SECURITIZATION AND SOCIAL DISTANCE

JONATHAN C. LIPSON*

Table of Contents

I. Introduction

With the benefit of ten years hindsight, it appears real-property mortgage-backed securities (RMBS) performed far worse in the financial crisis of 2007–08 (the Crisis) than other securitized asset classes.[1]

---

* Harold E. Kohn Professor of Law, Temple University-Beasley School of Law. This essay was written at the invitation of Professor Steve Schwarcz and the *Review of Banking & Financial Law*. It has benefitted from the comments of Jeffrey Naimon, Gay Seidman and Josh Whitford, as well as the research of Anjali Desphande and Dina Bleckman. Errors and omissions are mine, alone.

[1] *See also* Statement on Subprime Mortgage Lending, 72 Fed. Reg. 37,569 (July 10, 2007); *see generally Subprime and Predatory Lending: New Regulatory Guidance, Current Market Conditions, and Effects on Regulated Institutions*, *Hearing Before the H. Subcomm. on Fin. Inst. & Consumer Credit*, 110th Cong.

Observers have offered a host of explanations, focusing on poor underwriting,[2] irrationally exuberant investing,[3] and weak regulatory controls.[4] A subset of scholars has noted RMBS may also have failed—or failed worse than other asset classes—because of the "social distance" they created or exacerbated.[5] "Social distance" is shorthand for variance in levels of trust and reciprocity as functions of the "distance" between social groups or market actors, determined by various criteria, including geography, affinity groups, occupations, and other more conventional markers, such as class and race.[6]

It is not hard to see the intuition here. RMBS created or increased increased social distance in the financial crisis ex ante because each legal

---

(2007) (testimony of Sheila C. Bair, Chairman, Fed. Deposit Ins. Corp.) https://www.fdic.gov/news/news/speeches/archives/2007/chairman/spmar2707.html [https://perma.cc/L3FM-DL8Q] (explaining the need for new guidance and the effects the guidance will have).

[2] Steven L. Schwarcz, *Securitization, Structured Finance, and Covered Bonds*, 39 J. CORP. L. 129, 130 (2013) ("[S]ubprime loans were often made, for example, to borrowers with little de facto income . . . .").

[3] June Rhee, *Getting Residential Mortgage-Backed Securities Right: Why Governance Matters*, 20 STAN. J. L. BUS. & FIN. 273, 322 (2015) (discussing "irrational behaviors of the investors seen in RMBS market").

[4] Raymond H. Brescia, *Trust in the Shadows: Law, Behavior, and Financial Re-Regulation*, 57 BUFF. L. REV. 1361, 1401 (2009) (observing "the weak regulatory oversight of the shadow banking system both fed and gorged on the securitization of millions of mortgages").

[5] *See, e.g.*, Raymond H. Brescia, *The Cost of Inequality: Social Distance, Predatory Conduct, and the Financial Crisis*, 66 N.Y.U. ANN. SURV. AM. L. 641, 655 (2011) (demonstrating a trend of increasing income inequality in the United States since the 1970s); Bruce G. Carruthers, *The Meanings of Money: A Sociological Perspective*, 11 THEORETICAL INQUIRIES L. 51, 71 (2010) ("[A]nonymity and social distance between debtors and creditors is further exaggerated by practices like securitization, where separate debts are bundled together into portfolios, securities are issued against those portfolios, and then sold separately to different investors. With securitization, each debtor in effect owes a small amount to many creditors, and creditors are owed small amounts by many debtors."); Grant S. Nelson & Gabriel D. Serbulea, *Strategic Defaulters Versus the Federal Taxpayer: A Brief for the Preemption of State Anti-Deficiency Law for Residential Mortgages*, 66 ARK. L. REV. 65, 86 (2013) (observing that in the "securitization of mortgages, [] one can intuitively feel the social distance between mortgagor and lender becoming a chasm that the moral value of a promise can no longer cross").

[6] *See* discussion *infra* Section III.

step in these complex transactions—starting with the "bankruptcy remote" true sale of the mortgage—took the underlying financial asset (the mortgage) "away" from the homeowner who was the underlying obligor.[7] Then, after default, legal blockage unique to RMBS kept homeowner and mortgage servicer—often the villain in RMBS social distance stories—at a distance that impaired resolution.[8] Foreclosures languished for years in courts ill-equipped to handle the volume; servicers made sometimes massive errors in collection and enforcement of obligations; confusion about contractual commitments amongst investors and other participants may have exacerbated the problem.[9]

Yet, the question of social distance in securitization presents two puzzles. First, by what mechanism did the legal distance of RMBS effect (or affect) social distance? Many transactions involve significant *legal* distance, but they present no problems of *social* distance.[10] More specifically, all securitizations create legal distance through their bankruptcy remote structure, but not all securitizations present problems of social distance akin to those of RMBS.[11] Indeed, the idea that the legal

---

[7] *See* Rhee, *supra* note 3, at 275 ("[T]hese lenders were able to sell these mortgages and their risks to other entities (RMBS investors) that were more willing and believed to be better suited to take on such risks.").

[8] *See* Schwarcz, *supra* note 2, at 134 ("By enabling mortgage lenders to sell off loans as they were made . . . securitization is said to have created moral hazard since these lenders did not have to live with the credit consequences of their loans.").

[9] Miguel Segoviano et al., *Securitization: Lessons Learned and the Road Ahead* 37–38 (IMF, Working Paper No. 255, 2013) ("Once the U.S. mortgage crisis intensified, it quickly emerged that both servicers and trustees were insufficiently resourced to efficiently address the flood of foreclosures that ensued. Mortgage Electronic Registrations Systems, Inc. (MERS) was another weak operational link in the securitization industry . . . . [T]he owner of the mortgage note was not the registered owner of the mortgage.").

[10] Consider, for example, the 200-plus contracts involved in producing an iPhone. David Barboza, *An iPhone's Journey, From the Factory Floor to the Retail Store*, N.Y. TIMES (Dec. 12, 2016), www.nytimes.com/2016/12/29/technology/iphone-china-apple-stores.html.

[11] *See* Jonathan C. Lipson, *Re: Defining Securitization*, 85 S. CAL. L. REV. 1229, 1250 (2012) (observing "[n]early two-thirds of nonprime . . . [RMBS] were rated likely to default by 2010" versus "only 2.2 percent of credit-card securitizations had this low rating by the same time, and securitizations based on auto loans and equipment loans or leases were not downgraded at all") (citations omitted); *see also* Adam J. Levitin, *Skin-in-the-Game: Risk Retention Lessons from Credit Card Securitization*, 81 GEO. WASH. L. REV. 813, 848 (2013) (citing Jann

distance of RMBS securitization would create social distance is paradoxical, because formal structures such as law are often seen as cures for social distance problems.[12] Is it possible that, in this context, law was the disease? If so, how?

Second, and perhaps most practically, if we think social distance in securitization is a problem, what did we learn in the Crisis that might prevent or ameliorate these problems in the future? Literature on social distance in securitization does not explore these questions. This essay does, and suggests two ways to approach them.

First, the social distance experienced in RMBS resulted from a clash between two incompatible systems: the localized legal machinery of residential real property mortgages and the nationalized process of managing those mortgages. Securitization was designed, in part, to nationalize the home mortgage market, but in the Crisis, the parochial characteristics of local legal machinery and culture fit poorly with the nation-level structures, techniques, incentives, and perhaps cultures of the RMBS market. This clash caused both sets of systems to fail in ways that appear to have been unique to RMBS—and that drove the sense of social distance attributed to them.

Second, technological advances and alternative dispute resolution have been touted as solutions to securitization social distance problems because they reduce reliance on formal legal machinery and increase the possibility of value-preserving consensual resolutions.[13]

Swanson, *Consumer Loan Defaults Hit New Lows While Mortgage Defaults Rise*, MORTGAGE NEWS DAILY (Dec. 28, 2012), http://www.mortgagenewsdaily.com/12282012_loan_defaults.asp) ("Like credit card ABS, auto loan ABS did not experience the disastrous performance of MBS.").

[12] *See, e.g.*, *The Domain Name System: A Case Study of the Significance of Norms to Internet Governance*, 112 HARV. L. REV. 1657, 1677 (1999) ("[A]s 'social distance' between group members increases, stakes in a conflict enlarge, and outside interests become important, formal legal controls often prove more effective.").

[13] *See* Melina Rozzisi, *Let's Talk: How Mediation Programs Provide Access to Justice for Homeowners Going Through Foreclosure*, 18 PUB. INT. L. REP. 137, 140 (2013) (defining mediation as establishing "a forum where the parties involved in a dispute can work with a neutral party . . . to create a solution," thereby providing "an opportunity to remain outside of the intimidating adversarial system"); Am. Bar Ass'n's Task Force on Elec. Commerce, *Addressing Disputes in Electronic Commerce: Final Recommendations and Report*, 58 BUS. L. 415, 419 (2002) [hereinafter Task Force on Elec. Commerce] (arguing online dispute resolution (ODR) "allows for virtual communications

Undoubtedly, there is truth in this, but there has been remarkably little thought given to the costs and benefits of these alternatives.

