economic consequences of foreclosure. The negative impact of abandonment, for instance, would decrease in a collaborative DIL transaction between

\textsuperscript{42}. Miller, \textit{supra} note 37.
\textsuperscript{43}. U.S. S. J. \textsc{Economic Comm}, 110\textsuperscript{th} Con\textsc{g.}, \textsc{Sheltering Neighborhoods from the Subprime Foreclosure Storm} 15 (2007).
\textsuperscript{44}. \textit{Id}.
\textsuperscript{45}. \textit{Id}.
\textsuperscript{46}. \textit{Id.} at n.48.
borrower and lender. The depressive effect of foreclosure sales on other neighborhood properties could also be assuaged by the use of DIL transactions that allow for more flexibility in the ultimate sale of the home.

E. Potentials for Abuse

While the use of DILs has a variety of potential benefits, there remain certain pitfalls that must be considered. These issues fall into three broad categories: (1) legal issues that must be considered in order for a DIL transaction to withstand judicial scrutiny; (2) issues that a lender must consider in order for a DIL transaction to be worthwhile; and (3) protections for a borrower so that a DIL transaction is not ultimately used to the detriment of the borrower.

Under the first category—legal issues that must be considered in order for a DIL transaction to withstand judicial scrutiny—there are two primary considerations. First, the DIL must not be a “clog” on the mortgagor’s equity of redemption under applicable state law.\(^47\) And second, the DIL must not be construed to be an “equitable mortgage” that must be foreclosed by subsequent judicial action.\(^48\)

The doctrine of clogging a mortgagor’s equity of redemption arises from the common law principle that until a valid foreclosure decree has been issued, a mortgagor is entitled to “redeem” the property; that is, retain ownership by paying the indebtedness.\(^49\) Moreover, if the borrower fails to pay, she is entitled to have the property exposed to public sale, so that any value in excess of the mortgage debt may be realized and distributed to subordinate lien holders and the borrower. A DIL quite clearly cuts off these mortgagor’s rights, and thus it has sometimes been called a “clog” on the mortgagor’s equity of redemption and been held impermissible.\(^50\)

However, John Murray suggests that an arms-length, fully documented DIL transaction will ordinarily survive a clogging challenge, because “a [DIL] is subsequent to the original mortgage . . . [it] is a voluntary conveyance for independent and valuable consideration, and . . . it serves a socially useful purpose of allowing the mortgagor to avoid a time-consuming, costly, and public foreclosure, and possibly allow[s] the mortgagor to avoid personal liability on the debt . . . “\(^51\)

The main clogging issue that arises with regard to DIL transactions—which is intertwined with the issue of whether a DIL will be deemed an

\(^{47}\) Patrick Mears et al., Strategies for Secured Creditors in Workouts and Foreclosures, § 4.08(b) (2004).

\(^{48}\) Id.


\(^{50}\) Restatement (Third) of Property (Mortgages) § 3.1 (1997).

equitable mortgage—comes up generally in the scenario where a borrower, who is in default, asks the lender for an adjustment to her mortgage. The lender will often agree, on the condition that a mechanism (such as a deed-in-escrow) be put into place whereby title is transferred to the lender automatically if the borrower defaults again in the future, thus cutting off the borrower’s right (a) to insist upon a public sale and (b) to “redeem” the property by paying off the debt at any time until the auctioneer’s hammer falls (and, in some states, until many months after the sale has been completed). Courts are split on the issue of whether such transactions are generally valid.

The pertinent issue here is how these transactions should be treated in the home-mortgage context. Would it be sound policy to uphold these transactions where a home lender and borrower have agreed to a mortgage adjustment on the condition that the borrower places a DIL in escrow? The case law appears to distinguish the commercial and residential context on this issue, and for good reason. It would seem likely that a residential borrower would often lack the sophistication and representation to be adequately protected in entering such an agreement. This comment therefore does not argue that transactions involving placing a DIL in escrow should be used in the residential context. On the contrary, we are focusing on residential transactions in which the default has already occurred; there is no equity in the property; the borrower has no reasonable prospect of paying the loan and effectuating his right to redemption; and the DIL will be delivered absolutely and at once, rather than placed in escrow for delivery at some future time on a subsequent default.

