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Constitutional Law--Mortgages--Extra-Judicial Mortgage Foreclosure Not State Action

Daniel K. Barklage

CONSTITUTIONAL LAW–MORTGAGES–EXTRA-JUDICIAL MORTGAGE FORECLOSURE NOT STATE ACTION

Federal National Mortgage Association v. Howlett[1]

Defendant purchased and received a warranty deed to a house and lot. She gave an installment note secured by a deed of trust which contained a power of sale clause. The note and deed of trust were immediately assigned to plaintiff. Defendant defaulted on the note. Following the provisions in the deed of trust, publication of notice of the proposed sale was properly made. The sale was held and plaintiff purchased the property. Plaintiff then filed an unlawful detainer action to gain possession. Defendant counter-claimed, contending that the Missouri statutes governing extrajudicial foreclosure of mortgages and deeds of trust[2] violate the due process clause of the fourteenth amendment, because they deprive a person of property without sufficient notice and meaningful opportunity to be heard prior to foreclosure. The trial court upheld the statutory provisions and awarded possession to plaintiff. The Missouri Supreme Court affirmed, holding that the Missouri statutes did not constitute state action, because foreclosure of the deed of trust was made pursuant to the contractual provisions in the deed of trust and not by authority of state law. The due process issues of notice and hearing were not reached. The United States Supreme Court dismissed defendant's appeal for want of a substantial federal question.[3]

The due process clause of the fourteenth amendment requires sufficient notice and a meaningful opportunity to be heard. It is firmly established that this clause does not govern purely private activity. In order to invoke the due process clause, the plaintiff must show state action.[4] There are five possible theories upon which a court could find state action in extrajudicial foreclosure.

The first theory, the "direct" state action theory, is that state action exists when state agents act directly to enforce rights conferred by state statute. This theory arises from *Fuentes v. Shevin*[5] and *Sniadach v. Family*

1. 521 S.W.2d 428 (Mo. En Banc 1975), *appeal dismissed for want of a substantial federal question,* 96 S. Ct. 210 (1975).

2. §§ 443.290, .310, .320, .380, .410, RSMo 1969. Section 443.290, RSMo 1969, provides in relevant part:

> All mortgages of real or personal property, or both, with powers of sale in the mortgagee, and all sales made by such mortgagee or his personal representative, in pursuance of the provisions of such mortgages, shall be valid and binding by the laws of this state upon the mortgagors, and all persons claiming under them, and shall forever foreclose all right and equity of redemption of the property sold. . . .

3. 96 S. Ct. 210 (1975).

4. Lloyd Corp. v. Tanner, 407 U.S. 551, 567 (1972); Civil Rights Cases, 109 U.S. 3 (1883).

5. 407 U.S. 67 (1972).

Finance Corporation.[6] In *Fuentes* state action was found, albeit without discussion, on the basis of statutes which provided for the issuance of a writ of replevin by the court clerk, with service of the writ and seizure of the property by the sheriff. In *Sniadach* state action presumably was found on the basis of a statute which provided for the issuance of a writ of garnishment by a state court.

In *Turner* v. *Blackburn*[7] state action was found in an extrajudicial foreclosure proceeding on the basis of the "direct" state action theory. The court, in holding that the North Carolina extrajudicial foreclosure statutes were unconstitutional as applied, found that state action existed because the statutes provided for the direct participation of the court clerk in the extrajudicial foreclosure proceedings.[8]

The second theory, the "encouragement" theory, is that state action exists when statutes substantially encourage utilization of the challenged activity. This theory deals with government involvement in private activities as opposed to direct action by state agents to enforce statutory rights. In *Reitman v. Mulkey*[9] state action was found on the basis of the adoption of a state constitutional amendment which protected a property owner's common law right to refuse to sell, lease, or rent to anyone for any reason. This amendment repealed existing anti-discrimination laws and made the right to discriminate one of the basic policies of the state.[10] Racial discrimination was thereby "encouraged."