While a full assessment of these resolution mechanisms is beyond the scope of this essay, it appears any workable approach must satisfy four conditions: (i) prompt and accurate information exchange between obligor and servicer; (ii) meaningful communication between them; (iii) authority to act quickly; and (iv) a mechanism to formally recognize agreed resolutions. Certain considered solutions have the capacity to satisfy these conditions, though success is not guaranteed.

There is little question that social distance increases economic and social costs.[14] In securitization, this has been expressed as mal- and misfeasance problems of unusual proportions by many types of participants.[15] Securitization failures had severe economic consequences

---

between parties in cyberspace" and "provides a new and innovative means of resolving cross-border disputes—especially involving consumers" by letting parties "participate in ODR without having to travel to another jurisdiction to initiate a lawsuit or to participate . . . a face-to-face meeting or hearing").

[14] To read more regarding economic costs, see, e.g., Peter T. Leeson, *Social Distance and Self-Enforcing Exchange*, 37 J. LEGAL STUD. 161, 161 (2008) ("Social distance poses a problem for would-be traders. As individuals venture beyond their small, homogeneous social networks, uncertainty about potential trading partners' credibility rises. This uncertainty limits agents' ability to realize the gains from exchange."). To read further regarding larger social costs, see, e.g., David Sally, *Game Theory Behaves*, 87 MARQ. L. REV. 783, 791 (2004) ("Because we actively, and sometimes unconsciously, participate in the preservation of our perceptions and preferences, situations of great conflict and social distance are especially troublesome. We perceive our enemies to be evil, distant, strange, unapproachable, unfamiliar, distasteful, and unknowable. Moreover, we actively resist any evidence to the contrary."). There were, of course, also costs to taxpayers. *Bailout Tracker, Companies: Mortgage Servicers*, PROPUBLICA, https://projects.propublica.org/bailout/list/category/Mortgage%20Servicer (showing that taxpayers paid to bail out mortgage servicers).

[15] One attorney reported

> [i]n April [2011], 14 of the nation's largest banks and servicers signed consent orders with one or more federal regulators in an attempt to settle allegations of abusive foreclosure proceedings and other deficiencies in the mortgage servicing industry. As part of the settlement, the banks and servicers are required to put forth a plan to improve foreclosure and mortgage servicing procedures. The settlement

for investors and, in some cases, social costs for the communities involved.[16] At minimum, this indicates many RMBS transactions prior to the Crisis were improperly priced: they failed to internalize the true costs of resolution, costs created or magnified by the legal distance of the structures that were, ironically, one of the selling points of these deals.

The response to the Crisis has been fairly predictable: regulation and resistance. The Dodd-Frank Act of 2010 sought to internalize some of the costs of securitization through the "risk-retention" rules.[17] Almost immediately, these were challenged.[18] Although risk-retention rules were ultimately implemented,[19] it appears the current administration is sympathetic to those resisting the compliance costs and may relax the rules.[20] With or without risk retention, securitization has come back,[21]

> agreement also provides for sanctions in an undetermined amount.

Christine A. McGuinness, *A Look at Mortgage Foreclosure Abuse and the Future of the Mortgage Servicing Industry*, 17 WJSLR 1 (2011).

[16] Trip Gabriel, *Welcome Mat for Crime as Neighborhoods Crumble*, N.Y. TIMES, July 25, 2013, at A12 (explaining that in Cleveland, Ohio the foreclosure crisis's "legacy of abandoned homes has frayed neighborhoods, leaving behind those who cannot afford to get out," suggesting this situation contributes to crime in the city).

[17] Credit Risk Retention, 76 Fed. Reg. 24,090 (proposed Apr. 29, 2011) (detailing changes made from the original proposal aimed at reducing the cost of complying with the proposed rule).

[18] Legal Update from Morgan, Lewis & Bockius LLP, Charles A. Sweet & Melissa R. H. Hall, Treasury Recommends Changes to Post-Financial Crisis Securitization Rules (Oct. 23, 2017) [hereinafter Morgan Lewis Update], https://www.morganlewis.com/pubs/treasury-recommends-changes-to-post-financial-crisis-securitization-rules ("The Capital Markets Report reiterates the recommendation set forth in the Banking Report that [t]he risk retention requirement for RMBS should be substantially revised or repealed.").

[19] Credit Risk Retention, 79 Fed. Reg. 77602, 77604 (proposed Dec. 24, 2014) (to be codified at 24 C.F.R. 267) (showing the credit risk retention rules that were ultimately implemented).

[20] *See* Morgan Lewis Update, *supra* note 18. Included in their recommendations is reforming Dodd-Frank risk retention rules and relaxation of the disclosure requirements for securitization.

[21] According to Morgan Stanley, the global market for securitization stands at about $9.8 trillion. GREG FINCK & NEIL STONE, AN OVERVIEW OF THE GLOBAL SECURITIZED MARKETS (2017), Morgan Stanley (available at https://perma.cc/7DFF-K3TF).

and appears to be growing into new markets, such as "marketplace" lending, which may introduce new problems of social distance if—or when—it comes time to enforce the underlying obligations.[22]

This brief essay describes the legal distance created by securitization and how social scientists approach social distance problems. It provides a more granular explanation of how the legal distance of RMBS securitization might have created the observed social distance. I close by assessing proposals addressing social distance in securitization through new technologies and alternative dispute resolution techniques.

II. Securitization Structure and Legal Distance

Any effort to understand the means by which securitization could create social distance should begin with an understanding of the legal characteristics of the transactions. A "securitization" can be defined as a "purchase of primary payment rights by a special purpose entity that (1) legally isolates such payment rights from a bankruptcy (or similar insolvency) estate of the originator, and (2) results, directly or indirectly, in the issuance of securities whose value is determined by the payment

---

[22] In "marketplace lending," prospective borrowers can apply for loans, and the marketplace sponsor will use credit algorithms to decide whether the borrower and loan meet the standards of the online lending marketplace or platform. Legal Insight from K& L Gates LLP, Anthony R.G. Nolan & Edward T. Dartley, Securities Law Consideration in Online and Marketplace Lending 1 (Feb. 2016), www.klgates.com/files/Publication/2c229aa4-1c88-479d-87c3-6f364ac7131f/Presentation/PublicationAttachment/295b1837-18f5-48ef-b24f-7185db20c026/Securitization_and_Structured_Finance_ Alert_02032016.pdf [perma.cc/5BMQ-7AJH]. If it does, then the lending marketplace will approve the loan on a preliminary basis and will send the information about the loan to potential investors, who will determine whether to fund all or part of the loan. If there is enough investor interest, the online marketplace platform sponsor either originates the loan directly or through a licensed lending company or bank, or it will send the loan application to a third-party bank with whom they have a relationship. That bank or institution will then be the "lender of record," originate the loan, and assign it to the marketplace sponsor. The lending marketplace sponsor may sell portfolios of the loan to investors who want to hold the portfolios on their balance sheets, which may be on a single portfolio or a flow basis. *Id.* at 1–2; *see also* Nick Clements, *Led by Student Loans, Marketplace Lending Securitization Volume Soars*, FORBES (Oct. 21, 2016), https://www.forbes.com/sites/nickclements/ 2016/10/21/led-by-student-loans-marketplace-lending-securitization-volume-soars/#c65a5073c23b.

rights so purchased."[23] Although there are many variations, a securitization has three essential elements: (1) inputs; (2) a particular legal structure; and (3) outputs.[24] Collectively, these elements create legal distance with benefits and costs which, in the case of the Crisis, were not especially well anticipated.

A. Securitization Structure

> *Inputs.* In most securitizations, the inputs will be payment rights, such as those arising under mortgages, car loans, or student loans owing to the initial payee who made the loan (and who is thus typically referred to as an "originator").
>
> . . . .
>
> *Structure*. [T]he key structural feature in a securitization is typically thought to be the legal isolation of the inputs (payment rights) from the credit risk of the originator. This is [generally] accomplished by a "true sale" of the input assets from the originator to a "special purpose entity" (SPE) that is legally "remote" from the originator should the originator go into bankruptcy or a similar insolvency proceeding. If a securitization does not involve a "true sale" of these assets, it may be characterized instead as a loan secured by those assets. This, in turn, might expose the assets to the originator's bankruptcy (or similar insolvency) process, which could impair the assets' value. [L]egal academics have debated whether, or under what conditions, a securitization should be treated as "true sales." . . . Although it would appear that the need to achieve legal isolation was driven largely by the requirements of the rating agencies (who would not assign a desired rating absent a true sale opinion or effective substitute), it has come more generally to be considered the "holy grail" of securitization.
>
> *Outputs*. The output of a securitization is, as the name suggests, supposed to be "securities." While the term "securities" is itself sometimes disputed, in

[23] Lipson, *supra* note 11, at 1233.
[24] *Id.*

general, securitizations are financed, directly or indirectly, by the issuance of bonds, trust certificates, shares, or other instruments designated to have secondary market value . . . .

These basic elements are depicted graphically in in Figure 1.

