The Good Faith Approach to Foreclosure Mediation: An Assessment of Washington's Foreclosure Mediation Program

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THE GOOD FAITH APPROACH TO FORECLOSURE PREVENTION: AN ASSESSMENT OF WASHINGTON'S FORECLOSURE MEDIATION PROGRAM

Scott Kennedy*

ABSTRACT

Since 2007, concerns over high home foreclosure rates have played a dominant role in U.S. economic news and policy, and several states have responded with bold statutory and regulatory innovations. In July of 2011, Washington State implemented one such innovation: the Foreclosure Fairness Act (FFA). It grants defaulting homeowners the right to initiate a mediation in which lenders must consider the alternatives to foreclosure in good faith.

This article assesses the Washington model's potential to mitigate the forces frustrating foreclosure prevention. Despite the increasing viability of foreclosure's alternatives, national foreclosure rates remain high. Poor lender-borrower dialogue, a system of perverse servicer incentives, the securitization of mortgage assets, and a dearth of leverage and representation amongst homeowners have colluded to buoy those rates, and both borrowers and lenders often suffer as a result. The mandatory extrajudicial mediation program created by the FFA combats this market failure by fostering borrower involvement, imposing enforceable requirements on lenders, and setting a high and artfully defined good faith standard for mediations. While strong judicial precedent is still needed in Washington to clarify and reinforce some of the Act's requirements, the mediation model encapsulated in the FFA is a promising solution at the forefront of foreclosure prevention policy.

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INTRODUCTION

The national foreclosure crisis proceeds almost unabated since 2007 with costs felt by homeowners, communities, lenders, and governments alike.\(^1\) While the epidemic cuts across all communities, participants in the abysmal subprime mortgage market - a predominantly poor group victimized by innovations in predatory lending - have been hardest hit. Worse still, despite the increasing viability of foreclosure's alternatives, borrowers often lack the information, representation, and leverage necessary for a productive dialogue with their mortgage's often intransigent servicers. Because of this, countless homeowners are left without options after defaulting and endure preventable foreclosures as a result.

One promising solution is foreclosure mediation: a process in which borrowers and lenders meet to consider their options in a non-adversarial setting. A number of states have adopted policies designed to encourage mediation, but many lack concrete requirements for lenders and have had disappointing results. Heeding this shortcoming, Washington State enacted the Foreclosure Fairness Act (FFA)\(^2\) which took effect on July 22, 2011. It grants homeowners in default the right to initiate a mediation in which lenders must consider the available alternatives to foreclosure in good faith.

This article will assess the FFA's approach to foreclosure mediation by examining its potential to guarantee homeowners a meaningful opportunity to prevent needless foreclosure in the absence of judicial oversight. The FFA's mediation provisions offer substantial assistance for borrowers by imposing specific requirements on lenders that increase the likelihood of loan modification. However, the mediation program created by the FFA

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\(^1\) See, e.g., Debbie Gruenstein Bocian, et al., *Lost Ground, 2011: Disparities in Mortgage Lending and Foreclosures*, CTR. FOR RESPONSIBLE LENDING, 3 (Nov. 2011), http://www.responsiblelending.org/mortgage-lending/research-analysis/Lost-Ground-2011.pdf (finding that the foreclosure crisis is likely only half over because a large percentage of homeowners who obtained mortgages between 2004 and 2008 remain at "immediate, serious risk" of foreclosure).

\(^2\) The relevant provisions of the FFA regarding the foreclosure mediation program and its requirements are codified at WASH. REV. CODE 61.24.031, 033, 160, 163, 169, 177 (2012).
relies on the cooperation of lenders and the supervision of non-judicial mediators to realize these rights leaving unrepresented borrowers with the impracticable burden of enforcing the Act themselves. Ultimately, strong judicial precedent to clarify and reinforce the duties imposed by the Act is needed.

Part I will briefly summarize the causes and effects of the foreclosure crisis, and the plight of homeowners caught in it, in order to place the FFA in context and make a case for the practical and moral necessity of an effective public response. Part II will analyze the mediation provisions of the FFA, scrutinize their effect, and assess their strengths and weaknesses in the light of prior scholarship, practitioner perspectives, and other states' experiences. Based on this analysis, Part II will then offer a recommendation: Washington courts should follow the lead of Nevada, a state with a similar foreclosure mediation program, by establishing precedent clearly reinforcing the Act's good faith standard and requiring strict compliance of lenders.

I. THE FORECLOSURE CRISIS AND ITS CONSEQUENCES

A. Origins and Scope of the Crisis

The story of the FFA begins well before its implementation last July. In June of 2007, New York Times readers with an eye for finance may have noticed a satisfying headline: "Lehman Brothers Profit Climbs 27%." Most of the firm's assets had grown that year, and its chief financial officer, when asked about the one outlying category that had performed poorly, assured investors that "the subprime mortgage challenges are and will continue to be contained." Just over a year later, readers saw a different headline: "Life After Lehman Brothers." To the shock of global financial


4 Id.

markets, decaying mortgage assets had pulled one of the oldest and largest firms on Wall Street into bankruptcy almost overnight. And this announcement came just one week after the Bush administration had assumed emergency control of the nation's largest two mortgage finance companies, Fannie Mae and Freddie Mac. Drama in the upper echelons of U.S. finance, however, was only one aspect of the real crisis. By early 2008, roughly one in eleven homeowners across the country were past due or in foreclosure, housing prices had fallen 16 percent nationally, and foreclosure rates had risen 225% from 2006.