In *Northrip v. Federal National Mortgage Association*[11] state action was found in an extrajudicial foreclosure proceeding on the basis of the "encouragement" theory.[12] The Michigan district court found that state action existed because the extrajudicial foreclosure statute encouraged mortgagees to seek extrajudicial, rather than judicial, foreclosure. The court noted that mortgagees believed that the extrajudicial method required less time, effort, and expense than the judicial method.[13] The court said that Michigan's foreclosure statutes were an attempt to establish minimal requirements for regulating a contractual agreement between the parties.[14] However, the weight of authority in other jurisdictions has found no state action on the ground of "encouragement."[15]

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6. 395 U.S. 337 (1969).
7. 389 F. Supp. 1250 (W.D.N.C. 1975).
8. *Id.* at 1258. The court viewed the North Carolina extrajudicial foreclosure procedure as a streamlined judicial sale with the court clerk acting under detailed statutory authority.
9. 387 U.S. 369 (1967).
10. *Id.* at 381.
11. 372 F. Supp. 594 (E.D. Mich. 1974).
12. *See also* Garner v. Tri-State Development Co., 382 F. Supp. 377 (E.D. Mich. 1974) (a nearly identical case to *Northrip,* which was decided on the same state action ground).
13. 372 F. Supp. at 597.
14. This is also the position taken by the Missouri Supreme Court in *Howlett.* 521 S.W.2d at 432.
15. Adickes v. S.H. Kress and Co., 398 U.S. 144 (1970); Bryant v. Jefferson Federal Savings and Loan Ass'n, 509 F.2d 511, 514 (D.C. Cir. 1974). *See* Burke &

The third theory, the governmental function theory, is that state action exists when a private person performs a function which is governmental in nature.[16] In *Evans v. Newton*[17] private trustees succeeded a city as trustee of a park which was required by the trust instrument to be operated on a segregated basis. The United States Supreme Court held that the private trustees' management of the park was a governmental function, and their conduct constituted state action.[18] Therefore, the trustees could not operate the park on a segregated basis.

The holding in *Evans* is narrow, but its rationale could be applied to extrajudicial foreclosure.[19] One could argue that extrajudicial foreclosure statutes have delegated the traditional governmental function of judicial foreclosure to the trustee under a deed of trust.[20] In *Barrera v. Security Building and Investment Corp.*[21] the Fifth Circuit found that no state action existed because the termination of a debtor's equity of redemption had never been the exclusive prerogative of the state.[22] The court said that extrajudicial foreclosure under a power of sale clause is a traditional private remedy dating back to 1774.[23] Thus, the trustee in a power of sale situation cannot be deemed to have assumed a governmental function.

The fourth theory, the judicial enforcement theory, is that state action exists when state courts enforce private rights. In *Shelley v. Kraemer*[24] a Negro was the grantee of property subject to a restrictive

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Reber, *State Action, Congressional Power and Creditors' Rights: An Essay on the Fourteenth Amendment,* 46 S. CAL. L. REV. 1003, 1106 (1973). Cases dealing with the similar issue of "self-help" repossession under section 9-503 of the *Uniform Commercial Code* have generally found no state action and are often cited as authority in extrajudicial foreclosure cases. The issue is similar because the Code is a codification of pre-existing law and the power of sale statutes are often viewed as mere regulation of pre-existing law. *See, e.g.,* Turner v. Impala Motors, 503 F.2d 607 (6th Cir. 1974); Mayhugh v. Bill Allen Chevrolet, 371 F. Supp. 1, 5 (W.D. Mo. 1973); Oller v. Bank of America, 342 F. Supp. 21 (N.D. Cal. 1972); Kirksey v. Theilig, 351 F. Supp. 727 (D. Colo. 1972); Green v. First Nat'l Exchange Bank, 348 F. Supp. 672 (W.D. Va. 1972).

16. Terry v. Adams, 345 U.S. 461 (1953) ("pre-primary" elections with no formal state involvement held subject to fifteenth amendment); Marsh v. Alabama, 326 U.S. 501 (1946) (company-owned town held to have violated first amendment).

17. 382 U.S. 296 (1966).

18. *Id.* at 302.

