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Lenders and Land

*Ann M. Burkhart**

Using land to secure loans has been a particularly durable human institution. Mortgages¹ have existed since antiquity,² primarily because land generally retains its value and is permanent and immovable. In societies with largely nonmonetary economies, such as feudal England, land also has been particularly valued as a source of livelihood and of power. Therefore, land has been and continues to be desirable security for loans.

To retain its utility throughout the centuries, the mortgage necessarily has evolved to reflect changing legal and economic conditions. As is to be expected, the modern American mortgage creates some very different rights and liabilities than the forms of security used during the earliest common law, when physical battle was a legally prescribed means of determining the existence of a debt and mortgage.³ In one very important respect, however, the modern mortgagee is becoming increasingly more like its feudal counterpart. Substantial economic and legal incentives now exist, as they did during the early common law period, for a mortgagee to be concerned with and knowledgeable about the condition and use of the mortgaged land.

In fact, the mortgagee's relationship to the mortgaged land now has entered its third era. The first era began with the earliest forms of common law mortgages in the twelfth century and ran until the late sixteenth and early

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1. For ease of reference, the term "mortgage" will be used throughout this Article to refer generically to all forms of real estate security. Although the various types of real estate security and the documents by which they are created differ, those differences are irrelevant to the discussion in this Article, except where specifically noted otherwise.

2. See LEONARD A. JONES, *THE LAW OF MORTGAGES OF REAL PROPERTY* § 1 (8th ed. 1928).

3. See RANULF DE GLANVILL, *A TREATISE ON THE LAWS AND CUSTOMS OF THE REALM OF ENGLAND* bk. x, ch. 12 (G.D.G. Hall trans., 1965). In fact, battle was the "normal method of trying title to land in feudal and in royal courts." *Id.* at 180.

seventeenth centuries. This era was marked largely by the absence of an established and standardized money economy in England and by a prohibition on charging interest. During this period, lenders' return on investments flowed directly from the encumbered land. The lender took possession of the land and legally was entitled to its economic and legal benefits. As the mortgage relationship evolved during this era, it increasingly focused on the lender's rights in the encumbered land. In fact, the mortgage's true nature became obscured by the trappings of ownership afforded the mortgagee.

The first era ended when lenders were permitted to charge interest on loans and an increasingly strong money economy became established in England. During the second era, which has continued into this century, the pendulum has swung in the opposite direction. Lenders and the law increasingly have shifted focus from the encumbered land to the debt. The second era has been marked by efforts to facilitate and to expand the capital markets and trade. Two prime examples are the creation of holder-in-due-course status and creation of the secondary mortgage market. An increasingly attenuated relationship between the lender and the mortgaged land has been a hallmark of this second era.

The third era is now underway. Just as economic forces caused the mortgagee's relationship with the encumbered land to attenuate, social forces are now causing it to contract. The enormously expensive problem of treating hazardous waste sites and the imposition of cleanup costs on lenders have been substantial and visible factors in the new era. The laws concerning hazardous waste are only one example of the current process of evolution in this country from protecting private property and contract rights to protecting the common good. Attempts to deter crime also have made property forfeitures a substantial concern for lenders. The enormity of these and other societal problems are causing governments that are attempting to deal with them to impose costs on mortgagees or to interfere with or destroy mortgage interests. In the face of these new realities, prudent lenders are increasingly vigilant about which properties they will accept as security for a loan and about the activities conducted on the properties both before and during the life of the loan.

This Article will demonstrate the changing nature of the mortgagee's relationship with the land during each era. The Article will show that, like humans, common law mortgages have been in a state of evolution since their first appearance. Also like humans, more recent mortgage forms are not necessarily superior to earlier mortgage forms; they simply have adapted to their environment.

I. THE FIRST ERA

The first era of mortgages was defined by a prohibition on charging interest. During this era, the Church prohibited Christian lenders from charging interest.

The Church characterized an agreement to pay interest as a form of usury.⁴ As described in Glanvill's twelfth-century treatise on English law, a Christian lender who died while holding a debt on which interest was payable died as a sinner. As such, his personal property was forfeited to the king and his land reverted to the lord of the fee, rather than descending to his heirs.⁵ Bracton describes the same prohibition in his thirteenth-century treatise on English law and customs,⁶ and statutes enacted in the fourteenth⁷ and fifteenth centuries⁸ continued this prohibition.

Charging interest was prohibited to prevent economic exploitation of people who were unable or unwilling to live within their means. At this time, lenders had few opportunities to lend money for trade or for other economically productive activities because of the undeveloped state of England's trade economy. Therefore, lenders' primary source of income was from necessitous individuals. In response, the Church and the State acted to protect those in need from lenders.⁹

Due to the prohibition on charging interest and the limited number of property interests recognized during this period, the key feature of each type of mortgage used during the first era was the lender's possession of the encumbered land. Despite the debt relationship that was the obvious basis for the lender's right to possess, the lawyers of this era struggled to fit the lender's interest within one of the recognized estates in land. As a result, as security interests evolved, they moved further from their actual character—a lien—to an artificially characterized fee ownership.

During the first era of mortgages, land security arrangements evolved through three primary forms—the Glanvillian gage, the Bractonian mortgage, and the Littletonian gage. The earliest security arrangement to gain widespread acceptance was the gage, which Glanvill described in his treatise on English law. Glanvill described two types of gage: the *vif gage* ("living pledge") and the *mort gage* ("dead pledge").¹⁰ Both types of gage authorized the lender to take possession of the pledged land and to collect the rents and profits. In fact, the lender's possession of the pledged land was an essential element of each type of

4. The courts of law did not prohibit charging interest because it was a matter of private contract. See ALFRED W. B. SIMPSON, AN INTRODUCTION TO THE HISTORY OF THE LAND LAW 132 (1961).

5. See GLANVILL, *supra* note 3, bks. vii, x, chs. 8, 16; see also Harold D. Hazeltine, *The Gage of Land in Medieval England*, 17 HARV. L. REV. 549, 552 (1904).

6. See 2 HENRICI DE BRACON, ON THE LAWS AND CUSTOMS OF ENGLAND fols. 116b-117, at 328-32 (George E. Woodbine ed. & Samuel E. Thorne trans., 1968).

7. See 15 Edw. 3, st. 1 ch. 5 (1342) (Eng.).

8. See Hen. 8, chs. 5, 6 (1509) (Eng.).

9. See 8 WILLIAM S. HOLDSWORTH, A HISTORY OF ENGLISH LAW 101-02 (2d ed. 1937).

10. GLANVILL, *supra* note 3, bk. x, chs. 6-11. See also 2 FREDERICK POLLOCK & FREDERICK MAITLAND, THE HISTORY OF ENGLISH LAW 119 (2d ed. 1898).

gage: "If delivery of the pledge itself do not follow, the king's court is not accustomed to take cognizance of private agreements of this kind."¹¹

The lender's possession of the land served three important needs that arose from the relative infancy of the common law of land. First, in the absence of a land recording system, possession was the primary method by which the lender manifested and protected its interest in the land. "As long as the administration of justice is slow, weak and formal, the creditor will secure himself by that possession which is said of old to be nine points in the law."¹² The lender's possession also prevented further pledges of the land; by possessing the property, the lender put potential future lenders on notice of its prior interest.¹³

Second, taking possession of the property and collecting the rents and profits was a thinly disguised means of avoiding the prohibition on interest. Although a *vif gage* required the lender to apply the rents and profits to reduce the outstanding debt, a *mort gage* did not. Instead, the lender could keep the rents and profits with no obligation to account to the borrower for them.¹⁴ Unsurprisingly, the *mort gage* was the more frequently used gage.

The third reason for the lender's possession of the pledged land was to facilitate the lender's remedy upon default. If a borrower defaulted and did not cure the default within any court-ordered redemption period, title to the land was forfeited to the lender.¹⁵ The forfeiture occurred regardless of the land's value in relation to the outstanding debt and regardless of the value of the rents and profits that the lender had collected during the life of the gage. Under these circumstances, it would not be surprising if a borrower were less than cooperative in recognizing the lender's rights to the land. If the lender was

11. WILLIAM BLACKSTONE, COMMENTARIES ON THE LAWS OF ENGLAND 160 n.38 (W. Lewis ed., 1902). See also 1 GARRARD GLENN, MORTGAGES, DEEDS OF TRUST, AND OTHER SECURITY DEVICES AS TO LAND § 2, at 4 (1943).

12. William H. Lloyd, *Mortgages—The Genesis of the Lien Theory*, 32 YALE L.J. 233, 235 (1923).

13. See 2 BLACKSTONE, *supra* note 11, at 160.

14. This treatment of rents and profits was the primary distinction between the *vif gage* and the *mort gage* and is the source of the names for the two different gages. Because the holder of a *vif gage* was required to apply the rents and profits to the debt, the pledge was "living." The *mort gage*, on the other hand, was "dead" because the pledged property was not generating a benefit for the owner. See GLANVILL, *supra* note 3, bk. x, ch. 8.

15. If the gage contract included a forfeiture clause specifying that title would vest in the lender upon default, the forfeiture automatically occurred upon default without court action. If the gage contract did not include a forfeiture clause, the lender would acquire title by means of a court action in which the court determined the enforceability of the gage and of the default. As an early recognition that the lender's primary interest should be in repayment of the debt and not in retention of the land, the court would condition forfeiture on the borrower's failure to cure the default within a court-specified redemption period. See GLANVILL, *supra* note 3, bk. x, chs. 6-8.

already in possession, however, no legal action would be necessary to enforce the borrower's forfeiture of title.

Paradoxically, although the lender was legally required to take possession of the property to create a valid gage, the law did not protect this possession. The lender was characterized as having seisin, but only a limited form—*seisina et de vadio* ("seisin by way of pledge"). Because of this limited interest, the lender had no cause of action if its possession was disturbed by a stranger to the title or even by the borrower in violation of the gage contract.¹⁶ Glanvill seemed to justify this result on the ground that the lender's real interest was in the debt and not in the land.¹⁷ Other commentators have theorized that the lack of protection was attributable either to the early stage of development of the possessory actions, which protected only freehold estates,¹⁸ or to the connection between the *mort gage* and usury.¹⁹

Whatever the reason, the lack of protection for the lender's possession was a substantial defect in the Glanvillian gage's utility. As a consequence of this problem, medieval conveyancers sought to recast the security relationship in the thirteenth century by retaining those features of the gage that were attractive to lenders—the rights to possess the secured land and to collect rents and profits—and by eliminating the gage's objectionable feature—the absence of protection for the lender's possession. To be protectable, the interest had to be legally recognized. Therefore, choosing from the limited estates in land recognized at this time, lawyers recast the security transaction as a grant to the lender of a long term for years, such as five hundred or one thousand years, subject to the condition that the term for years would be void upon repayment.²⁰

16. Glanvill comments:

If the creditor loses seisin of his gage, whether by act of the debtor or of someone else, he shall not recover seisin of it with the aid of the court, not even by a recognition of novel disseisin. For if he has been disseised of his gage unjustly and without a judgment by someone other than the debtor, the debtor himself may have an assize of novel disseisin. If, on the other hand, he was disseised by the debtor himself, the court will not aid him to recover the gage from the debtor or to re-enter except through the debtor; for the creditor should have recourse to the principal plea to constrain the debtor to make satisfaction to him for his debt . . .

GLANVILL, *supra* note 3, bk. x, ch. 11. See also 2 POLLOCK & MAILAND, *supra* note 10, at 120-21; H.W. Chaplin, *The Story of Mortgage Law*, 4 HARV. L. REV. 1, 7 (1890); Hazeltine, *supra* note 5, at 555.

17. See GLANVILL, *supra* note 3, bk. x, ch. 11.

18. See 2 POLLOCK & MAILAND, *supra* note 10, at 120-21.

19. See SIMPSON, *supra* note 4, at 133.

20. See 3 BRACTON, *supra* note 6, fol. 268, at 285. In some cases, the lender immediately reconveyed the right to possess to the borrower, subject to forfeiture of title if the borrower defaulted. See GEORGE OSBORNE, HANDBOOK ON THE LAW OF MORTGAGES § 4, at 7 (2d ed. 1970); JOHN J. POWELL, A TREATISE ON THE LAW OF MORTGAGES 11-14 (4th ed. 1799).

This mortgage counterpart is called the Bractonian mortgage because it is described in Bracton's thirteenth-century treatise on English law and customs.

As with the Glanvillian gage, the holder of a Bractonian mortgage was entitled to possess the encumbered land and to collect its rents and profits. Also like the Glanvillian gage, the lender acquired fee title to the property if the borrower defaulted. Because the Bractonian mortgage conveyed a recognized estate in land to the lender, its right to possess was legally protected.²¹ Although possession by the lender was not an essential feature of the Bractonian mortgage, as it had been for the Glanvillian gage, possession of the property was still an essential aspect of the transaction because of the continuing prohibition against charging interest on loans.²²

Although the Bractonian mortgage successfully provided lenders with a protected right of possession, it fell into disuse because courts eventually refused to enforce the forfeiture clause according to its terms. As property law evolved toward stricter notions of seisin, courts increasingly had conceptual difficulties justifying the transformation of a leasehold, which was characterized as a chattel real, into a fee estate, which could be created only by formal livery of seisin.²³ Therefore, courts began characterizing the lender's interest in the land after default as a term for years, rather than as a fee estate.²⁴ In response, lenders began including a provision in the mortgage that the borrower would convey fee title to the lender upon default.²⁵ This solution proved to be less than satisfactory as lenders had difficulties enforcing this provision against a borrower who had lost a parcel of land worth potentially far more than the outstanding debt.

In response to this development, Littleton recast the loan transaction in approximately 1475. The Littletonian gage became the predominant form of real property security during this time and is the direct forerunner of the modern mortgage. Like Glanvill, Littleton adopted the term *mort gage*. The difference between Glanvill's and Littleton's explanations for this term's origin, however, demonstrated the increasing focus of the mortgage relationship on the encumbered land, rather than on the debt. Glanvill stated that a gage was "a dead gage (mortgage) . . . when the fruits and rents accruing during its continuance do not count towards repayment of the loan."²⁶ Littleton, on the other hand, stated that the term *mort gage* described the effect of the borrower's

21. Particularly in its earliest period of use, however, a Bractonian mortgage did not protect the lender's possession completely. See 2 POLLOCK & MAITLAND, *supra* note 10, at 106-10.

22. See OSBORNE, *supra* note 20, § 5, at 8.

23. See LITTLETON'S TENURES §§ 59, 349 (Eugene Wambaugh ed., 1903); SIMPSON, *supra* note 4, at 133; Hazeltine, *supra* note 5, at 556.

24. See EDWARD COKE, COMMENTARY UPON LITTLETON 216-18 (16th ed. 1809); 2 POLLOCK & MAITLAND, *supra* note 10, at 122-23; POWELL, *supra* note 20, at 11-12.

25. See POWELL, *supra* note 20, at 11-14.

26. GLANVILL, *supra* note 3, bk. x, ch. 6.

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default: if the borrower defaults, "then the land which is put in pledge . . . is taken from him for ever, and so dead [to him] . . ."27

The increasing focus on the land also is evident in the interest and rights a Littletonian gage gave a lender. The lender acquired fee title to the pledged land by formal livery of seisin.²⁸ Although the borrower retained a right of re-entry, that right did not constitute an estate in land.²⁹ If the borrower defaulted, the lender's title to the land became absolute. The borrower was not even accorded the right of redemption to prevent forfeiture of title that Glanvillian gagers had enjoyed almost three hundred years earlier.³⁰

Although the essence of the relationship between the borrower and the lender was merely a debt relationship, the law closed its eyes to the true character of the transaction and accorded the lender all the rights of fee ownership. As with the Glanvillian gage and the Bractonian mortgage, the lender enjoyed the rights to possess the property and to collect the rents and profits.³¹ Additionally, the lender's wife had a dower interest in the land; the lender was entitled to compensation if the land was taken by eminent domain; at his death, the land passed by his will, through intestate succession, or escheat; and the lender's creditors could seize the land.³² The law blinded itself so thoroughly to the true reason for the lender's acquisition of fee title that the gage entitled the lender to exercise the franchise, which was limited at this time to freeholders.³³

The Littletonian gage, therefore, was the culmination of a process by which the borrower and lender's relationship increasingly shifted from its true character and invested the lender with greater rights in the borrower's land. With the Glanvillian gage, the lender's right to possess the land was legally recognized but was not protected against even the gager's wrongful conduct. The Bractonian mortgage conveyed a protected chattel real to the lender, which

27. LITTLETON'S TENURES, *supra* note 23, § 332.

28. See LITTLETON'S TENURES, *supra* note 23, § 332; see also 2 BLACKSTONE, *supra* note 11, at 157-58.

29. See COKE, *supra* note 24, at 218; RICHARD W. TURNER, THE EQUITY OF REDEMPTION 11 (1931).

30. See OSBORNE, *supra* note 20, § 5, at 9.

31. See TURNER, *supra* note 28, at 88-90. As with the Glanvillian gage, Littleton distinguished between the *mort gage* and the *vivum vadium*. Although charging interest still constituted usury, the *mort gage* was "much more common[ly]" used than the *vivum vadium*. 2 BLACKSTONE, *supra* note 11, at 157. Moreover, although rents and profits were supposed to be applied to reduce the debt, Osborne states that the lender "almost certainly . . . made a surreptitious profit. The ability thus to circumvent the mandate against taking interest doubtless was a potent factor in the popularity of this form of security." OSBORNE, *supra* note 20 § 5, at 8 (footnote omitted).

32. See OSBORNE, *supra* note 20, § 5, at 9-10; Lloyd, *supra* note 12, at 239-40; see also LITTLETON'S TENURES, *supra* note 23, § 357.

33. See OSBORNE, *supra* note 20, § 5, at 10.

initially could convert to fee ownership. The Littletonian gage took the final step by conveying fee title to the lender with virtually all the rights attendant on such ownership.

The differences among these security arrangements, however, are less important than their similarities. For each type, the lender's right to possess the property, to collect the rents and profits, and to become the full fee owner if the borrower defaulted created obvious incentives for the lender to become knowledgeable about the land and to maintain it.

Beyond this economic incentive to enhance the land's value and productivity, the law created substantial additional incentives for the lender to be concerned with the property's condition. From an early date, a lender who possessed a borrower's land was legally liable for its condition. From at least the twelfth century, the lender was liable to the borrower for waste.³⁴ In describing the lender's duty with respect to pledged land, Glanvill stated:

[The creditor] is bound to keep the gage safely and not use it or deal with it anyway to its detriment. If any deterioration occurs during the fixed term while it is in the creditor's keeping and as a result of his fault, the value of the deterioration will be set off against the debt.

....

... When the debtor has repaid the debt, the creditor must restore to him in its original condition the thing gaged; and it will afford him no defense against the debtor that the thing was lost or damaged by accident while in his keeping, because he is strictly bound either to restore the thing gaged or make satisfaction for it, or else to lose his debt.³⁵

Glanvill clearly states that a lender is liable for voluntary waste, which is waste caused by the lender's actions. He is less clear that a lender is liable for permissive waste, which results from inaction, such as a failure to maintain. Glanvill does state that the lender must "keep the gage safely," which indicates liability for permissive, as well as voluntary, waste. He also states that the property must be restored to the debtor "in its original condition" and that the debt will be reduced "[i]f any deterioration occurs." Although Glanvill refers to deterioration resulting from the lender's "fault," the word "fault" generally includes a wrongful omission, as well as a wrongful act.³⁶ Therefore, a strong

34. The earliest written record of actions for waste is in 1177. See Sue Sheridan Walker, *The Action of Waste in the Early Common Law*, in *LEGAL RECORDS AND THE HISTORIAN* 185, 185 (J.H. Baker ed., 1975).

35. GLANVILL, *supra* note 3, bk. x, chs. 6, 8. Although the quoted language deals with a gage of personal property, Glanvill states that the rules are the same for gages of land. See GLANVILL, *supra* note 3, bk. x, ch. 8.

36. See BLACK'S LAW DICTIONARY 608 (6th ed. 1990).
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argument can be made that a lender in possession of the borrower's property had a duty to maintain it and also to prevent other forms of permissive waste.

As a tenant for a term, a Bractonian mortgagee, like a Glanvillian gagee, was liable for waste, and an action for waste was a common remedy by the end of the thirteenth century.³⁷ A lender who used the property "to the extent of rightful estovers . . . thus commits no waste or *injuria* by using within measure. But if he exceeds due measure by using and taking more than rightful estovers, he uses so to speak, another's property, and the waste will be wrongful . . ." ³⁸ Like Glanvill, Bracton does not expressly state that liability existed for both permissive and voluntary waste.³⁹ However, laws enacted in 1267, 1278, and 1292 made tenants, such as lenders, liable for both kinds of waste.⁴⁰ A lender also could be held liable for waste committed by a third party.⁴¹ Because the law enacted in 1278 provided that the penalty for waste during a tenancy was forfeiture of the property and, in some cases, treble damages,⁴² a Bractonian mortgagee obviously had substantial incentives to maintain the property and to protect it from harm by others.

In contrast, as a matter of title theory, a Littletonian gagee should not have been liable for waste because the borrower did not retain an estate in land, and the courts of law so held. By this point in the development of the common law, however, Chancery began to adjust lenders' and borrowers' rights and liabilities to reflect more accurately the substance of the security relationship. Therefore, although the Littletonian gagee was accorded virtually all the rights of fee ownership, equity imposed liability for waste on him.⁴³

The Littletonian gagee also could be held liable for nuisance for conditions on the gaged land. Liability could be imposed not only for conditions created

37. See Walker, *supra* note 34, at 185.

38. 3 BRACTON, *supra* note 6, fol. 316b, at 409. See S.F.C. MILSOM, HISTORICAL FOUNDATIONS OF THE COMMON LAW 292 (2d ed. 1981), for a description of a 1368 decision in which a tenant for life or for years was held liable for waste for burning down a house.

39. A reference in Bracton indicates that a possessor was liable for permissive waste. In his discussion of a dower holder's defense in an action for waste, Bracton states: "[Or] she may acknowledge that if houses have fallen in on account of age, she built better ones there. . . ." 3 BRACTON, *supra* note 6, fol. 315b, at 406. This example implies that a possessor was liable if a building had "fallen in on account of age" unless she has rebuilt the building. Because property possessors are not obligated to reverse the effects of normal depreciation, this example apparently refers to damage caused by a failure to maintain.

40. "For above five hundred years past all tenants for life or for any less estate, have been punishable or liable to be impeached for waste both voluntary and permissive." 2 BLACKSTONE, *supra* note 11, at 283.