1. Innovative Finance and Predatory Lending

The chain of events leading to the 2008 foreclosure surge that brought U.S. financial institutions to their knees began decades earlier. In the 1970s, the U.S. government had begun to deregulate consumer credit markets making it possible to extend larger loans to less credit worthy (or "subprime") borrowers by applying higher interest rates to offset the risk. Then in the early 2000s, when housing prices began to appreciate rapidly amidst a historically low personal savings rate, many renters in low income communities found themselves unable to afford a mortgage. In an effort to increase sales, lenders began to offer mortgages to these subprime borrowers with increasing ease: down payments were waived, repayment terms were extended, personal credit and income inquiries were slackened, and adjustable interest rates were

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7 Id.
11 Id. at 402.
introduced allowing borrowers to enjoy low initial monthly rates that could suddenly increase later.\textsuperscript{12}

The advent of the subprime market, falling interest rates, governmental programs promoting homeownership, and rampant speculation all colluded to push home prices up to artificially high levels.\textsuperscript{13} At the same time, the profits and liabilities associated with subprime mortgages were increasingly pooled in large-scale securities that permitted lenders to defer and diffuse their high risk.\textsuperscript{14} Then the financial institutions facilitating securitization began to rely on credit default swaps, a sophisticated form of investment insurance, to hedge the risk associated with these assets and reduce the capital banks would need to back them.\textsuperscript{15} Although these financial tools were designed to manage risk, they actually amplified it by creating a chain of institutions with interdependent and under-capitalized assets arranged like a row of dominoes.\textsuperscript{16}

2. The Collapse

The first domino fell in 2006 when inflated housing prices unexpectedly declined.\textsuperscript{17} Subprime mortgage holders, many of whom were sold loans they could not realistically afford, found themselves unable to make payments once their adjustable interest

\begin{itemize}
  \item \textsuperscript{13} See Dickerson, supra note 12, at 309-402.
  \item \textsuperscript{15} Id. at 1361.
  \item \textsuperscript{16} Id. at 1363. The mechanics of these credit default swaps, and the manner in which they amplified the risks associated with the subprime mortgages they insured, are exceedingly complex and beyond the scope of this article. Refer to McCoy, et. al for a more thorough explanation.
  \item \textsuperscript{17} Lauren Hassouni, \textit{The Nuts, Bolts, Carrots, and Sticks of the Mortgage and Foreclosure Crisis and a Suggested Solution}, 2010 ANN. SURV. OF BANKR. LAW 17 (2010).
\end{itemize}
rates increased. The fall in housing prices also left many "underwater," owing more on their mortgage than their house was worth and making it infeasible to sell. In this scenario, a defaulting homeowner's only option appeared to be foreclosure. Once subprime foreclosures exploded, the housing market was flooded with supply further depressing prices and pushing still more owners underwater. This trend soon spread to prime mortgage holders as well, many of whom had also been sold loans with adjustable rates and were now underwater and unable to pay. As a result, millions of homeowners remain in this precarious position today. An estimated 11 million homeowners are now underwater, and roughly 3.4 million mortgage holders are either 90 days behind on payments or in foreclosure.

B. The Financial and Social Costs of Foreclosure

This trend of widespread foreclosure exacts a staggering financial and social toll on borrowers, lenders, and communities. Home ownership builds relationships and social capital by tying homeowners to a geographic community, and the sense of commitment created by substantial long term debt fosters civic involvement and community cohesion. Severing borrowers' attachment to their homes eliminates these connections. In financial terms, foreclosure drastically weakens a family's

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18 Fishbein, supra note 14, at 26.
20 Id.
prospects of purchasing another home by destroying their credit, and it deprives them of what is typically their most valuable asset. In psychological terms, foreclosure robs people of an aspect of their identity and a place of deep emotional value. A home is no less than “the way we constitute ourselves as continuing personal entities in the world,” as property law scholar Margaret Radin might put it. Nor even does human physiology escape the toll: one recent study found that foreclosure adversely affects homeowners’ health and access to treatment.

The costs of foreclosure extend well beyond the borrowers who lose their homes. It drives down neighboring property values: just one foreclosure of a conventional single family home can reduce the value of any home within an eighth of a mile almost a full percentage point. Neighborhoods experiencing high rates of foreclosure also endure the blight and decay associated with abandoned properties, increases in crime, and a loss in tax revenue. Lenders, too, lose substantially in foreclosure, typically recouping only a portion of the mortgage's outstanding principal when selling a repossessed property. The nation's cash-strapped municipalities are especially hard hit. A typical foreclosure involves more than a dozen governmental agencies and twice as many municipal services generating direct costs sometimes

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25 Id. at 954.
26 Id. (quoting Margaret Jane Radin, Property and Personhood, 34 STAN. L. REV. 957, 959 (1982)).
28 Dan Immergluck & Geoff Smith, The external costs of foreclosure: The impact of single-family mortgage foreclosures on property values, HOUSING POLICY DEBATE, Jan. 2006 at 57.
29 Bocian, supra note 2, at 7.
30 See, e.g., Mortgage Bankers Ass'n, Lenders Cost of Foreclosure, CONGRESSIONAL EDUCATION SERIES BRIEFING at 2 (May 28, 2008), http://www.mbaa.org/files/Advocacy/2008/LendersCostofForeclosure.pdf (explaining that lenders lose an average of $50,000 per foreclosed home or as much as 30 to 60 percent of the outstanding loan balance).
exceeding $30,000 per property. And perhaps the most widely apparent cost of the crisis is the devastating effect its fallout has had on the national economy.

C. Populations Hardest Hit by the Crisis

Perhaps the most troubling dimension of the crisis is the reality that its greatest impact has fallen on the most vulnerable communities. Foreclosure rates are highest amongst borrowers who were sold high-risk subprime loans. These products were marketed to disadvantaged borrowers experiencing difficulty obtaining traditional mortgages either because of their weak finances or because of racial redlining, and as a result the crisis has had a disproportionate effect along socioeconomic and racial lines.

At the height of the subprime crisis in 2008, low-income and minority households were defaulting at three times the rate of other borrowers. Today approximately one in four Latino and African American borrowers, and one in four borrowers in low-income neighborhoods, has lost a home in foreclosure or entered serious delinquency on a mortgage. This means that many of the secondary consequences of widespread foreclosure, such as

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33 Bocian, supra note 2, at 3.