Even where clogging issues and equitable mortgage issues are not of concern, DILs are not “a universal panacea for mortgagees when the...
mortgagor has defaulted.\textsuperscript{56}

In fact, there are a number of circumstances that could, essentially, disqualify DILs as a viable option for lenders. These circumstances need to be considered in order to better understand an ideal incentive program that must take into consideration the real legal and economic consequences of using the DIL device instead of foreclosure (and vice-versa).

One such concern is whether there are junior liens on the property. Under a typical foreclosure proceeding, junior liens are extinguished.\textsuperscript{57} The completion of a DIL transaction, however, does not extinguish junior liens.\textsuperscript{58} Thus if a lender wished to use the DIL device on a property with junior liens, it would be necessary to later foreclose on the property after the DIL transaction has taken place.\textsuperscript{59} In the context of this discussion, it would then appear counter-productive to employ the DIL device in circumstances where there are junior liens or judgments on the property. The point that is argued in this comment is that the DIL device can serve as an efficient and cost-saving method for both borrower and lender, and that it is ultimately beneficial for the economy and local communities. In a situation in which it would be necessary to both use the DIL device and then foreclose on the property, it would appear that much of the benefit of the device would be lost. In particular, consider that the foreclosure process itself, especially in judicial foreclosure states, would still remain a costly and time-consuming process for the lender.\textsuperscript{60} Further, the negative impact of foreclosure on the property’s surrounding community, as discussed above, would to some degree still persist.\textsuperscript{61} Even the benefit to the borrower would likely be diminished by the need for a future foreclosure, as that future cost would—at least to some degree—be passed on to her in any deal involving a DIL that might be struck between the borrower and the lender.

Another issue that lenders must be concerned about when entering into a DIL transaction relates to the voluntariness of the transaction and adequacy of the consideration for the deed. Courts inherently view the

\textsuperscript{56} Mears, supra note 47, § 4.08(b).

\textsuperscript{57} Restatement (Third) of Property (Mortgages) § 7.1 (1997) (“A valid foreclosure of a mortgage terminates all interests in the foreclosed real estate that are junior to the mortgage being foreclosed . . . .”).

\textsuperscript{58} Mears, supra note 47, § 4.08(b).

\textsuperscript{59} See Murray, supra note 28, at 475 (noting that generally lenders do not accept DILs when there are subordinate liens or judgments on the property and that, if they do, it is important to structure the DIL transaction so as to avoid merging the lien with the title to the property). For a lengthier discussion on the concept of merger, see Nelson & Whitman, supra note 3, § 6.15.

\textsuperscript{60} Of course, if a lender is foreclosing on a home to which it has a deed, it would be expected that the process would be less contentious and thus, on average, less costly and time-consuming. Nevertheless, significant court costs and delays would still remain.

\textsuperscript{61} However, the problems flowing from abandonment likely would not persist.
borrower and lender as having disparate bargaining power, and thus will look closely at whether there was “undue influence, oppression, unfairness or unconscientious advantage.” If a court finds that the transaction was, in any of these ways, unfair, the transaction risks being overturned. This issue, however, from the perspective of the lender, is not of primary concern in the context of this comment. While it is certainly the case that an ideal DIL transaction will be robust under the light of judicial scrutiny, these particular concerns are more aptly considered in the following paragraph in the context of borrower protection. In a program that encourages the use of DILs, it would seem unnecessary to have added protection to ensure the judicial upholding of the deal—relating particularly to the fairness of the deal to borrowers—if fairness to borrowers is already being assured through measures protecting borrowers’ interests.

Borrower protection is perhaps the most important concern in the context of this comment relating to the use of DILs. While lenders often have significant legal resources, as well as experience in this area, borrowers are far less likely to have equivalent resources and experience. This problem is further amplified by the fact that borrowers who have defaulted often lack the money to hire adequate legal counsel to aid in the execution of a DIL transaction. The potential problems that need to be guarded against include: (1) a borrower who, as a result of entering into a DIL agreement, foregoes a valid defense to foreclosure; (2) a borrower who receives inadequate consideration in the DIL transaction; and (3) a borrower who is unduly influenced into entering the DIL transaction.

Regarding the first problem, uninformed financially troubled borrowers, presented with the possibility of extinguishing all in personam debt through a DIL transaction, might agree to enter such a transaction despite the possibility of a valid defense to foreclosure. In the specific context of subprime mortgages, predatory lending is an ever-present theme. And since such predatory practices can serve as a basis for a defense to foreclosure, it would be undesirable to endorse a system that did not ensure all foreclosure defenses were exhausted or, at the very least, known to the borrower so to be used as leverage in workout negotiations.