41. See COKE, *supra* note 24, at 53, 54.

42. See 2 BLACKSTONE, *supra* note 11, at 283; Walker, *supra* note 34, at 189-91.

43. See POWELL, *supra* note 20, at 248-49.

by the gagee, but also for pre-existing conditions,⁴⁴ which created a substantial incentive for a lender to inspect land before becoming a gagee. In contrast, a Glanvillian gagee was not liable for nuisance, though a private nuisance action had existed since the twelfth century.⁴⁵ In Glanvill's treatise, nuisance was categorized with the Assize of Novel Disseisin and was conceptualized as an interference with another property owner's seisin.⁴⁶ This link between nuisance and seisin protected a Glanvillian gagee from liability because he did not have seisin.⁴⁷ Similarly, a Bractonian mortgagee, as a termor rather than fee owner, originally was not liable for nuisance.⁴⁸ However, when the action on the case for nuisance replaced the assize for nuisance in the fifteenth century, the Bractonian mortgagee, like the Littletonian gagee, was liable for nuisance.⁴⁹

This legal liability for nuisance and for waste, together with the lender's substantial economic self-interest in maximizing both the land's rents and profits during the life of the loan and the land's value in case the lender acquired it on the borrower's default, made the land and the lender's relationship to it defining elements of the mortgage's first era. The chief underlying reasons were the Church's prohibition on charging interest and the relatively undeveloped state

44. See 3 BLACKSTONE, *supra* note 11, at 221; 2 POLLOCK & MAITLAND, *supra* note 10, at 55.

45. See RESTATEMENT (SECOND) OF TORTS § 821D cmt. a (1979).

46. See GLANVILL, *supra* note 3, bk. xiii, chs. 32-36. In one of the writs for nuisance, for example, Glanvill describes the altering of a river bank "to the nuisance of N's free tenement." See GLANVILL, *supra* note 3, bk. xiii, ch. 35; see also 3 BLACKSTONE, *supra* note 11, at 222; 1 POLLOCK & MAITLAND, *supra* note 10, at 53. Although originally categorized with the Assize of Novel Disseisin, by the thirteenth century the nuisance action increasingly was called an assize of nuisance. See GLANVILL, *supra* note 3, bk. xiii, ch. 34 n.1; S.F.C. Milsom, *Forward* to 1 POLLOCK & MAITLAND, *supra* note 10, at xlii.

47. Milsom states: "The reason for this must have been as obvious at the time as it has been obscure ever since." Milsom, *supra* note 46, at xliii. He presents an interesting hypothesis that the Assize for Novel Disseisin was not designed to protect in rem rights, such as possession, but to protect a feudal tenant in his relationship with his lord. As such, the Assize could not be used by or against a Glanvillian gagee. Similarly, the Assize was inapplicable to a Bractonian mortgagee. Although the mortgagee was a tenant, he was not a tenant in the feudal sense. See Milsom *supra* note 46, at xliii-xlv.

48. Bracton states that, to bring a nuisance action, "the plaintiff must have a free tenement, for no one may acquire a servitude attached to an estate or land unless he has an estate and a free tenement, nor may anyone be subject to a servitude unless he who has an estate and a free tenement." 3 BRACTON, *supra* note 6, fol. 234, at 195. He also states: "A nuisance . . . does not differ substantially from a disseisin. . . . [T]he nuisance may be removed and damages restored to the plaintiff, both for the disseisin of his tenement and for the nuisance. . . ." 3 BRACTON, *supra* note 6, fol. 232, at 190. See also Milsom, *supra* note 46, at xliii.

49. See 3 BLACKSTONE, *supra* note 11, at 222. The first reference to a termor's action on the case was in 1469. See William A. McRae, Jr., *The Development of Nuisance in the Early Common Law*, 1 U. FLA. L. REV. 27, 42 (1948).
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of the land laws. As will be discussed in the next section of this Article, the mortgage's second era has been defined by a shift in focus from the encumbered land to the secured debt.

II. THE SECOND ERA

The second era of mortgage law began during the late sixteenth and early seventeenth centuries as the English economy made the transition from feudalism to mercantilism. Two legal changes, in particular, reversed the traditional primacy of the mortgage over the debt: (1) Parliament repealed the prohibition on charging interest, which enhanced the debt's value, and (2) Chancery recast the mortgage relationship by creating the equity of redemption, which increasingly diminished the value of the lender's interest in the mortgaged land. The trends that marked the beginning of the second era have continued into the twentieth century. Mortgage securitizations and other developments have removed mortgagees ever further from the encumbered land, while holder-in-due-course status has continued to enhance the debt's value.

A. *Ascendance of the Debt*

During the first era of mortgage law, England did not have an established monetary economy for several reasons. First, during much of the Middle Ages, no uniform national currency existed.⁵⁰ Second, money was scarce. For example, during Richard I's reign, the total money supply consisted of approximately one shilling for each person subject to his reign.⁵¹ Third, counterfeiting and "clipping" (cutting off the edges of a coin) were rampant.⁵² Fourth, a great deal of the coinage was made of tin, which rapidly deteriorated.⁵³ Fifth, the value of coins and their foreign exchange rates were set not by market forces but by European rulers to effectuate political goals.⁵⁴ These problems were aggravated by the ban on usury, which distorted the European money markets and increased the demand for coins.⁵⁵

In contrast, the second era began with the dawning of the English monetary economy. With the "discovery" of America, England began importing large quantities of precious metals from this continent.⁵⁶ As a result, the quantity of

50. See ALEXANDER DEL MAR, HISTORY OF MONETARY SYSTEMS 239 (Augustus M. Kelley ed., 1969) (1895).

51. See *id.* at 240.

52. See GLYN DAVIES, A HISTORY OF MONEY: FROM ANCIENT TIMES TO THE PRESENT DAY 169-70 (1994); DEL MAR, *supra* note 50, at 240-42.

53. See DEL MAR, *supra* note 50, at 240-41.

54. See WILLIAM A. SHAW, THE HISTORY OF CURRENCY 47, 59-60 (2d ed. 1967).

55. See DAVIES, *supra* note 52, at 173.

56. See SHAW, *supra* note 54, at 61.

English currency steadily increased and, with it, England's foreign trade.⁵⁷ The increased amount of currency had a dramatic impact in England. It caused the "commercial and national, yea even literary, growth and expansion, which have made the Elizabethan age the glory of [England's] history."⁵⁸

To further stimulate trade and, thereby, to increase England's power, Parliament began loosening restrictions on interest. Parliament recognized that loaned money could now be used in trade for productive, as well as consumptive, purposes.⁵⁹ But continuing questions about the morality of charging interest inhibited Parliament from completely repealing the ban. Instead, Parliament repealed the ban piecemeal in an attempt to protect the needy from exploitation and at the same time to stimulate trade.⁶⁰

In 1623, Parliament eliminated the last prohibitions on charging interest,⁶¹ and the full effect of the English economy's monetization was felt in the area of real estate lending. Because lenders no longer had to take possession of the encumbered land to make a return on their loans, they increasingly permitted borrowers to retain possession until a default occurred. This practice took hold so rapidly that by the middle of the century, borrowers customarily retained possession.⁶² The legal significance of this fundamental change in the mortgage relationship is demonstrated by Parliament's restoration of the franchise to mortgagors in 1696.⁶³ As noted above, Parliament had given the franchise, which was limited to freeholders, to secured lenders during the era of the Littletonian gage.⁶⁴

The repeal of the ban on interest and the related increase in trade triggered another important development that substantially promoted debt's ascendancy in the mortgage relationship—the extensive use of negotiable instruments.⁶⁵ An early form of negotiable instrument had been used in England during the Middle Ages.⁶⁶ However, it was not until the years immediately after Parliament's repeal of the ban on interest that a negotiable instrument—the bill of exchange—came to be widely used.⁶⁷

57. See SHAW, *supra* note 54, at 119.

58. See SHAW, *supra* note 54, at 133.

59. See *supra* note 9 and accompanying text.

60. See 8 HOLDSWORTH, *supra* note 9, at 103-12.

61. 21 Jam. 1, ch. 17, § 2 (1624), *made permanent*, 3 Car. 1, ch. 4, § 5 (1627) (Eng.).

62. See 2 BLACKSTONE, *supra* note 11, at 159; 3 RICHARD R. POWELL, POWELL ON REAL PROPERTY ¶ 438, at 37-39 (1997).

63. See Lloyd, *supra* note 12, at 239.

64. See *supra* note 33 and accompanying text.

65. See 8 HOLDSWORTH, *supra* note 9, at 112.

66. Early forms of negotiable instruments existed in England by 1300. See Frederick K. Beutel, *The Development of Negotiable Instruments in Early English Law*, 51 HARV. L. REV. 813, 830 (1938).

67. "[I]t is clear that between 1622 and 1651 very great advances had been made <https://scholarship.law.missouri.edu/mlr/vol64/iss2/1>

Negotiable instruments were particularly valuable in trade because they were safer and easier to transport than precious metals, whether in the form of coins or bullion.⁶⁸ As a result, commercial practices directed the course of the bill's development. To enhance the bill's utility, mercantile custom provided special protections for the bona fide purchaser of a bill.⁶⁹ As is often the case, however, the law lagged behind practice, and the common law at this time did not provide similar protections. However, by the end of the century, the common law had yielded to mercantile custom and had laid the foundation for modern holder-in-due-course status.

The transformation began with Chief Justice Holt's 1696 decision in *Hussey v. Jacob*.⁷⁰ Holt said in that case that an assignee of a bill of exchange could enforce it even though the original holder could not because the underlying debt, being a gaming debt, was legally void. He stated that a contrary rule "would be very prejudicial to trade."⁷¹ One year later, Lord Chancellor Somers applied the same principle in the Court of Chancery in a case in which a bill of exchange had been given without consideration. Somers held that the bona fide purchaser of the instrument could enforce it: "[The purchaser] being an honest creditor and coming by this bill fairly for the satisfaction of a just debt, [the Chancellor] would not relieve against him, because it would tend to destroy trade which is carried on every where by bills of exchange"⁷²

In 1699, Holt added another brick to the foundation. In a case he decided that year, he held that if the holder of a bill payable to him or to the bearer lost the bill, he could not recover it from a third party to whom the finder had sold the bill. Holt gave only one reason—"by reason of the course of trade, which creates a property in the assignee or bearer."⁷³ The "course of trade" was mercantile practice.⁷⁴

towards making the bill of exchange a negotiable instrument." 8 HOLDSWORTH, *supra* note 9, at 155.

68. See 8 HOLDSWORTH, *supra* note 9, at 112; see also Grant Gilmore, *Formalism and the Law of Negotiable Instruments*, 13 CREIGHTON L. REV. 441, 448 (1979) ("[A] draft on a ranking London house was a much safer as well as a much more convenient thing to have than a bag-full of clipped Maria Theresa dollars.").

69. See 8 HOLDSWORTH, *supra* note 9, at 157.

70. 1 Comyns 4 (1696).

71. *Id.* at 5.

72. 1 Comyns 43 (1697).

73. 1 Salk 126 (1699).

74. "The assignability of bills of exchange payable to order was fully recognized; and many of the other rules relating to them were so contrary to the ordinary principles of the common law, that they could only be justified by a reference to mercantile custom." 8 HOLDSWORTH, *supra* note 9, at 170. One commentator states that the common law courts adopted the law merchant because of the courts' "inadequacy to deal with the subject matter . . ." Beutel, *supra* note 66, at 837-38. The common law courts had not wrested jurisdiction for cases involving commercial paper from the admiralty and staple courts until the seventeenth century. See Beutel, *supra* note 66, at 837-38; see also

Despite the increasing importance of trade and of the use of negotiable instruments, the courts rather inexplicably refused to extend these protections from bills of exchange to promissory notes.⁷⁵ Therefore, in 1704, Parliament did so in the Statute of Anne.⁷⁶ As with bills of exchange, the reason for protecting purchasers of promissory notes was to facilitate trade.⁷⁷ Lingering questions remained, however, about the scope of the protection.⁷⁸

These questions became more pressing with the advent of the Industrial Revolution in England. Just as the importation of precious metals from America had spurred English trade, the Industrial Revolution now greatly expanded it⁷⁹ and intensified the need for protected forms of negotiable instruments. To satisfy this need, bona fide purchasers had to be shielded not only from conflicting ownership claims, but also from contract defenses.⁸⁰

Lord Mansfield recognized this need and firmly enconced protection for bona fide purchasers in the common law in two key decisions. In *Miller v. Race*,⁸¹ he cut off all claims of ownership that conflicted with the bona fide purchaser's claim. In upholding a note purchaser's ownership against a claim that a prior possessor had stolen it, Lord Mansfield clearly stated the commercial considerations that underlay his decision:

[Bank notes] are not goods, not securities, nor documents for debts, nor are so esteemed; but are treated as money, as cash, in the ordinary course and transaction of business, by the general consent of mankind;

J. MILNES HOLDEN, *THE HISTORY OF NEGOTIABLE INSTRUMENTS IN ENGLISH LAW* 65 (1955).

75. See 8 HOLDSWORTH, *supra* note 9, at 172-73; Beutel, *supra* note 66, at 839.

76. 3, 4 Anne ch. 9 (1704): "An Act for giving like Remedy upon Promissory Notes, as is now used upon Bills of Exchange . . ."

77. See 8 HOLDSWORTH, *supra* note 9, at 176; see also JOSEPH STORY, *COMMENTARIES ON PROMISSORY NOTES* 6-7 (1845):

As commerce . . . advanced in its progress, the multiplicity of its concerns required, in many instances, a less complicated mode of payment than by Bills of Exchange. A trader, whose situation and circumstances rendered credit from the merchant or manufacturer, who supplied him with goods, absolutely necessary, might have so limited a connection with the commercial world at large, that he could not easily furnish his creditor with a Bill of Exchange on another man. But his own responsibility might be such, that his simple promise of payment, reduced to writing for the purpose of evidence, might be accepted with equal confidence, as a bill on another trader. Hence, it may reasonably be conjectured, Promissory Notes were at first introduced.

Id. (quoting KYD ON BILLS 18).

78. See Beutel, *supra* note 66, at 832.

79. See Gilmore, *supra* note 68, at 447.

80. See Gilmore, *supra* note 68, at 448-49.

81. 1 Burr. 452 (1758).

which gives them the credit and currency of money, to all intents and purposes.

.....

A bank note is constantly and universally, both at home and abroad, treated as money, as cash; and paid and received as cash; and it is necessary, for the purposes of commerce, that their currency should be established and secured.⁸²

Twenty-three years later, Mansfield held in *Peacock v. Rhodes*⁸³ that a bona fide purchaser takes free of all personal defenses that could have been asserted against the original note holder. His stated reason was to protect the market in negotiable instruments.⁸⁴ The English courts thereafter consistently protected bona fide purchasers, and by the mid-nineteenth century, the law concerning negotiable instruments was virtually identical to today's law.⁸⁵

Most American states adopted the Statute of Anne⁸⁶ and the special protection afforded bona fide purchasers in England.⁸⁷ When the 1882 English Bills of Exchange Act replaced the term "bona fide purchaser" with "holder in due course," the Uniform Negotiable Instruments Law of 1896 ("NIL"), which was adopted throughout the United States, incorporated the change. That term and the protection it connotes have continued through to modern law as important parts of NIL's successor, Article Three of the Uniform Commercial Code.⁸⁸

Although some modern commentators question whether holder-in-due-course status actually facilitates trade in goods,⁸⁹ it has facilitated trade in negotiable instruments. In 1996 alone, the secondary market bought \$799.6 billion in home mortgage loans.⁹⁰ As will be described in the next section, the phenomenal growth of this market constitutes the culmination of the second era

82. *Id.* at 457, 459.

83. 2 Dougl. 633 (1781).

84. *See id.* at 636.

85. *See* Gilmore, *supra* note 68, at 448.

86. *See* STORY, *supra* note 77, at 9.

87. *See* STORY, *supra* note 77, at 11.

88. *See* Gilmore, *supra* note 66, at 449 n.14, 457, 461.

89. *See, e.g.,* Albert J. Rosenthal, *Negotiability — Who Needs It?*, 71 COLUM. L. REV. 375, 401 (1971); John Evan Jones, Comment, *Consumer Protection — The Role of Cut-Off Devices in Consumer Financing*, 1968 WIS. L. REV. 505, 525-26. *But see* William H. Lawrence & John H. Minan, *The Effect of Abrogating the Holder-in-Due-Course Doctrine on the Commercialization of Innovative Consumer Products*, 64 B.U. L. REV. 325, 327-29 (1984); Ralph J. Rohner, *Holder in Due Course in Consumer Transactions: Requiem, Revival, or Reformation?*, 60 CORNELL L. REV. 503, 534-38 (1975).

90. *See* U.S. DEP'T OF HOUSING & URBAN DEV., SURVEY OF MORTGAGE LENDING ACTIVITY 3 (1997).

of mortgage law during which mortgagees have become increasingly removed from the encumbered land.

B. The Decline of the Mortgagee's Relationship to the Land

At the same time that the mortgage debt became increasingly more valuable to lenders, the mortgage and the lender's rights in mortgaged land became increasingly less valuable. This pendulum swing began during the late sixteenth century when Chancery began to recharacterize mortgages and the rights they granted to a lender. Rather than strictly enforce the forfeiture clause as the courts of law did, equity now permitted a borrower to recover his property if he repaid the debt within a reasonable time after its due date. This equitable right was called the equity or right of redemption.⁹¹ Originally, a borrower could take advantage of this equitable right only if he could prove an equitable ground, such as fraud, for his failure to repay the debt on its due date.⁹² This equitable right evolved so that by the early part of the seventeenth century, it applied to any borrower who tendered payment of the debt within a reasonable time after its due date regardless of the reason for failing to tender on the due date.⁹³

Equity may have created the equity of redemption for two reasons. First, equity abhors a forfeiture of title to land. Forfeiture pursuant to a mortgage was particularly abhorrent because the land's value normally exceeded the outstanding debt and because the debt was not reduced by the rents and profits collected by the lender from the land. Such a forfeiture smacked of penalty. Second, equity undoubtedly focused on the substance of the performance that was due to the lender. The lender's primary right was repayment of the debt. The precise time of payment was of only secondary importance. Therefore, if the lender received payment within a reasonable time after the specified due date, he should not be entitled to enforce such a potentially severe penalty against the borrower.⁹⁴

Despite its creation of the equity of redemption, Chancery at this time continued to treat the mortgagee as the fee owner of the encumbered land.⁹⁵ Parliament's repeal of the ban on charging interest, however, now provided an important impetus for the further development of the equity of redemption. As described above,⁹⁶ once lenders could legally collect interest, they normally allowed borrowers to retain possession of the land. As a result, Chancery

91. See 2 BLACKSTONE, *supra* note 11, at 158-59; Lloyd, *supra* note 12, at 235.

92. See OSBORNE, *supra* note 20, § 6, at 13.

93. See, e.g., *Hamilton v. Dirlton*, 1 Ch. Rep. 165 (1654); *Emanuel College v. Evans*, 1 Ch. Rep. 18 (1625), *cited in* 1 GLENN, *supra* note 11, at 12-13.

94. One commentator attributes Chancery's break with the courts of law on this issue to the struggle for power between the courts of law and of equity. See OSBORNE, *supra* note 20, § 6, at 13; see also Lloyd, *supra* note 12, at 235.

95. See 1 GLENN, *supra* note 11, § 2, at 9-10.

96. See *supra* notes 61-62 and accompanying text.

recharacterized the relationship of the borrower and lender during the life of the loan. Chancery now held that the equity of redemption constituted not just a right to pay a loan after its due date but an equitable estate in land. As such, the borrower's estate could be transferred, mortgaged, divided into smaller estates, subjected to dower and curtesy, and merged into the fee estate.⁹⁷

Although at this point in the mortgage's development the lender still was treated as retaining an estate in the encumbered land, the rights attendant upon the estate were substantially diminished. For example, in earlier times, a lender who took possession of the borrower's land could keep the rents and profits from the land with no obligation to apply them to reduce the debt or otherwise to account to the borrower for them.⁹⁸ Now, however, if the lender took possession of the property, he was held to a strict duty of accounting to the borrower and was under a legal duty to apply all amounts collected to the borrower's benefit.⁹⁹ In fact, Pollock says that, during this period in the mortgage's evolution, "the plight of a mortgagee in possession is one of the most unenviable known to the law."¹⁰⁰ This burdensome status made possession of the property during the life of the loan far less attractive to lenders.

In addition to altering the lender's rights during the life of the loan, the equity of redemption dramatically affected the lender's right to the land when the loan relationship terminated. When Chancery began treating borrowers as retaining an estate in the encumbered land, it did not provide a method by which a lender could terminate that interest. Therefore, when a loan went into default, only two methods existed to terminate the borrower's interest. The borrower voluntarily could transfer his estate in the land to the lender, which the borrower understandably might refuse to do if the land's value exceeded the debt amount. Otherwise, a lender had to establish that the borrower had abandoned his interest in the land. Because abandonment depends on proof of intent to abandon, this remedy also was problematic, especially because of Chancery's solicitude for borrowers. In fact, in one case, Chancery refused to find that a borrower had abandoned his interest twenty years after the loan's due date.¹⁰¹

Because this situation threatened to destroy the utility of land as collateral for loans, Chancery eventually created an equitable cause of action to eliminate the borrower's interest in the land. Upon proof that a loan was in default, Chancery would issue a decree that the borrower pay the loan within a specified time. If the borrower failed to do so, the court entered a decree of foreclosure, which eliminated the borrower's interest. The lender became the full fee owner

97. See 3 FRANCIS HARGRAVE & CHARLES BUTLER, NOTES ON LORD COKE'S FIRST INSTITUTE ON COMMENTARY UPON LITTLETON § 332 n.96 (1809); OSBORNE, *supra* note 20, § 7, at 16-17.

98. See *supra* note 14 and accompanying text.

99. See FREDERICK POLLOCK, THE LAND LAWS 134 (3d ed. 1896).

100. *Id.* (footnote omitted).

101. See 2 BLACKSTONE, *supra* note 11, at 158-59 n.29; 3 HARGRAVE & BUTLER, *supra* note 97, § 337 n.106.

of the land regardless of the land's value in relation to the outstanding debt amount.¹⁰² For this reason, this cause of action was called a "strict foreclosure,"¹⁰³ and it constituted the last significant vestige of the lender's ownership interest in the encumbered land.

The harshness of strict foreclosure precipitated a further intervention by Chancery to reflect the true nature of the loan relationship. As it had created the right to redeem in response to the harshness of a borrower's forfeiture of title when the loan was not paid on its due date, Chancery now created the right to redeem from a strict foreclosure. As with the first redemption right, the new redemption right could continue for years after the foreclosure and could be exercised even if the lender had sold the land.¹⁰⁴

Recognizing that keeping the land was again a problematic remedy, lenders voluntarily completed the loan relationship's shift in focus from the land to the debt. Lenders now began including in the loan documents a right to sell the property in case of default and to retain only so much of the loan proceeds as were needed to repay the debt.¹⁰⁵ If the sale price exceeded the debt, the owner or any junior lienors were entitled to the surplus. This remedy quickly became the most predominantly used,¹⁰⁶ and by the early 1800s in England, the lender's interest in the encumbered land firmly had shifted from fee title to a mere security interest.¹⁰⁷

The evolution of American mortgage law followed a similar, though abbreviated, course. As in England, mortgages in colonial America were worded as a conveyance of title to the lender, and some early American courts characterized them as such.¹⁰⁸ However, the popular perception from the earliest times was that a mortgage gave the lender only a security interest, and the borrower routinely retained possession of the property.¹⁰⁹ One commentator states that the borrower's retained possession was a reflection of hostility to the creditor class.¹¹⁰ A more likely explanation, however, is that the colonists were acting in accordance with the understanding that was obvious to everyone but lawyers—a mortgage is not intended to convey title to the lender but merely to serve as security for the loan. Unencumbered by centuries of mortgage practice in which lenders took possession of the mortgaged land, American mortgage law

102. See 2 BLACKSTONE, *supra* note 11, at 159; POLLOCK, *supra* note 99, at 134-35.

103. 1 GLENN, *supra* note 11, § 59.1, at 401.