36 Bocian, supra note 2, at 4, 6.
declining property values, diminished social cohesion, and increased crime, are also felt most strongly in these communities.\textsuperscript{37}

\textbf{D. The Need for an Effective Public Solution}

Taken together, the causes, costs, and disproportionate effects of the foreclosure epidemic make clear that an effective public response to defaulting homeowners' needs is both a practical and a moral imperative. Market forces have failed to correct the problem: foreclosure rates remain elevated over five years after their initial spike and show little sign of subsiding.\textsuperscript{38} And the financial and social harm incurred by troubled homeowners, their communities, and the national economy sets a high price on inaction.

Culpability for the subprime debacle may not be one-sided; borrowers are not entirely innocent. Some were guilty of sheer recklessness by pursuing mortgages they could not realistically afford, and a few even committed fraud by exaggerating their incomes or borrowing others' credit scores.\textsuperscript{39} But the lending practices that created the subprime market were indeed "predatory" if ever a lending practice was. Both small and large firms were guilty of widespread fraud, sometimes falsifying documents and inflating borrowers' incomes in order sell loans to unqualified applicants.\textsuperscript{40} And even more troubling, as many consumer advocates have argued, was lenders' ubiquitous willingness to sell mortgages that they knew buyers would be unable to afford once the adjustable interest rate reset.\textsuperscript{41}

Regardless of where the blame is placed, borrowers in foreclosure are, by and large, victims of a systemic failure in lending practices and a nationwide error in judgment. They were complicit in the subprime scheme, but usually only as a result of ignorance, confusion, and an enculturated misconception that

\begin{itemize}
  \item \textsuperscript{37} \textit{Id.} at 10.
  \item \textsuperscript{38} See Bocian, \textit{supra} note 2.
  \item \textsuperscript{39} Dickerson, \textit{supra} note 12, at 400.
  \item \textsuperscript{40} A. Mechel Dickerson, \textit{The Myth of Home Ownership and Why Home Ownership is Not Always a Good Thing}, 84 IND. L.J. 189, 219 (2009).
  \item \textsuperscript{41} \textit{Id.} at 220.
\end{itemize}
home ownership is always a sound investment. They are more likely to be African American or Latino, they will suffer long-term consequences, and their plight generates externalities that ripple throughout our economy and society. If government ever owed a duty to its citizens, pragmatism and compassion require that it engineer a lasting solution for troubled borrowers.

II. AVERTING FORECLOSURE: MEDIATION AND THE FORECLOSURE FAIRNESS ACT

A. Foreclosure Alternatives and their Limitations

Even in the absence of government intervention, underwater borrowers who have entered default generally have a variety of options to avert foreclosure. Each of these alternatives, as illustrated below, has serious shortcomings.

1. Short-Term Options

Those who have only temporarily lost their ability to make payments due to an acute circumstance such as illness can seek a repayment plan in which delinquent payments are distributed over time. In uncommon cases of severe hardship, they may also qualify for a forbearance, which allows a short-term suspension or reduction of payments. But these solutions are only helpful to borrowers who face short term mortgage difficulties, not to victims.

42 Id. at 215-216.
43 See sections I(C) and I(B), above.
44 A mortgage holder is "underwater" if he or she is unable to sell a home because the outstanding loan balance exceeds the home's current market value. See Eggert, supra note 20. This discussion of foreclosure alternatives is particularly relevant to underwater borrowers because others may have the more straightforward option of selling their home for profit to avert foreclosure.
of predatory lending whose inability to afford their mortgage may be more enduring.

2. Loss Mitigation

At the opposite extreme, borrowers with a home which they cannot remotely afford may exit the mortgage "gracefully" by surrendering their interest in the property via a deed-in-lieu of foreclosure, assumption of the mortgage by a third party, or short sale.\footnote{Id. at 33-34.} While these alternatives offer some advantages, especially by expediting the repossession process and saving borrowers' credit from the effects of foreclosure, they still require the borrower to surrender his or her home.\footnote{See Id.} Therefore they still carry many of foreclosure's worst consequences including homelessness, loss of investment, disruption of community, and emotional trauma. For this reason they do not constitute complete "solutions" for troubled homeowners.

3. Modification

For defaulting borrowers who want to stay in their homes but cannot afford their payment plan as structured, loan modification may be the best alternative to foreclosure. Modification involves a re-negotiation of the loan contract's terms wherein lenders agree to drop interest rates, extend the repayment term, and/or forgive a portion of the principal.\footnote{SEATTLE KING CTY. ASSET BUILDING COLLABORATIVE, supra note 47.} And it often makes financial sense for both parties. It eases a lender's repayment obligations, and because it allows lenders to avoid costly foreclosure, it can save them money.\footnote{Diane E. Thompson, Foreclosing Modifications: How Servicer Incentives Discourage Loan Modifications, 86 WASH. L. REV. 755, 759 (2011).} Unfortunately lenders regularly proceed with foreclosure even where modification would best serve their interests.\footnote{Bernanke, supra note 34.} This market failure is largely a result of the widespread securitization of mortgage assets: securitization puts control of the foreclosure process in the hands of the loan's
servicers, and their interests are misaligned with those of the mortgage’s diffuse investor pool.\textsuperscript{52}

4. Judicial Challenges

In a number of states homeowners have the option of defending against foreclosure in litigation. Because it is largely governed by the states, U.S. foreclosure law is not uniform. About 40 percent of states require foreclosures to proceed judicially, obliging lenders to file an action in court to repossess a property through foreclosure.\textsuperscript{53} The remaining states permit lenders to foreclose without judicial supervision via "power of sale." There the deed to a mortgaged property can be sold automatically by a third party trustee, without any judicial supervision or procedural restraints, after the borrower defaults and has received due notice.\textsuperscript{54}

Two practical realities arise from this distinction. Judicial foreclosure is slower and more costly, taking an average of 148 days longer than power of sale, but it also offers a procedural safeguard against lender abuses.\textsuperscript{55} In a typical judicial action, the borrower has the opportunity to contest foreclosure by presenting defenses such as fraud, fraudulent inducement, breach of fiduciary duty, and violation of the Truth in Lending Act, among others.\textsuperscript{56}

A recent jurisprudential development in Massachusetts may have provided homeowners in both judicial and non-judicial states\textsuperscript{57} with another tool for challenging foreclosure in court.\textsuperscript{58}

\textsuperscript{52} Id. A more detailed explanation of the flawed incentive scheme inhibiting modifications is offered in Part II(B), below.