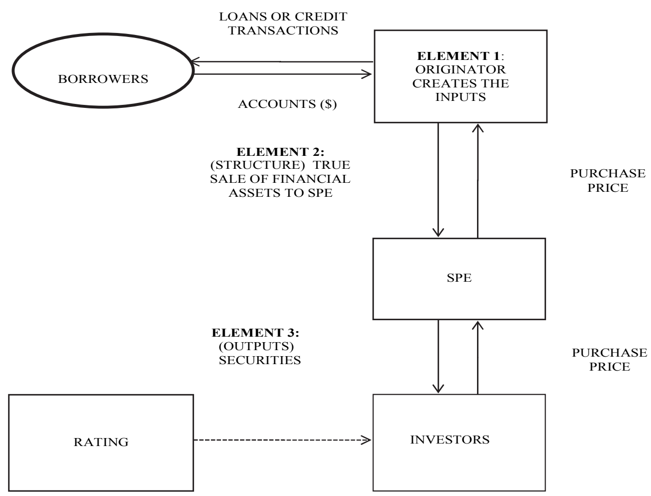

Figure 1. Basic Securitization Elements[25]

To see the legal distance this structure creates, consider the historic alternative: bank lending, which would begin and end at Element 1. Rather than an "originator," the loan would be made by a bank or mortgage lender which holds the loan to maturity. It would service the loan—meaning collect payments on it, enforce it in breach, etc.—and, crucially, work with the borrower in the event of trouble. Think of the movie *It's a Wonderful Life*.[26] But, beginning in the 1970s, a variety of forces coalesced to create a nationwide secondary market for home mortgages.[27] This ultimately took home mortgages from "Main Street to

[25] *Id.* at 1239–42.
[26] IT'S A WONDERFUL LIFE (Liberty Films 1946).
[27] Lipson, *supra* note 11, at 1247 (observing RMBS "likely developed when Congress created the Federal Home Loan Mortgage Corporation and broadened the authority of the Federal National Mortgage Association to purchase conventional and variable-rate loans").

Wall Street"[28] which, in turn, altered much of the legal architecture of the management of the mortgage.

B. RMBS Servicing

The model in Figure 1 significantly simplifies the architecture of RMBS securitization. In many (perhaps most or even all) cases, RMBS transactions involve many other parties, in particular trusts and "servicers." In Figure 1, for example, investors may not directly hold mortgages. Instead, there is a good chance they will acquire interests in a trust that will hold the mortgages.[29] The trust, the "Issuer" in Figure 2, will be under the care of a trustee, whose role is to distribute to the investors the principal and interest payments by the mortgagors whose mortgage loans constitute the trust corpus.

Moreover, neither the trustee nor the investors are in the business of actually dealing with the trust pool's loans. "Transaction costs make it impractical for the investors to manage the underlying loan portfolio."[30] The trust is an "inanimate shell that does not make much of a manager. The solution is for the investors to hire an agent, called a servicer, to administer the loan pool: to send out bills, allocate payments, dun delinquent homeowners, and foreclose on homes where the loan is in default."[31]

---

[28] Chris Markus et al., *From Main Street to Wall Street: Mortgage Loan Securitization and New Challenges Facing Foreclosure Plaintiffs in Kentucky*, 36 N. KY. L. REV. 395, 398 (2009) (discussing how securitization has allowed "hundreds or even thousands of mortgages from various locales [to be] pooled together and interests in the pool are sold as mortgage- backed securities").

[29] Petrovich v. Ocwen Loan Servicing, LLC, No. 15-CV-00033-EMC, 2016 WL 555959, at *2 n.2 (N.D. Cal. Feb. 12, 2016), *aff'd*, No. 16-15396, 2017 WL 6330877 (9th Cir. Dec. 12, 2017) ("'[S]ecuritization' is the process where (1) many loans are bundled together and transferred to a passive entity, such as a trust, and (2) the trust holds the loans and issues investment securities that are repaid from the mortgage payments made on the loans.").

[30] Anna Gelpern & Adam J. Levitin, *Rewriting Frankenstein Contracts: Workout Prohibitions in Residential Mortgage-Backed Securities*, 82 S. CAL. L. REV. 1075, 1088 (2009).

[31] *Id.*; *see also* Culhane v. Aurora Loan Servs. of Neb., 826 F. Supp. 2d 352, 376 (D. Mass. 2011), *aff'd*, 708 F.3d 282 (1st Cir. 2013) (stating trustees and investors aren't "in the business of servicing the trust pool's loans," so the trustee connects with a loan servicer specializing in" day-to-day management of mortgage loans").

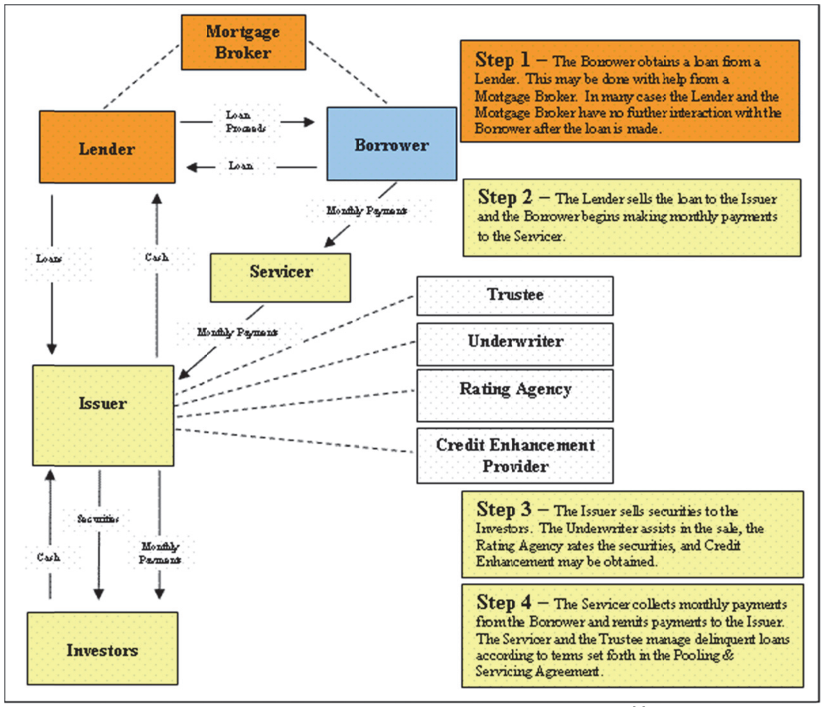

Figure 2. More Complex Securitization[32]

From the perspective of home mortgagors, the social distance of RMBS may acutely be a function of the geographic distance between the homeowner and mortgage servicer. The mortgage servicers perform "the day-to-day tasks related to the mortgages owned by the [SPE]."[33] Moreover, they "are responsible for handling defaulted loans, including prosecuting foreclosures and attempting to mitigate investors' losses."[34]

They perform many of the "Main Street" functions of banks under the old model. Yet, they are probably not on Main Street. Rather, servicers have no necessary geographic connection to the properties that

[32] *Possible Responses to Rising Mortgage Foreclosures, Hearing Before the H. Comm. on Fin. Servs.*, 110th Cong. (2007) (testimony of Sheila C. Bair, Chairman, Fed. Deposit Ins. Corp.), fdic.gov/news/news/speeches/archives/2007/chairman/spapr1707.html.

[33] Adam J. Levitin & Tara Twomey, *Mortgage Servicing*, 28 YALE J. REG. 1, 23 (2011).

[34] *Id.*

secure the mortgages they service. They appear to have become businesses with national or at least super-regional reach.[35] Although there is no readily available data on this, it appears servicers generally operate centralized facilities managing many, if not all, aspects of the mortgage servicing process.

Rhetoric about securitization seems to recognize the legal distance it creates.[36] The effect of the many securitization steps, according to Kathryn Judge, is to "lengthen[] the chain separating the original cash producing asset (the home loan) and the ultimate investor with economic rights to the cash flows coming from that asset."[37] Or, as Henry Paulson put it, securitization "separated originators from the risk of the products they originated."[38] The legal heart of securitization—bankruptcy "remoteness"—bespeaks a distance absent from older forms of consumer financing.

III. On Social Distance

The idea that securitization may create legal distance does not, however, explain how or why it may also have created social distance. As mentioned previously, "social distance" is used by social scientists to describe, among other things, the effect the "distance" between groups or actors has on trust and reciprocity.[39] The distance may be expressed in

---

[35] *See 2017–2018 NMSA Member Organizations*, NAT'L MORTGAGE SERVICING ASS'N, nationalmortgageservicingassociation.com/members/ [https://perma.cc/XP7K-N9VX] (last visited Mar. 20 2018) (listing national mortgage servicers such as, Bank of America, Capital One, and Wells Fargo).

[36] *E.g.*, FIN. CRISIS INQUIRY COMM'N, THE FINANCIAL CRISIS INQUIRY REPORT 142 (2011) http://www.gpo.gov/fdsys/pkg/GPO-FCIC/pdf/GPO-FCIC.pdf [https://perma.cc/9UQP-9EEG]; Kathryn Judge, *Fragmentation Nodes: A Study in Financial Innovation, Complexity, and Systemic Risk*, 64 STAN. L. REV. 657, 685 (2012).

[37] *See* Judge, *supra* note 36, at 661.