104. See 1 GLENN, *supra* note 11, § 61, at 405.

105. See TURNER, *supra* note 29, at 121.

106. See TURNER, *supra* note 29, at 121-22.

107. See 3 HARGRAVE & BUTLER, *supra* note 99, § 332 n.96.

108. See Chaplin, *supra* note 16, at 12; Lloyd, *supra* note 12, at 240-41.

109. See Chaplin, *supra* note 16, at 12; Lloyd, *supra* note 12, at 240-41.

110. See Lloyd, *supra* note 12, at 240-41.

evolved more quickly than English law to focus on the debt aspect of the mortgage relationship.¹¹¹

Despite this more rapid rate of change and despite the passage of more than three hundred years, American mortgage law still has not completed its transformation. Some states—the so-called title theory states—still characterize a mortgage as conveying title and the immediate right to possess the mortgaged land. Eight, or possibly as many as fourteen, states are title theory states.¹¹² The

111. Some early American courts and commentators did have difficulty developing a legal basis for the borrower's retained possession and, as a result, characterized the borrower as a tenant. See OSBORNE, *supra* note 20, § 13, at 23; POWELL, *supra* note 20, at 205-06. Other courts and some early state legislatures, however, properly characterized the lender's interest as a lien, rather than as an ownership interest.

South Carolina was the first state to enact legislation providing that a mortgage is mere security for a debt and not a transfer of title. Act of 1791, 5 S.C.L. (1 Brev.) 174 (1814). See also *Navassa Guano Co. v. Richardson*, 2 S.E. 307, 308-09 (S.C. 1887); *Verree v. Verree*, 4 S.C.L. (2 Brev.) 211 (1807). Widespread recognition of the true nature of a mortgage, however, is attributable to a line of New York Supreme Court decisions from the early nineteenth century. See *Lloyd*, *supra* note 12, at 241; see also, e.g., *Bryan v. Butts*, 27 Barb. 503 (N.Y. App. Div. 1857); *Runyan v. Mersereau*, 11 Johns. Ch. 534 (N.Y. Ch. 1814).

112. The title theory jurisdictions are:

Alabama: See ALA. CODE § 35-10-26 (1991);

Connecticut: See CONN. GEN. STAT. ANN. § 47-36h (West 1995); *Olean v. Treglia*, 463 A.2d 242, 250 (Conn. 1983) ("Under the law of Connecticut, a mortgagee is deemed to have taken legal title upon the execution of a mortgage on real property and therefore, in the absence of an agreement to the contrary, has a right to immediate possession against his mortgagor.");

District of Columbia: See D.C. CODE ANN. § 45-703 (1996);

Georgia: Although mortgages do not convey title in Georgia, see GA. CODE ANN. § 44-14-30 (1991), the normally used security instrument, the deed to secure debt, does convey title. See GA. CODE ANN. § 44-14-60 (1991);

Maine: See ME. REV. STAT. ANN. tit. 33, § 502 (West 1999);

New Hampshire: See *Furbush v. Goodwin*, 29 N.H. 321, 332 (1854); see also *State v. Marion*, 440 A.2d 448, 449 (N.H. 1982);

Rhode Island: See R.I. GEN. LAWS § 34-11-20 (1995);

Tennessee: See *Howell v. Tomlinson*, 228 S.W.2d 112, 116 (Tenn. Ct. App. 1949) ("The law of Tennessee has kept much of the common-law theory of mortgages . . . [I]t still adheres to the basic common-law notion that a mortgage vests the mortgagee with the legal title to the land and the right to immediate possession."); see also *In re Maryville Sav. & Loan Corp.*, 31 B.R. 597, 598 (E.D. Tenn. 1983), *aff'd in part, rev'd in part*, 743 F.2d 413 (6th Cir. 1984).

The law in six states is unclear as to whether the jurisdiction is a title theory state:

Arkansas: See *In re Crime Free, Inc.*, 196 B.R. 116, 119 (Bankr. E.D. Ark. 1996) ("[T]he mortgagee, under Arkansas law, has title to the real property which passed when the debtor gave the mortgage to the creditor. *The contract between the parties contemplated possession of the property by the debtor during the time the debtor agreed to pay back its loan.*" (citation omitted) (emphasis added)); *Bank of Oak Grove v.*

great majority of states, however, properly characterize a mortgage as being a mere lien. These so-called lien theory states treat mortgages as transferring neither title nor the right to possess but only the right to sell the property upon default. A few states—the intermediate theory states—have not yet completed the transition from title theory to lien theory. They treat mortgages as conveying title but no right to possess until the borrower defaults.¹¹³

Even in the title theory states, state laws and practices increasingly have shifted the focus of the mortgage relationship from the land to the debt. Statutes in some title theory states significantly alter the rights that once characterized title theory treatment of mortgages.¹¹⁴ Judicial decisions in other title theory

Wilmot State Bank, 648 S.W.2d 802, 803 (Ark. 1983) (“[W]e are unwilling to decide the issue on as broad and undefined a principle as lien versus title theories of mortgages. Our cases do not support the argument that clearly.”);

Maryland: *Compare* Darnestown Valley-WHM Ltd. Partnership v. McDonald’s Corp., 650 A.2d 1365, 1369 (Md. 1994) (“[T]here is usually incorporated into a mortgage of a leasehold estate . . . a provision whereby the mortgagors, their personal representatives and assigns, may continue to hold and possess the mortgaged premises. . . . The effect of this agreement on the part of the mortgagee, which is known as a redemise, is to make of the mortgagor, in most respects, a tenant to the mortgagee.”), *with In re Bethesda Air Rights Ltd. Partnership*, 117 B.R. 202, 208 (Bankr. D. Md. 1990) (“[T]he mortgagor is entitled to possession and the trappings of ownership until default, subject to the rights of the mortgagee.”).

Massachusetts: *See* Bank v. International Bus. Mach. Corp., 915 F. Supp. 491, 496 (1996) (describing Massachusetts as a title theory state but stating that “the mortgagee may enter into possession of the mortgaged property upon default and before foreclosure”); *In re Tricca*, 196 B.R. 214, 217 (Bankr. D. Mass. 1996) (“Massachusetts is a title theory state with respect to mortgages. This means that the mortgagee holds legal title to the real property and the mortgagor retains only the equity of redemption accompanied by a right to possession.”).

North Carolina: *Compare* Neil Realty Co. v. Medical Care, Inc., 431 S.E.2d 225, 226 (N.C. Ct. App. 1993) (“North Carolina is considered a title theory state with respect to mortgages, where a mortgagee does not receive a mere lien on mortgaged real property, but receives legal title to the land for security purposes.”), *with* Butner v. United States, 440 U.S. 48, 52 n.3 (1979) (“[A] mortgagee is entitled to possession of the mortgaged property on default . . .”).

Pennsylvania: *See In re Wynnewood House Assocs.*, 121 B.R. 716, 721 n.3 (Bankr. E.D. Penn. 1990) (“Pennsylvania is generally viewed as a ‘title’ state, as opposed to a ‘lien’ state, concerning security interests in realty However, as is true in many states, the title versus lien distinction has been blurred by court decisions.”).

Virginia: *Compare* Eastern Sav. Bank v. Epcos Newport News Assocs., 14 B.R. 990 (Bankr. S.D.N.Y. 1981) (stating that Virginia is a title theory state), *with In re Vienna Park Props.*, 120 B.R. 332 (Bankr. S.D.N.Y. 1990) (“[T]here is room to doubt the conclusion in *Epcos* that Virginia recognizes the title theory.”), *rev’d*, 136 B.R. 43 (Bankr. S.D.N.Y. 1992).

113. *See* GRANT S. NELSON & DALE A. WHITMAN, REAL ESTATE FINANCE LAW §§ 4.1-4.3, at 127-35 (3d ed. 1994).

114. *See id.* § 4.1, at 129; 3 POWELL, *supra* note 62; Robert Kratovil, *Mortgages* <https://scholarship.law.missouri.edu/mlr/vol64/iss2/>

states also have modified the common law treatment of mortgages.¹¹⁵ Even where the law has not been changed, mortgages routinely provide that the borrower can retain possession until default or foreclosure.¹¹⁶ Moreover, in every title theory state, the lender must apply all collected rents and other income from the property to reduce the debt.¹¹⁷ Thus, even the title theory states recognize that the lender's paramount right is to repayment of the debt, with the land and its rents and profits merely providing a source of repayment.

This conclusion is confirmed by the title theory states' treatment of the lender's interest in the land. The interest clearly is treated as something other than actual ownership of an estate in land. Title theory states do not assess real property taxes against the mortgagee's interest.¹¹⁸ The mortgagee's interest can

— *Problems in Possession, Rents, and Mortgage Liability*, 11 DEPAUL L. REV. 1, 5 (1961).

115. See, e.g., *Red Rooster Constr. Co. v. River Assocs., Inc.*, 620 A.2d 118 (Conn. 1993). In *Red Rooster*, the court stated:

Despite our title theory of mortgages, “[i]n substance and effect . . . and except for a very limited purpose, the mortgage is regarded as mere security . . . and the mortgagor is for most purposes regarded as the sole owner of the land” The mortgagee “has title and ownership enough to make his security available, but for substantially all other purposes he is not regarded as owner, but the mortgagor is so regarded, always subject of course to the mortgage.”

Id. at 122 (citations omitted); *Turner Adver. Co. v. Garcia*, 311 S.E.2d 466, 468 (Ga.) (stating security deed conveys title but only a limited right to possess), *cert. denied*, 469 U.S. 824 (1984); *In re Maryville Sav. & Loan Corp.*, 31 B.R. 597 (E.D. Tenn. 1983), *aff'd in part, rev'd in part*, 743 F.2d 413 (6th Cir. 1984). In *Maryville Savings*, the court stated:

In Tennessee, execution and delivery of a deed of trust or mortgage on real property passes legal title to the land to the trustee or mortgagee. Tennessee is therefore known as a “title theory” state. Tennessee courts, however, are not strict in their application of the “title theory.” The doctrine is applied only when necessary to protect the mortgagee's security afforded by the estate.

Id. at 598 (citations omitted).

116. See NELSON & WHITMAN, *supra* note 113, § 4.1, at 129; Kratovil, *supra* note 114, at 5-6; see also *Williams v. Safe Deposit & Trust Co.*, 175 A. 331, 333 (Md. 1934).

117. See ME. REV. STAT. ANN. tit. 33, § 502 (West 1999); *In re 5028 Wisconsin Ave. Assocs., Ltd.*, 167 B.R. 699, 705 (Bankr. D.D.C. 1994); *Nettles v. First Nat'l Bank*, 388 So. 2d 916, 920 (Ala. 1980); *Karnes v. Marrow*, 864 S.W.2d 848, 850 (Ark. 1933); *Milici v. Ferarra*, 48 A.2d 562, 564 (Conn. 1946); *Williams Realty & Loan Co. v. Simmons*, 3 S.E.2d 580, 583 (Ga. 1939); *Hubbard v. Safe Deposit & Trust Co.*, 192 A. 592, 594 (Md. 1937); *Barrows v. Boles*, 687 A.2d 979, 988 (N.H. 1996); *Koury v. Sood*, 62 A.2d 649, 652-53 (R.I. 1948); *Schmid v. Baum's Home of Flowers*, 37 S.W.2d 105, 110 (Tenn. 1931); Kratovil, *supra* note 114, at 7.

118. See ALA. CODE § 40-5-12 (1991) (listing property that is subject to taxation; mortgagee's interest not included); *Hood v. Clark*, 37 So. 550 (Ala. 1904); ARK. CODE ANN. § 26-26-709(a) (Michie 1992); CONN. GEN. STAT. ANN. § 12-64(a) (West 1995)

be transferred or extinguished by an assignment or release, rather than by a deed or other formal conveyance.¹¹⁹ Neither dower nor curtesy, when recognized, attached to the mortgagee's interest.¹²⁰

The virtual abolition of strict foreclosure in this country also is strong proof that a mortgage does not convey an estate in land even in title theory jurisdictions. For strict foreclosure to operate, the foreclosing lender already must have title to the land. Strict foreclosure does not vest new rights in the lender; it simply eliminates the borrower's rights.¹²¹ All but three states have eliminated strict foreclosure except in the most limited circumstances.¹²² States have rejected strict foreclosure not because lenders were seeking a more efficient method of foreclosure, as they had in England. Instead, state legislatures have abolished strict foreclosure because the lender's right is only to repayment of the

(listing property that is subject to taxation; mortgagee's interest is not included); *Lockwood v. Blodgett*, 138 A. 520 (Conn. 1927); D.C. CODE ANN. §§ 47-813, -822 (1996); GA. CODE ANN. § 48-5-9 (1991) (requiring possession); *Decatur County Bldg. & Loan Ass'n v. Thigpen*, 160 S.E. 387 (Ga. 1931); ME. REV. STAT. ANN. tit. 36, § 551 (West 1999) (listing property subject to taxation but excluding mortgages); *Williams v. Hilton*, 35 Me. 547 (1853); MD. CODE ANN. TAX-PROP. §§ 6-101 to -104 (1994) (listing property that is subject to taxation; referring to interest of mortgagor or grantor under a deed of trust as taxable); N.H. REV. STAT. ANN. § 73:10 (1991) (taxing property to person claiming or in possession); R.I. GEN. LAWS § 44-4-5 (1995) ("The mortgagor shall be deemed to be the owner of mortgaged real estate, so long as the same is in the mortgagor's possession."); TENN. CODE ANN. § 67-5-501 (1994).

119. See ALA. CODE § 35-10-27 (1991); *Turner v. Flinn*, 72 Ala. 532 (1882); ARK. CODE ANN. § 18-40-109 (Michie 1987); CONN. GEN. STAT. ANN. §§ 49-9, -10 (West 1995); GA. CODE ANN. § 44-14-3 (1991); *Frost v. Gazaway*, 176 S.E.2d 476 (Ga. Ct. App. 1970); ME. REV. STAT. ANN. tit. 33, § 551 (West 1999); *Allard v. Lane*, 18 Me. 9 (1840); MD. CODE, REAL PROP. § 3-105 (1994); *Baker v. Otto*, 22 A.2d 924, 926 (Md. 1941); N.H. REV. STAT. ANN. § 479:7 (1991); R.I. GEN. LAWS § 34-26-3 (1995); *Polston v. Scandlyn*, 108 S.W.2d 1104, 1107, 1109 (Tenn. Ct. App. 1937).

120. See, e.g., *Barton v. Lumpkin*, 171 So. 2d 101, 103 (Ala. 1965); ARK. CODE ANN. § 28-11-303(c) (Michie 1987); *Fish v. Fish*, 1 Conn. 559 (1816); D.C. CODE ANN. § 19-102(b) (1996); *LaGrange Mills v. Kener*, 49 S.E. 300, 303 (Ga. 1904); ME. REV. STAT. ANN. tit. 6, ch. 65, § 32 (1884) (providing that a mortgagee's interest is not subject to dower or curtesy), *repealed*, ME. REV. STAT. ANN. tit. 18-A, §2-133 (1964); *Knox v. Stamper*, 46 A.2d 361, 365-66 (Md. 1946); *Stanton v. Boatright*, 302 S.W.2d 347, 349 (Tenn. 1957).

121. See OSBORNE, *supra* note 20, § 312, at 653.

122. Several states permit strict foreclosure in very limited circumstances, such as when a junior lienor was omitted from a judicial foreclosure sale and the mortgaged land was worth less than the outstanding amount of the debt being foreclosed. See NELSON & WHITMAN, *supra* note 113, §7.10, at 487-90. Three states permit strict foreclosure in less narrowly defined situations: (1) Connecticut: See CONN. GEN. STAT. ANN. §§ 49-15, -16, -19, -20, -24 (West 1995); (2) Vermont: See VT. R. CIV. P. 80.1 (1988); and (3) Illinois: See *Great Lakes Mortgage Corp. v. Collymore*, 302 N.E.2d 248, 250 (Ill. App. Ct. 1973).

debt and not to the land. Foreclosure by sale has been the predominant foreclosure method in America since the beginning of the nineteenth century.

Even when a lender can take possession of the mortgaged property, such as with the borrower's consent or pursuant to an assignment of rents, substantial disincentives exist for doing so. A mortgagee in possession is subject to "harsh" rules of accounting.¹²³ Pursuant to these accounting rules, a mortgagee is required to account not only for any money actually collected from the property, but also for any revenue that *could* have been generated if the mortgagee had managed the property like a "provident owner."¹²⁴ The borrower's debt must be reduced by all such revenues in excess of the lender's expenses in operating the property.

A mortgagee in possession also is subject to substantial potential management liabilities. First, the mortgagee can be liable for injuries sustained on the property and for nuisances existing on the property even if the defective condition already existed when the mortgagee went into possession of the land.¹²⁵ Second, if the mortgagee is unable to lease the land, authority exists that the mortgagee actually must work the land, such as by farming it, and must account to the borrower for the generated income.¹²⁶ If the mortgagee fails to do so, it still must account to the borrower for the land's fair rental value.¹²⁷ Third, the mortgagee is obligated to maintain the property and will be liable for damages caused by its failure to act.¹²⁸ Finally, the mortgagee may be liable for violating any covenants that run with the land.¹²⁹ These sources of management liability are particularly troublesome for the usual lenders because their land possession and management functions generally have so far atrophied from those of their earlier counterparts. Therefore, mortgagees generally prefer not to take possession of the encumbered land even if they could do so.¹³⁰

The practical and legal burdens now imposed on a mortgagee in possession, coupled with the changes in mortgage law and practice that substantially have limited the circumstances under which the mortgagee even has the option to take possession, have substantially contributed to the shift in emphasis from the land to the debt in mortgage transactions. This shift in emphasis also has been caused in large part by the dramatic transformation of the national and international capital markets. American lenders traditionally made loans based on the security of land located within fifty miles of their office.¹³¹ In part, this was due to legal

123. NELSON & WHITMAN, *supra* note 113, § 4.27, at 185.

124. NELSON & WHITMAN, *supra* note 113, § 4.27, at 186, 188.

125. See NELSON & WHITMAN, *supra* note 113, § 4.26, at 183-84; Kratovil, *supra* note 114, at 23-24.

126. NELSON & WHITMAN, *supra* note 113, § 4.28, at 188.

127. See NELSON & WHITMAN, *supra* note 113, § 4.28, at 187-88.

128. See NELSON & WHITMAN, *supra* note 113, § 4.29, at 189-90.

129. See NELSON & WHITMAN, *supra* note 113, § 4.26, at 184-85.

130. See NELSON & WHITMAN, *supra* note 113, § 4.33, at 195.

131. "In the 'good old days,' savings institutions didn't buy and sell loans. They

limitations on lenders' powers.¹³² But it also reflected the essentially personal character of the relationship between the borrower and lender.

That personal relationship has been shattered by the explosive growth of the secondary mortgage market during the past twenty-five years. Purchasers in the secondary mortgage market buy mortgage loans from the lenders that originated them. The market has caused mortgage holders to become increasingly removed from the mortgaged land. In fact, most purchasers in the secondary market have never seen the land on which they hold mortgages. The borrower's creditworthiness and the property's stream of income have become far more important to mortgage holders than the land. The result is that mortgages increasingly are viewed as investment devices administered by corporations, rather than as a personal relationship between a borrower and lender.¹³³ "The secondary market is like a great food processor. What goes in comes out unrecognizable to borrowers and lenders, but looks appetizing to investors. The raw material in the process, the mortgage itself, now is incidental to the process."¹³⁴

A secondary market for mortgages is not a new development. Mortgages have always been transferable, and a market for mortgages existed in England as early as the thirteenth century.¹³⁵ In this country, a market for mortgages has existed for the past century.¹³⁶ The market in America was relatively quiet, however, until the 1930s, when Congress acted to overcome the Great Depression's devastating effects on the housing market. Foreclosures reached record numbers, and hundreds of thousands of people were homeless.¹³⁷ Investors lost confidence in mortgage lending, which substantially contributed to a decrease in available capital and the constriction of the housing market.¹³⁸ In response, Congress created the Federal Housing Administration (FHA) in 1934. The FHA was authorized to insure home mortgage loans, thereby protecting lenders from borrower defaults. This protection enabled lenders to require smaller down payments and to extend the terms of loans, which enabled

made conventional loans within 50 miles of their home offices and kept them in portfolio until they were paid off." *Secondary Mortgage Market*, SAVINGS INSTS., Jan. 1988, at S-11.

132. See Joseph Philip Forte, *From Main Street to Wall Street: Commercial Mortgage-Backed Securities*, PROB. & PROP., Jan./Feb. 1996, at 8.

133. See 3 POWELL, *supra* note 62, at 37-38.

134. TUCHMAN, LATEST INNOVATIONS IN THE UNITED STATES MORTGAGE MARKET 126 (1990).

135. See Jo Anne Bradner, *The Secondary Mortgage Market and State Regulation of Real Estate Financing*, 36 EMORY L.J. 971, 974 (1987).

136. See Joseph C. Shenker & Anthony J. Colletta, *Asset Securitization: Evolution, Current Issues and New Frontiers*, 69 TEX. L. REV. 1369, 1380 (1991).

137. See Bradner, *supra* note 135, at 975.

138. See Robin Paul Malloy, *The Secondary Mortgage Market — A Catalyst for Change in Real Estate Transactions*, 39 SW. L.J. 991, 992 (1986).

more prospective borrowers to qualify for home loans. Government insurance also helped restore investor confidence in the mortgage market, thereby increasing available capital.

To provide further support to the housing market, Congress created the Federal National Mortgage Association (FNMA) in 1938. FNMA, which is now named Fannie Mae, was the first government agency created for the purpose of participating in the secondary mortgage market.¹³⁹ Fannie Mae's initial charge was to buy FHA-insured loans. When Fannie Mae purchased a loan, the originator had a renewed source of capital for lending and was freed from the risk of default on the loan. Moreover, through its purchases, Fannie Mae was able to funnel funds from regions of the country that had a capital surplus to regions that had insufficient capital for home lending. Because of this program's success in stimulating the housing market, Congress extended Fannie Mae's purchasing authority in the 1940s to Veterans Administration (VA) guaranteed loans.