\textsuperscript{54} Id.


\textsuperscript{57} Although it resulted from a judicial action, this development is not limited to judicial foreclosure states because Massachusetts foreclosures may proceed without judicial actions via power of sale. See MASS. GEN. LAWS ch. 183, §21 (2011).
The state's Supreme Court invalidated several foreclosures because ownership of the mortgages had been securitized and the foreclosing servicers were unable to show a clear chain of title. Given the widespread use of securitization in mortgage finance today, this could have far reaching implications for borrowers. However, judicial challenges of this kind offer most victims of the crisis little hope because few can afford representation to mount a legal defense.

**B. State Facilitated Foreclosure Mediation: The Most Promising Public Response**

1. The Absence of a Federal Solution: HAMP's Failure

The most significant federal attempt to assist homeowners facing foreclosure, the Home Affordable Modification Program (HAMP), has had disappointing results. In February of 2009, the Obama Administration unveiled the plan as its response to the epidemic. The program committed $75 billion to incentivize loan modifications by offering direct payments to lenders for each successful modification of a delinquent borrower's mortgage. HAMP appeared to have significant potential to assist homeowners. Lenders only qualified for subsidies if they made sufficient concessions to reduce mortgage payments to 38% of the borrower's monthly income.

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58 See Recent Case, Massachusetts Supreme Judicial Court Unanimously Voids Foreclosure Sales Because Securitization Trusts Could Not Demonstrate Clear Chains of Title to Mortgages, 125 HARV. L. REV. 827, 833 ("the Ibanez court's resolution of this issue may serve as a model for other state courts. . . and it provides mortgage loan borrowers with another potential defense to foreclosure.").


60 See McCoy, supra note 16.

61 See Brescia, supra note 36, at 309 ("Unfortunately for many subprime borrowers, they cannot afford an attorney to defend them in such an action, and the complicated defenses that might be available are often too difficult to raise without an attorney.").


63 Id.

64 Id.
From the outset, however, the program performed poorly. In its first year only about 230,000 out of almost four million troubled borrowers (about 6%) entered permanent modifications under the program, and performance was "anemic" thereafter. Despite the promise of subsidies, HAMP failed to get lenders on board. Participation was entirely voluntary, and the administration excluded any enforceable requirements of lenders for fear of threatening the overall economic recovery. The program also admitted only those borrowers that were already in default and could show financial hardship. Although it has helped a limited number of homeowners, HAMP has failed to have a significant effect on the foreclosure crisis as a whole.

2. State Efforts to Facilitate Mediation

The absence of an adequate federal response to the crisis has made state level policies for foreclosure reduction all the more essential, and foreclosure mediation programs have emerged as the most promising approach. The basic appeal of mediation in this setting is intuitive: because foreclosure represents a negative outcome for both borrowers and lenders, it is not a prize to be won but a loss to be avoided. A consultation between borrower and lender in the presence of a neutral third party offers a better opportunity to explore alternate outcomes than the adversarial setting of judicial foreclosure or the automatic process in power of sale, and it helps to equalize the significant power differential between borrowers and lenders.

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68 Id.

69 See section I(B), above.
Twenty-five states and the District of Columbia have now implemented mediation programs in one form or another. Many, however, have failed to incorporate concrete requirements of lenders and therefore do little to encourage modification. The most successful attempts have shown that strong mediation programs can increase loan modifications and reduce foreclosures with no delay in the foreclosure process, and because many involve modest fees collected from the parties, they can do it at little or no cost to the state.

C. The FFA's Approach to Foreclosure Mediation

House Bill 1362 was signed into Washington law as the Foreclosure Fairness Act on April 14, 2011. The FFA made Washington only the third non-judicial foreclosure state, after Nevada and Maryland, to implement a foreclosure mediation program. It contains strong provisions with significant potential, and because Washington foreclosures can proceed without judicial oversight, it represents an effort to afford all delinquent

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70 See NAT'L CONSUMER LAW CTR., Foreclosure Mediation Programs by State, http://www.nclc.org/issues/foreclosure-mediation-programs-by-state.html (last visited Mar. 16, 2012). The programs vary widely with respect to their strength. Some, such as a mediation diversion program in Philadelphia’s courts, are automatic, and mandatory and subject to judicial scrutiny. Others, such as California’s, are un-supervised and voluntary, imposing no direct obligations on lenders.


72 Geoff Walsh, Rebuilding America: How States Can Save Millions of Homes Through Foreclosure Mediation, NAT'L CONSUMER LAW CTR. 6-7 (February 2012).

73 Foreclosure Fairness Act, ch. 58, 2011 WASH. SESS. LAWS 580.

Washington homeowners access to a neutral third party process for the first time.  

1. Washington's Foreclosure Process Prior to the FFA

Washington's foreclosure requirements prior to the FFA resembled those in other non-judicial states. While it is possible to pursue foreclosure via judicial action in Washington, it is not required, and lenders generally avoid it in order to minimize cost and complexity. A lender has direct "power of sale" to foreclose without judicial intervention because Washington home loans, technically known as "deeds of trust," involve a third party trustee that holds the deed to the property until the borrower repays. Because it holds the deed, the trustee can directly repossess a property on a lender's behalf if the borrower defaults.

Under this system, the only procedural safeguards a lender must satisfy to foreclose on a delinquent mortgage involve a series of notice requirements. Before the FFA, a borrower who missed a payment was entitled to a warning notice from a lender, and as soon as 30 days after that the lender could issue an official notice of default marking the beginning of the foreclosure process.