[38] FIN. CRISIS INQUIRY COMM'N, *supra* note 36, at 142.

[39] *See* Michael W. Macy & John Skvoretz, *The Evolution of Trust and Cooperation Between Strangers: A Computational Model*, 63 AM. SOC. REV. 638, 651 (1998) ("[T]he earliest trust rule is based on social distance—trust neighbors, but not outsiders."). Social distance is generally sourced in the work of Bogardus. *See, e.g.*, Emory S. Bogardus, *Social Distance and Its Origins*, 9 J. APPLIED SOC. 216 (1925); Emory S. Bogardus, *Measuring Social Distances*, 9 J. APPLIED SOC. 299 (1925). Bogardus was more interested in purely social phenomena, such as attitudes toward race, than exchange relationships. EMORY S. BOGARDUS,

geographic terms, by "classes" as understood in economic terms (e.g., rich v. poor), or by other associational or affinity groups, such as race or religion.[40]

Much of the literature on social distance seeks to understand when socially-distant actors will cooperate or defect.[41] Those who are closer will tend to exhibit mutual trust, and thus cooperate without fear of strategic defection.[42] "Reciprocity" suggests there will be mutually-recognized opportunities for revenge and reward that discipline and channel behavior away from defection.[43] In general, cooperation declines as distance grows because the closer actors are in social terms, the more likely they are to legitimately trust one another and have opportunities to reciprocate in the event of defection.[44]

Social distance may erode trust and reciprocity, and so the question arises: what factors may provide a substitute that makes cooperation more plausible? Observers tend to believe exogenous institutional forces, such as "law," can induce cooperation among

---

IMMIGRATION AND RACE ATTITUDES (1928). He created a "social distance scale" to measure group relationships. Emory S. Bogardus, *A Social Distance Scale*, 17 SOC. & SOC. RES. 265, 269 (1933).

[40] It has, for example, been used to study the characteristics of attorneys and their relationships with their clients. JOHN P. HEINZ ET AL., URBAN LAWYERS: THE NEW SOCIAL STRUCTURE OF THE BAR (2005); JOHN P. HEINZ & EDWARD LAUMANN, CHICAGO LAWYERS: THE SOCIAL STRUCTURE OF THE BAR 59–61 (1982) (proposing the legal profession is divided into "two broad types of lawyers: those serving corporations and those serving individuals and individuals' small businesses" and suggesting, "[t]o the extent that practitioners of the most elite forms of corporate law graduated from the same few law schools, while personal injury or criminal lawyers studied at less prestigious, local law schools, 'old school tie' networks may increase the social distance between these types of practice"); *see generally* EDWARD O. LAUMANN, PRESTIGE AND ASSOCIATION IN AN URBAN COMMUNITY (1966).

[41] *E.g.*. Macy & Skvoretz, *supra* note 39, at 651 (discussing trust between neighbors and strangers and its dependence upon social distance); HEINZ & LAUMANN, *supra* note 40, at 59–61.

[42] Macy & Skvoretz, *supra* note 39, at 639 ("[C]onventions for trusting strangers take root in 'neighborhoods' or 'cliques' characterized by relatively dense interactions, and that these rules then diffuse to other regions via weak ties to members of socially distant neighborhoods or cliques.").

[43] *Id*. ("[T]he prospect of retaliation or loss of reputation can deter both sides from defecting.").

[44] *See id.* at 651.

strangers whose social distance might permit strategic behavior.[45] Yet, as will be explained in the next part, formal law in RMBS may have increased social distance, not reduced it. First, it may help to unpack what social distance means in the context of RMBS securitization, where it apparently has both "vertical" and "horizontal" dimensions.

A. Vertical Social Distance

Vertical social distance depicts a hierarchical and ordinal relationship amongst social groups.[46] Associated with the Bogardus Social Distance Scale,[47] vertical social distance holds that society is constructed to confer greater prestige, power and benefits on some groups than others.[48] Those at the top will fare better than those at the bottom, and the distance between them may form self-reinforcing barriers to social integration.[49] For example, a well-known study of lawyers found "axes of stratification" based on gender and minority.[50]

RMBS securitization may have contributed to vertical social distance by virtue of efforts to lend to lower-income and minority borrowers. For many, these subprime loans appeared to be predatory because they were made to borrowers who did not understand the obligations they were undertaking, and at rates that may have been higher due to the low socioeconomic status of the borrower.[51] Although lenders

---

[45] *Id.* at 638–39 (citations omitted) ("The standard solution to these social traps is to impose formal or informal social controls . . . . Formal controls require the organized ability to monitor and sanction compliance with the terms of an agreement. However, formal control can be costly if monitoring is difficult or if sanctions require extensive litigation.").

[46] Emory S. Bogardus, *Leadership and Social Distance*, 12 SOC. & SOC. RES. 173, 174 (1927).

[47] Bogardus, *A Social Distance Scale*, *supra* note 39, at 269.

[48] Bogardus, *supra* note 46 at 174 (describing, in vertical social distance between leaders and a group, the recognition given to leaders in the form of "rank, position, [or] honors").

[49] *Id.* at 175 ("Unsuccessful 'competitors,' no matter how worthy, feel a loss of social status; they may be tempted to blame the successful leader for their own lack of success, or set themselves apart from the successful leader and thus deliberately though unwittingly, create social distance.").

[50] HEINZ ET AL., *supra* note 40, at 62–69.

[51] Kathleen C. Engel & Patricia A. McCoy, *Turning A Blind Eye: Wall Street Finance of Predatory Lending*, 75 FORDHAM L. REV. 2039–40 (2007) (asserting the vast majority of subprime loans are now securitized, leading to claims that

disclaim bias, evidence shows minority borrowers tended to be steered into higher-priced subprime mortgages, even when they may have qualified for less expensive loans.[52] The failures of subprime RMBS may have contributed to urban blight in communities that were already fragile, exacerbating a sense of vertical social distance between different socio-economic groups.

Professor Brescia, for example, argues securitization contributed to the breakdown of the "traditional borrower-lender relationship," where lenders no longer worried about long-term viability of the borrower, since they were looking to originate loans and securitize them quickly.[53] He links the financial crisis and social inequality because, in his view, securitization increased social inequality which, in turn, increased social distance.[54]

B. Horizontal Social Distance

Horizontal social distance addresses problems of trust and reciprocity in remote transacting.[55] Social distance is problematic because

---

securitization facilitates predatory lending, arguing securitization shields investors from credit and litigation risk associated with predatory loans and increases market forces for predatory lending); Creola Johnson, *Fight Blight: Cities Sue to Hold Lenders Responsible for the Rise in Foreclosure and Abandoned Properties*, 2008 UTAH L. REV. 1169, 1170 (2008) ("Some of these [subprime mortgage] loans were given to borrowers with poor credit histories and in amounts exceeding their ability to repay."); Christopher L. Peterson, *Predatory Structured Finance*, 28 CARDOZO L. REV. 2185, 2186–87 (2007) (stating "mortgage loans, particularly more expensive loans [were] marketed to those with poor credit histories").

[52] Alan M. White, *Borrowing While Black: Applying Fair Lending Laws to Risk-Based Mortgage Pricing*, 60 S.C. L. REV. 677, 687–88 (2009). Some commentators drew explicit links between race and securitization's ills. *See* Ann Coulter, *They Gave Your Mortgage to a Less Qualified Minority*, HUMAN EVENTS (Sept. 24, 2008), www.humanevents.com/article.php?id= 28714 [https://perma.cc/7VK4-5FDR] ("A decade later, the housing bubble burst and, as predicted, food-stamp-backed mortgages collapsed. Democrats set an affirmative action time-bomb and now it's gone off.").

[53] *See* Brescia, *supra* note 5, at 680.

[54] *Id.* at 665–66.

[55] *See* Nancy R. Buchan et al., S*wift Neighbors and Persistent Strangers: A Cross-Cultural Investigation of Trust and Reciprocity in Social Exchange*, 108 AM. J. SOC. 168, 169 (2002).

complex interactions are not possible without it, yet it may produce "social traps"—"situations in which a behavior that yields immediate individual advantage leads to negative long-term consequences for the self or others."[56] Further, "[w]here there is 'an unavoidable time lag between promise and delivery . . . a trap might arise . . . . [F]or instance, the 'quality of goods or services exchanged may turn out to be less than expected after it is too late to recover.'"[57]

On this view, RMBS securitization created two distinct social traps—one in which homeowners trapped servicers, and the other, vice versa. As to the former, some observers worried strategic borrower default. Professors Nelson and Serbulea, for example, argue "the social distance between mortgagor and lender [is] becoming a chasm that the moral value of a promise can no longer cross."[58] This intuition ostensibly supports their claim that "securitization of mortgages has had a psychological effect on mortgagors, once again weakening their moral connection with the mortgagee."[59]

Carruthers situates the question of social distance in securitization in the general tension between aspirations of relational contracting in theory and negotiability of contracts in practice:

> With full negotiability, A's promissory note still encumbers A, but it no longer binds A to B. Instead, it obliges A to repay whoever is the bearer of the promissory note. . . . And while the loan originated in the context of a particular debtor-creditor relationship, after the debt has changed hands several times the final creditor may be someone completely unknown to the debtor. The debt has become more impersonal and

---

[56] *Id.*
[57] *Id.* at 169 (quoting Macy & Skvoretz, *supra* note 39, at 638). "There is," Macy and Skvoretz argue, "no tougher test of the possibility of cooperation between self-interested actors, or more generally, of self-interest as the basis of social order." Macy and Skorvetz, *supra* note 39, at 639.
[58] Nelson & Serbulea, *supra* note 5, at 66; *see also* Tess Wilkinson-Ryan, *Breaching the Mortgage Contract: The Behavioral Economics of Strategic Default*, 64 VAND. L. REV. 1547, 1563–64 (2011) (observing how the distance between the parties leads to a failure of reciprocity).
[59] Nelson & Serbulea, *supra* note 5, at 87 (citing Wilkinson-Ryan, *supra* note 58, at 1550) (discussing the negative effects caused by the way mortgagors review their relationships with lenders who are several times removed from the transactions).