With regard to the problem of a borrower who receives inadequate consideration for a DIL transaction, a lender—as mentioned previously—is

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62. Nelson & Whitman, supra note 3, § 6.19; see also Murray, supra note 28, at 463–65 (discussing factors that may taint a transaction between a borrower and lender).

63. For a discussion of foreclosure defenses, see Martin C. Bryce, Jr., Foreclosure Developments, Mortgage Fraud, Counterclaims and Defenses, 64 Consumer Fin. L. Q. Rep. 4 (2010).

64. See Daniel Lindsey, Prevent People from Wrongfully Losing Their Homes, 21 CBA Rec. No. 7, at 38 (2007) (discussing foreclosure defenses in the context of predatory loans in the state of Illinois).
very likely to have far greater experience in such transactions than a borrower. Consequently, any deal that is struck has the potential to be, not a representation of the true bargaining power of the parties, but rather a reflection of the disparate knowledge of the circumstances. Consider the following fact pattern as an illustration: A borrower is in default on a recourse loan with an outstanding balance of $300,000, secured by a mortgage on a home worth $290,000. Further, assume that, first, the foreclosure process would cost the lender $20,000 to complete and, second, the lender believes that, while it could likely obtain a deficiency judgment against the borrower, it knows that collecting the judgment would be unlikely. The opportunity to extinguish the possibility of the deficiency judgment through a DIL transaction might be appealing to a borrower. Nevertheless, the opportunity of a better deal, unbeknownst to her, might exist. In particular, the lender, it can be assumed, would gain $20,000\(^{65}\) by extinguishing the debt using the DIL transaction, some of which the borrower might be in a position to bargain for. The point, it should be noted, is not that the borrower should be entitled to some of this excess $20,000, but rather that, in an ideal scenario, the borrower would be negotiating with the same knowledge that the lender has, and the ultimate agreement is merely a reflection of the parties’ relative bargaining power, rather than a reflection of asymmetric information.

The final problem that must be considered, which is certainly compatible with—and not always separable from—the two problems discussed immediately above, is that of a borrower entering into a DIL transaction as a result of undue influence from a lender. DIL transactions are considered “lender-friendly” agreements.\(^{66}\) Thus, it follows that, in certain instances, large institutional lenders with substantial legal representation and bargaining power could strong-arm borrowers into accepting DILs even though it may be to their disadvantage. The possible ramifications of such an outcome could involve, as discussed above, a borrower’s acceptance of a DIL transaction that eliminates a viable foreclosure defense, or (especially if there is equity in the property) the acceptance of a deal that is substantially less than what she could have received had she not been unduly forced to accept the deal.

Each of the three problems discussed could be largely solved by the presence of competent, knowledgeable counsel representing the borrower. With such representation, it would seem unlikely that a viable foreclosure

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\(^{65}\) This assumes that the lender would not be able to recover a deficiency judgment against the borrower and thus would realize $270,000 through foreclosure ($290,000 on the sale minus $20,000 in costs) as opposed to $290,000 through the use of the DIL transaction.

defense would be left either unused in a challenge to foreclosure or unused as leverage in bargaining for a DIL transaction. Furthermore, a competent and knowledgeable attorney would have full knowledge of the situation and thus bargain on a level with less asymmetric information than her client might on her own. And, lastly, a borrower’s counsel would zealously defend the borrower’s interests, ensuring that the borrower is not forced into a DIL transaction that is not in her best interest. Of course, the idea of ensuring legal representation in these matters is not a groundbreaking notion. The question then becomes how to ensure that result. This question will be addressed in the section below on the proposed incentive program.

IV. CURRENT INCENTIVE PROGRAM—HOME AFFORDABLE FORECLOSURE ALTERNATIVES (HAFA) PROGRAM

The Federal Government currently has a program in place to incentivize the use of DILs in certain circumstances. The program is known as the Home Affordable Foreclosure Alternatives Program (“HAFA”) and is part of the expanded Home Affordable Modification Program (“HAMP”). Under HAFA, the U.S. Department of the Treasury gives incentive payments to borrowers, mortgage servicers, and investors for the use of short sales or DIL transactions when other modification options have been exhausted and a variety of other requirements are met.