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75 See Foreclosure Fairness Act, supra note 75 ("The legislature finds that. . . Washington's nonjudicial foreclosure process does not have a mechanism for homeowners to readily access a neutral third party to assist them in a fair and timely way.").


77 Although home loans in power of sale states such as Washington are most accurately called "deeds of trust" (See 59 C.J.S. Mortgages § 17), they are nonetheless colloquially referred to as "mortgages." For convenience and clarity to the average reader, this paper uses the term "mortgages" loosely to refer both to mortgages and deeds of trust.

78 Deeds of trust differ from mortgages in that the former involves at least three parties (a lender, a borrower, and a trustee who holds the deed) while the latter involves only two parties (lender and borrower). See 59 C.J.S. Mortgages § 17.

79 See Id. at § 16.

Thirty days after the notice of default a lender could issue a notice of trustee sale warning of impending foreclosure. This is the first public notice of foreclosure, and it must be posted in a conspicuous location on the borrower's property (often on the front door). Then the lender must publish the notice on two more occasions, after which it may sell the property and evict the borrower unless he or she cures the default prior to sale. The entire foreclosure process, therefore, could be completed unilaterally with nothing but a series of mailings and postings on the lender's part. Unless borrowers had the financial means and legal cause to challenge foreclosure in court, they were largely at lenders' mercy in any attempt to explore foreclosure alternatives.

2. Mandatory Mediation under the FFA

The FFA changed this by guaranteeing that borrowers facing foreclosure will have the opportunity to enter mediation prior to foreclosure. Thirty days prior to issuing a notice of default, lenders must send borrowers a mediation notice, the substance of which is prescribed by statute. This notice advises borrowers that they are in danger of losing their home but have a right to mediation and should contact a housing counselor immediately. Borrowers may then contact a Department of Commerce housing counselor or a private attorney who will refer them to mediation.

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81 Id.
82 Id.
84 Neas, Supra note 81.
85 For convenience, the term "lender" will hereinafter refer collectively to the loan's owners (i.e. the obligees or beneficiaries) as well as any of their agents, servicers, or trustees involved in the foreclosure.
87 Id.
88 Id.
Significantly, lenders must furnish an agent for mediation who has personal authority to agree to a proposed settlement that may alter the terms of the loan. This is a crucial requirement. Because mortgages today are often managed by large corporate servicers, and their ownership is diffused in a complex securitization scheme, if borrowers have the onus of finding the "right person" with sufficient authority to negotiate in this labyrinth it would often prove fruitless.

Mediation under these provisions is not strictly mandatory. Although it is required of lenders at a borrower's request, it is not otherwise required in order to foreclose. The responsibility of initiating mediation is on borrowers, and if they fail to do so they lose their right to it.

3. The Requirement of Good Faith and its Corollaries

Most significantly, the FFA requires lenders to consider the feasibility of available alternatives and negotiate to realize them in good faith. Mediators are required to submit reports to the department after all mediations certifying that the parties negotiated in good faith. A finding that the lender failed to proceed in good faith invokes judicial enforcement; it may be used by the borrower to enjoin foreclosure in court. Borrowers, too, must negotiate in good faith or the lender will be authorized to proceed with foreclosure.

The FFA's definition of what satisfies or violates the good faith requirement gives rise to some of its most powerful

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90 See McCoy, supra note 15.
91 WASH. REV. CODE 61.24.031(1) (2012) (informing borrowers that if they do not respond within 30 days of the pre-foreclosure options notice a notice of default may be issued and they may lose their house).
92 Id.
94 Id. at (11)(a). Notably, however, the provision specifically explains that this finding may be used to enjoin the non-judicial foreclosure action that was the basis for the mediation, implying that a lender could still pursue judicial foreclosure after a finding of failure of good faith. Whether lenders would choose to invoke this option, and whether they would succeed, remains to be seen.
95 Id. at (12).
requirements, especially given a recent amendment clarifying its language. A lack of good faith on the part of either party is defined as a) failure to participate in a timely manner, b) failure to provide certain documents to the mediator as required by the Act, c) failure to furnish an agent empowered to agree to negotiated settlements, or d) an inappropriate request by the borrower that the lender waive certain future claims.

This definition gives the FFA its teeth. The requirement to provide necessary documentation is key because it triggers another provision that describes the documents a lender must submit. Among these are documents detailing both the lenders' financial calculation as to the feasibility of a loan modification and documents explaining, in reasonable terms, the basis for any decision not to modify the loan. As will be discussed in further detail below, these requirements may go farther than any other toward encouraging permanent loan modifications and avoiding foreclosures.

D. Making Modification More Likely: The FFA’s Greatest Strength

1. Modification's Appeal as a Foreclosure Alternative

Long-term loan modification remains a best-case alternative to foreclosure. For homeowners, sustainable

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96 See E.S.H.B. 2614, 62nd Leg., 2012 Reg. Sess. (Wa. 2012) at 13-17. As of the date of this article's submission the amendment has passed both the house and senate almost unanimously and awaits only the governor's signature, who is expected to sign it. For the purposes of this analysis, the author presumes it will become law. The amendment simplifies the good faith requirement by reducing what was a long list of circumstances constituting a lack of good faith to just four key ones, the most important of which may be (10)(c): failure to submit required documents. See Id. at 16-17. This in turn triggers provisions detailing the documentation to be required from lenders including their modification analysis. See Id. at 13-14.

97 Id.

98 Id. at 14 (requiring documentation of "[a]ll borrower related and mortgage related input data used in any net present value analysis" and "[a]n explanation regarding any denial for a loan modification, forbearance, or other alternative . . . .").
Modification may represent a true solution because it can reduce monthly payments to a manageable level. In so doing, it remedies the central problem that helped create the foreclosure crisis: overextension of credit through predatory lending. And as a matter of public policy, this solution averts the personal and societal costs of foreclosure by permitting the borrower to keep his or her home.