> anonymous. Such anonymity and social distance between debtors and creditors is further exaggerated by practices like securitization, where separate debts are bundled together into portfolios, securities are issued against those portfolios, and then sold separately to different investors. With securitization, each debtor in effect owes a small amount to many creditors, and creditors are owed small amounts by many debtors.[60]

At the same time, there is concern mortgage servicers engaged in abusive or deceptive practices, trapping homeowners. Professor Porter explains

> servicers have a financial incentive to impose additional fees on consumers . . . . A consumer is only obligated to pay charges if the charges are permitted by the terms of the mortgage and by state and federal law. To validate such charges, consumers must know how the servicer calculated the amount due and whether such fees are consistent with their loan contracts. A lending industry representative has admitted that "[m]ost people don't understand the most basic things about their mortgage payment[s]." Mortgage servicers can exploit consumers' difficulty in recognizing errors or overcharges by failing to provide comprehensible or complete information. In fact, poor service to consumers can actually maximize servicers' profits.[61]

There is certainly intuitive merit to these observations. But the writing about securitization and social distance makes little effort to draw a connection between the legal distance the transactions were designed to create and the social distance they in fact created. By what mechanism does social distance occur and why does it seem limited to RMBS, and not appear in other long-chain consumer transactions, including consumer-facing securitizations?

---

[60] Carruthers, *supra* note 5, at 71 (2010).

[61] Katherine Porter, *Misbehavior and Mistake in Bankruptcy Mortgage Claims*, 87 TEX. L. REV. 121, 128 (2008).

IV. How Securitization Creates Social Distance—Legal Blockage and Uncertain Exit

At least until the Crisis, there is little doubt RMBS securitization appeared to be working well going forward.[62] It created legal distance, but that was part of its "alchemy."[63] This distance created value by managing financial risk through asset pooling and allocation.[64]

In theory, securitization should also have worked in reverse. When mortgagors defaulted, the trust would apparently have the option to "put" the mortgages back through the chain, ultimately to the originator. [65] While this may not entirely telescope the legal distance created by securitization—and would not bring servicers physically closer to homeowners—it was thought to allocate risk of loss effectively, and thus to reflect a sensible economic approach.[66]

---

[62] *See* Steven L. Schwarcz, *The Alchemy of Asset Securitization*, 1 STAN. J. L. BUS. & FIN. 133, 134 (1994).

[63] In an earlier and perhaps more innocent time, Professor Schwarcz observed

> securitization is an alchemy that really works. In securitization, a company partly "deconstructs" itself by separating certain types of highly liquid assets from the risks generally associated with the company. The company can then use these assets to raise funds in the capital markets at a lower cost than if the company, with its associated risks, could have raised the funds directly by issuing more debt or equity. The company retains the savings generated by these lower costs, while investors in the securitized assets benefit by holding investments with lower risk. The article concludes by describing those areas where securitization opportunities have yet to be fully explored.

Id. at 134.

[64] *Id*. at 135–45 (describing the basic process of using securitization to distance assets from risk).

[65] *See* Robert T. Miller, *The RMBS Put-Back Litigations and the Efficient Allocation of Endogenous Risk Over Time*, 34 REV. BANKING & FIN. L. 255, 261 (2014) ("Under these so-called 'Repurchase Provisions,' if a loan sold in the transaction does not conform to the seller's representations in the agreement, then the seller is required to cure the breach within a specified period of time (typically sixty days) or, after demand by the purchaser, repurchase the loan at full value.").

[66] As Miller observes:

Yet, it did not. When a homeowner defaulted on a mortgage, the servicer's agreement with the trust likely provided servicing had to be turned over to a special servicer or subservicer.[67] In theory, the special servicer or subservicer would maximize the value of the mortgage obligation for the benefit of trust investors. This implied the legal distance between the underlying obligor and investors would collapse, enabling the mortgage to be "put back" in greater proximity to the borrower.

In practice, however, the legal distance of securitization was a blockage making it difficult for local legal regimes to respond effectively to nationalized demands of the secondary mortgage market. When these two realms—the local and the national—clashed, the systems ground to a halt, creating or exacerbating social distance that may have already existed.

A. Representation and Warranty Litigation

One form of legal blockage introduced by, and perhaps unique to, RMBS involved litigation amongst securitization participants over

---

> Although the sale of the loans to the purchaser first places on the purchaser, as owner of the loans, all of the risks associated with the loans, nevertheless the contract shifts back to the seller certain endogenous risks related to the loans—that is, risks such as fraud in the underwriting process, departures from good underwriting practices, or failures of key financial variables (such as the value of the property, the loan-to-value or combined loan-to-value ratios, or the borrower's income or FICO score), to be as the parties believed them to be when they valued the loans and the RMBSs backed by them. The reason for shifting such endogenous risks back to the seller is clear: when the seller was itself the originator of the loans, it could at the lowest cost detect such errors and prevent them from occurring, and even when the seller was not the originator but purchased the loans from the originator, the seller rather than purchaser was in a position to contract with the originator to get the originator to assume these risks.

Id. at 286–87.

[67] Richard R. Goldberg, *Players in the Universe of Securitized Loans*, SX008 ALI-CLE 1415 (2015).

claims the mortgage seller breached representations and warranties.[68] Several cases have arisen in New York[69] and federal courts[70] regarding these claims. Robert Miller explains this is because

> if a loan sold in the transaction does not conform to the seller's representations in the agreement, then the seller is required to cure the breach within a specified period of time (typically sixty days) or, after demand by the purchaser, repurchase the loan at full value . . . . Thus, the primary remedy sought by the plaintiffs in these cases is generally an order requiring the seller to repurchase all non-conforming loans in accordance with the Repurchase Provision.[71]

The main question in these cases often involved the statute of limitations and whether it began to run when the securitization first closed or later when mortgagors defaulted.[72] To an extent, this issue has been put to rest. In *ACE Securities Corp. v. DB Structured Products, Inc.*, the New York Court of Appeals held, under New York law—which applies to most RMBS transactions—claims generally accrue at the time the lenders and sponsors represent and warrant—not when the breach is discovered at some later point (upon default).[73]

Yet, for an important period of time, they likely created uncertainty among servicers, investors, and other participants who had the right and responsibility to enforce a defaulted mortgage. This uncertainty would have been a kind of legal blockage creating or exacerbating social distance.

---

[68] *See* Miller, *supra* note 65, at 259–61 (highlighting the representations and warranties expressed in a contract agreement as they describe the quality of the mortgage loan).

[69] *See id.* at 260 n.11.

[70] *See id.* at 261 n.12.

[71] *Id.* at 261.

[72] *See, e.g.*, Deutsche Bank Nat'l Trust Co. v. Quicken Loans, Inc., No. 13 Civ. 6482(PAC), 2014 WL 3819356, at *2–4 (S.D.N.Y. Aug. 4, 2014) (finding the operative date for statute of limitations is the date the representations and warranties were breached, not the closing date).

[73] Richard E. Gottlieb & Brett J. Natarelli, *Ace in the Hole: Developments Since Ace Securities in Residential Mortgage-Backed Securities Litigation*, 72 BUS. L. 585 (2017) (discussing ACE Securities Corp. v. DB Structured Products, Inc., 36 N.E.3d 623 (N.Y. 2015)).

B. Standing Litigation

Another related form of legal distance introduced by RMBS was confusion about who could enforce defaulted securitized mortgages independent of litigation regarding representation and warranty. In some cases, servicers seeking to foreclose a mortgage on behalf of a trust could not show the trust had title to the mortgage.[74] In such case, courts were understandably reluctant to permit the foreclosure to continue, since the plaintiff in the case may not be asserting its own rights, but someone else's.[75]

Standing became a question in the Crisis because RMBS transactions often involved bulk sales of mortgages and resales of some mortgages amongst trusts, often without recording the mortgages or their transfers in the appropriate public registry (e.g., the county recorder of deeds).[76] In particular, the Mortgage Electronic Recordation System (MERS) was used to replace traditional paper-based recordation at the local county level with a privately-held electronic registry.[77] There was, however, no guarantee local courts would recognize MERS registrations and, when faced with a conflict between MERS and county-level recordings, courts might be reluctant to permit mortgage enforcement.[78]

---

[74] *See, e.g.*, *In re* Foreclosure Cases, 521 F. Supp. 2d 650, 654 (S.D. Ohio 2007) (giving plaintiffs thirty days to submit evidence proving that they had standing to file the complaint); *In re* Foreclosure Cases, Nos. 07CV2282, 7CV2532, 07CV2560, 07CV2602, 07CV2631, 07CV2638, 07CV2681, 07CV2695, 07CV2920, 07CV2930, 07CV2949, 07CV2950, 07CV3000, 07CV3029, 2007 WL 3232430, at *3 (N.D. Ohio Oct. 31, 2007) (finding plaintiffs could not show proof of ownership of the note or mortgage).