In order to be eligible for the HAFA program, a borrower must meet the basic eligibility requirements of HAMP. The borrower must show

67. See infra Part V.

the Secretary [of the Treasury] shall implement a plan that seeks to maximize assistance for homeowners and use the authority of the Secretary to encourage the servicers of the underlying mortgages, considering net present value to the taxpayer, to take advantage of the HOPE for Homeowners Program... or other available programs to minimize foreclosures

). See also U.S. DEP’T OF TREASURY, PERFORMANCE AND ACCOUNTABILITY REPORT: FISCAL YEAR 2010 209–10 (Nov. 15, 2010) (describing HAFA as being included in HAMP, which, in turn, is part of MHA, which is part of TARP).
69. Under the HAFA short sale program, “servicer[s] allow... the borrower to sell the property for less than the total amount due on the mortgage. The servicer will accept the net proceeds from the sale of the property in full satisfaction of the total due on the first mortgage.” Rao, supra note 4, § 2.8.11.2.
71. Id.
that: (1) the mortgage loan is secured by a one to four-unit property, one unit of which is the borrower’s principal residence; (2) the property is not condemned or vacant; (3) the unpaid balance of the mortgage loan for a one-unit property does not exceed $729,750;\(^\text{72}\) (4) the minimum monthly mortgage payment is greater than 31\% of the borrower’s monthly gross income; and (5) the borrower has a documented financial hardship indicating an inability to make monthly mortgage payments.\(^\text{73}\) Under HAFA the borrower is required to deliver clear and marketable title.\(^\text{74}\) If all HAFA requirements are met, and a successful DIL transaction takes place, the borrower is entitled to up to $3000 for moving expenses, a servicer is entitled to a $1500 payment, and an investor is entitled to up to $2000 to be compensated for the release of subordinate liens.\(^\text{75}\) Originally, under a HAFA DIL transaction, a borrower was required to move out of the property within thirty days of the consummation of the deal.\(^\text{76}\) As of December 28, 2010, however, the Treasury enacted new rules that allow for DILs 'with deed-for-lease provisions and future repurchase agreements.\(^\text{77}\) These changes allow a borrower to enter into a DIL agreement with a servicer and either remain living on the property while paying rent to the servicer, or have the option to repurchase the property at some future time.\(^\text{78}\)

Likely owing to the very recent expansion of HAMP to include the HAFA program as well as the very narrow focus of the program, there has been little discussion of the program’s effectiveness or desirability in scholarly literature.\(^\text{79}\) There are, however, general discussions of HAMP and its effectiveness thus far.\(^\text{80}\) One such article,\(^\text{81}\) and testimony of a Treasury official,\(^\text{82}\) have noted that after the first year of HAMP the Federal

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72. This limit increases incrementally with the number of units of the property. If the property is two units, then the limit is $934,200; for three units it is $1,129,250; and for four units it is $1,403,400. \textit{Id.}

73. \textit{Id.}

74. RAO, supra note 4, § 2.8.11.1.

75. U.S. Dep’t of Treasury, \textit{Home Affordable Modification Program Compensation Matrix} 4 (Nov. 9, 2010) [hereinafter \textit{Compensation Matrix}].


78. \textit{Id.}

79. As of the writing of this comment, a Westlaw search of law review and journal articles returns only two references to the HAFA program, both of which only mention the program in passing.


81. \textit{Id.} at 743.

Government realized the need for an alternative program that offered short-sales and DILs—hence the adoption of HAFA.

Next, this comment will evaluate the HAFA program, both through an evaluation of the empirical data released by the government, and through the lens of the issues raised in the above sections. This will be done first through an examination of the increase in use of DILs as a result of the implementation of the program, and then by looking at the advantages of using DILs for the borrower, the lender (or servicer), and the economy at large, as well as the potential hazards that their use creates. The main flaws with the current government program, evaluated in this light, are that: (1) the incentive payments are relatively small and unlikely to alter a borrower or lender’s behavior; (2) the “counseling” that is offered through the program is too weak to protect borrowers’ interests; and (3) the program’s eligibility requirements are too strict.

The first flaw with the current incentive program for DILs is that the incentive payments are likely too small to significantly alter the behavior of either borrowers or lenders. In January 2012, the average foreclosed home sold for over $182,000. The typical incentive payments for a servicer is $1500. This payment is less than one percent of the average foreclosure sale price of homes nationwide. As a result, it would seem unlikely that it would play any substantial role in a servicer’s calculus in deciding whether or not to accept a DIL. While this argument is certainly not airtight, there is also empirical evidence that indicates the ineffectiveness of the program.