Modification also offers lenders an opportunity for significant savings over the high cost of foreclosure. When weighing the relative desirability of these two options, lenders typically consider a "net present value" (NPV) calculation that allows them to weigh the losses to be incurred from a foreclosure sale against the cost of modification and its accompanying risk of re-default. If the modification scores a better NPV than foreclosure, it is in the lender’s best financial interest to modify. And modification often does score a better NPV: on average, it results in smaller losses for lenders than foreclosure.

Despite its potential, however, loan modification remains an elusive outcome: only about three percent of mortgages in serious default undergo it. This almost inscrutable market failure may be preventing countless troubled homeowners from avoiding foreclosure while simultaneously exacerbating lenders’ losses. Any

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99 Not all modifications are a blessing. Many modifications have involved a mere short term reduction in monthly payments which, once it expires, leaves the borrower back where he or she started. Others restructure the terms of the loan but fail to reduce monthly payments and sometimes even increase them. Such modifications usually end with the homeowner back in default. Modification is only a worthy solution if it offers a sustainable alternative payment arrangement for the homeowner. See Thompson, supra note 45, at 760.


101 Id.

102 See note 31.

103 The NPV is a financial tool that helps investors calculate the anticipated future costs and proceeds associated with an investment and convert those figures to a current cash value. See Kazakes, supra note 101, at 1419.

104 Walsh, supra note 74, at 12.

105 Kazakes, supra note 98, at 1399.

106 Paul Kiel, Banks Modifying Tiny Percentage of Mortgages in Need, PROPUBLICA (Nov. 22, 2010), http://www.propublica.org/article/mortgage-modifications-rare-as-they-were-19-months-ago.
public policy intended to reduce foreclosures must address this obstacle to have a significant impact.

2. Factors Inhibiting Modification

   a. Poor Communication and Borrower Ignorance

   In the absence of governmental intervention, several factors are discouraging loan modification in the marketplace. First, the mere absence of dialogue between borrowers and lenders is a major inhibitor. Freddie Mac reports that, of borrowers who have lost their home to foreclosure in recent years, 50% never once communicated with their lender.107 This is especially troubling given that another Freddie Mac survey reported 61 percent of delinquent borrowers were entirely unaware that there are alternatives to foreclosure.108 When asked why they failed to either initiate or return communications with their lenders, borrowers most frequently cited a belief that their prospects were hopeless and that lenders would be unable or unwilling to help.109 Modification is a renegotiation of the mortgage's terms, but renegotiation is impossible in the absence of dialogue between parties. Delinquent borrowers must be aware of their options and willing to talk for modification to be plausible.

   b. Misaligned Servicer Incentives

   Another major impediment to modification is a misalignment of incentives between lenders and mortgage servicers. The word "lender" is often used loosely in reference to a group of entities that includes both servicers and investors. Investors are the true "lenders:" it is they who are owed the loan's principal, and only they have an ownership interest in the

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108 Id.
109 Id.
mortgage. Servicers, on the other hand, are entities who manage mortgages on investors' behalf in exchange for fees. It is the servicers who generally collect mortgage payments, conduct foreclosures, and negotiate modifications.

This dichotomy is one of mismatched incentives. Because mortgage investors are generally a large, diffuse, and unwieldy group of individuals whose ownership interest in the property is securitized, they have all the power but none of the control. They can seldom influence servicers' actions, and servicers remain insulated from investors' incentives as a result. Servicers operate with their own set of incentives based on fees, administrative costs, and third party organizations, all of which motivate them in ways that are often at odds with the investors they represent. And unlike investors, servicers do not usually lose money on foreclosures. In fact, they sometimes make more money from foreclosing than from modifying. These incentives encourage servicers to pursue foreclosure even where modification would be better for the investor.

c. The Lack of Mandatory and Enforceable Public Policies

One final explanation for modification's scarcity is the absence of mandatory programs designed to foster it. HAMP's failure to generate a tide of modification resulted from several flaws, but the single biggest was its voluntary nature. Before HAMP's implementation, servicers' fear that the government would impose a mandatory program caused modifications to go up,
but once the program's final form was unveiled, they declined.\textsuperscript{118} The mere anticipation of a mandatory program may have stimulated modification, and the introduction of a voluntary one depressed it. And not only was participation in the program voluntary, but the components within it also lacked enforcement and accountability. HAMP required servicers to consider whether modification involving a principal or payment reduction would benefit a loan’s investors, but the program did not require them to implement those reductions even where they would clearly save lenders money.\textsuperscript{119}

Under-performing state mediation programs offer a similar lesson. Many of the earliest and weakest state attempts failed to place meaningful, enforceable obligations on lenders.\textsuperscript{120} In 2009, the National Consumer Law Council opined: "If the programs continue to demand little or no accountability from servicers, they will likely go the way of other efforts to control foreclosures that relied on voluntary compliance by the lending industry."\textsuperscript{121}

3. The FFA Addresses Modification's Inhibitors

\textit{a. Communication and Participation}

Many of these obstacles are addressed in Washington's FFA, thus making modification more attainable. First, the program takes steps to involve delinquent borrowers in the foreclosure process and educate them about alternatives. Mediation participation is voluntary for borrowers, and there may always be those who choose to ignore the process. However, two aspects of the program are likely to bring more homeowners into the fold.