[75] U.S. Bank Nat'l Ass'n v. Ibanez, 941 N.E.2d 40 (Mass. 2011); Adam J. Levitin, *The Paper Chase: Securitization, Foreclosure, and the Uncertainty of Mortgage Title*, 63 DUKE L.J. 637, 650 (2013).

[76] *See* Levitin, *supra* note 75, at 648 ("Securitization transactions require multiple bulk transfers of mortgages in order to achieve various credit ratings, bankruptcy, tax, accounting, and bank-regulatory-capital benefits. Absent clear documentation of these transfers, the various transactional benefits are in doubt, which would undermine the economic viability of securitization. Title-and-transfer system clarity is essential for securitization.").

[77] Culhane v. Aurora Loan Servs., 826 F. Supp. 2d 352, 368 (D. Mass. 2011); David P. Weber, *The Magic of the Mortgage Electronic Registration System: It Is and It Isn't*, 85 AM. BANKR. L.J. 239, 239 (2011).

[78] *See* Weber *supra* note 77, at 246–47 (explaining MERS has faced inconsistent results in state courts).

MERS made concrete the problem of social distance in RMBS securitization because it sought to remove from local legal machinery the power to determine title to real property located in that jurisdiction, instead transferring it to a computer server in some indeterminate location. Except for auto loans, consumer-facing securitizations are generally not secured and not subject to local recordation. MERS was apparently distinctive to RMBS in the Crisis, and largely failed to bridge the systemic distance between the national mortgage market and the local legal mechanisms needed to enforce mortgages.[79] While courts have grown somewhat more comfortable with MERS' role in these transactions,[80] in the near term, it appears to have created legal blockage making resolution more difficult. This legal blockage produced the social distance which undermined conditions of trust and reciprocity that might have resolved defaults more efficiently and fairly in the Crisis.

C. Litigation Overload

The sheer volume of mortgages sold into RMBS also contributed to the legal distance, because ordinary legal mechanisms for addressing default—local courts—were swamped when they began to fail.[81] Since mid-2007, more than 7.5 million homes were subject to foreclosure, according to a 10-year retrospective of the U.S. residential foreclosure crisis.[82] Nearly 1.7 million homes entered foreclosure in 2007, and another 2.2 million in the first three quarters of 2008.[83] The dramatic

---

[79] *See id.* at 245–46 (recognizing that, although it was simple to identify the past mortgage holder, the legal landscape had significantly changed making it difficult to identify the mortgage holder).

[80] More recently, courts have permitted MERS to exercise a power of sale after foreclosure. *See* Eaton v. Fed. Nat'l Mortg. Ass'n, 969 N.E.2d 1118 (Mass. 2012).

[81] *See* Gottlieb & Natarelli, *supra* note 73, at 585–86 (detailing the wide-scale nature of RMBS-related litigation during and following the Crisis).

[82] *Mortgage Performance: Foreclosure Report Highlights 10-Year Retrospect of the US Residential Foreclosure Crisis*, REALTYPRO NETWORK: BLOG (Mar. 13, 2017), https://realtypronetwork.com/mortgage-performance-fore closure-report-highlights-10-year-retrospect-of-the-us-residential-foreclosure-crisis [https://perma.cc/S2Y7-ACFM].

[83] Adam J. Levitin, *Resolving the Foreclosure Crisis: Modification of Mortgages in Bankruptcy*, 2009 WIS. L. REV. 565, 566–67 (2009) (citing HOPENOW, MORTGAGE LOSS MITIGATION STATISTICS: INDUSTRY EXTRAPOLATIONS (QUARTERLY FOR 2007 AND 2008) (2009), http://www.hopenow. com/industry-

increase in foreclosure filings between 2006 and 2008 paralyzed many state and bankruptcy courts.[84]

The problem was driven in part by the automated nature of the loan servicing process. As described by the bankruptcy court in *In re Taylor*,[85] in many instances of default, an electronic case management system would select and issue to local counsel instructions to foreclose, along with the supporting loan documentation and a performance timetable.[86] Yet, local attorneys had little capacity to discuss adjustments or ascertain or correct facts with their clients.[87] As Judge Sigmund observed "[t]he thoughtless mechanical employment of computer-driven models and communications to inexpensively traverse the path to foreclosure offends the integrity of our American bankruptcy system."[88] Error rates among serviced mortgages were high.[89] The volume of mortgage lending, made possible by a nation-level RMBS market, was too much for local legal actors asked to resolve defaults through ordinary legal mechanisms, such as judicial foreclosure.[90] The Crisis made tangible the legal distance of RMBS.

D. Conflicting Incentives

Ordinarily, the preferred way to address financial default is to renegotiate the underlying obligation.[91] Doing so increases the likelihood

---

data/HOPE%20NOW%20National%20Data%20July07%20to %20Jun09%20v2.pdf [https://perma.cc/HGL9-9C86]).

[84] Matthew J. Burne, *Are Bankruptcy LMPs Still Relevant? One Court's Story*, 36 AM. BANKR. INST. J., 38, 38 (2017) (discussing foreclosure rate)

[85] 407 B.R. 618 (Bankr. E.D. Pa. 2009), *rev'd*, No. 09–cv–2479–JF, 2010 WL 624909 (E.D. Pa. Feb. 18, 2010), *rev'd in part, vacated in part, aff'd in part,* 655 F.3d 274 (3d Cir. 2011).

[86] *Id*. at 627.

[87] *Id.* at 650.

[88] *Id.* at 651.

[89] Porter, *supra* note 61, at 182.

[90] *Id.* at 170 ("Further, my interviews with dozens of consumer attorneys before beginning this study revealed that only a few practitioners regularly review all mortgage claims. The high-volume nature of consumer practice undoubtedly explains this situation, but it does not excuse it.").

[91] Levitin, *supra* note 83, at 575 ("In a perfectly functioning market without agency and transaction costs, lenders would be engaged in large-scale modification of defaulted or distressed mortgage loans, as the lenders would prefer a smaller loss from modification than a larger loss from foreclosure.").

of recovering more than liquidation values by forestalling some current obligations in the hope of capturing the upside in a better future.[92] Renegotiating requires the borrower and lender to be able to communicate in order to resolve their differences.[93] This, in turn, requires proximity between the parties, as well as authority to act.[94]

RMBS servicing regimes precluded the ability to modify loans.[95] Servicers literally had to keep borrowers at arms' length because of contractual constraints with investors.[96] As Professor Schwarcz explains:

> Servicing agreements typically oblige servicers to manage loans in the "best interests" of MBS holders, a somewhat ambiguous standard that might expose servicers to liability for even good-faith decisions if, in retrospect, investors suffer harm. Servicing agreements also often include absolute restrictions on changing the terms of loans, limits on the number of modifications for a given asset pool or for a given loan over its lifetime, maximization of the net present value of cash flows (even at the cost of foreclosure on a potentially salvageable loan), and the requirement of consent from outside parties such as bond insurers, rating agencies, and credit enhancement providers before altering more than 5 percent of the loans in a mortgage pool.[97]

"Securitization contracts," according to Gelpern and Levitin, "have many attributes designed to make modification costly and difficult."[98] Servicing agreements terms

> often explicitly limit modification of the underlying mortgage loans. Loan modification limitations are designed to restrict the discretion of the servicer so as to mitigate agency risk in securitizations. Sometimes

[92] *Id.*
[93] *Id.*
[94] *See id.*
[95] *See* Steven L. Schwarcz, *The Conundrum of Covered Bonds*, 66 BUS. L. 561, 578 (2011).
[96] *Id.*
[97] *Id.*
[98] Gelpern & Levitin, *supra* note 30, at 1088.

