Mortgage Defense and the Law of Restitution

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April 16, 2012

Wanton and willful financial misconduct in the origination, securitization, servicing and foreclosure of a mortgage debt will not bar collection and enforcement of the debt. Notwithstanding the creditor's misconduct, the sanctity of debt is the controlling and paramount variable. Judges believe that absent strict enforcement of the obligation to repay debt, the engine of commerce will grind to a halt without lubrication of the gears with commercial credit.

Courts throughout the country faced with the choice of enforcing rules or protecting the flow of commercial credit have overwhelmingly found it in the public interest to enforce debt. Accordingly the courts have accorded judicial license for continued egregious and demonstrable financial misconduct by banks engaged in single family residential mortgage lending.

Robosigning, forged signatures, fraudulent documents, non-compliance with the requirements prescribed by Chapter III and Chapter IX of the UCC, payment by a third party of debt installments, lack of possession of the original mortgage note endorsed in blank have all been disregarded or disallowed by courts as defenses to the enforcement of a mortgage debt.

What price has this expedient accommodation of commerce exacted? By overlooking wanton and willful financial misconduct, we have sacrificed transparency, accountability, regulatory oversight judicial integrity, objectivity and neutrality and due process. The foray into judicial activism and realism has preferred the certainty of an outcome favorable to the creditor banks over disinterested adherence to legal authorities.

Unarticulated has been the rationale which underpins the legal outcomes. Often, it seems as if the judge knows the destination to be reached without being able to explain how the court got there. The substructure is predicated upon the law of restitution. Judges realize that current statutory and case law are woefully behind the curve when it comes to the technological transformation of the business landscape. The courts have still not caught up with the changes wrought in the secondary mortgage market by the impact of digital technology upon the origination, securitization, servicing and foreclosure of mortgages.

Courts have had great difficulty reconciling digitized transactions customarily used in mortgage based transactions and the legal requirements for paper records, signatures, precisely defined legal instruments. Business practices have changed while legal requirements have not. Accordingly, the courts have felt themselves constrained to fight a vanguard action to buy time for legislative changes to be made. In the meantime, business must continue to be conducted. There is no timeout or half time interval in commerce.

Instinctively, because most judges appear to be unaware of this, the courts have created a new rule of restitution. Restitution is a claim by a person to recover property which belongs to the person from another person to whom the property does not belong. It is based upon the theory of ”unjust enrichment”. To allow the other person to keep property which does not belong to the person thereby working its deprivation upon the person to whom it does belong creates a windfall of unearned enrichment and justifies restoring the property to its rightful owner. The bottom line is the bottom line: so long as a debtor is in default, the debtor has suffered no harm as a result of creditor's enforcement of the mortgage agreed to by both parties.

In a nutshell, the law of restitution has been relied upon in foreclosure. Acting under equity, courts have determined that, notwithstanding the misconduct of the creditor and its agents, to disallow the debt works a greater injustice. Enforcing the debt to prevent unjust enrichment of the debtor is the paramount and controlling variable. Courts have used a variety to legal constructs to implement this rule including theories of equitable assignment, restitution, equitable subrogation and constructive trust. To reach the desired outcome, courts have barred procedural and substantive foreclosure defenses. For example courts have ruled:

• that affirmative defenses are "outside the four corners" of the document,

• the Master Pooling and Servicing Agreement is a contract of sale and assignment of the mortgage portfolio, and

• a copy of a note endorsed in blank suffices for a claim of payment and foreclosure in the event of default.

To prevent unjust enrichment, courts have, for example:

• overlooked forged documents,

• disregarded noncompliance with notice and service requirements,

• ignored robosigning,

• relied upon meretricious documents,

• waived lack of standing,

• disregarded Chapter III of the UCC, Negotiable Instruments,

• disregarded Chapter IX of the UCC, Secured Transactions,

• circumvented the law of contracts,

• refused to apply the "unclean hands" doctrine in an equity proceeding.

The outcome is always the same. The right guy got paid. The wrong guy was not unjustly enriched. Consequently, wanton and willful financial misconduct in the origination, securitization, servicing and foreclosure of a mortgage debt will not bar collection and enforcement of the debt.

This still leaves the question precisely what must the creditor show. A court may require a showing that the creditor is the right guy to get paid as well as the debtor is the wrong guy to be enriched. Alternatively, the court could simply require a showing that the debtor is in default to enforce the mortgage. In this event, there would be no requirement of evidence that the debtor is legally entitled to collect the debt. The law of restitution would allow the right creditor to file suit to collect from the wrong creditor. However, the debtor could not raise a defense that the creditor was not legally entitled to receive payment. In the latter case, so long as there is evidence that the debtor is in default, even a ham sandwich can foreclose. The latter rule invites thieves and miscreants to attempt to collect and foreclose in the event of default a loan owned by another party. Nevertheless, courts routinely disregard evidence that the plaintiff seeking to enforce the loan does not own the loan.