By design, mediation programs tend to bring borrowers into contact with housing counselors.\textsuperscript{122} The FFA does this by providing funding to double the number of public counselors in the state.\textsuperscript{123} This form of involvement is critical: one study found that

\textsuperscript{118} Id.
\textsuperscript{119} Id. at 826-827.
\textsuperscript{120} Walsh, supra note 73, at v.
\textsuperscript{121} Id.
\textsuperscript{122} Walsh, supra note 74, at 6.
\textsuperscript{123} Bhatt, supra note 75.
homeowners who received counseling were 1.7 times more likely to avoid foreclosure.\textsuperscript{124} And by educating and encouraging delinquent borrowers, counselors can help relieve the sense of resignation and hopelessness that prevent so many of them from opening a dialogue with lenders.\textsuperscript{125}

The FFA's notice requirements are also likely to increase borrower awareness and participation. First, the mediation notice that borrowers receive before the foreclosure process begins includes information on foreclosure's alternatives and on their rights under the FFA.\textsuperscript{126} This could help educate borrowers at a critical early stage before the notice of default arrives triggering anxiety and despair. Second, lenders must satisfy an exhaustive due diligence requirement when attempting to initiate contact with a borrower involving a series of calls and letters over multiple weeks.\textsuperscript{127} This could further increase the likelihood of dialogue.

Finally, the act's most recent amendment grants borrowers more time to request mediation in an especially promising way: they now have until 20 days after of the notice of foreclosure sale to initiate the process.\textsuperscript{128} The period immediately after the notice of sale may prove a particularly fertile one for mediation requests. Because this notice is posted on the property's front door,\textsuperscript{129} it can serve as a "wake-up call" for some borrowers, helping them realize that they are in imminent danger of foreclosure and in need assistance.

\textit{b) Enforceable Requirements of Lenders and Servicers}

The FFA's enforceable requirements for lenders have the potential to bypass problematic servicer incentives and encourage modification. The Act requires servicers to submit documentation of their NPV\textsuperscript{130} analysis along with a written statement explaining their rationale for any decision not to modify a loan.\textsuperscript{131} It also

\textsuperscript{124} \textit{Id.}
\textsuperscript{125} See note 106.
\textsuperscript{126} See note 86.
\textsuperscript{127} \textit{WASH. REV. CODE} 61.24.031(5) (2012).
\textsuperscript{128} E.S.H.B. 2614, \textit{supra} note 94, at 12.
\textsuperscript{129} See note 83.
\textsuperscript{130} "Net Present Value" calculations. See note 103.
\textsuperscript{131} See note 96.
requires the parties to "address" any issues and alternatives that may enable the borrower to keep his or her home, such as loan modification, as part of the mediation.\textsuperscript{132}

Finally, it requires the parties to negotiate in good faith to realize these alternatives.\textsuperscript{133} A lender's failure to provide the necessary documents or to demonstrate a good faith effort to avoid foreclosure could trigger a finding of bad faith by the mediator, thus permitting the borrower to enjoin foreclosure.\textsuperscript{134} This last provision gives the Act teeth and will help it avoid the failures of voluntary mediation and modification programs.

The good faith requirement may appear unenforceably vague at first, but the standard can have a concrete legal effect in this context. Washington courts have not yet interpreted the FFA's language, but other states offer persuasive authority for defining good faith mediation. In \textit{Wells Fargo Bank, N.A. v. Hughes},\textsuperscript{135} a New York Court dismissed a lender's foreclosure action after a finding of bad faith. A state anti-predatory lending statute granted defaulting recipients of subprime adjustable rate mortgages the right to a renegotiation conference, and it required lenders in the conference to make a good faith effort to avoid foreclosure.\textsuperscript{136} In this instance, however, the lender obstinately refused to alter the mortgage to include a fixed rather than an adjustable rate, and it only offered the struggling borrower a modification agreement that would actually have increased her monthly payments by 35\%.\textsuperscript{137} The Court found that this behavior violated the statute's good faith negotiation requirement and dismissed the foreclosure action accordingly.\textsuperscript{138} Similarly, in \textit{BAC Home Loan Servicing v. Westervelt},\textsuperscript{139} a New York Court found bad faith when a servicer provided poor and inconsistent reasons for its denial of a HAMP modification. As these cases illustrate, the statutory good faith negotiation requirement can have a concrete legal effect, and lenders who disregard it may jeopardize their ability to foreclose.

\begin{footnotes}
\footnotetext{133} \textit{Id.} at
\footnotetext{134} See note 92.
\footnotetext{135} 897 N.Y.S. 2d. 605 (Sup. Ct. Erie Co. 2010)
\footnotetext{136} \textit{Id.} at 608.
\footnotetext{137} \textit{Id.} at 610.
\footnotetext{138} \textit{Id.}
\footnotetext{139} 29 Misc.3d 1224(A), (N.Y. Sup. Dutchess Co., 2010)
\end{footnotes}
Taken together, the FFA's requirements of lenders have the potential to make any feasible modification a reality despite servicers' problematic incentives. A servicer who discloses NPV calculations showing that modification would cost less than foreclosure, but who nonetheless refuses to modify, is put in a precarious position by these provisions. If the servicer's own calculations plainly show that modification would be more profitable to the lender, it will be hard pressed to justify a subsequent foreclosure to the mediator's and borrower's satisfaction. Given the severe consequences resulting from a bad faith finding, servicers in mediation would be wise to heed the FFA's requirements in earnest.

E. Problems With Implementation: Servicer Intransigence

Despite all its promise, the FFA's implementation has not been without difficulty. Although no official data on the Act's performance will be available until December of 2012, practitioners with exposure to its early implementation offer valuable insights. This anecdotal evidence suggests that the chief roadblock in realizing the FFA's full potential has been intransigence on the part of servicers in mediation. Many have

140 See WASH. REV. CODE 61.24.163 (15) (requiring the department of commerce to submit performance statistics on the mediation program to the state legislature every year beginning on December 1, 2012). However, a department of commerce official generously provided the author with preliminary statistics based on the first six months of the program's implementation. As of March 21, 2012, there had been 1165 referrals to mediation. So far, 117 of these have resulted in an agreement, 147 resulted in no agreement, 23 resulted in a finding of borrower bad faith, and 19 result in a finding of lender bad faith. The dept. official stressed that these statistics were too preliminary to form the basis of any analytic inferences. E-mail from Leslie Wolff, Mgmt. Analyst, Cmty. Serv. and Hous. Div., Wash. State Dep't of Commerce, to [author's name redacted in accordance with WLR competition rules], J.D. Candidate, University of Washington School of Law (Apr. 9, 2012, 15:50 PST) (on file with author).

