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Monthly condensed analyses of crucial real estate and economic issues offered by the UCLA Anderson Forecast and UCLA Ziman Center for Real Estate. Here, Kathleen Smalley and Alfred M. Clark, Partners at Locke Lord LLP, analyze attempts to create uniformity from state to state in real estate finance law.

Cost and Confusion Left Over from the Mortgage Crisis: The Need for Uniformity in Real Estate Law

By Kathleen Smalley and Alfred M. Clark

The U.S. election has re-ignited popular debate about the costs and benefits of federalism with its unique relationship between the national government and the states. Among other differences, the federal government speaks nationally with a single voice, creating certainty and uniformity, while the states can be laboratories to try locally tailored solutions.

"All parties should benefit from better predictability and the efficiency that come with consistent rules."

This balance creates a conundrum for real estate finance, where the trend over the past 25 years has been to rely on uniformity to create efficient scale. On the ground, we see it in the proliferation of chain stores, replicating a formula that works in one location around the country and the world. In finance, we see it in the trend toward uniform agreements. Fannie Mae and Freddie Mac use the same terms and forms of agreement on every multifamily transaction, often to the dismay of borrowers whose deals do not quite fit. Likewise, the Commercial Mortgage Backed Securities market relies on uniformity in structure, carveouts, remedies and covenants.

Meanwhile, the law, while not moving in the opposite direction exactly, is not evolving in tandem with the deals. Real property is largely a matter regulated by the states, with key elements of many real estate financings receiving dramatically different treatment in different states. Some states allow the enforcement of the rights under these security instruments by a private action in the form of nonjudicial foreclosure, where private parties take property without the oversight of any government official. Others insist that this taking occur only through judicial process. One system prizes speed and low cost; the other fair process. Some states allow the lender to sue the borrower personally for any difference between the amount of the debt and the proceeds at the foreclosure sale. Others limit the borrower's liability to the difference between the debt and the judicially determined fair market value of the property. Still others limit the lender to the security and effectively make the loan nonrecourse. This list could go on at great length.

Many of these different treatments date to the 1930s; some came about in the downturn of the late 80s and early 90s; still others arose from in the most recent crisis. New variations always seem to be introduced as waves of borrowers lose their property in foreclosure and state legislatures try to relieve the distress. But the states react differently, with varying effectiveness. Consider the treatment of key questions by California, Texas, and Florida.

Treatment of Key Mortgage Issues in 3 States [1]			
	CA	TX	FL
Nonjudicial foreclosure available?	Yes	Yes	No
Must the lender produce the original note to foreclose?	No	No	Yes (unless it follows appropriate procedure for lost/destroyed note)
Typical time to foreclose	4 months for nonjudicial foreclosure	21 days (plus any contractual notice periods) for nonjudicial foreclosure	Depends on docket in relevant court.
Deficiency judgment available to lender?	Only after judicial foreclosure of certain loans; then to the extent of difference between foreclosure proceeds and judicially determined fair market value.	To the extent of difference between foreclosure proceeds and judicially determined fair market value	To the extent of difference between foreclosure proceeds and judicially determined fair market value.
Redemption rights for borrower?	Only after judicial foreclosure of certain loans	No	Yes, for at least 10 days after foreclosure sale.

[1] Based on the American College of Mortgage Attorneys, Mortgage Law Summary (2015-2016)

Which is the best solution for each question is debatable. But what is striking is the cost that this variability in rules imposes on portfolio or repetitive transactions. Each transaction requires local counsel on the negotiation and enforceability of these agreements. Further, the underwriting must account for the risks to each side that arise from the many unique combinations of rules, based on state law.

Amidst this cost and confusion there is a model for reform. In some areas of the law, we have reached a middle ground on federalism. As one state's solution to a problem emerges as superior, others may begin to follow that rule (without federal compulsion). Or states start to value uniformity and predictability so much that they adopt the majority rule without debating which is "best." Organizations like the Uniform Law Commissioners and the American Law Institute, which propose model laws, based on trends across the states, actively encourage this middle ground.

Perhaps the best-known of these projects is the Uniform Commercial Code, adopted (with some minor variations) by 50 states, the District of Columbia, and Puerto Rico. The UCC governs sales of goods (i.e., personal property), payment systems, and most related financing. When you write a check, with very few exceptions, you know the applicable rules – whether you wrote it in New York, California, or Iowa. The UCC facilitates commerce and finance enormously.

The comparable proposed model laws for real estate finance are the Nonjudicial Foreclosure Act, the Home Foreclosure Procedures Act, and the Model Construction Lien Act. But so far, not a single state has adopted them. The Assignment of Rents Act has fared only slightly better – with five adoptions and one state considering it. Legislative inaction is exacerbated by the slow evolution of much of the law: in California, it was 2016 – eight years after the housing crash – before our Supreme Court resolved key questions presented by securitization of mortgages under California law, and many remain unresolved. These answers come far too late to help many of the borrowers who lost their homes, or the lenders who paid to litigate thousands of cases.

Perhaps this widespread variation means that no state has yet found a good practical, speedy, and fair solution to the enforcement of security interests in real property. But surely the financial crisis, so heavily connected to mortgage finance, should lend some urgency to the search. Borrowers may be forgiven for focusing on their short-term interest in a crisis, lobbying for relief, which turns into more variations. But, over the whole cycle, all parties should benefit from better predictability and the efficiency that come with consistent rules. And the commercial real estate community should encourage their state legislators to solve this problem before the next crisis comes along.