> modification is forbidden outright; sometimes renegotiation is permitted only under limited circumstances; sometimes only certain types of renegotiation are permitted; and sometimes third-party consent is required to renegotiate loans beyond a specified cap (typically 5 percent of the pool). [Servicing agreements] occasionally limit the number of renegotiations by loan or by year. Additionally, servicers may be required to purchase any loans they renegotiate at the face value outstanding or at a premium. Imposing the full cost of modification on the servicer makes them reluctant to modify; it is meant to serve as a barrier to renegotiation.[99]

This suggests a tendency to foreclose rather than renegotiate. "Servicers may be reluctant to engage in a restructuring," Professor Schwarcz explains:

> [I]f there is uncertainty whether their costs will be reimbursed; whereas foreclosure costs are relatively minimal. Servicers may also prefer "foreclosure over restructuring" because foreclosure "is more ministerial and thus has lower litigation risk." Restructuring can involve difficult decisions. For example, in a mortgage securitization transaction in which "cash flows deriving

[99] *Id.* at 1089–91 (citations omitted); *see also* LARRY CORDELL ET AL., THE INCENTIVES OF MORTGAGE SERVICERS AND DESIGNING LOAN MODIFICATIONS TO ADDRESS THE MORTGAGE CRISIS, IN LESSONS FROM THE FINANCIAL CRISIS: CAUSES, CONSEQUENCES, AND OUR ECONOMIC FUTURE, 231, 231–32 (Robert W. Kolb ed., 2010) ("The revenue and cost structures of the mortgage servicing business shed some light on why mortgage servicers might foreclose upon a distressed borrower rather than pursue an alternative, such as a loan modification."). Some researchers, however, have suggested securitization documentation may not have been as restrictive as suggested. *See* John Patrick Hunt, *What Do Subprime Securitization Agreements Say About Mortgage Modification?*, 31 YALE J. ON REG. ONLINE 11, 15 (2013) ("[O]nly about 8% of the agreements by dollar volume contain outright bans on mortgage modification. Most agreements (60% by dollar volume) permit material modification subject to conditions. Among the most common conditions are that default must be reasonably foreseeable or imminent, that the servicer must follow 'normal and usual' servicing practices.").

> from principal and interest are separately allocated to different investor" classes, or tranches, "a restructuring that reduces the interest rate would adversely affect investors in the interest-only tranche" (and likewise, a restructuring that reduces principal would adversely affect investors in the principal-only tranche).[100]

This preference for formal legal resolution rather than informal renegotiation also converted the legal distance of the parties into social distance. While federal programs were intended to promote renegotiation, they had mixed success.[101] Although bankruptcy might have been an option for some borrowers, it was often too little, too late. In any case, at the height of the Crisis, constraints on RMBS servicers keeping them from renegotiating outside of bankruptcy court did not evaporate when the borrower went into bankruptcy.[102]

These legal phenomena kept borrower and loan servicer distant from one another at times when they could have resolved the default—either by negotiating new terms or giving the property to the lender—more quickly and cheaply than judicial foreclosure.

V. Closing the Gap?

Closing the social distance created by the legal distance of RMBS securitization requires four things: (i) timely information exchange; (ii) communication; (iii) authority to act; and (iv) a mechanism to formally recognize the resolution. The social distance problems of the Crisis reflected an inability to satisfy these criteria. This part assesses

---

[100] Schwarcz, *supra* note 2, at 136.

[101] In 2009, the U.S. government announced the Making Home Affordable program, which included a modification program and a refinance program. *See* Jean Braucher, *Humpty Dumpty and the Foreclosure Crisis: Lessons from the Lackluster First Year of the Home Affordable Modification Program (HAMP)*, 52 ARIZ. L. REV. 727, 748 n.97 (2010).

[102] Alan M. White & Carolina Reid, *Saving Homes? Bankruptcies and Loan Modifications in the Foreclosure Crisis*, 65 FLA. L. REV. 1713, 1715 (2013) ("Although in theory both borrower and investor are better off avoiding foreclosure, in practice it has proven to be much more difficult to modify loans, and the number of modifications has fallen significantly short of the number of distressed borrowers.").

proposals that might satisfy the criteria, using technology and alternative dispute resolution.

A. Virtual Early Warning and Modification Systems

In a better world, mortgage servicers and borrowers would have the incentive and capacity to communicate when the borrower is headed for financial trouble, but before a payment default. In theory, servicers could access to real-time information about a borrower's income and financial position that might tip off the servicer that the borrower lost her job, incurred other major debts, and so on. They would have the authority from the trustees of the trusts that own the mortgages to make whatever deals seem appropriate—whether restructuring or taking the property—and these adjustments could be made quickly in a way that was binding on the parties.

This would be a virtual replica of the relationship between George Bailey and his bank's borrowers in *It's a Wonderful Life.*[103] Rather than waiting for payment default, borrower and servicer could proactively identify the problem and modify the mortgage to address it, perhaps by reducing and extending interest or principal payments, to make it easier for the borrower to remain in the house or to enable the borrower to cede the house to the lender if it appears a workout is not plausible.

There is a push to harness computing technology to steer the process in this direction. Computer-assisted mortgage modification would build on technology that has automated the loan underwriting process.[104] It appears possible for lenders to determine in little time whether a borrower is qualified to borrow.[105] If so, the same technology may be

---

[103] IT'S A WONDERFUL LIFE, *supra* note 26.

[104] Ben Lane, *"Rocket Mod": The Future of Mortgage Default Servicing? How Technology Will Change Loss Mitigation*, HOUSINGWIRE (Feb. 15, 2017), https://www.housingwire.com/articles/39232-rocket-mod-the-future-of-default-servicing [perma.cc/2JD2-CLAG] (discussing Quicken Loans' proposal to reduce mortgage modification from 60 days to "no days").

[105] Fannie Mae's "Day 1 Certainty" program, for example, "gives lenders freedom from representations and warranties plus greater speed, simplicity, and enables an improved borrower experience." *Day 1 Certainty*, FANNIE MAE, https://www.fanniemae.com/singlefamily/day-1-certainty [perma.cc/ CCL9-U7J7] (last visited May 13, 2018).

used to determine whether, and how, to modify a defaulted mortgage.[106] This technology might reduce social distance. For example, payment monitoring technology may detect a homeowner has a lost a job and stream of income. Servicers could then pro-actively engage the borrower to help mitigate the loss.[107]

It is important to be realistic about human limitations here. Even if technology may detect potential defaults early, there is no reason to think homeowners would necessarily embrace the opportunity to work issue out with their mortgage servicer.[108] If the Crisis is any indication, financially distressed homeowners may not be the most proactive borrowers or especially receptive to communicating with mortgage servicers.[109] Nor is there reason to think technology would magically make servicers beneficent and wise. In any case, it does not appear these systems have yet taken off. While they might, they might also raise concerns about privacy, consumer protection, and information security, so they may not develop rapidly. Free from the exigencies of the Crisis, pressure to invent or improve these modification mechanisms may stall in the face of other priorities.

B. ADR and ODR

Assuming early detection systems are not possible or permissible, servicers and borrowers would have to resolve payment defaults or other serious problems through more conventional mechanisms. But, as explained above, those mechanisms appeared to contribute to social distance in the Crisis, not to reduce it—and that was one reason RMBS performed worse than parties expected.

One alternative that has received some attention is alternative dispute resolution (ADR)—in particular, mediation as an alternative to

---

106 Lane, *supra* note 104.

107 *Id.*

108 Lew Sichelman, *Lenders' Reps Go Door to Door Trying to Help Delinquent Borrowers*, L.A. TIMES (Mar. 28, 2010), http://articles.latimes.com/2010/mar/28/business/la-fi-lew28-2010mar28 [https://perma.cc/8YWH-Z8KP] (discussing the difficulty lenders have getting in contact with delinquent borrowers, even when they are attempting to help the borrowers save their homes).

109 *E.g.*, *id.*

mortgage foreclosure.[110] But traditional ADR cannot overcome problems of cost, distance and systemic asymmetry that created legal blockage and social distance. So, it may also be worth considering how ADR and technology are merging in online dispute resolution.

1. ADR

Mortgage foreclosure ADR became important as foreclosure litigation began to fill courts in 2008.[111] In Philadelphia, for example, the Residential Mortgage Foreclosure Diversion Program developed in response to the rising number of residential mortgage foreclosures in Philadelphia.[112] The program sought to divert owner-occupied residential properties from sheriff's sale to a mandatory conciliation conference between homeowners and lenders/servicers to see if a workout could be reached to avoid a sheriff's sale and keep borrowers in their homes.[113]

In 2013, Professor Nussbaum argued that alternative dispute resolution was a superior mechanism in addressing the mortgage crisis to traditional, formal legal methods, such as judicial foreclosure.[114] "Including an ADR process as a compulsory step in foreclosure gives the homeowner a right to negotiate with the loan servicer . . . and also provides for some oversight of the loan servicer's decision-making."[115] Like many, she viewed the social distance created by RMBS securitization as part of the underlying problem.[116] ADR has the potential to

---

[110] *E.g.*, THE REINVESTMENT FUND, PHILADELPHIA RESIDENTIAL MORTGAGE FORECLOSURE DIVERSION PROGRAM: REPORT OF FINDINGS - UPDATE 2014 2 (2014), www.reinvestment.com/wp-content/uploads/2015/12/Diversion_Court_Findings-Update_Report_2014.pdf [https://perma.cc/LJV4-UK95] (discussing the City of Philadelphia's Alternative Dispute Resolution Diversion Program implemented in the wake of a "foreclosure moratorium" in 2008).

[111] Rozzisi, *supra* note 13, at 140.

[112] THE REINVESTMENT FUND, *supra* note 110, at 1.

[113] *Id.* (discussing the requirements lenders must adhere to before they can foreclose on a delinquent borrower under Philadelphia's program).