Despite Fannie Mae's success, the secondary market remained relatively small until the 1970s.¹⁴⁰ Before 1970, Fannie Mae had been restricted to buying FHA-insured and VA-guaranteed loans.¹⁴¹ Spurred by a concern that housing demand would exceed the supply of mortgage capital, Congress expanded the government's role in the secondary market. In 1968, it divided Fannie Mae into two parts: (1) the entity currently known as Fannie Mae and (2) the Government National Mortgage Association (GNMA), which is now named Ginnie Mae. The new Fannie Mae is a federally chartered institution but is owned by private shareholders. It could now purchase conventional mortgages (mortgages that are not insured or guaranteed by a federal agency), as well as FHA and VA mortgages. Additionally, Congress authorized Fannie Mae to issue securities backed by pools of its mortgages ("mortgage-backed securities"). Unlike Fannie Mae, Ginnie Mae is a government corporation within the Department of Housing and Urban Development. Ginnie Mae was created to handle special government assistance and housing support programs and to guarantee securities backed by FHA and VA loans.¹⁴²

Despite Fannie Mae's new authority to purchase conventional loans, they were not as readily saleable on the secondary market as FHA and VA loans. With the real estate boom in the late 1960s, mortgage capital was not always available in sufficient quantities in boom areas. Therefore, Congress enacted the Emergency Home Finance Act in 1970. The Act created a third government-sponsored institution in the secondary mortgage market—the Federal Home

139. See *id.* at 992-93; Shenker & Colletta, *supra* note 136, at 1383-84.

140. See THE SECONDARY MORTGAGE MARKET: A HANDBOOK OF STRATEGIES, TECHNIQUES, AND CRITICAL ISSUES IN CONTEMPORARY MORTGAGE FINANCE 74 (Jess Lenderman ed., 1987) [hereinafter SECONDARY MORTGAGE HANDBOOK].

141. See Bradner, *supra* note 135, at 976-77.

142. See Bradner, *supra* note 135, at 977.

Loan Mortgage Corporation (FHLMC). FHLMC, which is now named Freddie Mac, specialized in buying conventional home mortgages.¹⁴³

Fannie Mae, Freddie Mac, and Ginnie Mae have been responsible for radical changes in mortgage lending relationships. To finance their secondary market activities, Fannie Mae and Freddie Mac have issued stock, bonds, and notes.¹⁴⁴ But of far greater importance are Fannie Mae's, Freddie Mac's, and Ginnie Mae's sale of mortgage securities. Rather than sell whole mortgages to individual investors, as had formerly been the practice, all three entities began creating pools of mortgages and selling either fractional ownership interests in the mortgages (participation certificates) or bonds secured by a pool of mortgages (mortgage-backed bonds). In the former, ownership of the mortgages is transferred to investors. In the latter, the investor acquires only a security collateralized by the pool of mortgages.¹⁴⁵

These mortgage securities have been immensely successful in drawing capital into the residential mortgage market. Within twenty years of their birth in 1970, mortgage-backed securities outgrew the combined markets for corporate bonds and municipal bonds.¹⁴⁶ By the mid-1990s, more than three-quarters of the new single family residential mortgages were being securitized.¹⁴⁷ Based on its sale of mortgage securities, Fannie Mae has become the largest corporation in the United States with assets exceeding \$351 billion.¹⁴⁸ Its assets are \$15 billion greater than those of Chase Manhattan, the largest U.S. bank. Fannie Mae has \$80 billion more in assets than General Electric and ranks 29th on the 1997 Fortune 500 list.¹⁴⁹

The sale of mortgage securities has enabled Fannie Mae, Freddie Mac, and Ginnie Mae to become extremely important in residential mortgage lending. At the end of 1996, Fannie Mae had total mortgages outstanding worth more than \$830 billion, which is more than one-fifth of the \$4 trillion U.S. residential mortgage market.¹⁵⁰ Together, Fannie Mae and Freddie Mac purchased 44% of the conventional conforming single-family mortgages¹⁵¹ originated in 1996, and

143. See Bradner, *supra* note 135, at 978.

144. See NELSON & WHITMAN, *supra* note 113, § 11.3, at 790.

145. See Bradner, *supra* note 135, at 983. For ease of reference, the term "mortgage securities" will be used to refer to mortgage-backed securities and participation certificates.

146. See Henry A. Fernandez, *Globalization of Mortgage-Backed Securities*, 1987 COLUM. BUS. L. REV. 357, 357.

147. See Forte, *supra* note 132, at 12.

148. See FANNIE MAE, 1996 ANNUAL REPORT 66. In a July 1997 letter, Fannie Mae announced that its assets had increased to \$366 billion. *Id.*

149. See Richard W. Stevenson, *The Velvet Fist of Fannie Mae*, N.Y. TIMES, Apr. 20, 1997, at F9.

150. See FANNIE MAE, 1996 ANNUAL REPORT 2.

151. "Conventional" mortgages are mortgages that are not insured or guaranteed by a federal agency. "Conforming" mortgages are mortgages securing an original <https://scholarship.law.missouri.edu/mlr/vol64/iss2/1>

41% and 53% of the loans originated in 1995 and 1994, respectively.¹⁵² In the first quarter of 1998, Fannie Mae and Freddie Mac issued \$103.53 billion in new mortgage-backed securities.¹⁵³ In 1995, Ginnie Mae financed 800,000 residential mortgages, and its mortgage-backed securities program guaranteed securities totaling \$64 billion. Its total mortgage-backed securities outstanding were valued at \$464 billion.¹⁵⁴

This tremendous market presence in the residential mortgage market has profoundly altered the formerly personal nature of the mortgage lending relationship. This change has been further fueled by private entities' sale of mortgage-backed securities. In 1977, Bank of America was the first private entity to sell mortgage-backed securities.¹⁵⁵ Despite the success of this issuance, the growth of the private mortgage-backed securities market did not initially enjoy the same explosive growth as the market for Fannie Mae, Freddie Mac, and Ginnie Mae securities because these government-related entities were free of several regulatory constraints binding private issuers.¹⁵⁶

To encourage the private sector's involvement in raising capital for residential mortgage lending, Congress enacted the Secondary Mortgage Market Enhancement Act of 1984 (SMMEA).¹⁵⁷ The Act eliminates many of the legal obstacles to private issuances, although it does not provide the full faith and credit of the United States. Despite this remaining competitive disadvantage, the private mortgage securities market rapidly expanded after SMMEA's enactment. Within four years, private offerings increased seven-fold to more than \$71 billion; more than one-third of all private offerings were mortgage-backed securities.¹⁵⁸

The mortgage securities market had another substantial growth spurt in the 1980s when it expanded into commercial mortgage lending. The commercial

principal amount that is less than a statutorily-specified limit. "Single-family" includes one-to-four family homes. FREDDIE MAC, 1996 ANNUAL REPORT 16.

152. See FREDDIE MAC, 1996 ANNUAL REPORT 16.

153. See *Fannie, Freddie Report Record Earnings in Boom Mortgage Market of Early '98*, INSIDE MORTGAGE FIN., Apr. 24, 1998, at 9.

154. See GOVERNMENT NAT'L MORTGAGE ASSOC., 1995 ANNUAL REPORT 1.

155. See Bradner, *supra* note 135, at 979.

156. For example, unlike the private issuers at this time, the government-related issuers did not have to register their offerings under the securities laws and were not bound by state legal investment laws and blue sky laws. Moreover, Ginnie Mae securities are less risky than private securities because Ginnie Mae's securities are backed by the full faith and credit of the United States. Although Fannie Mae and Freddie Mac are not similarly backed, investors commonly assume that the federal government would stand behind securities issued by them. See Bradner, *supra* note 135, at 980; Shenker & Colletta, *supra* note 136, at 1385-86.

157. Pub. L. No. 98-440, 98 Stat. 1689 (1984) (codified in scattered sections of 12 U.S.C. and 15 U.S.C.).

158. See Edward L. Pittman, *Economic and Regulatory Developments Affecting Mortgage Related Securities*, 64 NOTRE DAME L. REV. 497, 497 (1989).

market had remained largely unsecuritized during the rapid expansion of the residential market for two primary reasons. First, commercial properties and loans are less uniform than residential properties and loans. As a result, the commercial real estate lending market historically has not had uniform underwriting standards or loan documentation, both of which are essential to investor evaluation of the mortgages in a securitized pool. Second, the federal government traditionally has not been as concerned with the commercial real estate market as it has been with the housing market. Therefore, the federal government did not provide the same supports to the commercial market that it provided to the residential market, such as buying, insuring, guaranteeing, and pooling mortgages.¹⁵⁹

The commercial mortgage market greatly expanded, however, in the 1980s. At that time, credit rating agencies began evaluating and rating commercial mortgages as they had been doing for residential mortgages for a decade. With ratings available for commercial mortgage securities, they became far more saleable. Even investors without any knowledge about the real estate and mortgage markets now could evaluate the relative benefits of investing in commercial mortgage securities in comparison to other types of investments.¹⁶⁰ The commercial mortgage securities market was further accelerated when the federal government began issuing commercial mortgage securities. In 1989, Congress created Resolution Trust Corporation (RTC) to handle the assets of failed thrift institutions.¹⁶¹ In that process, RTC had to dispose of an immense number of mortgages. Because disposing of them individually would have been extremely difficult and time-consuming, RTC pooled them and issued mortgage-backed securities. In 1992 alone, it issued \$9.1 billion in these securities.

The methods RTC created to securitize these mortgages have provided a more uniform national structure for the secondary market to securitize commercial mortgages.¹⁶² Although commercial mortgage-backed securities were issued for less than five and one-half percent of the total outstanding commercial mortgage debt in 1994,¹⁶³ many people speculate that securitization may substantially displace traditional commercial mortgage lending practices as it has in the residential mortgage lending market.¹⁶⁴ If that prediction is correct, the total value of mortgage-backed securities in this country will increase

159. See Shenker & Colletta, *supra* note 136, at 1398-99.

160. See Shenker & Colletta, *supra* note 136, at 1401-02.

161. Financial Institutions Reform, Recovery, and Enforcements Act of 1989, Pub. L. No. 101-73, § 501, 103 Stat. 183, 184 (1989) (codified in scattered sections of 12 U.S.C.).

162. See Laurence G. Preble, *The Recapitalization of Real Estate*, PROB. & PROP., Mar./Apr. 1994, at 45, 48-49.

163. See Forte, *supra* note 132, at 13.

164. See Peter F. Culver, *The Dawning of Securitization*, PROB. & PROP., Mar./Apr. 1994, at 34, 34.

dramatically; commercial properties in the United States have an estimated aggregate value of a few trillion dollars.¹⁶⁵

The rapidly growing secondary mortgage market is not the only real estate finance vehicle that is displacing the traditionally personal relationship between borrowers and lenders. The real estate investment trust (REIT), which has been enjoying a resurgence of popularity in the 1990s, is having the same effect.¹⁶⁶ A REIT is a corporation or trust that pools investors' funds to make mortgage loans ("mortgage REITs") or to buy real estate ("equity REITs").¹⁶⁷ Their popularity with investors is demonstrated by the immense size of their holdings; American REITs currently have more than \$116.6 billion in assets.¹⁶⁸

In fact, Congress authorized the creation of REITs as a means to encourage investors to invest in real estate in the same way that they invest in stock and bond mutual funds.¹⁶⁹ REIT shares are traded on national and regional stock exchanges, including the New York Stock Exchange, the American Stock Exchange, and NASDAQ. REIT shares provide investors with greater liquidity and diversity than is possible with more traditional forms of real estate investment.¹⁷⁰ But REIT investors, like mortgage securities investors, are far removed from the land in which they acquire an interest. Most REIT investors never even see the land; they simply buy shares at a stock exchange.

Investors' unfamiliarity with the lands in which they own interests is most clearly illustrated by the popularity of American mortgage securities and REITs with foreign investors.¹⁷¹ Billions of dollars of these securities are listed on foreign stock exchanges and have been sold throughout the world.¹⁷² The rapidly increasing foreign appetite for American real estate securities has been responsible for the galloping growth of American investment bankers' overseas

165. See Shenker & Colletta, *supra* note 136, at 1397.

166. REITs had been widely used in the early 1970s, but the REIT market crashed in the mid-1970s in what has been called the "REIT debacle." See James de Bree, *Unleveraged Buyouts: Using REITs to Securitize Real Estate*, REAL EST. FIN. J., Fall 1993, at 31, 31.

167. Larry Witner, *REITs: The Revolution in Real Estate Financing*, 22 REAL EST. L.J. 248, 249 (1994).

168. See NAREIT Online, Doc. #20 <<http://www.nareit.com/taxondem/201.html>>.

169. See Preble, *supra* note 162, at 45.

170. See Preble, *supra* note 162, at 46; cf. Edward I. Biskind, "Old-Fashioned" Real Estate Investment: A Viable Choice for the 1990's, REAL EST. FIN. J., Winter 1997, at 65.

171. American mortgage securities and REITs are attractive to foreign investors for several reasons. One of the primary reasons is to avoid the tax on capital gains imposed by the Foreign Investment in Real Property Tax Act. See Witner, *supra* note 167, at 251; see also de Bree, *supra* note 166, at 32.

172. See David Alan Richards, "Gradable and Tradable:" *The Securitization of Commercial Real Estate Mortgages*, 16 REAL EST. L.J. 99, 110 (1987); see also TUCHMAN, *supra* note 134, at 21, 40, 42; Malloy, *supra* note 138, at 1014 n.155; Shenker & Colletta, *supra* note 136, at 1422-26.

offices. For example, Morgan Stanley's London office increased from 80 to 750 people in four years, and its Tokyo office grew from 15 to 350 people in that same time.¹⁷³ Presumably, the international investors in American real estate securities have never seen, much less inspected, the lands underlying them.

In fact, a key attraction of mortgage securities is that investors do not have to conduct the types of property evaluations necessary for more direct forms of real estate investment.¹⁷⁴ The phenomenal growth in the secondary market is largely attributable to its success in attracting investment by the huge pool of investors who formerly avoided investing in real estate because of a lack of real estate expertise.¹⁷⁵ Mortgage securities are touted as an investment that does not require the time consuming and tedious task of evaluating hundreds or thousands of loan files. Like foreign investors, American investors rarely examine an appraisal or title report, much less inspect the property itself.¹⁷⁶ Indeed, property inspections would be daunting for even the most energetic investor. To diversify risk and to maintain liquidity, mortgage pools are geographically diverse. For example, one credit rating agency's ratings require that no more than ten percent of the properties in the mortgage pool be from any one standard metropolitan statistical area.¹⁷⁷

Rather than relying on personal evaluations, mortgage securities investors normally rely on credit ratings.¹⁷⁸ As described above, the commercial mortgage securities market did not become firmly established until credit ratings became available.¹⁷⁹ But even the rating agencies do not significantly focus on the mortgaged land in assessing the risk of mortgage securities. Although mortgage investors traditionally had been primarily concerned with the quality of the mortgaged land, the land has a relatively insignificant effect on today's ratings. Instead, the ratings are based on the mortgage pool's projected cash flow.¹⁸⁰ The physical condition of the mortgaged properties is a factor considered in an analysis of a mortgage pool, but it is only one factor of many. Virtually every other factor focuses on the loans.¹⁸¹ Rating agencies normally do not even

173. See Fernandez, *supra* note 146, at 362.

174. See 3 POWELL, *supra* note 62, at 37-43; SECONDARY MORTGAGE HANDBOOK, *supra* note 140, at 74; Bradner, *supra* note 135, at 990; *Secondary Mortgage Market*, *supra* note 131, at S-14.

175. See Bradner, *supra* note 135, at 990.

176. See 3 POWELL, *supra* note 62, at 37-43; Richards, *supra* note 172, at 119.

177. See Bradner, *supra* note 135, at 991 n.92.

178. See Forte, *supra* note 132, at 12.

179. See Richards, *supra* note 172, at 113; Shenker & Colletta, *supra* note 136, at 1401.

180. See Richards, *supra* note 172, at 115; Shenker & Colletta, *supra* note 136, at 1401.

181. See Forte, *supra* note 132, at 12; Norman Weinberg, *The Changing Wisdom Regarding Real Estate Investment Strategy*, REAL EST. REV., Winter 1997, at 3.

inspect the land, but instead simply rely on photographs.¹⁸² For residential mortgages, agencies usually do not even look at photographs.

This focus on cash flow reflects the school of thought that a loan should not be made if the land is necessary to justify the extension of credit.¹⁸³ But the pressure to produce loans has caused originators to make loans with less documentation than traditionally has been required for mortgage loans.¹⁸⁴ This lack of attention to the land and to its value became so pronounced and widespread that, as part of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989, Congress enacted legislation to regulate appraisers and the appraisal process in an effort to make appraisals more accurate.¹⁸⁵ The House Committee on Government Operations reported that incorrect appraisals had become a "serious national problem" that "seriously damaged" and "contributed directly to the insolvency of hundreds" of financial institutions.¹⁸⁶ The immense dimensions that this problem assumed before being recognized again demonstrates the mortgage securities market's general indifference to the mortgaged land.

The rapid and pervasive automation of lending activities and of the mortgage securities market has significantly contributed to a focus on the quantitative aspects of the securities offering, rather than on its qualitative features, such as the condition of the mortgaged land. Lenders now originate out-of-state loans by means of computerized loan origination networks.¹⁸⁷ Technology also has facilitated the rapid sale of loans from their originators to the secondary market.¹⁸⁸ When Freddie Mac first computerized its purchasing activities in the early 1980s, an investment banker transferred 1,070 loans to Freddie Mac in twelve minutes via Freddie Mac's computer.¹⁸⁹ Fannie Mae estimates that, by the year 2000, eighty percent of its loan purchases will be by

182. See Richards, *supra* note 172, at 119.

183. See Joanne Robbins Hicken, *Real Estate Appraisers and Appraisals: Changes Mandated by FIRREA*, 20 REAL EST. L.J. 157, 178-79 (1991).

184. See TUCHMAN, *supra* note 134, at 39; Pittman, *supra* note 158, at 546;

185. 12 U.S.C. §§ 3331-3352 (1994). Section 3331 provides:

The purpose of this chapter is to provide that Federal financial and public policy interests in real estate related transactions will be protected by requiring that real estate appraisals utilized in connection with federally related transactions are performed in writing, in accordance with uniform standards, by individuals whose competency has been demonstrated and whose professional conduct will be subject to effective supervision.

12 U.S.C. § 3331 (1994).

186. HOUSE COMM. ON GOV'T OPERATIONS, IMPACT OF APPRAISAL PROBLEMS ON REAL ESTATE LENDING, MORTGAGE INSURANCE, AND INVESTMENT IN THE SECONDARY MARKET, H.R. REP. NO. 99-891, at 8 (1986).

187. See Richards, *supra* note 172, at 110.

188. See Malloy, *supra* note 138, at 994 n.23; Pittman, *supra* note 158, at 541; Richards, *supra* note 172, at 110.

189. See TUCHMAN, *supra* note 134, at 39.

computer.¹⁹⁰ Technology also has been created to facilitate mortgage securities trading by providing rapid access to sophisticated information about securities, analysis of investment opportunities, and stewardship of holdings.

Such rapid and massive selling of mortgages and mortgage securities requires uniformity. Standardization of mortgage loans enables purchasers to invest in mortgages without separately analyzing each mortgage in the pool. Mortgages become more liquid investments, and transaction costs are diminished. As a result, the mortgage market operates more efficiently.¹⁹¹

Although borrowers benefit from the resulting enhancement in the flow of capital nationally and internationally, the market demand for standardization has triggered a ripple effect, each ring of which increasingly has caused a decline in the individualized treatment of borrowers. The first wave of homogenization was the standardization of loan documentation. In 1970, Fannie Mae and Freddie Mac promulgated standard residential loan forms.¹⁹² The documents became so widely used that, by 1984, the then Vice Chair of the Federal Reserve Bank said: "We have now reached a point where conventional mortgage documents are standardized nationally."¹⁹³ Commercial loan documentation currently is undergoing a similar, albeit less rapid and thorough, standardization process.¹⁹⁴

The next wave of homogenization moved beyond the terms of the loan and has affected the work to be performed with the loan proceeds. Developers now are counseled to plan the funded building project in accordance with secondary mortgage market construction standards. "Increasingly, [borrowers and lenders] must refer to the objectives and business standards of unknown investors as benchmarks for the conduct of what superficially appears to be a local real estate transaction."¹⁹⁵

The next outward ripple has affected industries related to mortgage lending. Fannie Mae and Freddie Mac now investigate private mortgage insurers and maintain an approved list of insurers.¹⁹⁶ To decrease the transaction costs that would be incurred to separately examine the insurance for each mortgage in the pool purchased or securitized, mortgage insurance also has become increasingly standardized.¹⁹⁷

The final ripple of standardization has the potential to cause the most dramatic change to the mortgage relationship. Despite the states' jealous control of the laws affecting land within their borders, the market pressure for

190. See FANNIE MAE, 1996 ANNUAL REPORT 5.

191. See Bradner, *supra* note 135, at 991-92; Malloy, *supra* note 138, at 1014-15.

192. See NELSON & WHITMAN, *supra* note 113, §3.36, at 789.

193. H.R. REP. NO. 98-994 (1984), reprinted in 1984 U.S.C.C.A.N. 2827, 2846. See also 3 POWELL, *supra* note 62, at 37-44.

194. See Forte, *supra* note 132, at 14.

195. Malloy, *supra* note 138, at 1017.

196. See NELSON & WHITMAN, *supra* note 113, §11.3, at 789.

197. See Bradner, *supra* note 135, at 991 n.93.

federalization of mortgage law, particularly with respect to foreclosures, is increasing. With the expanding importance of the secondary market, mortgage loans are more widely being viewed as a matter of national, rather than strictly local, importance.¹⁹⁸ The secondary market wants standardized mortgage laws for the same reasons it wants standardized loan documents, construction standards, and mortgage-related services—to decrease transaction costs, increase efficiency, and facilitate the secondary mortgage market.

The differences among states' foreclosure laws are particularly troublesome to the secondary market because of the impact these laws can have on the amount and timing of the income stream from the mortgage pool.¹⁹⁹ A state's foreclosure methods and foreclosure-related borrower protection laws can substantially affect the collectability of a defaulted loan. For example, the Minnesota statutory redemption statute permits a borrower to retain possession of property for up to a year after it has been sold at a foreclosure sale.²⁰⁰ In California, a lender may be prohibited by an antideficiency statute from suing a borrower for repayment of the debt after a foreclosure sale even if the mortgaged land has dropped in value to less than the debt amount.²⁰¹ These Minnesota and California laws are not anomalies. Many states have similar statutes.²⁰² Moreover, states vary greatly in the amount of time and money needed to complete a foreclosure sale.²⁰³

The differences among the states are so pronounced that they can have a significant impact on the value of mortgage securities. For this reason, prospectuses for mortgage securities offerings usually include a description of the mortgage laws for the states in which the pooled mortgages originated.²⁰⁴ The relevant state laws also significantly affect credit rating agencies' evaluations of mortgage securities.²⁰⁵ Presumably, mortgage securities with lower ratings will be less attractive to investors and may impede the flow of mortgage capital to those states with more pro-borrower foreclosure laws.