19. *Contra,* Bryant v. Jefferson Federal Savings and Loan Ass'n, 509 F.2d 511 (D.C. Cir. 1974). *But cf.* Gibbs v. Titelman, 520 F.2d 1107 (3d Cir. 1974); Adams v. Southern California First Nat'l Bank, 492 F.2d 324 (9th Cir. 1973) (both rejecting the governmental function test in cases involving section 9-503 of the *Uniform Commercial Code).*

20. Muller, *Deed of Trust Foreclosure: The Need for Reform . . . Fair Play and the Constitution Revisited,* 29 J. Mo. B. 222, 229 (1973). *See* United States v. Fox, 94 U.S. 315, 320 (1877); McCormick v. Sullivant, 23 U.S. (10 Wheat.) 192, 202 (1825).

21. 519 F.2d 1166 (5th Cir. 1975).

22. *Id.* at 1173.

23. *Id.* at 1172.

24. 334 U.S. 1 (1948).

covenant. Neighbors who were parties to the discriminatory restrictive covenant brought suit to restrain the Negro from taking possession. The United States Supreme Court held that the restrictive covenants were not in themselves illegal, but judicial enforcement of them would constitute state action and thus violate the fourteenth amendment.[25]

The Supreme Court has neither expressly limited nor extended the *Shelley* rationale.[26] If extended to extrajudicial foreclosure, one could argue that almost all private agreements would be subject to the fourteenth amendment because enforcement of such agreements by courts would constitute state action.[27] The *Shelley* rationale has not been, and should not be, extended beyond its facts.[28]

The fifth theory, the "pervasiveness" theory, is that state action exists when a statutory scheme pervasively governs the challenged activity. The state places itself in a symbiotic relationship with the private parties so as to become a joint participant in the challenged activity. In *Burton v. Wilmington Parking Authority*[29] a private restaurant operator leased the premises from a state agency which operated the public building in which the restaurant was located. The Court declared that the statutory scheme was so pervasive that private activity became, in effect, state activity and that the state was a joint participant in the operation of the restaurant; thus, the restaurant's refusal to serve Negroes was state action.

In *Barrera v. Security Building and Investment Corp.*[30] the Fifth Circuit rejected the "pervasiveness" theory and found no state action in the Texas extrajudicial foreclosure statutes. The court declared that the statutes merely regulated the manner in which private parties may exercise the power of sale after they have agreed to use that remedy. The court concluded that the nexus between the state and the trustee was not sufficient to treat the trustee as the equivalent of the state.

In *Howlett* the Missouri Supreme Court rejected four theories of state action and did not discuss the "pervasiveness" theory. The court rejected the "direct" state action theory by stating that under the Missouri statutes there is no direct involvement of state agents to enforce

25. The case suggested a new, far-reaching concept of state action. The Court declared: "[I]t would appear beyond question that the power of the State to create and enforce property interests must be exercised within the boundaries defined by the Fourteenth Amendment." *Id.* at 22.

26. Barrows v. Jackson, 346 U.S. 249 (1953), applied *Shelley* and affirmed its holding, but also involved a restrictive covenant. In Lombard v. Louisiana, 373 U.S. 267 (1963), the Court avoided using *Shelley* and applied the rationale of state-compelled segregation.

27. Global Industries, Inc. v. Harris, 376 F. Supp. 1379, 1383 (N.D. Ga. 1974).

28. Several cases have rejected the *Shelley* rationale where deprivation of due process property rights was alleged. Adams v. Southern California First Nat'l Bank, 492 F.2d 324 (9th Cir. 1973) (*Uniform Commercial Code* § 9-503); Global Industries, Inc. v. Harris, 376 F. Supp. 1379 (N.D. Ga. 1974) (extrajudicial foreclosure); Bond v. Dentzer, 362 F. Supp. 1373 (N.D.N.Y. 1973) (wage assignment).

29. 365 U.S. 715 (1961).