In particular, it can be shown empirically by comparing the Department of Treasury’s statistics for new DIL transactions before and after the enactment of HAFA. The HAFA program was initiated in April 2010; from September 30, 2009 to September 30, 2010 there was an increase in the use of DILs by 40.2%. While this, on its face, might be persuasive evidence of the efficacy of the program, the number must be considered in light of the overall number of completed foreclosures over the same period of time. After all, the point of the DIL incentive program is to prevent

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84. COMPENSATION MATRIX, supra note 75, at 4.
86. See OCC and OTS Mortgage Metrics Report, supra note 16, at 42 (showing that there has been an increase from 118,606 to 186,854 completed foreclosures, and an increase from 1233 to 1729 new DIL actions in the time period from September 30, 2009 to September 30, 2010). Note that this data does not look at every foreclosure and DIL action in the U.S., rather it addresses “residential mortgages serviced by national banks and federally regulated thrifts,” which comprise 64% of all outstanding mortgages in the U.S. Id. at 4.
foreclosures from taking place. Thus, the true metric to consider in measuring the efficacy of the DIL incentive program is not the increase in the use of DILs, but rather the ratio between the number of DILs and the number of foreclosures. In particular, during the time period from September 30, 2009 to a year later, the number of completed foreclosures rose 57.5%. \(^{87}\) This indicates a decrease in the ratio of DILs to completed foreclosures. \(^{88}\) If the program were to be presumed effective—that is, that the incentive program actually incentivized—one would expect a rise in the use of DILs to at least keep pace with the rise of completed foreclosures.

The second flaw of the current program is that it does not offer sufficient representation for borrowers. The main protection offered is counseling from HUD-approved housing counselors\(^{89}\) and access to the HOPE telephone hotline.\(^{90}\) While these services are undoubtedly valuable resources for many individuals, they fall short of the type of ideal representation discussed above.\(^{91}\) Specifically, the problems of an underrepresented borrower, who might have a defense to foreclosure or the ability to bargain for a more favorable deal, are conceivably still likely to occur even under the safeguards of HAFA’s current system. There is a fundamental difference between the advice of a free counselor through a non-profit organization, and that of a paid attorney who represents a borrower’s interests in dealing with lenders. Of course, from a normative standpoint it is always ideal to have all parties represented to as great an extent as possible; the real question is how this can be made feasible when a borrower has limited resources. This comment’s proposed solution will be discussed in section V, below.

The third flaw of the DIL program offered by HAFA is that it is too restrictive in its offering of incentives for DIL. The HAFA program essentially creates a threshold requirement for participation in the program by requiring first that the borrower meet the eligibility for HAMP.\(^{92}\) While the strict requirements under HAMP might make sense for that program, they make less sense in the context of the HAFA program—in particular, the requirement that only individuals who can show they are both “in default or are in ‘imminent default’” and are in “financial hardship” are eligible for the program.\(^{93}\) These requirements were, in part, to ensure that the program would not introduce a moral hazard where borrowers would

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87. Id.
88. To be precise, the ratio decreased from 1233 / 118,606 = 0.0104 to 1729 / 186,854 = 0.0093.
89. Handbook, supra note 70, at 73.
90. Id. at 37.
91. See supra Part III.B.
92. See Handbook, supra note 70, at 106 (“The [HAFA] Program provides incentives . . . on an eligible loan under HAMP.”).
93. Braucher, supra note 80, at 732.
purposefully default in order to receive a favorable modification on their mortgage. The benefits of DILs, however, are not necessarily subject to the same concerns as modifications, and thus the threshold requirements for access to the government’s incentive program should not necessarily be the same. With the economic crisis and the substantial drop in home values, as discussed above, it is conceivable that it would be economically sound policy to offer incentive programs for DILs to individuals, even if they cannot demonstrate financial hardship. As an illustration, consider the example discussed above, modified slightly. In this instance, we still assume an individual owes $300,000 on a recourse mortgage secured by a home worth $290,000, but we now assume that the borrower only expects the foreclosure process to cost $10,000. Now further assume that the lender believes it has a 50% chance of collecting on a deficiency judgment. And finally, assume that the borrower is not in as deep financial hardship as is necessary to meet the requirements of either the HAMP or HAFA program, and is therefore not eligible for them. The question to be asked is whether it would be sound policy to incentivize the parties to enter a DIL transaction.