To prevent this disruption in the flow of capital, some commentators have called for Congress to intervene and preempt state foreclosure laws with a uniform national procedure.²⁰⁶ At first, federal preemption of this magnitude may seem unthinkable. The great variations among states' foreclosure laws reflects decades of evolution in the borrower-lender relationship based on the unique experiences of each state. However, the federal government has

198. See Bradner, *supra* note 135, at 971, 991; Malloy, *supra* note 138, at 1018.

199. See Bradner, *supra* note 135, at 994-95, 1000.

200. MINN. STAT. ANN. § 580.23 (West 1988).

201. CAL. CIV. PROC. CODE. §§ 580b, 580d (West 1999).

202. See NELSON & WHITMAN, *supra* note 113, §§ 8.3, 8.4.

203. See Bradner, *supra* note 135, at 997-98.

204. See Bradner, *supra* note 135, at 995.

205. See Bradner, *supra* note 135, at 994-95, 1000-01.

206. See Bradner, *supra* note 135, at 1001, 1003.

demonstrated its willingness to preempt state mortgage lending laws in three ways.

First, Congress already has enacted laws preempting state foreclosure laws for loans held by the Department of Housing and Urban Development (HUD). Congress enacted the Single Family Mortgage Foreclosure Act in 1994²⁰⁷ and the Multi-Family Mortgage Foreclosure Act in 1981²⁰⁸ for HUD-held loans. Each Act exempts HUD from state foreclosure laws. During the past two years, Congress has come very close to enacting a federal foreclosure bill that would have preempted state foreclosure laws for all mortgages held by any federal agency.²⁰⁹ Although the bill was not enacted, knowledgeable observers are predicting that it will be introduced in Congress again.²¹⁰ As Congress attempts to balance the federal budget, the significant cost savings resulting from an elimination of borrower protection statutes and from a speedier foreclosure process make preemption of state law particularly attractive.

Second, even without express congressional preemption, a variety of federal agencies rely on the Supremacy Clause of the U.S. Constitution to justify their refusal to comply with state mortgage laws. When an agency acts as a mortgagee, its actions are governed by federal law. The issue that arises in this context is whether the agency should adopt state law as the federal rule or craft a new federal rule to be applied nationally.²¹¹ Even in the absence of an express preemptive federal regulation, agencies often refuse to adopt state law as the federal rule. Federal agencies have been particularly hostile to state mortgagor protection laws, such as statutory redemption rights and antideficiency legislation.²¹²

The outcomes in cases concerning the agencies' obligation to observe state mortgage law have been mixed,²¹³ particularly because the United States Supreme Court's most important decision on this issue, *United States v. Kimbell Foods*,²¹⁴ sets out a three-part test that provides little concrete guidance. In determining whether a federal agency should observe state law as the federal rule, the Court said that three factors must be considered: (1) whether the federal program, by its nature, requires uniform national rules; (2) whether application of state law would frustrate the federal program's objectives; and (3) the extent to which application of a federal rule would disrupt commercial relationships

207. 12 U.S.C. §§ 3751-3768 (1994).

208. 12 U.S.C. §§ 3701-3717 (1994).

209. The bill originally was included in H.R. 2234, which was designated the Debt Collection Improvement Act of 1995. It since has been included in a variety of other bills. See Patrick A. Randolph, Jr., *The New Federal Foreclosure Laws*, 49 OKLA. L. REV. 123, 123 (1996).

210. See *id.*

211. See *United States v. Kimbell Foods, Inc.*, 440 U.S. 715, 718 (1979).

212. See NELSON & WHITMAN, *supra* note 113, §11.6, at 843.

213. See NELSON & WHITMAN, *supra* note 113, §11.6, at 845-46.

214. 440 U.S. 715 (1979).

that were based on state law.²¹⁵ The frequency with which federal agencies refuse to observe state law since the *Kimbell Foods* decision indicates the agencies' belief that state regulation of mortgage transactions is less important than a more efficient federal mortgage program.

Finally, Congress has preempted state law to protect lenders and the capital markets even when a federal agency is not directly involved in the loan relationship. When rapidly rising interest rates threatened the viability of banks, savings and loan associations, and other lenders in the 1980s, Congress preempted state law restrictions on the enforceability of due-on-sale clauses,²¹⁶ usury,²¹⁷ and alternative mortgage instruments.²¹⁸ Although the usury law preemption applied only to federally-related loans, Congress extended the due-on-sale clause and alternative mortgage instruments preemptions to state-chartered lenders. Additionally, Congress has imposed affirmative obligations on many, or in some cases all, state-chartered lenders pursuant to legislation such as the Real Estate Settlement Procedures Act,²¹⁹ which imposes disclosure requirements concerning closing-related services and prohibits referral fees; the Truth in Lending Act,²²⁰ which imposes disclosure requirements concerning finance charges; the Fair Housing Act,²²¹ which prohibits discrimination in the terms or availability of mortgage loans; and the Home Mortgage Disclosure Act,²²² which requires lenders to publish information about their residential lending activities.

These incursions by the federal government into the area of mortgage law reflect both its desire for a more uniform and efficient system and its willingness to displace state law with federal law. Congress's enactment of the Secondary Mortgage Market Enhancement Act²²³ demonstrates most pointedly its willingness to act to assist the growth of the secondary mortgage market. The importance of the foreclosure process to the desirability of mortgage securities offerings may prompt Congress to preempt state law.

Congress may be particularly motivated to preempt state foreclosure laws because past attempts to achieve voluntary national uniformity by the states have failed. The National Conference of Commissioners on Uniform State Laws has promulgated two model acts that include mortgage foreclosure procedures—the

215. *See id.* at 728.

216. 12 U.S.C. § 1701j-3 (1994).

217. 12 U.S.C. § 1735f-7 (1994).

218. 12 U.S.C. §§ 3801-3806 (1994).

219. 12 U.S.C. §§ 2601-2617 (1994 & Supp. II 1996).

220. 15 U.S.C. §§ 1601-1693 (1994 & Supp. II 1996).

221. 42 U.S.C. §§ 3601-3631 (1994 & Supp. II 1996).

222. 12 U.S.C. §§ 2801-2811 (1994 & Supp. II 1996).

223. *See supra* text accompanying note 157.

Uniform Land Transactions Act²²⁴ and the Uniform Land Security Interest Act.²²⁵ Despite the benefits of uniformity in this area, neither Act has been adopted in any state. Therefore, Congress may determine that federal imposition of uniform foreclosure procedures would mark the end of a process by which the traditionally personal relationship between borrower and lender has been transformed to a transaction governed by the needs of the national market.

Because mortgage lending has become so focused on the national and international markets, far less attention is paid to the local aspects of the mortgage transaction. The traditional lender has become increasingly less important as evidenced by the rapid growth of the mortgage banking industry. Mortgage bankers offer potential borrowers an array of mortgage loan programs. Providing information and choice is the mortgage banker's primary service to the borrower. The mortgage banker will originate the loan but will not continue as mortgagee for very long. Mortgage bankers typically sell the loans they originate within 90 to 180 days.²²⁶ Although the mortgage banker may continue to service the loan by collecting payments and performing related services, information and choice apparently have become more important to borrowers than a long-term personal relationship with a lender. In 1996, mortgage bankers originated 57% of the \$785.4 billion in new single-family residential mortgage loans.²²⁷

But even loan origination has the potential to become increasingly depersonalized. Just as technology has facilitated the sale of mortgage securities by the secondary market, it facilitates loan originations. Computerized loan origination networks (CLOs) are computer systems that provide information to prospective borrowers about a variety of loan products and services. In addition, some CLOs can process, underwrite, and originate loans.²²⁸ Although the CLO normally is operated from the office of a person with whom the borrower has worked to buy property, such as a real estate agent or a builder, the borrower may not have any personal contact with the lender making the loan.²²⁹ In fact, the borrower may not even know who the lender is until the payment coupon book arrives in the mail.

224. Unif. Land Transactions Act §§ 3-501 to -513, 13 U.L.A. 469, 599-622 (1986).

225. Unif. Land Security Interest Act §§ 501-514, 7A U.L.A. 403, 449-73 (Supp. 1999).

226. See *The Mortgage Banking Process*, California Mortgage Bankers Association <<http://www.cmba.com/html/mortgageprocess.htm>>.

227. See U.S. DEP'T OF HOUSING & URBAN DEV., SURVEY OF MORTGAGE LENDING ACTIVITY 1, 2 (1997).

228. See HUD Statement of Policy 1996-1: Computer Loan Origination Systems (CLOs), 24 C.F.R. pt. 3500 (1998).

229. See Henry L. Judy, *The U.S. Electronic Mortgage Market*, 12TH BIENNIAL CONF. OF THE INT'L BAR ASS'N SECTION OF BUS. L. 18 (1995).

Some CLOs have exceeded \$1 billion in annual originations.²³⁰ Although this dollar amount is large, it is a small percentage of the residential mortgage origination market, which annually places hundreds of billions of dollars in loans. But the efficiency of CLOs with the attendant decrease in transaction costs makes computerized loan origination an attractive alternative for many borrowers and lenders.

However, CLOs have a new rival for business—the Internet. During the past few years, borrowers have been able to get information on a great variety of loan programs and even to originate loans via the Internet.²³¹ With access to loans from the solitude of home or office, prospective borrowers no longer need to access information through a real estate agent's CLO, much less through a loan officer at a bank or even a mortgage banker. Although Internet loan programs are in their infancy, they present the specter of a future in which the mortgage relationship is completely depersonalized. Whether called "lenderless loans"²³² or "paperless mortgages,"²³³ modern mortgages have evolved a great deal since the time when lenders took possession of mortgaged land and were responsible for its physical condition.

Mortgages now are owned by faceless groups of investors from around the world. Loan transactions conform to the secondary market's standards, rather than to the particulars of the borrower's needs, and the pressure of the market is increasingly standardizing mortgage law and practice. The emphasis on efficiency has shifted loan originations from the local lender to mortgage bankers and potentially to the electronic realm. But these tremendous forces have been yielding at least in part to the enormity of the societal problems that America is confronting today. Just as economic forces caused the increasing distance between mortgage holder and landowner, societal forces are causing the relationship to contract.

III. THE THIRD ERA

Mortgage law has now entered its third era. The hallmark of this era is the imposition of liabilities and responsibilities on mortgagees for the mortgaged land, which represents a significant break with the past. The first era of mortgage law was marked by increasing enhancement and protection of the

230. See Christopher M. Hess & Chris F. Kemerer, *Computerized Loan Origination Systems: An Industry Case Study of the Electronic Markets Hypothesis*, MIS Q., Sept. 1994, at 251, 262.

231. See James R. DeBoth, *The Internet is Reviving Computerized Loan Origination*, <<http://banking.interest.com/sa960131.htm>>; H. Jane Lehman, *Shop for a Home on the Internet?*, 79 CONSUMERS' RES. MAG. 31 (1996), available in 1996 WL 9051709; BANK ADV. NEWS, May 9, 1997, at 6, available in 1997 WL 10158606.

232. See Preble, *supra* note 159, at 50.

233. See *The Paperless Mortgage*, NAT'L MORTGAGE NEWS, Mar. 5, 1997, available in 1997 WL 8644333.

lender's rights in the mortgaged land, which culminated in the Littletonian gage. During the second era, when the debt became more important to lenders than the mortgaged land, the law enhanced and protected the value of the debt with holder-in-due-course status. At the same time, the lender became increasingly removed from the mortgaged land. In contrast, the third era is characterized by the imposition of burdens on mortgagees. The shift has been caused by the enormity of some of the problems with which American society is struggling—in particular, environmental degradation and crime. Largely beginning in the 1980s, the government has enlisted the resources of financial institutions to fight these battles, as well as a variety of smaller battles. The effect has been to bring mortgagees closer to the mortgaged land.

A. Asset Forfeiture

Asset forfeiture laws are a striking example of the law's changed treatment of lenders. Although forfeiture laws are of ancient origin and have existed in this country for over two hundred years,²³⁴ they were seldom enforced until the 1980s.²³⁵ Law enforcement agencies have since been enforcing them with breathtaking aggressiveness. The United States General Accounting Office (GAO) reported that the value of inventoried properties seized by the Departments of Justice and the Treasury increased from \$33 million in 1979 to

234. The history of asset forfeiture law dates to Biblical times. If an object caused the death of a person, the object or its value was forfeited to the state as a "deodand" to be used in expiation for the death. "If an ox gore a man or a woman, and they die, he shall be stoned and his flesh shall not be eaten." *Exodus* 21:28. As the religious significance of forfeiture waned, government recognized that forfeiture served both as a source of revenue and as a punishment for careless or criminal acts. Historically, English law recognized three kinds of forfeiture: (1) deodand, (2) common-law forfeiture, which forfeited the property of convicted felons and traitors to the Crown, and (3) statutory forfeiture for property used in violation of the customs and revenue laws. The United States adopted English statutory forfeiture law but not deodand or common law forfeitures. See DAVID B. SMITH, PROSECUTION AND DEFENSE OF FORFEITURE CASES 3-1 (1997) (stating forfeiture must be authorized by a specific statute). For a discussion of the history of forfeiture, see 1 STEVEN L. KESSLER, CIVIL AND CRIMINAL FORFEITURE: FEDERAL AND STATE PRACTICE § 1.02 (1997); George C. Pratt & William B. Peterson, *Civil Forfeiture in the Second Circuit*, 65 ST. JOHN'S L. REV. 653, 656-64 (1991) (tracing the history of forfeiture in colonial and antebellum America and through "a substantial body of case law on civil forfeiture" in the Second Circuit).

235. See U.S. GEN. ACCT. OFF., ASSET FORFEITURE: A SELDOM USED TOOL IN COMBATING DRUG TRAFFICKING (1981) [hereinafter ASSET FORFEITURE: A SELDOM USED TOOL]; U.S. GEN. ACCT. OFF., HIGH RISK SERIES: ASSET FORFEITURE PROGRAMS (1995) [hereinafter HIGH RISK SERIES]; HR REP. NO. 95-7, at 5 (1995), available in 1995 WL 234642 ("Although the government has had forfeiture authority for over 200 years, it was rarely utilized as a law enforcement tool until the 1980s.").
<https://scholarship.law.missouri.edu/mlr/vol64/iss2/1>

almost \$2 billion in 1994.²³⁶ Hundreds of millions of dollars of assets have been added to the federal Assets Forfeiture Fund since then.²³⁷ By 1993, the federal government alone had seized over 30,000 pieces of real and personal property²³⁸ based on over 140 federal forfeiture provisions.²³⁹ The states also have become aggressive in their use of forfeiture laws.²⁴⁰ Many of these federal and state laws can destroy a mortgage even if the lender has acted in complete good faith. Moreover, the government may attempt to recoup payments already made to the lender by arguing that they were made with forfeitable funds.²⁴¹

The government's interest in forfeiture initially was sparked by two major criminal concerns—organized crime and the illegal drug trade. In 1970, Congress enacted both the Racketeer Influenced and Corrupt Organizations Act (RICO)²⁴² to fight criminal organizations and the Continuing Criminal Enterprise Act (CCE) to fight drug trafficking operations.²⁴³ Both laws include forfeiture

236. See HIGH RISK SERIES, *supra* note 235, at 2.

237. The Department of Justice reported that new assets worth \$487.5 million were added to the Fund in 1995, \$338.1 million in 1996, and \$110 million in the first quarter of 1997. *Civil Asset Forfeiture Reform Act: Hearings on H.R. 1835 Before the House Comm. on the Judiciary*, 105th Cong. 116 (1997) (statement of Stefan D. Cassella, Assistant Chief, Asset Forfeiture and Money Laundering Section, Criminal Division, Department of Justice).

238. See Steven L. Schwarcz & Alan E. Rothman, *Civil Forfeiture: A Higher Form of Commercial Law?*, 62 *FORDHAM L. REV.* 287, 289 (1993).

239. See KESSLER, *supra* note 234, § 7.01, at 7-3 (Release #6, 10/97). They cover a wide variety of activities, including smuggling, copyright infringement, tax fraud, money laundering, and drug trafficking. For a comprehensive listing of the federal forfeiture statutes, see KESSLER, *supra* note 234, app. B; Elizabeth A. Skorcz, Comment, *RICO Forfeiture: Secured Lenders Beware*, 37 *U.C.L.A. L. REV.* 1199, 1212-15 (1990) (discussing RICO's forfeiture provisions). The Money Laundering Act, 18 *U.S.C.* § 981 (1994), is an example of a federal forfeiture statute that poses significant risks for lending institutions. See Edward E. Sterling, *Responding to the Risks of Forfeiture (With Form)*, 394 *PLI/REAL* 445, 448 (1992) ("In the upcoming years, concern about the risk of forfeiture of real property will probably be centered on the Money Laundering Act.").

240. For example, between 1989 and 1993, California state law enforcement officials seized more than \$170 million in assets pursuant to California forfeiture laws. See Sarah Henry, *The Thin Green Line*, *CAL. LAW.*, Sept. 1994, at 46, 47. Assets of more than \$3 million were seized in a single New York county by the District Attorney between 1990 and 1992. See Mary M. Cheh, *Can Something This Easy, Quick, and Profitable also be Fair? Runaway Civil Forfeiture Stumbles on the Constitution*, 39 *N.Y.L. SCH. L. REV.* 1, 48 n.16 (1994). In New Jersey, between 1986 and 1992, state officials seized and sold more than \$83 million in assets pursuant to New Jersey's forfeiture laws. See Jay Romano, *Protests Mount over Police Confiscations*, *N.Y. TIMES*, Sept. 13, 1992, at 1.

241. See Skorcz, *supra* note 239, at 1202.

242. 18 *U.S.C.* §§ 1961-1968 (1994).

243. 21 *U.S.C.* § 848 (1994).

provisions. Many states have since enacted laws patterned after RICO²⁴⁴ and CCE,²⁴⁵ as well as a wide variety of other forfeiture statutes.

Although organized crime and the illegal drug trade sparked the government's interest, the explosive growth in the use of forfeiture is attributable to a variety of other factors, including the increasing variety and number of forfeiture laws,²⁴⁶ statutory amendments that expanded the reach of existing forfeiture laws,²⁴⁷ and ballooning government expenditures to combat crime.²⁴⁸ Aggressive use of forfeiture laws also can be motivated by racial prejudice²⁴⁹ and by efforts to boost arrest and seizure rates.²⁵⁰ However, the strongest impetus may be financial self-interest. When addressing a group of law enforcement personnel at a seminar on forfeitures, a United States Attorney reportedly said: "Ladies and gentlemen, this is a gold mine."²⁵¹ Through a procedure known as "ear-marking," law enforcement agencies that carry out forfeitures often receive

244. See, e.g., MINN. STAT. ANN. §§ 609.901- .912 (West 1988); WIS. STAT. ANN. §§ 946.80- .88 (West 1991); see also Paul Van Houten et al., *RICO*, 28 AM. CRIM. L. REV. 637, 637 n.1 (listing the thirty-one "little RICO" state laws).

245. The state laws often are based on the model civil drug forfeiture act, the Uniform Controlled Substances Act (U.C.S.A.), which is patterned after the federal Controlled Substances Act. UNIF. CONTROLLED SUBSTANCES ACT §§ 101-607 (1970), 9 U.L.A. 652 (1997). The CCE was part of the Controlled Substances Act. See 21 U.S.C. §§ 801-971 (1994).

246. See James Bovard, *The Dangerous Expansion of Forfeiture Laws*, WALL ST. J., Dec. 29, 1997, at A11 ("Asset forfeiture laws have been spreading like a computer virus through the nation's statute books.").

247. For example, the Comprehensive Crime Control Act of 1984 amended the Controlled Substances Act to permit forfeiture of real property. See 21 U.S.C. § 881(a)(7) (1994).

248. See Eric Blumenson & Eva Nilsen, *Policing for Profit: The Drug War's Hidden Economic Agenda*, 65 U. CHI. L. REV. 35, 36 (1998) (stating that, in the effort to combat the illegal drug trade in the United States, the federal government spends \$15 billion annually and state governments spend \$33 billion).

249. For examples of how forfeiture laws have been used to target and punish minorities, see SMITH, *supra* note 234, § 1.01, at 1-25 to 1-28 & nn.12-13 (stating that: (1) of 1,084 traffic stops videotaped in Volusia County, Florida, 69% of those stopped were African-American or Hispanic although they constituted only five percent of the motorists on the portion of the highway patrolled by Volusia County officers; (2) 82% of the cars that police searched were driven by African-Americans or Hispanics; (3) drivers got all their seized money back in only four of the 199 seizures in which no arrest was made; (4) officers in Volusia County admitted that they were instructed to "target minorities;" and (5) "racial targeting is the rule, rather than the exception, all over the country").

250. See SMITH, *supra* note 234, § 1.01, at 1-8.

251. Judith Dennison Wolferts, *In re One-Hundred Two Thousand Dollars, Cash-Friendly Civil Forfeiture*, 1993 UTAH L. REV. 971, 971 (quoting Dan Luzadder, "Gold Mine" Praised at Seminar for Forfeitures, ROCKY MOUNTAIN NEWS, Aug. 11, 1991, at 8).

part of the proceeds from forfeited assets.²⁵² For jurisdictions that authorize earmarking, property seizures can provide low- or under-budgeted law enforcement agencies with an important source of revenue.²⁵³ Evidence exists that some agencies use the forfeiture laws as a means to establish financial independence or semi-independence.²⁵⁴

Courts, legislators, and many others²⁵⁵ have criticized current forfeiture practices as being abusive and uncontrolled. For example, in *United States v. All Assets of Statewide Auto Parts, Inc.*, the Second Circuit Court of Appeals stated: "We continue to be enormously troubled by the government's increasing and virtually unchecked use of the civil forfeiture statutes and the disregard for due process that is buried in those statutes."²⁵⁶ The GAO has labeled asset forfeiture a "high risk" area,²⁵⁷ a term used to designate federal programs that are "especially vulnerable to waste, fraud, abuse, and mismanagement."²⁵⁸ The GAO's concerns with forfeiture range from the mismanagement and misappropriation of seized property to the overzealous use of forfeiture by

252. The federal Comprehensive Crime Control Act of 1984 established the earmarking of forfeited assets. See 28 U.S.C. § 524 (1994). Many state forfeiture laws also contain earmarking provisions. See SMITH, *supra* note 234, at 1-8.1.

253. See *Georgia v. Bell (In re Bell)*, 215 B.R. 266, 270 n.8 (Bankr. N.D. Ga. 1997) ("[U]nderfunded and hard-pressed government and law enforcement agencies could easily become accustomed to the large revenue created through civil forfeiture of drug-related property.") (citing Wolferts, *supra* note 251); John Dillin, *Government's Big Grab Civil Forfeiture*, CHRISTIAN SCI. MONITOR, Oct. 5, 1993, at 6 (noting that "cash-strapped" jurisdictions may use forfeiture proceeds to buy new law enforcement equipment or to pay a portion of officers' salaries), available in 1993 WL 7156676.

254. See Blumenson & Nilsen, *supra* note 248, *passim*.

255. See, e.g., Amendments to the Unif. Controlled Substances Act (1990): Article V. Civil Forfeiture, at 5 (stating that the government's use of the forfeiture laws has "confirmed that prosecutorial discretion cannot alone provide sufficient protection of important legal interests."), reprinted in 3 KESSLER, *supra* note 234, at I-38; Blumenson & Nilsen, *supra* note 248, at 37 (asserting that the "forfeiture laws . . . are producing self-financing, unaccountable law enforcement agencies divorced from any meaningful legislative oversight. There are numerous examples of such semi-independent agencies targeting assets with no regard for the rights, safety, or even lives of the suspects"); Henry, *supra* note 240, at 46, 48 (stating that California "county governments and law enforcement departments have milked the asset-forfeiture program to fund other operations; and overeager police have injured—even killed—innocent citizens in raids that critics charge were motivated by the promise of asset-forfeiture booty").