30. 519 F.2d 1166 (5th Cir. 1975).

rights conferred by statute. The court declared that the rights are conferred by individual agreement of the parties.[31]

The court was probably correct because the Missouri extrajudicial foreclosure statutes do not provide for significant participation by state agents, as did the replevin statute in *Fuentes*. In Missouri the recorder of deeds and the sheriff are only marginal participants in the extrajudicial foreclosure scheme.[32]

The *Howlett* court also rejected the "encouragement" theory, stating that wills, contracts, and many other forms of private activity in Missouri are regulated by statute, and thus the statutes arguably encourage such activities. The court concluded that the mere fact that statutes authorize private conduct does not convert the acts of private individuals into state action. The court said that state action is not present unless the state law dictates the choice to be made by the party or significantly interferes with the free exercise of that choice.[33]

The court was correct in rejecting the "encouragement" theory of state action and distinguishing *Reitman v. Mulkey*. The court relied heavily on cases which have found no encouragement under section 9-503 of the *Uniform Commercial Code,* which allows "self-help" repossession of personal property subject to a security interest. The court stated that the Code is basically a codification of existing law. Similarly, the court declared that the Missouri statutes merely recognize a foreclosure method which existed at common law by contract even before Missouri had enacted any statute concerning it.[34] However, the court did not mention

31. 521 S.W.2d at 438. The court also declared that the present Missouri statutes "merely give recognition to foreclosures accomplished pursuant to a contractual right and establish minimum standards which must be met. . . ." *Id.* at 432.

32. Sections 442.380-.400, RSMo 1969, provide for recording deeds of trust. Section 443.340, RSMo 1969, provides for the appointment of the sheriff as trustee in certain instances. Sections 443.040-.050, RSMo 1969, provide for identification of notes secured by deed of trust by the recorder. Section 443.325, RSMo 1975 Supp., provides for persons desiring notice of the foreclosure sale to file a request for notice with the recorder. One commentator believes that the recorder's part in the process is a factor for finding state action in Missouri, Muller, *Deed of Trust Foreclosure: The Need for Reform . . . Fair Play and the Constitution Revisited,* 29 J. Mo. B. 222, 229 (1973). *See* Garner v. Tri-State Development Co., 382 F. Supp. 377, 379 (E.D. Mich. 1974) (the ministerial acts of the sheriff and registrar of deeds constituted state action in extrajudicial foreclosure).

A factor which might constitute direct action in some cases is the extensive participation of state and federal lending programs in the foreclosure process. The government is often directly involved in the liquidation of security. Comment, *Power of Sale Foreclosure After Fuentes,* 40 U. CHI. L. REV. 206, 217 (1972). In *Howlett,* the plaintiff, a government-sponsored corporation, purchased the property at the trustee's sale. In addition, the defendant paid only $81.48 of her $98.36 monthly installment. The remainder was paid by the government under a subsidy program.

33. 521 S.W.2d at 436, *citing* Burke & Reber, *State Action, Congressional Power and Creditors' Rights: An Essay on the Fourteenth Amendment,* 46 S. CAL. L. REV. 1003, 1109 (1973).

34. 521 S.W.2d at 432. *See also* Stine v. Wilkinson, 10 Mo. 75 (1846); Carson v. Blakely, 6 Mo. 273 (1840).

that in *Reitman* the state was also encouraging the exercise of a common law right—the right to discriminate.[35] Thus, the encouragement given by the Missouri statutes to this common law contractual power of sale could logically be state action under *Reitman*.[36]

The court impliedly rejected the governmental function theory even though it was not specifically discussed. The express holding in *Howlett* was that the foreclosure of the deed of trust on defendant's property was pursuant to the contractual provisions in the deed of trust and not by authority of state law. Thus, the Missouri foreclosure statutes do not delegate to a private party the power to foreclose.[37] The court was correct in rejecting the governmental function theory because the termination of a debtor's equity of redemption has never been the exclusive prerogative of the state.[38]

The court rejected the judicial enforcement theory of *Shelley v. Kraemer,* stating that Missouri courts play no role in extrajudicial foreclosure proceedings. The contract between the parties provides for extrajudicial foreclosure and specifies the procedures to be followed.[39] The court distinguished *Shelley* by declaring that it has not been extended into the area of extrajudicial foreclosure.[40]

The Missouri court correctly rejected the judicial enforcement theory of *Shelley*. In Missouri title to the property passes to the foreclosure sale purchaser by virtue of the trustee's deed. The acquisition of title is complete without any court action. Courts are only utilized when the mortgagor refuses to surrender possession and the purchaser files an unlawful detainer action.[41] The sole question in this action is the right of possession, because a Missouri statute provides: "The merits of title shall in nowise be inquired into. . . ."[42] Thus, Missouri courts are not involved in the process by which title passes and only become involved when the purchaser seeks to enforce contractual rights he previously acquired by virtue of the foreclosure sale.