In this particular situation, the borrower may very well have incentive to offer a DIL to the lender, but a lender will have little incentive to accept one. Thus, while the benefit to a lender individually will be minimal, the point to consider is the cost and gain from offering an incentive to them to enter into such an agreement. Discussed in detail above, the cost of foreclosure to communities, local governments, state court systems, area housing and the broader economy can be substantial. In this marginal example, any non-trivial incentive payment to the parties would be sufficient to alter their behavior. In this particular instance, an extension of the current incentive program—i.e., payments of between $1500 and $3000—to include a circumstance such as this, might very well be sufficient to incentivize the parties to enter into a DIL transaction. Further, considering the costs of foreclosure, a payment totaling less than a

94. Id.
95. See supra Part III.E.
96. If a lender accepts the DIL, the borrower will be free from the debt for which she would otherwise be accountable.
97. The reason the lender will have little incentive to accept a DIL is because under either situation the lender expects to walk away with $290,000. Using a DIL transaction, the $290,000 home would be handed over to the lender. By foreclosing on the home, the lender will sell it for $290,000, have costs of $10,000, and have a 50% of collecting on a $20,000 deficiency judgment. Thus, under the foreclosure route, the lender will also expect to walk away with (290,000 – 10,000 + (0.5 * 20,000)) = $290,000.
98. See supra Parts III.C–D.
99. See COMPENSATION MATRIX, supra note 75 (setting out details of current HAMP incentives).
few thousand dollars would likely be far less than the damages mitigated by the payment. There are indeed problems with expanding a DIL incentive program to include homeowners who are not in financial trouble; for example, the fear that the program might incentivize individuals, who might otherwise stay in their home, to default. In fact, this is one such fear that shaped the original HAMP guidelines and requirements. This concern will be addressed in the proposed changes section, below.

V. PROPOSED CHANGES TO THE HAFA PROGRAM

Paralleling the three main criticisms of the HAFA program outlined in the section above, this comment proposes three alterations to the program in order to (1) better meet its stated goals, (2) better protect homeowners and their interests, and (3) expand the program in order to further aid in the economic and housing recoveries.

The first, and primary, change would be to increase the incentive payments to borrowers and lenders. While this comment does not intend to propose an ideal number for the incentive payments, it seems relatively clear that they are insufficient in their current form. With the payments being such a small proportion of the possible sale price at foreclosure, in their current form they are only likely to be a secondary consideration for most borrowers and lenders.

The second proposed change would be to allocate some portion of the borrower’s increased incentive payment for legal services in the aid of completing a DIL transaction. This would ensure that the borrower is fully informed and represented in the transaction, that he is not abandoning a valid defense to foreclosure, that there are no inequitable information asymmetries during the bargaining process, and that the transaction is generally in the borrower’s best interest. Indeed, the program in its current form offers incentive payments that must be used for moving expenses. And while moving is a necessary aspect of these transactions, the same money allocated for those purposes could very well be more useful for borrowers if all or part of it were allocable to legal representation. Legal representation, after all, has the potential to increase the borrower’s long-term wealth if the alternative is to enter into an unfavorable deal with a lender.

At least one state agrees that legal representation for individuals going through foreclosure is a necessity. New York has recently outlined a plan to ensure that foreclosure defendants have legal representation. The rationale behind the move is both to further help people to stay in their

100. Braucher, supra note 80, at 732 (“[HAMP] eschewed steps that . . . might have created a moral hazard by encouraging underwater debtors to default.”).
101. Streitfeld, supra note 37.
homes, and to effectively deal with the influx of foreclosure cases. This is the same reasoning that supports changing HAFA’s compensation (in whole or in part) from moving expenses to legal aid. Moreover, unlike the New York program, additional appropriation would not be necessary in order to effectuate this change in the program. Compensation money for moving expenses already exists and is available; this money could simply be used to pay legal counsel, rather than moving companies, or be divided in some way between them.