256. 971 F.2d 896, 905 (2d Cir. 1992).

257. See HIGH RISK SERIES, *supra* note 235.

258. See HIGH RISK SERIES, *supra* note 235. The perception of law enforcement's use of the forfeiture laws has changed dramatically in recent years. Only fourteen years before characterizing asset forfeiture as a high risk area, the GAO labeled forfeiture a "seldom used tool." ASSET FORFEITURE: A SELDOM USED TOOL, *supra* note 235, cited in HIGH RISK SERIES, *supra* note 235.

agencies that have “vested interests in receiving the proceeds of forfeitures.”²⁵⁹ Congress has held hearings relating to abuses of forfeiture laws,²⁶⁰ and forfeiture reform legislation has been introduced in the Senate and in the House.²⁶¹ Courts and commentators have been particularly harsh in their criticism of earmarking.²⁶²

Despite the government’s aggressive use of the forfeiture laws and mounting criticisms of seizures, courts construing the laws have been remarkably callous toward mortgagees and owners of other interests in seized property. In forfeiture actions, courts routinely and explicitly sacrifice an innocent individual’s private property interest to serve public purposes. For example, in *Calero-Toledo v. Pearson Yacht Leasing Co.*,²⁶³ the U.S. Supreme Court upheld the constitutionality of a seizure of property from an owner that was innocent of any wrongdoing. The Court upheld the seizure on the basis that forfeiture furthers the community goods of deterring crime and punishing wrongdoing. The Court also upheld the forfeiture on the basis that it creates an incentive for lenders and others to act in the best interests of the community: “To the extent that such forfeiture provisions are applied to lessors, bailors, or secured creditors who are innocent of any wrongdoing, confiscation may have the desirable effect of inducing them to exercise greater care in transferring possession of their property.”²⁶⁴ The Supreme Court recently strongly reaffirmed this holding.²⁶⁵

State courts have been equally unsympathetic to claims by innocent owners, including innocent lenders. For example, in *Commonwealth v. One 1978 Ford Van*,²⁶⁶ the Massachusetts Court of Appeals upheld the constitutionality of a state forfeiture law that destroyed a lender’s security interest in seized property. The trial court expressly found that the lender “had done all that reasonably could be expected of it to insure that the [seized property] would not be used in violation

259. HIGH RISK SERIES, *supra* note 235, at 234, 650.

260. See *Civil Asset Forfeiture: Hearings on H.R. 1835 Before the House Comm. on the Judiciary*, 105th Cong. (1997).

261. Representative Henry Hyde (R-IL) introduced the Civil Asset Forfeiture Reform Act of 1993 in the House as H.R. 2417. Senator James M. Jeffords (R-VT) introduced similar legislation in the Senate as S. 1665. Several other proposals have been introduced, but Congress has yet to enact a major forfeiture reform bill. See SMITH, *supra* note 234, at 1-20 to -22.1 & n.8, for a thorough tracking of the reform bills in Congress.

262. See SMITH, *supra* note 234, § 1.01, at 1-8.1 & n.21.1 (criticizing the earmarking policy and listing several courts that also have criticized the practice); see also Blumenson & Nilsen, *supra* note 244.

263. 416 U.S. 663 (1974).

264. *Id.* at 687-88.

265. *Bennis v. Michigan*, 116 S. Ct. 994 (1996).

266. 419 N.E.2d 1060 (Mass. Ct. App. 1981). *But cf.* *Threlkeld v. Mississippi*, 586 So. 2d 756, 759 (Miss. 1991); *New Jersey v. One 1976 Pontiac Firebird*, 402 A.2d 254, 258 (N.J. Super. Ct. App. Div. 1979).

<https://scholarship.law.missouri.edu/mlr/vol64/iss2/1>

of the narcotic drug laws.”²⁶⁷ Despite the lender’s diligence, the appellate court held that its security interest was eliminated and that the forfeiture was not unconstitutional. The court’s opinion reflects its indifference to the loss that the forfeiture law inflicted on the blameless lender:

As a sizeable commercial financing house, Ford [Motor Credit Company] must have foreseen and taken into account the occasional loss of a security interest to forfeiture. Moreover, forfeiture does not extinguish the underlying debt which remains enforceable against the maker of the note and any indorsers. While the principal debtor’s status after conviction may render collection on the note impractical, that factor alone would not require invalidation of the forfeiture as an unconstitutional taking.²⁶⁸

As in *Calero-Toledo*, the court justified this result on the ground that the public good is served by forfeitures because they raise revenue for law enforcement, penalize wrongdoing, and prevent further illegal use of seized property.²⁶⁹

Calero-Toledo and *One 1978 Ford Van* represent a profound change in the law’s treatment of secured lenders. During the first eight hundred years of mortgage law’s development, the law reflected a paramount concern for lenders’ best interests. Lenders’ possession of mortgaged land with no obligation to account to the owner and the holder-in-due-course doctrine are two notable examples of the special status that the law traditionally has afforded lenders. The regular use of the forfeiture laws to destroy security interests and to force lenders to act as a “private police force”²⁷⁰ for the benefit of the community sharply breaks with this tradition.

The unfairness of imposing this burden on an innocent person for the community good has prompted legislatures to include an “innocent owner”

267. *One 1978 Ford Van*, 419 N.E.2d at 1061.

268. *Id.* at 1064.

269. *See id.*

270. Commentators have argued that requiring lenders to act as a private police force for potential criminal activity is fundamentally unjust. *See, e.g.*, Brief of the Institute for Justice as Amicus Curiae in Support of Petitioner at 4, *Bennis v. Michigan*, 516 U.S. 442 (1996) (No. 94-8729). *But cf. Dime Savings Bank Finally Free of Low-Doc Investigation by U.S.*, NAT’L MORTGAGE NEWS, May 27, 1996 (reporting statements by a New York bank official that the bank has aided the government in cases of bank fraud and will continue to cooperate with the government), available in 1996 WL 11670009. The government has stated that it intentionally has enlisted lenders as watchdogs. “Financial institutions are in a unique position to assist law enforcement at the federal and state levels by reporting suspicious transactions that might indicate money laundering.” U.S. GEN. ACCT. OFF., REPORT, MONEY LAUNDERING: NEEDED IMPROVEMENTS FOR REPORTING SUSPICIOUS TRANSACTIONS ARE PLANNED, May 30, 1995, at 36 (No. GAO/GGD-95-156).

defense in many forfeiture laws. However, not all innocent owner defenses apply to land. In Wisconsin, for example, the defense applies only to seized vehicles.²⁷¹ In other jurisdictions, courts deny the defense to mortgagees by construing the word "owner" to exclude them.²⁷² But even when a mortgagee comes within the scope of the innocent owner defense, the protection it affords can be more apparent than real for three reasons: (1) forfeiture laws have differing and ambiguous standards and procedures for successfully asserting the defense; (2) even if a lender satisfies the requirements of the innocent owner defense, it still may lose its mortgage based on the "relation back" doctrine; and (3) lenders that satisfy the innocent owner standard may be unable to recoup the full amount of the outstanding debt in the forfeiture proceeding and may be unable to foreclose the mortgage.

1. Standards and Procedures

Statutory definitions of an "innocent owner" are necessarily somewhat vague. For example, RICO defines an innocent owner as a person who was "reasonably without cause to believe that the property was subject to forfeiture."²⁷³ Similarly, Treasury regulations promulgated pursuant to the federal Asset Forfeiture Amendments Act of 1988 provide that an owner is innocent if it "reasonably attempted to ascertain the use of the property in a normal and customary manner" and "did not know or consent to the illegal use of the property or, in the event that the [owner] knew or should have known of the illegal use, the [owner] did what reasonably could have been expected to prevent the violation."²⁷⁴ Terms such as "reasonably," "knew or should have known," and "normal and customary manner" are extremely malleable and provide little concrete guidance to lenders attempting to structure loan transactions in a manner that will satisfy the requirements of the innocent owner defense.

The lack of statutory guidance is compounded by conflicting judicial interpretations. In determining whether an owner "knew" of illegal activity, some courts have held that an owner is innocent if it did not have actual knowledge.²⁷⁵ Other courts have interpreted the word "knew" to incorporate a

271. WIS. STAT. ANN. § 961.55(1)(d)(4) (West 1991).

272. *See, e.g., Commonwealth v. One 1978 Ford Van*, 419 N.E.2d 1060, 1062-63 (Mass. Ct. App. 1981). Some jurisdictions have enacted separate innocent secured party statutes. *See, e.g., UNIF. CONTROLLED SUBSTANCES ACT* § 505(f), 9 U.L.A. 638-39 (1994); WIS. STAT. ANN. § 961.55 (West 1991).

273. 18 U.S.C. § 1963(c) (1994).

274. 19 C.F.R. § 171.52(c)(ii), (iii) (1998).

275. *See Republic Nat'l Bank v. United States*, 506 U.S. 80 (1992); *United States v. 6960 Miraflores Ave.*, 995 F.2d 1558 (11th Cir. 1993), *cert. granted sub nom. Republic Nat'l Bank v. United States*, 502 U.S. 1090, *rev'd on other grounds*, 506 U.S. 80 (1992); *United States v. 141st Street Corp.*, 911 F.2d 870 (2d Cir. 1990); *United States v. 141st Street Corp.*, 911 F.2d 870 (2d Cir. 1990); <https://scholarship.law.missouri.edu/mlr/vol64/iss2/1>

negligence standard; even if the owner did not have actual knowledge, it is not an innocent owner if it could have learned about the illegal activity by conducting a reasonable investigation.²⁷⁶

Similarly, courts have differed in their interpretation of the innocent owner standard contained in the federal Controlled Substances Act and in many state laws. Under those laws, the illegal activity must have occurred “without the knowledge or consent of” the allegedly innocent owner.²⁷⁷ In addition to the differing interpretations of the word “knowledge” described above, courts differ on whether the standard is conjunctive or disjunctive. Courts that interpret the standard conjunctively require an owner to prove both lack of knowledge and lack of consent.²⁷⁸ Courts that interpret the standard disjunctively hold that an owner is innocent if it either did not know of the illegal activity or, if it did know, did not consent.²⁷⁹ Because of these differing interpretations, under the same set of loan procedures a lender could be an innocent owner in one jurisdiction but not in another. This difference in interpretation can be a particular problem for the secondary mortgage market. Moreover, the definitions of an “innocent owner” impose on the lender the difficult burden of proving a negative—that it did not know or consent.

In addition to the difficulties of proving innocent owner status, the statute’s procedural requirements impose burdens both when the loan is made and when forfeiture proceedings begin. Some forfeiture laws impose pre-loan requirements on lenders and destroy the lender’s security interest if it fails to comply. For example, in *South Carolina State Law Enforcement Division v. Crook*,²⁸⁰ an innocent lender lost its security interest because it did not comply with a state forfeiture law that required lenders to inquire into the borrower’s character before making a loan and to obtain the borrower’s affidavit that she has never been charged or convicted of a drug law violation.²⁸¹

States v. A Fee Simple Parcel of Real Property Situated in Bal Harbour, 650 F. Supp. 1534 (E.D. La. 1987); *Missouri v. 1973 Fleetwood Mobile Home*, 802 S.W.2d 582 (Mo. 1991); see also *KESSLER*, *supra* note 234, § 11.06[10], at 11-203.

276. See *United States v. \$215,300 United States Currency*, 882 F.2d 417 (9th Cir. 1989); *State v. Singleton*, 396 So. 2d 1050, 1053-54 (Ala. 1981); *Pugh v. Alabama ex rel. Galanos*, 441 So. 2d 931 (Ala. Ct. App. 1983); *Alaska v. Rice*, 626 P.2d 104 (Alaska 1981).

277. See, e.g., 21 U.S.C. § 881(a)(7) (1994).

278. See, e.g., *United States v. 6640 SW 48th St.*, 41 F.3d 1448, 1452-53 (11th Cir. 1995) (“We have described Section 881(a)(7) as reflecting ‘two interrelated aims of Congress: to punish criminals while ensuring that innocent persons are not penalized for their unwitting association with wrongdoers.’”) (citations omitted).

279. See, e.g., *United States v. One 1973 Rolls Royce*, 43 F.3d 794, 805 (3d Cir. 1994); *United States v. 6109 Grubb Road*, 886 F.2d 618, 626 (3d Cir. 1989).

280. 255 S.E.2d 846 (S.C. 1979).

281. See *id.* at 847-48 (citing S.C. CODE ANN. § 44-53-530(5a) (Law Co-op 1976)).

Obtaining a borrower's affidavit and investigating the borrower's character, by themselves, do not appear to be unduly burdensome, at least if the statute specifies how the inquiry should be conducted. However, statutory pre-loan requirements do not all come from one forfeiture law. Instead, the mortgaged land is subject to seizure under a wide variety of federal and state forfeiture laws, each of which may have its own requirements. To be safe, a lender would have to structure the loan transaction to satisfy each one.

In contrast, when the forfeiture proceeding begins, the lender needs to comply with only one law. However, the lender may confront a different type of problem. A lender will lose its security interest if it does not declare and defend its interest in the forfeiture proceeding in accordance with statutory procedures.²⁸² For example, in *Key Bank v. City of Everett*,²⁸³ a bank lost its security interest because it failed to give written notice of its claim to the appropriate law enforcement agency. However, not all forfeiture laws require the government to give secured lenders personal notice of a forfeiture proceeding.²⁸⁴ Therefore, the lender's time to file its claim may expire before it even knows about the proceedings.

2. Relation Back Doctrine

Even if a lender complies with all the statutory requirements and convinces the government or a court that it is an innocent owner, the lender still might lose its mortgage or the debt payments it has received. Pursuant to the relation back doctrine, title to forfeited property vests in the government as soon as the illegal act is committed, rather than when the forfeiture proceedings are complete. Therefore, after property has been used in connection with an illegal activity, any conveyance of the property by the apparent owner is void because title already has vested in the government. The doctrine is designed to prevent an owner from thwarting a forfeiture action by transferring the property. However, the doctrine applies even against innocent purchasers, including innocent mortgagees, even though no public record gives notice of the land's forfeitable status.

Fortunately, in 1993, the United States Supreme Court limited the impact of the relation back doctrine on innocent owners. In *United States v. 92 Buena*

282. John J. Byrne, *When the Government Says "Mine,"* 83 A.B.A. BANKING J. 61, 62 (1991), available in 1991 WL 2858302.

283. 841 P.2d 800, 801 (Wash. Ct. App. 1992). The notice requirement is codified at WASH. REV. CODE § 69.50.505(d) (1988). The court rejected the bank's argument that it was not an "owner" within the meaning of the statute because it merely held a security interest in the seized property. *Key Bank*, 841 P.2d at 802.

284. See, e.g., 21 C.F.R. § 1316.75 (1998) (notice by publication for forfeitures under the Controlled Substances Act); KAN. STAT. ANN. § 65-4171(c) (1992) (notice by publication); MICH. COMP. LAWS ANN. § 333.7523(a) (West 1992) (notice by publication); KESSLER, *supra* note 234, §§ 11.03[2], [4], [5], [8], [9].
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Vista Avenue,²⁸⁵ the Court held that the relation back provision in the federal Controlled Substances Act²⁸⁶ did not override the Act's innocent owner defense. The Court correctly reasoned that a contrary interpretation essentially would nullify the innocent owner defense whenever the illegal conduct occurred before the innocent owner acquired its interest in the property.²⁸⁷ Because the Court's decision rests on the well-established rule of construction that a statute should be interpreted so as to give effect to all its parts, the Court's reasoning should be persuasive to courts interpreting other federal and state forfeiture laws. However, the Court's holding will not protect a lender from the relation back doctrine if the applicable forfeiture law does not include an innocent owner defense. In that case, the lender's mortgage will be void if it was given after the land was used in connection with an illegal activity.

3. Scope of Recovery

Even when an innocent owner defense is available and a mortgagee manages to qualify for it, the mortgagee may not recover the entire outstanding debt in the forfeiture proceeding. Although courts uniformly hold that a mortgagee can recover the outstanding principal and interest that accrued before seizure of the property, courts are split concerning the mortgagee's right to recover post-seizure interest and the attorneys' fees and costs incurred to defend its mortgage in the forfeiture proceeding.²⁸⁸ Courts also are split concerning the mortgagee's right to foreclose the mortgage after forfeiture proceedings are commenced.²⁸⁹ Therefore, even those mortgagees who fare the best in a forfeiture action may recover less than the entire debt, may have to absorb the expense of defending its lien, and may be unable to exercise the most important right granted by a mortgage—the right to foreclose.²⁹⁰

These very real and substantial potentials for loss in a forfeiture proceeding have provided strong motivation for lenders to become well acquainted with prospective borrowers and with the land they offer as security. In an attempt to

285. 507 U.S. 111 (1993).

286. 21 U.S.C. § 881(a)(6) (1994).

287. 92 *Buena Vista Avenue*, 507 U.S. at 124.

288. See KESSLER, *supra* note 234, § 7.03[1].

289. See KESSLER, *supra* note 234, § 7.03[1][a][iv].

290. In 1991, the Executive Office for Asset Forfeiture of the Department of Justice provided limited relief for mortgagees when it promulgated the Expedited Forfeiture Settlement Policy for Mortgage Holders. Pursuant to this Policy, the Justice Department can settle claims made by mortgagees. Mortgagees are paid for their perfected mortgages and convey their security interest to the government. The payment includes principal, accrued interest to the date of payment, and casualty insurance premium payments made by the mortgagee. However, the mortgagee may recover its attorneys' fees and costs "only in exceptional circumstances."

avoid forfeiture, one author recommends that lenders take the following steps before making a loan:

- A. Tour the customer's business to be sure it is legitimate.
- B. Interview employees concerning the nature and propriety of the customer's business.
- C. Analyze the financial situation of the borrower and guarantors.
 - Review Financial Statements:
 - a. Substantiate sources of income; confirm employment and income levels;
 - b. Compare income levels to education and experience level of borrower/guarantor;
 - c. If possible, compare financial statements to recent tax returns to see if there is any hidden income;
 - d. Be wary of foreign (or non-local) sources of money or collateral;
 - e. Substantiate sources of assets; compare to income level.
- D. Ascertain relationship of borrowing entity or person to related entities or persons.
- E. Obtain and review a search of judgments, liens, lis pendens.
- F. Consider reviews of databases which include news and financial information and reported cases.
- G. Do not rely exclusively on references from other bankers or financial backers.
- H. Be wary of fast-talking or big-name borrowers.²⁹¹

The depth and breadth of these recommended investigations demonstrate the concern that lenders have about the loss of their loan security in the event of a forfeiture. And the concern continues throughout the life of the loan. After making a mortgage loan, careful mortgagees continue monitoring the mortgaged land.

The extra investigations that lenders must conduct because of the forfeiture laws have increased the costs of lending, increased interest rates, and decreased access to mortgage funds.²⁹² Moreover, lenders are hampered in conducting the investigations by uncertainty concerning the standard of care they must exercise to qualify for the innocent owner defense.²⁹³ Because a mortgage derives its

291. Sterling, *supra* note 239, at 448.

292. Brief of Federal Home Loan Mortgage Corporation as Amicus Curiae in Support of Respondent at 22, *United States v. 92 Buena Vista Avenue*, 507 U.S. 111 (1993) (No. 91-781).

293. See Craig L. Webb, *Home Lenders Better Beware as Forfeiture Cases Increase*, MORTGAGE MARKETPLACE, June 7, 1993 (stating that courts have not provided lenders with adequate guidelines regarding forfeiture laws), available in 1993 WL <https://scholarship.law.missouri.edu/mlr/vol64/iss2/1>

value from certainty, questions concerning its forfeitability harm not only borrowers and lenders, but also the lending industry and the economy as a whole.²⁹⁴ These significant negative effects on lending clearly demonstrate the extent to which forfeiture laws have forced lenders to focus increased attention to the lands on which they hold mortgages.

B. Environmental Liabilities

Though of much more recent origin than forfeiture law, environmental law has evolved relatively quickly to create potential liability for mortgagees far in excess of their potential liability in a forfeiture action. As a result of a forfeiture, a mortgagee may lose its mortgage, and the secured debt may become unrecoverable. Like forfeiture laws, environmental laws can destroy a mortgage and render the borrower insolvent so that the debt is uncollectible. However, an environmental law also can make a mortgagee personally liable for millions of dollars²⁹⁵ and can subject it to criminal charges.²⁹⁶ A mortgagee also may be

3086406. Some courts have held that the bank must exercise "reasonable diligence." See *Alabama v. Johnston*, 565 So. 2d 262, 263 (Ala. Civ. App. 1990) (holding that the bank could not prevent illegal use of the property and, therefore, its security interest was not forfeitable). Other courts have required only that the innocent owner prove a valid security interest in the property to prevent forfeiture. See *Utah v. One 1979 Pontiac Trans Am*, 771 P.2d 682, 685 (Utah Ct. App. 1989) (stating that under a state criminal forfeiture statute, the secured interest is preserved from forfeiture once the secured party establishes that it has an actual good faith interest in the property not obtained by fraud or deceit); cf. *Calero-Toledo v. Pearson Yacht Leasing Co.*, 416 U.S. 663, 689 (1974) (stating in dictum that a truly innocent owner may be exempt from forfeiture if "he was uninvolved in and unaware of the wrongful activity, but also that he had done all that reasonably could be expected to prevent the proscribed use of his property. . . .") (emphasis added).

294. See Brief of Federal Home Loan Mortgage Corporation as Amicus Curiae in Support of the Respondent at 5, *United States v. 92 Buena Vista Avenue*, 507 U.S. 111 (1993) (No. 91-781) ("[T]he bedrock of the mortgage industry is predictability. . . . [T]he foundation of the industry is the stability and reliability of the enforceable home mortgage."); Brief of American Bankers Association as Amicus Curiae in Support of Respondent at 5, *United States v. 92 Buena Vista Avenue*, 507 U.S. 111 (1993) (No. 91-781) ("The lack of certainty on the scope of liability under various laws . . . has forced banks to withhold credit or somehow restrict the flow of funds to otherwise worthy customers. This obviously has had a negative effect on the economy.") (footnote omitted); see also David R. Fine & Raymond P. Pepe, *Bennis v. Michigan and Innocent Owners in Civil Forfeiture: Balancing Legitimate Goals with Due Process and Reasonable Expectations*, 5 GEO. MASON L. REV. 595, 620-23 (1997) (stating that the potential for forfeiture imposes significant burdens on financial institutions).