By deciding *Howlett* on the basis of the vague concept of state action,[43]

35. Note, *State Action: Theories For Applying Constitutional Restrictions to Private Activity,* 74 COLUM. L. REV. 656, 666 (1974).

36. In Northrip v. Federal National Mortgage Ass'n, 372 F. Supp. 594 (E.D. Mich. 1974), the court found that the state "encouraged" extrajudicial foreclosure under statutes similar to Missouri's.

37. The court noted that when Missouri statutes only provided for judicial foreclosure, extrajudicial foreclosure was upheld in several Missouri cases as being a valid contractual power. "Such a power of sale in a deed of trust would authorize extrajudicial foreclosure even if there was no statutory provisions. . . ." 521 S.W.2d at 433.

38. Barrera v. Security Building and Investment Corp., 519 F.2d 1166, 1173 (5th Cir. 1975).

39. "No state agent is involved and no state action is present in these activities." 521 S.W.2d at 437.

40. *Id.* at 438.

41. § 534.030, RSMo 1969.

42. § 534.210, RSMo 1969.

43. The state action concept involves no clear and concrete tests; "the concept is notoriously, scandalously lacking in these; it is itself nothing but a

the Missouri Supreme Court avoided reaching the merits of defendant's due process arguments. The court may have been motivated by many factors in reaching this result. The court may have believed that the Missouri foreclosure statutes would not have passed constitutional muster. If this were the case, the court in *Howlett,* or subsequent cases, would have been confronted with a bewildering variety of issues. These issues include: what form of notice is required?; should all interested parties—*e.g.,* junior lienors, be entitled to notice as a matter of right?; at what stage in the foreclosure process would notice be required?; what is the nature of any required hearing?; when, and before whom, would the hearing take place?; and, perhaps most importantly, would a decision invalidating the Missouri extrajudicial foreclosure statutes be applied retroactively? An affirmative answer to the last question would have played havoc with Missouri land titles.

Another factor which may have influenced the *Howlett* court is that the statutes in question in that case had been amended before the decision to provide for notice of the foreclosure sale to the record owner of the land, the mortgagor, and any other person who had previously requested notice of the sale.[44] Because the statutes, as amended, at least provide for some due process notice protection,[45] the court may have been understandably reluctant to pass on the constitutionality of the old statutes.

By finding no state action the *Howlett* court has allowed the continuation of an economical foreclosure process, but it also limited the mortgagor's right to show that he is not in default. Missouri should compromise these interests and adopt a statute similar to the one recently adopted in North Carolina, which provides for a pre-foreclosure hearing before the clerk of the court instead of a full judicial hearing.[46] Under

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catch-phrase." Black, *Forward: "State Action," Equal Protection, and California's Proposition 14,* 81 HARV. L. REV. 69, 88 (1967). The real policy behind invoking the state action concept is often the judicial concern that expansion of the state action concept will subject numerous forms of private activity to fourteenth amendment standards merely because the state encourages or authorizes the private activity. The *Howlett* court reflected this concern. 521 S.W.2d at 437.

44. § 443.325, RSMo 1975 Supp.

45. Even with this notice provision, the statutes may not be sufficient to meet due process standards. "As *Fuentes* makes clear . . . the notice refers to notice of the hearing. . . ." Garner v. Tri-State Development Co., 382 F. Supp. 377, 380 (E.D. Mich. 1974). Missouri statutes do not provide for a hearing either before or after the trustee's sale. In addition, the mortgagor's only remedy is to seek injunctive relief, with the mortgagor having the burden of proof. The common denominator of *Fuentes* and *Sniadach,* however, is that the creditor, not the debtor, bear the burden of proving the probable validity of his claim at the hearing. *Id.*

Missouri statutes might be upheld through the doctrine of waiver. A carefully drafted deed of trust with power of sale could constitute a waiver of due process rights. Nelson, *Deed of Trust Foreclosure Under Powers of Sale,* 28 J. MO. B. 428, 433 (1972).

46. The statute provides in part:

> The hearing provided by this section shall be held before the clerk of court in the county where the land, or any portion thereof, is situated.