Finally, the third proposed change would be to loosen the restrictions on the availability of the program. In particular, the proposed change would loosen the financial hardship requirement. As mentioned earlier, the most glaring problem with reducing or eliminating the financial hardship requirement is the moral hazard that might be created by incentivizing underwater debtors to default on their mortgages. Thus, this comment proposes that incentive payments be allowed for borrowers who do not meet the financial hardship requirement, but that the payments are modified depending on certain criteria. The concept would be to allow higher payments for those who are more likely to default and lower for those who are less likely to do so. This determination could be made based on two criteria: (1) the financial position of the borrowers, and (2) the degree to which the mortgage loan is underwater. That is, if an individual is in a financially sound position, and their mortgage loan is not deep underwater, there is very little likelihood of their default. Such individuals would thus not be entitled to much, if any, incentive payment. However, an individual who is in financial distress and whose loan is deep underwater would have a high probability of defaulting. Thus, such an individual would be entitled to a higher incentive payment to enter into a DIL transaction. In this way, the moral hazard problem is minimized. If someone is unlikely to default on their loan, then there will be little incentive for them to do so.

This expansion of eligibility could also aid in the industry’s recovery from the foreclosure controversy. Allowing incentive payments for DILs might encourage otherwise skeptical lenders to accept DILs in areas where foreclosures have been frozen. This could allow for those losses on the lenders’ books to be realized earlier, benefiting the broader economy.

102. Id.
103. See Handbook, supra note 70, at 107 (“A borrower has documented a financial hardship and represented that he or she does not have sufficient liquid assets to make the monthly mortgage payments.”).
104. See supra Part II.C.
105. See Daniel Alpert, Op-Ed., Why Own When You Can Lease, N.Y. TIMES, Aug. 1, 2009 (arguing, in part, that in order “[t]o put the bubble behind us, we need to place mortgage lenders on a path to settling up with underwater homeowners”).
addition, an expansion of the program would also aid in clearing up state court dockets.\textsuperscript{106}

It is important to note that the proposed expansion would not do away with the home value ceilings that are currently part of the HAMP and HAFA programs, nor would it be meant to serve as a subsidy to otherwise financially healthy individuals to abandon their home to foreclosure. This comment does not argue that taxpayer money should be used to pay wealthy people to abandon, say, multi-million dollar homes when the mortgages on those homes become burdensome. The expanded program suggested would remain limited to people who: (1) are financially troubled (just with looser restrictions than the current program); (2) own homes that have values less than the current HAMP restrictions; and (3) own homes that have values less than what is owed on the mortgage.

VI. \textsc{r}emainin\textsc{g} \textsc{p}roblems

This comment is not arguing that DILs can serve as the solution for the economic and mortgage crises. In fact, the thrust of the argument is that the use and incentivization of DILs can only, in certain instances, mitigate some of the damage.\textsuperscript{107} Most important is to note that DILs can be beneficial only in certain instances. There are a variety of situations in which DILs either are not practical or would not be beneficial. For instance, if there is equity in the property or a defense to foreclosure, DIL should certainly not be used. Furthermore, if a timely short-sale can be made and agreed to by the parties, such a transaction would likely be a better option than a DIL. And, even in instances where a DIL might seem beneficial, lenders may still resist acceptance of a deed because (among other reasons) they do not want the asset on their books or the cost of upkeep of the property if they retain it.

VII. \textsc{c}onclusion

The housing crisis has revealed a variety of defects in the mortgage lending industry—many of which could have, and should have, been remedied prior to the housing market’s rapid decline. Nevertheless, these defects were quite obviously not cured, and the full extent of their negative impact on the future of the U.S. housing market remains to be fully discovered. There are, however, measures that have been taken to minimize the negative impact of those defects, including the Federal

\textsuperscript{106} See \textit{supra} Part III.C.
\textsuperscript{107} This is a sentiment with which the Federal Government most likely agrees, having enacted the HAFA program to begin with. \textit{See also Foreclosure Prevention, supra note 82, at 8 (“HAFA . . . will help to prevent costly foreclosures”).}
Government’s HAMP and HAFA programs. Yet, even these programs are not entirely without their own defects. This comment argues that one particular device, DILs, can be utilized to a greater extent to aid in the housing market’s recovery. The current HAFA program offers too little, in terms of both compensation and protection, and is offered to too small of a subset of individuals. The program should be expanded to aid the market in its recovery by decreasing the number of foreclosure actions and incentivizing lenders to settle their underwater loans. The DIL device is by no means a cure-all for the woes of the U.S. economy and housing market, but it is an important tool that should be utilized to a greater extent.