295. See *infra* text accompanying notes 334-37.

296. For example, see *Commonwealth v. Advantage Bank*, 550 N.E.2d 1388 (Mass. 1990), in which a bank was criminally charged under a state lead-based paint law for failing to correct lead-based paint violations in a building on which it held a mortgage.

held liable as a defendant in a toxic tort lawsuit.²⁹⁷ In an attempt to avoid such liability, lenders now bear the burdens of conducting environmental inspections of lands offered as collateral and of requiring borrowers to correct any environmental violations before a loan will be made. In these ways, government has conscripted lenders to enforce the environmental laws, as well as to help fund environmental cleanups.

1. Inspections and Corrections

As with forfeiture laws, a myriad of federal, state, and local environmental laws affect real property. Environmental laws regulate virtually every aspect of the environment, including air,²⁹⁸ water,²⁹⁹ underground storage tanks,³⁰⁰ solid³⁰¹ and hazardous³⁰² wastes, pesticides,³⁰³ endangered species and their habitats,³⁰⁴ lead,³⁰⁵ asbestos,³⁰⁶ radon,³⁰⁷ radiation,³⁰⁸ noise,³⁰⁹ and mining.³¹⁰ Some of these

297. "Toxic tort liability has increased dramatically since 1980 under state common law," and there has been talk of creating a new federal tort or administrative compensation system for personal injury and property damage due to toxic substances. 1 *Envtl. Due Diligence Guide* (BNA) 101:19 (1999). A court also may hold a lender liable for pollution based on a common law aiding-and-abetting theory. *See id.* at 101:20.

298. *See, e.g.*, Clean Air Act, 42 U.S.C. §§ 7401-7671 (1994).

299. *See, e.g.*, Federal Water Pollution Control Act, 33 U.S.C. §§ 1251-1387 (1994); Marine Protection, Research, and Sanctuaries Act, 33 U.S.C. §§ 1401-1445 (1994); Safe Drinking Water (Public Health Service Act), 42 U.S.C. §§ 300f to 300j-26 (1994).

300. *See, e.g.*, Resource Conservation and Recovery Act, 42 U.S.C. §§ 6991-6991i (1994) (Subtitle I) (amending the Solid Waste Disposal Act); ALA. CODE § 22-36-6 (1991); ARIZ. REV. STAT. ANN. § 49-1017 (West 1997); CAL. HEALTH & SAFETY CODE § 25299.70 (West 1992 & Supp. 1999).

301. *See, e.g.*, Solid Waste Disposal Act, 42 U.S.C. §§ 6901-6992k (1994).

302. *See, e.g.*, Comprehensive Environmental Response, Compensation, and Liability Act, 42 U.S.C. §§ 9601-9675 (1994); CONN. GEN. STAT. ANN. § 22a-451(a) (West 1995); DEL. CODE ANN. tit. 7, §§ 6301-6319 (1991 & Supp. 1998); FLA. STAT. ANN. ch. 403.702 (West 1998); GA. CODE ANN. §§ 12-8-90 to 12-8-99 (1991 & Supp. 1998).

303. *See, e.g.*, Federal Insecticide, Fungicide, and Rodenticide Act, 7 U.S.C. §§ 136-136y (1994).

304. *See, e.g.*, Endangered Species Act, 16 U.S.C. §§ 1531-1534 (1994).

305. *See, e.g.*, 24 C.F.R. pt. 35 (1998); 40 C.F.R. pt. 745 (1998); ARK. CODE ANN. § 20-27-607(a), (b) (Michie 1991); CONN. GEN. STAT. ANN. § 47a-8 (West 1995); 410 ILL. COMP. STAT. 45/11 (West 1997); IOWA CODE §§ 135.100-.105B (1997); KY. REV. STAT. ANN. §§ 211.900-.905) (Michie 1995 & Supp. 1996).

306. *See, e.g.*, Occupational Exposure to Asbestos Standards, 29 C.F.R. §§ 1910.1001, 1915.1001, 1926.1101 (1998); 40 C.F.R. § 61.145 (1998); ALASKA STAT. §§ 18.31.010-.050 (Michie 1991); 105 ILL. COMP. STAT. 105/1 (West 1997).

307. *See, e.g.*, KY. REV. STAT. ANN. §§ 211.855-.856 (Michie 1995); Maine Dep't
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laws provide circumstances under which a mortgagee can be personally liable for pollution. But even those laws that do not create a direct personal risk for lenders create substantial indirect risks that motivate lenders to act as environmental watchdogs. Enforcement of an environmental law can adversely affect or destroy both the borrower's ability to repay the loan and the value of the security for the loan.

If the government enforces an environmental law against a borrower, the borrower may be liable for large costs to correct the violation and for penalties and fines. The borrower might even be imprisoned. In either event, the borrower's ability to repay the loan can be impaired or destroyed. Additionally, the borrower's ability to repay the loan can be seriously compromised if a necessary environmental permit is revoked, denied, or made subject to conditions that prevent the borrower's business from operating profitably.

If the borrower is unable to repay the loan for one of these reasons, the lender's recourse against the security also may be adversely affected. The environmental contamination may cause the land's value to diminish to less than the outstanding debt or cause the land to have a negative value because the cleanup cost will exceed the land's value even after the contamination is eliminated.³¹¹ To compound this problem, the stigma of former contamination often continues to depress the land's value even after a cleanup.³¹²

Aside from the mortgaged land, the mortgage itself may become worthless. If the government incurs expenses in assessing or correcting an environmental problem on the mortgaged land, some state statutes give the government a lien on the land that takes priority over existing liens.³¹³ Under this type of statute, a mortgage will be subordinated to the environmental "superlien" even if the mortgage was recorded before the environmental problem existed. If the superlien secures a debt greater than the land's value, which can easily happen, the mortgage is worthless. If the government exercises its right to sell the

of Human Servs. Regs., CODE ME. R. ch. 330 § 19 (1999).

308. *See, e.g.*, Atomic Energy Act, 42, U.S.C. §§ 2011 to 2297g-4 (1994).

309. *See, e.g.*, Noise Control Act, 42 U.S.C. §§ 4901-4918 (1994); Clean Air Act, 42 U.S.C. §§ 7641-7642 (1994).

310. *See, e.g.*, Surface Mining Control and Reclamation Act, 30 U.S.C. §§ 1201, 1202, 1211 (1994); KAN. STAT. ANN. § 49-428 (1992); LA. REV. STAT. ANN. § 30:905.4 (West 1989); MD. CODE ANN., ENVIR. § 15-1107 (1994).

311. *See Should Government Agencies and Private Lending Institutions be Forced to Pay Enormous Sums to Clean Up Environmental Contamination They Did Not Cause?: Hearing on S. 651 Before the Comm. on Banking, Housing, and Urban Affairs*, 102d Cong. 53, 61, 65-66 (1991) (testimony of L. William Seidman, Chair, Federal Deposit Insur. Corp.) [hereinafter *Hearing on S. 651*].

312. *See* 2 *Env'tl. Due Diligence Guide* (BNA) 501:8505 (1999).

313. *See, e.g.*, CONN. GEN. STAT. ANN. § 22a-452a (West 1995); LA. REV. STAT. ANN. § 30:2281 (West 1989 & Supp. 1999); ME. REV. STAT. ANN. tit. 38, § 1371 (West 1989 & Supp. 1998); MASS. GEN. LAWS ch. 21E, § 13 (1994).

property to satisfy the debt secured by the superlien, the mortgage will be extinguished.

Not all statutory environmental liens are superliens. Some are subject to the same priority rules as mortgages.³¹⁴ Even if the government's lien is junior to the mortgage, however, it can create risks for the mortgagee. If the total debt secured by the property, including debts secured by the mortgage and by the government's lien, exceeds the land's value, the owner may have little incentive to continue making payments on the debts, particularly if state laws or the loan agreement protect the owner from liability beyond the loss of the land.³¹⁵

The risks of borrower default and of destruction of the mortgage's value provide strong inducements to lenders to avoid lending money on the security of environmentally contaminated property. The possibility that environmental liability might render a lender insolvent has prompted the Federal Deposit Insurance Corporation (FDIC) to require that lenders conduct an environmental assessment before making a loan to be secured by almost any commercial real estate and, increasingly, by residential real estate. The FDIC also requires lenders to monitor the property and the borrower during the life of the loan for any possible sources of environmental contamination.³¹⁶ If the property presents a minimal risk of contamination, such as a home in an established residential area, the assessment may be conducted by a layperson, such as the loan officer. For any other type of property, however, a professional environmental inspector must perform the assessment.³¹⁷

The FDIC guidelines warn that bank examiners will investigate the lender's environmental risk program and its compliance with that program. If an examiner determines that the lender has not implemented an adequate environmental risk program, the bank may be criticized, subjected to heightened scrutiny, fined, and subjected to stricter control by the examiners.³¹⁸ The Office of the Comptroller of the Currency has promulgated similar environmental inspection standards for banks engaged in asset management activities.³¹⁹

314. See, e.g., ALASKA STAT. § 46.08.075 (Michie 1996); ARIZ. REV. STAT. ANN. § 49-295 (West 1997); ARK. CODE ANN. §§ 8-7-417(a) to -516(a) (Michie 1992).

315. For example, the owner might be protected by antideficiency legislation. See NELSON & WHITMAN, *supra* note 113, § 8.3. The owner also would be protected if the mortgage provided that the owner is not personally liable for the debt, which is commonly known as a "nonrecourse loan." See NELSON & WHITMAN, *supra* note 113, § 2.1, at 17-19.

316. See FEDERAL DEPOSIT INSUR. CORP., GUIDELINES FOR AN ENVIRONMENTAL RISK PROGRAM 8 (1993), available in 1993 FDIC Interp. Ltr. LEXIS 69, *10-*11 [hereinafter FDIC GUIDELINES].

317. See *id.* at *9-*10.

318. See Malcolm D. Griggs, *Lender Liability and Environmental Risk Management*, 67 FLA. B.J. 80, 83-84 (1993).

319. See OFFICE OF THE COMPTROLLER OF THE CURRENCY, EXAMINING CIRCULAR 256 (1991), available in 1991 WL 434657, at *9-*10.
<https://scholarship.law.missouri.edu/mlr/vol64/iss2/1>

The secondary mortgage market also has been a strong force in requiring lenders to establish environmental risk programs. For example, Fannie Mae requires that, for every multi-family mortgage it buys, the original lender must have conducted an environmental assessment of the mortgaged land and must continue to monitor the property during the life of the loan.³²⁰ Fannie Mae expressly requires lenders to become knowledgeable about all federal, state, and local laws affecting health, safety, or the environment. To create an incentive to fulfill these duties responsibly, the lender is liable to Fannie Mae for all warranties, representations, and certifications that the lender must give concerning the land's environmental condition. To further protect itself, Fannie Mae will not buy a mortgage on lands that are most likely to be contaminated, such as waste disposal sites or properties that adjoin contaminated property. Fannie Mae also requires lenders to obtain promises from borrowers to report all violations of environmental laws and to correct all such violations. Fannie Mae's importance as a purchaser in the secondary market has made this institution, created in the apex of the second era of mortgage law, into a powerful force for implementing the requirements of the third era.

In light of the wide variety of environmental laws, a properly conducted environmental assessment includes many aspects of the property and of the borrower's use of the property. Model procedures for environmental risk programs direct lenders to inspect the property for a broad range of environmental risks and warning signs, including: (1) underground storage tanks, (2) equipment contaminated with polychlorinated biphenyls (PCBs), (3) asbestos-containing material, (4) lead-based paint, (5) radon, (6) unpermitted air emissions or waste water discharges, (7) urea formaldehyde foam insulation, (8) public drinking water supplies that exceed EPA's lead concentration level limits, (9) indications of mishandling of pesticides, herbicides, rodenticides, fertilizers, paints, solvents, and maintenance chemicals, (10) stained soil, (11) hazardous waste generation, (12) contaminated fill dirt, and (13) denuded or stressed vegetation.³²¹ As additional means of uncovering potential environmental problems, the model procedures direct lenders to (1) examine past ownership and use of the property and of adjacent properties to determine whether they previously have been used for businesses that generate pollution, (2) review the borrower's records concerning its use and disposal of hazardous substances, (3) review the public records for any citations of the borrower for violating an environmental law, (4) review state and federal lists of contaminated properties, and (5) interview the property's owner, occupants, and workers.³²² And this is just a Phase I assessment.³²³ If the Phase I assessment raises any questions about

320. See FANNIE MAE DUS GUIDE, pt. X — ENVIRONMENTAL HAZARDS MANAGEMENT PROCEDURES (1994).

321. See 2 *Env'tl. Due Diligence Guide* (BNA) 501:8508 to :8518 (1999).

322. See *id.* at 501:8507.

323. *Id.* ASTM (formerly the American Society for Testing and Materials) has

the property's environmental condition, the lender may require a more intensive investigation, known as a Phase II assessment.³²⁴ Even if the Phase I assessment does not reveal any problems, lenders continue to monitor the property during the life of the loan in an attempt to avoid the losses that can occur if the property becomes polluted.³²⁵

If the inspector discovers pollution on the property, the lender will not make the loan unless the borrower first corrects the problem.³²⁶ For example, if the inspector discovers an underground storage tank on the property that does not comply with relevant regulations, model underwriting standards instruct lenders not to make the loan unless the borrower brings the tank into compliance with the regulations and takes soil samples from around the tank and performs a sample analysis of the tank's contents to prove that the tank has not leaked. If a tank is no longer in use or if the borrower is unable to prove that the tank has not leaked, the lender is instructed to deny the loan unless the borrower (1) removes the tank or, if removal is impossible, closes the tank in place, (2) performs soil and groundwater sampling and a sample analysis of the tank's contents, and (3) contracts for a cleanup if the analysis shows that the tank has leaked. The underwriting standards impose similarly stringent requirements for all the other types of pollutants included in the environmental assessment.³²⁷

By essentially conscripting lenders both to inspect properties and to require environmental cleanups, the government has created a regulatory system many times more comprehensive and efficient than the government could achieve alone. Under this system, virtually every parcel of commercial real estate in this country will be subjected to an environmental inspection because virtually every property owner borrows money and gives a mortgage when purchasing the property or at some other time during its period of ownership. Moreover, the inspections are conducted at no cost to the government, which is no small benefit because environmental appraisals generally cost between \$2,500 and \$10,000, and can be much more costly.³²⁸ It has been estimated that, in connection with

issued standards for conducting environmental assessments. The standards are intended to provide guidance concerning the types of inspections that should be undertaken to qualify for an "innocent owner" defense. The Standard Practice for a Phase I Environmental Site Assessment is designated E 1527-97.

324. The standard practice for a Phase II Environmental Site Assessment is E 1903-97.

325. The environmental risk assessment should continue during the life of the loan by monitoring the borrower and the real property collateral for potential environmental concerns. The institution should be aware of changes in the business activities of the borrower that result in a significant increased risk of environmental liability associated with the real property collateral. FDIC GUIDELINES, *supra* note 316, at 11.

326. Env'tl. Due Diligence (BNA): *The Complete Resource Guide for Real Estate Lenders, Buyers, Sellers and Attorneys*, at 1 (1999).

327. See 2 Env'tl. Due Diligence Guide (BNA) 501:8508 to :8509 (1999).

328. William Holt, *Minimizing Environmental Risks*, J. COMMERCIAL LENDING, <https://scholarship.law.missouri.edu/mlr/vol64/iss2/1>

secured loans, over \$35 million was paid for environmental assessments in just one year.³²⁹ This lender-enforced system also substantially increases the number of environmental problems that are corrected. Because businesses and individuals need to borrow capital, conditioning a loan on an environmental remediation provides a powerful incentive to the owner to correct the problem. As with property inspections, these cleanups usually occur without government intervention. Although increased compliance with environmental laws is a very desirable public good, it is achieved at the expense of lenders who lose revenue by refusing to make loans because of an environmental problem and who incur the costs and delays associated with inspections and corrections.

2. Funding Environmental Protection

In addition to prompting lenders to inspect properties and to require environmental cleanups, environmental laws have created substantial potential personal liability for mortgagees to pay for the cost of eliminating pollution and for injuries suffered as a result of the pollution. A significant source of this liability is the federal Comprehensive Environmental Response, Compensation, and Liability Act (CERCLA),³³⁰ often referred to as "Superfund."³³¹ Congress enacted CERCLA in 1980 in response to the widespread problem of improper hazardous waste disposal. CERCLA authorizes the government to clean hazardous waste sites and to recover its costs from the "owner and operator" of the site, among others,³³² or to order them to clean the site.³³³ The costs of a cleanup can be substantial. The average cost of a CERCLA cleanup is \$30 million, and it can be as much as \$100 million.³³⁴ A CERCLA defendant also can be liable for the injury, destruction, or loss of natural resources, contamination of neighboring properties, fines, and penalties,³³⁵ and it can be held liable for the entire amount because CERCLA liability usually is strict, joint, and several.³³⁶

Sept. 1993, at 59, 64, 67.

329. *Envtl. Due Diligence (BNA): The Complete Resource Guide*, *supra* note 326, at 3.

330. 42 U.S.C. §§ 9601-9675 (1994).

331. Although "Superfund" is commonly used to refer to the Act, the word more properly describes the Hazardous Substance Response Trust Fund, which helps fund government response costs under CERCLA. *See* 42 U.S.C. §§ 9631-9633, *repealed by* Superfund Amendments & Reauthorization Act of 1986, Pub. L. No. 99-499, § 517(c)(1), 100 Stat. 1613, 1774 (1986).

332. *See* U.S.C. § 9607(a) (1994).

333. *See* U.S.C. § 9606(a) (1994).

334. *See* S. REP. NO. 104-185, at 18 (1995), *available in* 1995 WL 747809, at *47.

335. *See* 42 U.S.C. § 9607(a)(4) (1994).

336. Ann M. Burkhart, *Lender/Owners and CERCLA: Title and Liability*, 25 HARV. J. ON LEGIS. 317, 328 (1988).

With the potential for such a large judgment, lenders are attractive CERCLA defendants because they are perceived as having deep pockets.³³⁷ Although some courts have been sympathetic to lenders in determining the scope of their CERCLA liability, other courts have been quite receptive to CERCLA actions against them. For example, when discussing the justification for imposing liability on lenders even though they did not cause the pollution, one court demonstrated an unsympathetic attitude toward lenders: "Mortgagees. . . have the means to protect themselves, by making prudent loans. Financial institutions are in a position to investigate and discover potential problems in their secured properties. For many lending institutions, such research is routine. CERCLA will not absolve them from responsibility for their mistakes of judgment."³³⁸ The mixed judicial treatment of lender liability, coupled with ambiguous statutory standards, created a great deal of uncertainty for lenders.

When lenders have been sued as CERCLA defendants, courts have held them liable under CERCLA both as owners and as operators. A mortgagee can be liable as an "owner" when it acquired title to the mortgaged property in a foreclosure action or by means of a deed in lieu of foreclosure.³³⁹ A mortgagee can be liable as an "operator" when it participated in the owner's business operations.³⁴⁰ One court even held a mortgagee liable as an "operator" because it appeared to have "the capacity to influence the [owner's] treatment of hazardous wastes."³⁴¹ Although other courts have been more restrictive in their interpretations of CERCLA, lenders' total potential CERCLA liability is estimated to exceed \$100 billion.³⁴²

Lenders understandably became quite disturbed by the magnitude of this potential liability and lobbied vigorously for CERCLA amendments to limit or eliminate their liability. Congress did amend CERCLA in the Superfund

337. *Hearing on S. 651, supra* note 311, at 209, 220 (statement of Harris H. Simmons, representing the American Bankers Assoc.).

338. *United States v. Maryland Bank & Trust Co.*, 632 F. Supp. 573, 580 (D. Md. 1986) (footnotes omitted).

339. *See, e.g.*, *Guidice v. BFG Electroplating & Mfg. Co.*, 732 F. Supp. 556, 562-63 (W.D. Pa. 1989); *United States v. Maryland Bank & Trust Co.*, 632 F. Supp. 573, 577-78 (D. Md. 1986). *But see* *United States v. McLamb*, 5 F.3d 69, 72-73 (4th Cir. 1993); *Waterville Indus., Inc. v. Finance Auth.*, 984 F.2d 549, 552-54 (1st Cir. 1993); *United States v. Mirabile*, 15 *Env'tl. L. Rep. (Env'tl. L. Inst.)* 20,994, 20,995-97 (E.D. Pa. 1985).

340. *See, e.g.*, *United States v. Nicolet, Inc.*, 712 F. Supp. 1193, 1202-05 (E.D. Pa. 1989).

341. *United States v. Fleet Factors Corp.*, 901 F.2d 1550, 1557 (11th Cir. 1990), *cert. denied*, 498 U.S. 1046 (1991).

342. *U.S. Asks Supreme Court not to Review Fleet Factors Ruling on CERCLA Liability*, *ENVTL. REP. (BNA)*, Dec. 21, 1990, at 1583. Others have argued that the burdens on banks have been exaggerated. Amy Dockser Marcus & Amy Stevens, *Banks' Burden in Waste Cleanups is Overstated, According to Study*, *WALL ST. J.*, Apr. 11, 1991, at B5.

Amendments and Reauthorization Act of 1986 (SARA). However, Congress apparently was more concerned with cleaning hazardous waste sites than with protecting lenders. SARA largely reaffirmed courts' interpretations of CERCLA's liability provisions. In fact, some commentators have said that a better acronym for the amendment would be RACHEL—Reauthorization Act Confirms How Everyone's Liable.³⁴³

Ten years later, Congress again amended CERCLA, this time providing a relatively safe harbor for mortgagees. The amendments closely follow rules that the Environmental Protection Agency (EPA) previously had promulgated but which applied only to actions by EPA and the Department of Justice.³⁴⁴ Therefore, the amendments were necessary to protect mortgagees from third party liability. The amendments specify in some detail the actions that a mortgagee can take without becoming liable as an "owner and operator," and Congress was far more generous in defining the permitted actions than some courts had been. For example, Congress provided that a lender would not be liable as an "owner" if it purchased the property at its foreclosure sale if the lender sought to re-sell the property "at the earliest practicable, commercially reasonable time, on commercially reasonable terms, taking into account market conditions and legal and regulatory requirements."³⁴⁵ Although this language does not provide concrete guidance to lenders, it certainly leaves a lot of room to maneuver. Congress also expressly provided that a lender would not be liable as an "operator" solely because it had the "capacity to influence" the borrower's operations.³⁴⁶ Congress also amended the Resource Conservation and Recovery Act (RCRA) to provide the same protection to mortgagees when they become the "owner or operator" of a petroleum underground storage tank.³⁴⁷

The amendments' legislative history and the preamble accompanying the EPA rules reflect that Congress and EPA had not been particularly moved to action by a desire to protect lenders, although they must have been motivated at least in part by intense lender lobbying for clearer standards and greater

343. ZYGMUNT J.B. PLATER ET AL., *ENVIRONMENTAL LAW AND POLICY: NATURE, LAW, AND SOCIETY* 279 (1992).

344. Final Rule on Lender Liability Under CERCLA, 57 Fed. Reg. 18,344 (1992). Although EPA stated that the rule defined the rights of both the government and third parties, *see* Fed. Reg. 18,368, the District of Columbia Circuit Court of Appeals subsequently held that EPA did not have authority to limit third parties' rights under CERCLA. *Kelley v. EPA*, 15 F.3d 1100, 1107-08 (D.C. Cir. 1994), *cert. denied sub nom.*, *America Bankers Ass'n v. Kelley*, 115 S. Ct. 900 (1995). In 1995, EPA and the Department of Justice (DOJ) issued the Policy on CERCLA Enforcement Against Lenders and Government Entities that Acquire Property Involuntarily, in which the EPA and the DOJ stated that they would observe the terms of the 1992 lender liability rule as their enforcement policy. 60 Fed. Reg. 63,517 (1995).