[114] Lydia Nussbaum, *ADR's Place in Foreclosure: Remedying the Flaws of a Securitized Housing Market*, 34 CARDOZO L. REV. 1889, 1891–92 (2013).

[115] *Id*.

[116] *Id.* at 1906 ("Securitization changed how foreclosure decisions were made. As a result, a basic presumption of conventional foreclosure laws no longer applied and instead millions of foreclosures occurred without a cost-benefit analysis to determine the best option for recouping the value of the loan. Borrowers and

address this by collapsing that distance, "establishing a direct communication between a homeowner and a decision-maker with the authority to undertake an alternative to foreclosure."[117]

ADR would be effective, she argued,[118] since securitization made foreclosures a "national economic activity difficult for individual states to regulate," because there was no all-encompassing legislation to end foreclosures or reset mortgages.[119] As a result, different local and state governments focused on ways to amend their foreclosure procedures, and ADR could be an option in that process.[120]

Foreclosure ADR programs can be developed either through the judiciary or by legislation,[121] they can be mandatory or optional, and, if the latter, could presumably be at the option of either the borrower or the servicer.[122] There are different ways to fund them, and different points in the process when they could start.[123] All, however, focus on foreclosure as the legal moment for which an alternative is proposed, and not some

---

investors suffered the consequences and local and national economics suffered.").

[117] *Id*. at 1891; *see also id.* at 1907 ("The sheer volume of foreclosures was overwhelming and compromised the integrity of foreclosure proceedings . . . . Little or no time was spent by the judge assessing the merits of the foreclosure petition, such as whether the entity seeking foreclosure had the legal right to do so and whether it had complied with state law.").

[118] *See id.* at 1907, 1909–14. Nussbaum says the main objectives of ADR are to resolve communication barriers caused by securitization, provide oversight of loan servicers' conduct, educate homeowners about their rights in foreclosure, assist with a high volume of cases in court, and alleviate community blight. *Id.*

[119] *Id.* at 1907.

> Foreclosure is a contractual remedy for lenders when a loan is delinquent and, although state governments could delay foreclosure, they could not deny lenders the right to foreclose. Furthermore, the financial situation of each homeowner and the reasons for being in default were highly individualized, making it extremely difficult for a legislature to develop a law tailored narrowly enough to achieve its compelling interest to protect homeowners by the least restrictive means possible.

Id. at 1907–08.

[120] *Id.* at 1908.

[121] *Id.* at 1916.

[122] *See id.* at 1926–29.

[123] *See generally id.* at 1947–48.

earlier point in time, as would be the case with the early-warning systems discussed above.

Nussbaum argues there are two key features to any of these programs:

> First, to be eligible for these programs borrowers must be owner-occupiers of the property in jeopardy and that property must be the borrower's primary residence. Second, the programs require direct communication about the loan between the borrower and the lender or loan servicer. In general, a representative of the lender, usually an attorney hired by the loan servicer, must appear in person and must have the authority to negotiate and modify the loan secured by the mortgage.[124]

Both respond to the social distance created by RMBS. The requirement that this involve the owner/occupant of a primary residence implies at least one of the parties is locked into a particular place. There is no reason why ADR must occur in that place—and one can imagine some concern about forcing homeowners to travel to a remote location to resolve a dispute—but of course the servicer's ultimate strategic move is to take the house, which it is not going to do from the offices of JAMS.[125]

The second key feature, direct communication, more obviously connects to the problem of social distance.[126] Nussbaum notes the servicer's representative is likely to be an attorney and may participate by phone.[127] It is difficult to know the legal ethics of giving an attorney blanket authority to modify a loan, but the basic instinct would seem to be correct: to resolve these disputes more effectively, one needs information, communication, authority to act, and the resulting agreement should be more or less formally recognized.[128]

---

[124] *Id.* at 1914.
[125] JAMS provides alternative dispute resolutions services. JAMS, https://www.jamsadr.com/.
[126] *See* Nussbaum, *supra* note 114, at 1914.
[127] *Id.*
[128] *Id.* at 1930–35, 1941–44 (emphasizing the role of attorneys in ADR and the homeowner and attorney's joint efforts to facilitate an effective foreclosure negotiation).

A study of the details of these programs is beyond the scope of this paper, but ADR is certainly not a perfect solution. At a high level of generality, these programs offer benefits of a greater likelihood of resolution and at a faster pace.[129] Assuming ADR is held near the borrower's physical location, the costs would be borne largely by the servicer, because it would have to send authorized personnel to the borrower's location to participate in the program. If it involves arbitration, then concerns about that process would presumably appear here. These include worries that arbitration favors repeat players (i.e., servicers), may be remote from the borrower, and may not honor the rule of law.[130]

Because mortgage servicers typically operate on a national or super-regional level, physical ADR would not necessarily overcome the systemic mismatch that contributes to social distance in this context. Mortgage servicing has become much costlier since the Crisis. According to the Mortgage Bankers Association, performing loans were nearly three times more expensive to service in 2016 than 2008—in the same period, the charge for servicing non-performing loans increased by a multiple of five.[131]

Requiring servicers to travel to defaulting borrowers to engage in mediation would doubtless add greater costs, and perhaps at the least opportune moment: when many mortgages are defaulting, possibly exposing the servicer to repurchase risk. There is already concern new regulatory burdens have increased the costs of servicing which, in turn, are passed through to borrowers.[132] Borrowers may not wish to pay more

---

[129] *See id.* at 1952 (describing one of the clear benefits of ADR as opening the lines of communication and forcing servicers to "behave as a traditional lender might").

[130] Donna M. Bates, *A Consumer's Dream or Pandora's Box: Is Arbitration A Viable Option for Cross-Border Consumer Disputes?*, 27 FORDHAM INT'L L.J. 823, 846–47 (2004) ("This new pro-arbitration landscape raises doubts as to fairness, efficiency, and legal due process, values normally protected by consumer legislation.").

[131] *MBA Chart of the Week: Servicing Costs Per Loan (Single-Family)—Performing v. Non-Performing*, MORTGAGE BANKERS ASS'N (July 24, 2017) https://www.mba.org/mba-newslinks/2017/july/mba-newslink-monday-7-24-17/residential/mba-chart-of-the-week-servicing-costs-per-loan-(single-family)-performing-v-non-performing [https://perma.cc/2G6G-MV32].

[132] *See also* Jacob Gaffney, *Fitch: These 4 Things Keep Driving up the Cost of Mortgage Servicing*, HOUSINGWIRE (Dec. 12, 2017), https://www.housingwire.com/articles/42061-fitch-these-4-things-keep-driving-up-the-cost-of-

for homes today simply for assurance that if they default—a prospect they probably cannot imagine ex ante—they will have a live mortgage servicer with whom to work out the loan.

2. ODR

Another approach has the potential to bring together some of the benefits of technology and informality, at least on a virtual basis, through "online dispute resolution" (ODR). According to the American Bar Association Business Law Section:

> ODR is a broad term that encompasses many forms of alternative dispute resolution (ADR) that incorporate the use of the Internet, Web sites, e-mail communications, streaming media, and other information technology as part of the dispute resolution process. Parties may never meet face-to-face when participating in ODR. Rather, they might communicate solely online.[133]

At least some observers believe ODR is the "wave of the future" because it automates many functions previously performed by individuals and ameliorates the problem of physical distance between the parties.[134] Large consumer-facing business such as eBay have apparently developed successful automated ODR systems.[135]

ODR is new, however, and it is not known whether or to what extent it could address future failures in consumer-facing securitizations. Business communities, commentators, and policy makers "recognize the value of ODR platforms but are struggling to locate appropriate funding and demarcate the bounds of ODR use vis-à-vis brick-and-mortar

---

mortgage-servicing [https://perma.cc/M9CY-HPUW] (describing a "'general consensus . . . that investments in regulatory tracking and monitoring systems have taken priority over areas that can drive improvements in loan performance management'").

[133] *See* Task Force on Elec. Commerce, *supra* note 13, at 419.

[134] Victor Li, *Is Online Dispute Resolution the Wave of the Future?*, A.B.A. J. (2016), http://www.abajournal.com/news/article/is_online_dispute_resolution_the_wave_of_the_future [https://perma.cc/P2VG-JCPG].

[135] *Id.*

courts."[136] More fundamentally, as with any technology that displaces functions performed largely by people, many of the concerns and problems are currently difficult to foresee. At minimum, an effective ODR program would have to build in the characteristics essential to physical ADR: information, communication, authority, and formal recognition.[137] In principle, there is no reason why this could not happen.

VI. Conclusion

Observers have suggested RMBS caused or enhanced social distance promoting strategic behavior and reducing incentives to efficiently resolve borrower-level distress. Yet, these observers have not explained how that might have occurred or what to do about it. This paper helps fill these gaps. While ODR techniques are new and have not been tested in any large-scale crisis, securitization participants should think about how to develop such systems to address the next major downturn more effectively than the last.

---

[136] Scott J. Shackelford & Anjanette H. Raymond, *Building the Virtual Courthouse: Ethical Considerations for Design, Implementation, and Regulation in the World of ODR*, 2014 WIS. L. REV. 615, 617 (2014).
[137] *See* Nussbaum, *supra* note 114, at 1914–15.