What does all this mean for mortgage defense. It means the tactics used have implemented an incorrect strategy. The arguments typically made results in a defense which will be ignored by the court. Defense counsel is unable to make an argument that can convince the court, namely that curing the default by foreclosure works a greater harm than forgiveness of the debt. When it comes to foreclosure, restitution talks; every other defense walks.

What problems are created by reflexive use of the restitution rationale?

1. It rewards creditor misconduct and noncompliance with legal authorities, enacted, decisional and regulatory. When it comes to blanket use of the restitution rule, as one notorious foreclosure mill operator phrased it: “Su casa es mi casa.” It does not matter what a creditor does to a debtor, it still remains “Give me my money or I take your house.” The restitution doctrine is a license for predatory banking and investment practices.

2. If the putative creditor does not have to submit evidence showing ownership of the debt, anyone-including a thief in the night-can foreclose on a home in default.

3. The rule as applied flouts federal and state efforts to regulate loan origination, securitization, servicing and foreclosure.

4. It invites the court to ignore the substantive and procedural due process rights of the means that unless the pleading is made, it is waived and cannot be raised in subsequent litigation.

What is missing from this picture? Defense counsel must recognize not ignore the restitution rationale. If allowing the debtor to avoid repayment of the debt is wrong, overlooking misconduct by the creditor is also wrong even if the lesser wrong. The new rule of the case appears to be that unjust enrichment by disallowing the debt is an inequitable remedy for creditor misbehavior. Nevertheless, this rule does not hold that every remedy against the misbehavior of the creditor is inequitable. Restitution is a two edged sword.

If it is wrong to enrich the debtor by allowing the claim, it is also wrong to enrich the creditor for its misconduct. Equity should never tolerate such asymmetric, invidious imbalance. There is no reason in law or in equity to require the creditor not to be held accountable for proven misconduct. Typically, court rules have sanctions for misbehavior in court proceedings by counsel or counsel’s client. Similarly, most state court rules of civil procedure provide for setoff and counterclaim, in many cases making such pleadings mandatory. Mandatory pleading means that unless the pleading is made, it is waived and cannot be raised in subsequent litigation.

What I am suggesting is a revision of defense strategy as follows:

(a) Where possible, argue that the creditor is not a holder in due course.

(b) For every affirmative defense, raise a setoff or counterclaim for monetary damages.

(c) Demonstrate that each counterclaim is mandatory and must be pled in the foreclosure proceeding. Otherwise, it is waived.

(d) Raise claims related to origination, securitization, servicing including unfair debt collection practices and foreclosure.

(e) Oppose creditor's motion to set off the counterclaim with the mortgage debt or a deficiency judgment because:

(i) Such a set off is premature prior to conduct of the foreclosure auction.

(ii) The remedy of damages is inadequate and inequitable if set of against the mortgage debt given creditor misconduct.

(iii) The set off is against public policy because it would not deter the misconduct in the future since the set off makes the award of damages for mortgage-based misconduct pointless.

(f) Request the court to stay the foreclosure (preempting creditor's Motion for Partial Summary Judgment to allow the foreclosure to proceed) pending a completion of the proceeding to allow the court to determine and debtor to argue that monetary compensation for creditor misconduct will be inadequate restitution to debtor.

The use of the counterclaim strategy promotes the use of alternate dispute resolutions instead of foreclosure. When it comes to the business of banking, it is all about the money. When a home is foreclosed, the lender usually realizes less than 50% of the amount of indebtedness. If added to this discount is a sizeable counterclaim which must be paid to the debtor and which cannot be set off against the debt, the net amount recoverable by foreclosure significantly exceeds the cost of the outcome of an alternate dispute resolution. In short, implementation of the counterclaim strategy will allow the courts to continue to collect filing fees for foreclosure cases which nevertheless are likely to be more expeditiously resolved with extra-judicial settlements.

The counterclaim strategy is not a "slam dunk" for mortgage defense. It takes time and money to discover and produce the evidence needed to support each counterclaim. In other words, the counterclaim strategy imposes time and expense costs upon debtor and creditor. For the debtor, winning a case is not cheap. For the creditor having to pay a counterclaim can become expensive. Business common sense should motivate each side to reach a compromise and accommodation. The whole point to drive home to the creditor is that successful foreclosure may become counterproductive for debt recovery. The creditor may win the battle, i.e. the foreclosure will take place but make an improvident recovery where the light cast is not worth the price of the candle.

Just because a court determines that the remedy of judicial cancellation of the debt is not warranted does not mean that willful mortgage related misconduct does not result in liability compensable by monetary damages.