141 Because this is an early stage in the FFA's implementation, published research and analysis of its performance remain scarce. For this reason, section II(D)'s factual observations are based entirely on anecdotal evidence obtained from practitioner interviews.

142 Conference Telephone Interview with Catherine West & Lili Sotelo, Attorneys, Northwest Justice Project (Mar. 8, 2012) (Ms. West is a foreclosure prevention attorney who has represented borrowers in FFA mediations. Ms.
adopted an adversarial approach and tone in mediations, treating the discussion more like a litigation to be won than a negotiation to be resolved. It is apparent that many servicers still intend to make a case for the borrower's delinquency and push for foreclosure even in this non-adversarial context.

Many servicers have also been slow to comply with the Act's requirement of good faith in an apparent attempt to test their limits under the new regime. Borrowers' representatives and mediators have met with resistance when requesting that servicers provide documentation of their NPV calculations as required by the statute. Some servicers have evasively claimed that they do not perform these calculations unless they have already formed an intent to modify the loan. This excuse, however, lacks credibility. The NPV is widely used in the mortgage industry as a mechanism for assessing the attractiveness of modification. This purpose is rendered mute if the calculation is performed only after the modification decision has been made. Some servicers have also failed to produce agents with sufficient authority to approve negotiated alterations to the mortgage as required by the statute. This, too, constitutes a violation of good faith as defined by the FFA.

In some cases, only a borrower's threat of litigation is sufficient to force FFA compliance. This tactic can be effective, but it is impracticable for borrowers without an attorney, and many homeowners enter both mediation and foreclosure without representation. And while the mediator's presence as a supervisory force is helpful, it falls short of discouraging servicers' misconduct in all instances. Mediators have the power to issue a finding of bad faith, but many are attorneys from other areas of practice who have far less experience in residential foreclosure than the sometimes

Sotelo has organized and conducted training sessions for FFA mediators and has regularly been invited by the Washington State Legislature to offer testimony on the FFA from her expertise).

143 Id.
144 Id.
145 Id.
146 Kazakes, supra note 104.
147 West, supra note 142.
148 Id.
aggressive servicer representatives before them. For these reasons, although the FFA's requirements offer an effective mechanism for promoting sustainable modification, unrepresented borrowers in mediation are left with the impracticable burden of enforcing the Act themselves against servicers adopting a dubiously loose interpretation of those requirements.

F. Recommendation

Anecdotal evidence from the FFA's implementation indicates that Washington's mediation program will reach its fullest potential only with firm judicial precedent. Borrowers frustrated by servicer intransigence should bring litigation to force FFA compliance. In response, Washington courts should concretely reinforce both the scope and the seriousness of the FFA's obligations on lenders. Recent judicial developments in Nevada offer a good model for this.

The FFA was based partly on the Nevada model of foreclosure mediation. Nevada's program is substantially similar to Washington's: it requires lenders to pursue foreclosure's alternatives in good faith, submit their NPV calculations to mediators, and furnish an agent with personal authority to renegotiate the loan's terms. During the first two years of the Nevada program mediators enforced these requirements unevenly, and servicer compliance was unreliable.

However, two recent Nevada Supreme Court decisions mandate a more consistent approach. In both cases, servicers had attended mediation without all the documentation required by statute, and they furnished representatives who lacked clear authority to alter the terms of the mortgage. The Court ruled that compliance with the mediation statute's clear requirements must be strict, and it enjoined the foreclosures accordingly. These

\begin{footnotes}
\footnote{149} Id. \\
\footnote{150} Id. \\
\footnote{151} See Walsh, supra note 74, at 27. \\
\footnote{152} Id. \\
\end{footnotes}
decisions sent a message to mediators and lenders that the mediation program's requirements are enforceable and concrete.\footnote{Walsh, supra note 74, at 27.}

Washington has a similar statute and faces a similar problem: servicers appear to be testing the system's limits and inconsistently complying with the FFA. Clear legal precedent, establishing both that the requirement of good faith is strict and that failure to comply will jeopardize the lender's ability to foreclose, is needed. Like a warning beacon, this could set boundaries for servicers in mediation and encourage uniform compliance.

\textbf{CONCLUSION}

The excesses in subprime lending that sowed the seeds of 2008's financial collapse have left an indelible mark on the national economy and ignited a surge in home foreclosures that may endure for years to come. Subprime borrowers, a disproportionate share of whom reside in poor or minority communities, were victimized by a predatory system. Many now find themselves in foreclosure without the information, financial resources, or lender cooperation necessary to avert disaster. And high foreclosure rates harm lenders, communities, and governments as well as borrowers.

Foreclosure is often avoidable; defaulting homeowners have several alternatives. While many of these represent infeasible or undesirable outcomes for most borrowers, one alternative, loan modification, has significant promise. It offers homeowners a means of keeping their homes and lenders a means of mitigating their losses. But this solution is realized too infrequently because a lack of lender-borrower dialogue and a perverse system of servicer incentives have suppressed it. Given the high societal costs of foreclosure and the market's failure to correct the problem in the absence of government intervention, an effective public response is needed.

State sponsored mediation programs offer one of the best solutions available for stemming the tide of foreclosure. In Washington, the Foreclosure Fairness Act represents a strong
example of such a program. It addresses the factors inhibiting modification by fostering borrower involvement and establishing enforceable requirements of lenders. The Act requires lenders to furnish an agent empowered to alter the mortgage, submit their NPV calculations to the mediator, justify any decision not to modify, and negotiate in good faith to avert foreclosure. And non-compliance with these provisions can jeopardize their ability to foreclose. Although the act's initial implementation has been hindered by servicer intransigence, if Washington courts follow Nevada's lead by interpreting the FFA to require strict compliance it will cement these duties and incentivize positive outcomes for both lenders and borrowers.

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