345. 42 U.S.C. § 9601(20)(E)(ii)(II) (1994).

346. 42 U.S.C. § 9601(20)(F)(i)(II) (1994).

347. 42 U.S.C. § 6991(b)(h)(9) (1994).

protection from liability. Rather, the legislative history and preamble state that Congress and EPA were motivated by the necessity of protecting the flow of capital necessary for funding environmental protections and cleanups. Confronted with the specter of huge personal liabilities for environmental cleanups, lenders became more conservative in their lending practices. For example, most lenders stopped lending against the security of a landfill or waste disposal site.³⁴⁸ Forty-five percent of lenders stopped making loans to the types of businesses most frequently associated with pollution, such as service stations, dry cleaners, and, ironically, recycling facilities.³⁴⁹ Lenders were denying one-third of loan applications for underground storage tanks.³⁵⁰ By 1992, ninety percent of commercial bankers had refused to make a loan because of concern that the land offered as security was environmentally contaminated.³⁵¹ Lenders were concerned not just by the potential magnitude of cleanup costs, but also by the number of contaminated properties. Eight percent of commercial properties are estimated to require environmental cleanup.³⁵²

Although intended to facilitate environmental cleanups, CERCLA and RCRA were having the opposite effect. Fear of liability caused lenders to refuse to make loans to those property owners and businesses that pose the greatest environmental risks. If the owner of a business that produces pollutants cannot borrow money, it is much less able to install, maintain, and modernize pollution control technology and otherwise to comply with the environmental laws.³⁵³ If the land becomes contaminated, a lender will not make a loan to enable the owner to eliminate the contamination because the lender now knows that the land is contaminated and, therefore, undesirable security for a loan.³⁵⁴ Moreover, the lender's knowledge of the pollution would destroy its ability to assert the "innocent owner" defense provided in CERCLA. Because the only other defenses to CERCLA liability are an act of God or an act of war, a lender that loses the innocent owner defense is in an extremely bad position.³⁵⁵

The constriction of credit to those businesses most likely to pollute also created a potentially greater detrimental effect to environmental protection. If

348. See 2 *Envtl. Due Diligence Guide* (BNA) 501:8501.

349. See S. REP. NO. 104-185, at 18-19 (1995), available in 1995 WL 747809, at *47.

350. See *Hearing on S. 651*, supra note 311, at 212-13 (statement of the American Bankers Assoc.).

351. See *Mortgage Lenders are Pleased with EPA Liability Regulation: Legislation Still Needed*, MORTGAGE MARKETPLACE, May 4, 1992, at 1.

352. See *Borrowers Should Examine Pollution Insurance to Ensure that Coverage is Worth the Cost*, MORTGAGE MARKETPLACE, June 29, 1992, at 2.

353. See *Hearing on S. 651*, supra note 311, at 2 (statement of Senator Jake Garn, R-Ut.).

354. See *Hearing on S. 651*, supra note 311, at 214 (statement of the American Bankers Assoc.).

355. See 42 U.S.C. § 9607(b)(1), (2) (1994).

business owners cannot afford to purchase and maintain pollution control technology, producers and servicers of that technology also will suffer. In the preamble to its new lender liability rule for underground storage tanks (USTs), EPA clearly expressed its concern about this problem:

The Agency is also concerned that if otherwise credit-worthy UST owners and operators are unable to obtain financing to perform leak detection tests, or to upgrade or replace deficient tanks, the market for UST equipment could be adversely affected, thereby limiting the availability and/or affecting the cost of such equipment. In addition, a lack of adequate capital could produce a ripple effect which would cut across other portions of the UST-related industrial sector for equipment and services EPA believes that this sector has suffered as a direct result of the capital squeeze on UST owners and operators. The Agency is further concerned that many UST equipment manufacturers may find it increasingly difficult to sustain their production of UST equipment. Unnecessary constrictions on the free flow of capital for UST improvements to meet regulatory requirements could force companies to abandon their production of UST equipment or to close altogether, and it may have adverse impacts on the environment by inhibiting future investment in or development of new UST technological innovations.³⁵⁶

This language is representative of the remainder of the preamble and of the commentary accompanying EPA's CERCLA lender liability rule. For example, in the EPA Fact Sheet on the Effect of Superfund on Lenders That Hold Security Interests in Contaminated Property, EPA stated that it was providing some protection for lenders from CERCLA liability because the existing law was interfering with efforts to rehabilitate brownfields.³⁵⁷ "Brownfields" are lands that either are or are perceived as being environmentally contaminated. The potential for CERCLA liability associated with brownfields inhibits lenders from advancing the funds necessary for a cleanup or redevelopment. As a result, contaminated parcels of land may be abandoned, often in an area already experiencing other forms of urban decay, and pollution-creating industries build on formerly undeveloped lands. As a result, jobs were lost in urban areas and polluting activities spread into formerly uncontaminated areas.

356. Underground Storage Tanks — Lender Liability Rule, 60 Fed. Reg. 46,692, 46,693 (1995).

357. EPA Fact Sheet on the Effect of Superfund on Lenders that Hold Security Interests in Contaminated Property (1996), *available in 2* Env'tl. Due Diligence Guide (BNA) 501:1161 (1999): "The Lender Policy was issued as part of EPA's Brownfields Economic Redevelopment Initiative, a series of efforts designed to help states, communities, and other stakeholders in economic redevelopment to work together in a timely manner to prevent, assess, safely clean up, and sustainably reuse brownfields."

EPA's expressed concerns about the negative effects of lender liability on the availability of capital to enhance environmental protection also is consistent with the legislative history for the 1996 amendments to CERCLA and RCRA.³⁵⁸ In marked contrast to the first two eras of mortgage law, Congress expressed little concern about the problems that the laws create for lenders. Although Congress presumably was influenced by lender lobbying, the written legislative history focuses on the necessity of reinvigorating the lenders' role in funding environmental protection, rather than on a concern for the large potential liabilities confronting lenders.

Additional protection for lenders may be needed to make funds flow in the amounts necessary to eliminate existing pollution and to prevent additional pollution from occurring. Although the 1996 amendments limited the potential for lenders' personal liability under CERCLA and RCRA, they did not eliminate it, and more than forty states have state counterparts to CERCLA or RCRA that have not been similarly amended.³⁵⁹ A wide variety of other laws also create potential personal liability for mortgagees, and every environmental law creates the potential for borrower default and impairment of the loan security. When formulating policy on the issue of lender liability, an inherent tension exists between the incentives that potential liability creates for lenders to inspect properties and to condition loans on environmental remediation and the disincentives it creates for loans to those borrowers most likely to pollute. Legislatures clearly have determined, however, that lenders' best interests must be subordinated to the public's desire for a cleaner environment.

C. Trends

Although lender liabilities under the environmental and forfeiture laws break sharply from a long-standing legal tradition of protecting lenders, these laws are not anomalies in modern America. Rather, lender liability reflects three relatively recent trends in American law: (1) strict product liability, (2) the privatization of enforcement, and (3) increased restrictions on private property rights. With an increasingly populous and complex society, government's abilities to monitor conduct and to correct harmful conditions, such as pollution, crime, and decaying inner cities, have been overwhelmed. Therefore, government is placing more burdens on private individuals to promote the public good. Some burdens are affirmative—a lender may have to clean a hazardous waste site or a manufacturer may have to pay damages for injuries from a product though the manufacturer exercised due care. Other burdens are negative—property rights are diminished or destroyed. With the pervasive reach of their lending activities and their relatively large resources, lenders in particular

358. See S. REP. NO. 104-185, at 18-19 (1995), available in 1995 WL 747809 at *46-*48.

359. See 1 *Env'tl. Due Diligence Guide* (BNA) 101:1 (1999).
<https://scholarship.law.missouri.edu/mlr/vol64/iss2/1>

are attractive candidates for helping the government implement a variety of programs.

1. Strict Product Liability

Lender liability in many ways parallels manufacturers' strict product liability. Like a manufacturer, a lender may suffer adverse consequences though it exercised due care. For example, it may lose its mortgage in a forfeiture action, or the mortgaged land may become worthless because of pollution. Lender liability also accomplishes many of the same goals as product liability. Both types of liability (1) create incentives for increased safety controls, (2) force cost internalization, and (3) increase the likelihood that an injured party will be compensated.

a. Safety Incentives

Strict product liability is premised on the fact that manufacturers normally make economically rational decisions about the level of quality control they implement. By increasing manufacturers' liability for product defects, manufacturers are motivated to increase their quality controls, thereby decreasing the frequency and severity of injuries. Lender liability accomplishes the same goal. Threats of large personal liability, loss of loan security, and an increased likelihood of borrower default based on enforcement of an environmental or forfeiture law have caused lenders to exercise increased due diligence. Lenders have responded to the threat of increased liability by conducting substantial pre-loan investigations of potential borrowers and of their land and by monitoring them during the life of the loan. If pollution or criminal activity is discovered, the lender will refuse to make the loan, though the lender may permit the owner of polluted land to remediate it in order to get the loan. Loan documents now routinely include the borrower's express agreement to refrain from polluting or engaging in illegal conduct on the mortgaged land.

Product liability and lender liability also create an incentive for a more indirect method of quality control. Strict product liability encourages retailers to deal only with reputable wholesalers and encourages wholesalers to deal only with reputable manufacturers and distributors. Similarly, environmental and forfeiture liabilities encourage lenders to deal only with nonpolluting, noncriminal borrowers and encourage secondary market purchasers to deal only with cautious lenders. Over time, less careful manufacturers and borrowers will have less access to capital and, therefore, will be less able to do harm or will go out of business.³⁶⁰

360. Although, as noted in the last section of this Article, a polluting business' inability to obtain credit may be harmful to the environment because the business is less able to pay for pollution control technologies and cleanups and may be more likely to

b. Cost Internalization

Strict product liability forces manufacturers to internalize the costs of injuries caused by their goods, rather than leaving those costs with the injured individuals. When the cost is internalized, the price of the product increases, which normally decreases consumption. In some cases, the price increase may be so great that the manufacturer goes out of business or stops selling that particular product. On the other hand, if the manufacturer continues production of the injury-producing item, the increased price will spread the cost of the injury to all who purchase the item and enjoy its benefits.

The environmental and forfeiture laws similarly force lenders to internalize the costs of polluting or illegal activities that they facilitate by supplying credit. The lender benefits from the loan payments, including accrued interest, generated by those polluting or illegal activities. If the lender has to pay environmental cleanup costs or has to write off a loan because the borrower cannot repay it and the security interest is worthless, the loss will be spread across other consumers of credit and services from that lender. If the losses are sufficiently large, the lender no longer will be competitive in the marketplace and may even become insolvent. In an attempt to avoid a loss of that magnitude, lenders routinely impose on borrowers the smaller costs of investigations of the borrower and of the borrower's land and of environmental insurance for the lender.

c. Increased Likelihood of Compensation

A person injured by a defective product can recover from anyone in the chain of manufacture and distribution, rather than having recourse only against the retailer, which may be a small or thinly capitalized operation. With an expanded pool of defendants, the injured party's chances for recovery are substantially enhanced. Similarly, the government is more likely to be compensated in full if it can recover its cleanup costs from the lender, rather than only from the wrongdoing borrower who may have disappeared, be in prison, or be insolvent. If the loan has been sold to the secondary market, the government has an even deeper set of pockets to pursue than a single property owner or possibly a single neighborhood lender. In the case of a forfeiture, the government's recovery will be greater if the mortgage encumbering the property also is forfeited and thereby eliminated from the title.

Although lender liability parallels strict product liability in these three important ways, lender liability goes a step beyond product liability. As stated above, product liability applies to each link in the distribution chain between the manufacturer and the injured party. However, it does not extend further back in

the chain to reach those who supplied non-defective materials to the manufacturer. For example, a metal supplier is not liable for a defect in a tool made with the metal unless it was the source of the defect and not always even then.³⁶¹ In the context of lender liability, the lender is analogous to a material supplier. It supplied capital to the person who created the pollution or performed the illegal act. Therefore, lender liability is not simply analogous to strict product liability. Rather, it also reflects a second trend in the law—the privatization of enforcement.

2. Privatization of Enforcement

As discussed above, the potential losses to lenders from enforcement of the environmental and forfeiture laws have caused lenders to become a private police force; lenders investigate borrowers and inspect their lands for evidence of wrongdoing. Government has begun privatizing enforcement in a variety of settings to accomplish public goals more comprehensively and efficiently than would be possible with government enforcement alone. For example, in *Faragher v. City of Boca Raton*,³⁶² the United States Supreme Court recently held that an employer can be liable for sexual harassment committed by its supervisory personnel. The Court's reasoning reflects a clear intent to enlist employers' efforts to enforce Title VII's prohibition against employment discrimination: "It would therefore implement clear statutory policy and complement the Government's Title VII enforcement efforts to recognize the employer's affirmative obligation to prevent violations . . ."³⁶³ As with lender liability, employer liability under Title VII has prompted many employers to enforce the law. They create anti-harassment policies, conduct training sessions, investigate charges of harassment, and discipline offenders.

Lenders have proven to be a particularly attractive agent for privatized enforcement. When a prospective borrower needs money, it will consent to an investigation or to a wide range of other requirements. For that reason, the law traditionally has been concerned with protecting needy borrowers from overreaching lenders. But now lenders' leverage over borrowers makes lenders particularly valuable as enforcement tools, especially because the great majority of landowners borrow money sometime during their period of ownership. Therefore, legislatures already have begun imposing significant burdens on lenders to implement a variety of government programs that are of little or no

361. See EDWARD J. KIONKA, *TORTS IN A NUTSHELL* 228 (2d ed. 1992).

362. 118 S. Ct. 2275 (1998).

363. *Id.* at 2292.

direct benefit to lenders. For example, lenders already have the following obligations to advance government programs:

1. To help prevent money laundering and other criminal activities, lenders must report to the government any currency transaction exceeding \$10,000 in one day,³⁶⁴ any suspected violation of federal law, and any suspicious transaction related to money laundering.³⁶⁵ This obligation can be extremely detrimental to a lender's best interests; by filing these reports, a lender may lose its innocent owner defense under a forfeiture law because it had self-documented knowledge of possible criminal activity.

2. The federal Community Reinvestment Act (CRA)³⁶⁶ requires lenders to meet the credit needs of their local communities, including the needs of low and moderate income residents. CRA's primary purpose is to preserve local communities by eliminating the blight of decaying neighborhoods,³⁶⁷ and it has resulted in over \$30 billion of credit to lower income communities.³⁶⁸ Many legislators support CRA because it accomplishes this public good without public expenditure.³⁶⁹ Lenders, on the other hand, complain that the Act imposes substantial administrative burdens on them and forces them to make overly risky and unprofitable extensions of credit.³⁷⁰

3. In the wake of massive floods in recent years, federal legislation now requires lenders to determine whether land offered as collateral is in a flood hazard area and, if so, to notify the borrower of the flood hazard, require the borrower to purchase flood insurance, escrow for flood insurance premium payments if it escrows money for other purposes, and purchase insurance if the borrower does not.³⁷¹ A Senate committee report clearly demonstrates the privatization-of-enforcement purpose for this law. The report states that the law

364. See 31 C.F.R. § 103.22 (1998).

365. See 12 C.F.R. § 21.11 (1998).

366. 12 U.S.C. §§ 2901-2907 (1994).

367. See Jonathan R. Macey & Geoffrey P. Miller, *The Community Reinvestment Act: An Economic Analysis*, 79 VA. L. REV. 291, 294, 299 (1993).

368. See Allen J. Fishbein, *The Community Reinvestment Act After Fifteen Years: It Works, But Strengthened Federal Enforcement is Needed*, 20 FORDHAM URB. L.J. 293, 294 (1993).

369. See Macey & Miller, *supra* note 367, at 343.

370. See Macey & Miller, *supra* note 367, at 295.

371. See National Flood Insurance Reform Act of 1994, Pub. L. No. 103-325, 108 Stat. 2160, 2255 (1994). See also Leonard A. Bernstein et al., *Flood Insurance "Reform" Act Engulfs Mortgage Lenders*, 48 CONSUMER FIN. L. Q. REP. 304 (1994).
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imposes these duties on lenders to “decrease the financial impact of flooding to the federal government, to taxpayers, and to citizens who are victims of floods.”³⁷² Because of these public benefits, similar legislation was introduced in Congress the following year to cover other natural disasters, such as earthquakes, hurricanes, volcanic eruptions, windstorms, and tsunamis.³⁷³ Like the intended beneficiaries of these bills, lenders will benefit from more comprehensive insurance coverage on mortgaged land. However, if that benefit outweighed the administrative burden on lenders, they presumably would have required the insurance, as they do for hazard insurance, without the necessity of a federally-imposed duty.

4. To help prevent the serious health problems associated with lead-based paint in housing, the Department of Housing and Urban Development (HUD) has published a proposed rule that would require mortgagees both to give information concerning lead-based paint hazards to certain residential tenants when a loan secured by the property is refinanced³⁷⁴ and to require appraisers to examine certain housing offered as collateral for deteriorating lead-based paint.³⁷⁵ Distributing health literature to tenants bears little, if any, relation to regular lending activities, and requiring additional inspections by appraisers will increase the cost of lending.

Battling crime, renewing lower income communities, and helping potential flood victims and tenants are worthwhile goals, but they are public goals. Far from providing a benefit to lenders, they have increased lenders' costs and liabilities. A good argument exists that lending institutions have a duty to the public because the public has benefitted them in many ways. The savings and loan bailout is just one, particularly vivid example. However, this burdening of lenders does represent a significant change from the centuries during which the law was primarily concerned with protecting lenders' interests.

372. S. REP. NO. 103-169, at 195 (1994), *reprinted in* 1994 U.S.C.C.A.N. 1881, 2025.

373. Representative Bill Emerson (R-MO) introduced H.R. 1856, the Natural Disaster Protection Partnership Act. Senators Ted Stevens (R-AK) and Daniel Inouye (D-HI) introduced S. 1043, the Natural Disaster Protection and Insurance Act.

374. 61 Fed. Reg. 29,170, 29,210 (1996), *to be codified at* 24 C.F.R. § 36.84 (proposed Jun. 7, 1996).

375. 61 Fed. Reg. 29,170, 29,210 (1996), *to be codified at* 24 C.F.R. § 36.86 (proposed Jun. 7, 1996).

3. Restrictions on Private Property Rights

The swinging of the legal pendulum from protection of private property rights to protection of the public good is not limited to mortgagees. In this way, lender liability reflects a third trend in the law. Wetlands regulations and endangered species habitat protection are just two examples of the ways in which private owners' use of their land has been burdened for the public good within the relatively recent past. Regulatory infringements on private property rights have occurred so frequently in recent years that a strong private property rights movement has arisen in response. Just since 1991, this movement has been responsible for legislation in twenty-five states that provide a variety of protections for landowners from the effects of government regulation.³⁷⁶ The movement also has been successful in prompting Congress to consider private property rights legislation several times during the past few years.³⁷⁷

These modern infringements on private property rights are not unique in American law. Despite claims by the private property rights movement that government intrusions on ownership have reached unprecedented levels,³⁷⁸ the law has afforded greater or lesser degrees of protection for private property rights throughout our history. For example, before the Revolution and into the nineteenth century, most states did not compensate landowners for property taken for roads and other public uses.³⁷⁹ Similarly, during the years preceding the Civil War, courts limited the scope of nuisance law to protect railroads from actions for property damages by neighboring landowners.³⁸⁰

A crucial distinction exists, however, between the current cycle of government intrusion on private property rights and earlier cycles. In earlier times, the impetus for these intrusions was economic development. By making roads and railroads cheaper to build, for example, America could be developed more quickly. Railroads and other industries were the primary beneficiaries of these changes in the law, though the public also clearly benefitted. In contrast, today's restrictions impede development by creating liabilities for lenders. As a result of these liabilities, lenders are more cautious in extending credit, especially to industry. Despite this effect, however, government may be

376. See Harvey M. Jacobs, *The Impact of State Property Rights Laws: Those Laws and My Land*, LAND USE L. & ZONING DIG., Mar. 1998, at 3, 3.

377. Most recently, Congress considered the Omnibus Property Rights Act of 1997 (S. 781), which was designed to establish a new federal process for protecting property owners' rights. The Senate considered a similar bill in 1995 (S. 605), and the House of Representatives passed sweeping takings legislation that year (H.R. 925). During the 1990s, Congress also has considered a variety of other bills designed to protect private property rights. See Jacobs, *supra* note 371, at 3.

378. See Jacobs, *supra* note 371, at 6.

379. See MORTON J. HORWITZ, *THE TRANSFORMATION OF AMERICAN LAW, 1780-1860*, at 63 (1977).

380. See *id.* at 70-71.

expected to continue enlisting lenders' efforts and resources for a variety of programs in the future because lenders have proven to be an effective adjunct to the government's efforts to contain pollution, crime, and a variety of other societal problems.

IV. CONCLUSION

Despite the direct line of development from the twelfth-century *mort gage* to the modern mortgage, lenders' relationship with mortgaged land has changed dramatically over time. Under the earliest forms of land security, the lender took possession of the land, collected its income with no duty to account to the borrower, enjoyed the legal rights associated with land ownership, and kept the land if the borrower defaulted regardless of the land's value in relation to the debt. These rights are unimaginable today. However, they had the effect of creating a close relationship between the lender and the land. As a possessor and possible owner, the lender had strong incentives to become familiar with the land, particularly because the lender was personally liable for its condition. During this first era of mortgage law, the law focused on providing enhanced protection for the lender's rights in the land.

In marked contrast, during the second era of mortgage law, lenders became further and further removed from the land. When England made the transition from feudalism to mercantilism, the debt assumed primary importance in the loan relationship. At the same time that the law provided increasing protections for the lender's rights with respect to the debt, equity chipped away at the lender's rights in the land until the mortgage properly was characterized as a mere lien. The lien enables the lender to sell the land to satisfy the debt but no more. The focus on the debt and the income stream that it represents has accelerated in modern times as debts and mortgages are securitized and sold to investors around the world who have never seen the mortgaged land, much less taken an active interest in it.

Today, in the third era of mortgage law, mortgagees again face significant liabilities as a result of their interest in the mortgaged land. Unlike the first era, their liabilities do not arise from possession of the land. They result instead from government efforts to address societal problems, such as crime, pollution, and the decay of the inner cities. Because virtually every parcel of privately owned land is mortgaged at some time, lenders are uniquely situated to help implement government programs at little or no cost to the government. For this reason, while the first two eras of mortgage law were characterized by the law's increasing protections for lenders, the hallmark of the third era may prove to be the law's increasing burdens for lenders to further the public good.

