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DISTRICT COURT

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STATE OF NEW MEXICO
COUNTY OF SANTA FE
FIRST JUDICIAL DISTRICT COURT

NO. D-101-CV-2015-02177

U.S. BANK, NATIONAL ASSOCIATION, AS TRUSTEE FOR C-BASS 2007-SPI TRUST, MORTGAGE LOAN ASSET –BACKED CERTIFICATES, SERIES 2007-SP1,

Plaintiff,

v.

MUKHTIAR S. KHALSA, GURNAM K. KHALSA, JPMORGAN CHASE BANK, N.A. AND UNKNOWN TENANTS, REAL NAMES UNKNOWN,

Defendants.

DEFENDANT'S REPLY TO PLAINTIFF'S RESPONSE TO THE MOTION TO DISMISS UNDER AN UNCONSCIONABLE CONTRACTAS A MOTION FOR SUMMARY JUDGMENT UNDER RULE 12(B)(6)

COMES NOW, Defendant, Mukhtiar S. Khalsa, by and through his own counsel, and in reply to Plaintiff's Response to Defendant, Mukhtiar S. Khalsa's Motion to Dismiss under an Unconscionable Contract as a Motion for Summary Judgment under Rule 12(B)(6) states;

INTRODUCTION

Within the four corners of the Motion to Dismiss under an Unconscionable Contract, ("MTD"), material facts are laid out to support an argument that the particular mortgage ("Mortgage") that is the subject of this action has certain terms that render it an unconscionable contract. Plaintiff raises no genuine issue to oppose that Defendant as the moving party is entitled to a judgment as a matter of law. Plaintiff does not deny that those contractual terms render Mr. Khalsa's Mortgage unconscionable. Plaintiff instead appears to apply its opportunity to respond as an attempt to set public policy.

A recent Comment published Yale Law Journal[1] (complete Comment attached as EXHIBIT B) addressed this same topic with a very different conclusion. That Comment makes the argument that; "*By focusing on the immediate consequence of a ruling for homeowners* [as defendants in foreclosure], *the courts ignore perverse incentives created by allowing banks to continue to externalize the costs of their mistakes.*[2]" The Comment recognizes that; "*courts are afraid to bar future attempts to foreclose.*[3]", and that "[the Court's] *approach is to bend the rules of res judicata to avoid a windfall for homeowners*[4]". The Comment warns; "*This approach creates few benefits and significant economic problems. In this Part, we argue that further subsidizing banks' poor litigation practices results in deadweight loss by contributing to negative public-health outcomes and by disincentivizing banks from improving their servicing and litigation techniques*[5]".

Mortgages do not need to be written with terms that do not comport to law, are self contradictory, are meant to allow the mortgagee the right to prosecute, but not meant to allow the mortgagor an effective means to challenge the mortgagee's right to prosecute and contain the three elements that define an adhesion contract. Mr. Khalsa's Mortgage was written with those terms.

REPLY

Plaintiff's Response "Section I Motion to Dismiss Standard"

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[1] COMMENT: In Defense of "Free Houses", February, 2016, Yale Law Journal, 125 Yale L.J. 1115, Authors, Megan Wachspress, Jessie Agatstein And Christian Mott

[2] *Id*

[3] *Id*

[4] *Id*

[5] *Id*

In section I of Plaintiff's Response to the MTD ("Response to the MTD") the MTD is described as a Rule 12(B)(6) motion[6]. Rule 12(B) requires a Rule 12(B)(6) motion to "*be treated as one for summary judgment and disposed of as provided in Rule 1-056 NMRA*". Under Plaintiff's guidance, and pursuant to Rule 12(B), Defendant will treat the MTD as a motion for summary.

Section I raises no genuine issue to oppose the argument that this particular Mortgage has certain terms that render it an unconscionable contract.

Plaintiff's Response Section II "Plaintiff's Complaint is legally sufficient in declaring that Plaintiff has standing and Plaintiff is legally entitled to enforce the Note and Mortgage"

Within the four corners of the MTD, material facts are laid out to support an argument that this particular Mortgage has certain terms that render it an unconscionable contract. Plaintiff's unresolved assertion; "*Plaintiff's Complaint is legally sufficient in declaring that Plaintiff has standing and Plaintiff is legally entitled to enforce the Note and Mortgage*" falls outside the four corners of the MTD and is immaterial to the MTD arguments.

Section II raises no genuine issue to oppose the argument that this particular Mortgage has certain terms that render it an unconscionable contract.

Plaintiff's Response Section III "There was no "Partial" Assignment"

Nowhere within the four corners of the MTD is an allegation brought that suggests that a partial assignment of the instrument of the mortgage loan has occurred. MTD does argue that "partial sale" terms of the Mortgage do not comport to law and is meant to allow the mortgagee the right to prosecute, but not meant to allow the mortgagor an effective means to challenge the mortgagee's right to prosecute. Plaintiff does not appear to disagree with that argument.

[6] Response to the MTD Section I at page 2 first line in the first paragraph

Section III raises no genuine issue to oppose the argument that this particular Mortgage has certain terms that render it an unconscionable contract.

Plaintiff's Response Section IV "Mortgage Loans are not unconscionable by reason of their giving the note holder the right to enforce"

It is very difficult to determine what argument Plaintiff attempts within this Section. It appears that the argument brought is, if a bank wrote the contract, the contract cannot be unconscionable, or perhaps Plaintiff argues that if Mr. Khalsa was stupid enough to sign an unconscionable mortgage he is stuck with it. Plaintiff shows no support for either argument, and the MTD addresses both[7].

Section IV raises no genuine issue to oppose the argument that this particular Mortgage has certain terms that render it an unconscionable contract.

Plaintiff's spurious argument against windfall for the Defendant

The mandate of New Mexico Supreme Court ("NMSC") in *Cordova v. World Finance Corp. of NM*[8] deprives all New Mexico Courts of jurisdiction over subject matter created by a contract which is unconscionable. Were Plaintiff to prevail in this action, with an unconscionable contract that it bought from New Century Bank and it now improperly attempts to enforce, Plaintiff would be unjustly enriched. Were Defendant to be foreclosed under an unconscionable contract, one individual would be improperly stripped of his property.

[7] Our law has never really required that a person seeking relief from an unconscionable contract must first establish that he or she actually had to have been a madman or a fool to sign it. It is sufficient if the provision is grossly unreasonable and against our public policy under the circumstances ***Cordova v. World Finance Corp. of NM***, 208 P. 3d 901) ¶ 31- NM: Supreme Court (2009)

[8] We will not allow our courts to be used to enforce unconscionable arbitration clauses any more than we will allow them to be used to enforce any other unconscionable contract in New Mexico. ***Cordova v. World Finance Corp. of NM***, 208 P. 3d 901) ¶ 38- NM: Supreme Court (2009)

Plaintiff's emotional diatribe in the Introduction of the Response improperly postulates; *"they ask that Plaintiffs Complaint be dismissed, that they be released from the duty to repay the debt, and that, in addition, they be recover a windfall of more than 3/4 of a million dollars"*.

The Boogie Man's role is to scare little children; he has no jurisdiction within this action. Plaintiff had every opportunity to appropriately raise genuine issues to oppose that the material facts show the terms of Mr. Khalsa's Mortgage render it an unconscionable contract. Plaintiff has raised no such issues.

This Court has no jurisdiction over subject matter created by a contract which is unconscionable. If Mr. Khalsa were released from his "duty", (as described by Plaintiff), that release would come from New Century Bank's poor and improper business practices and Plaintiff's neglect of due diligence.

Because Plaintiff has bought into a liability that is dependent on New Century Bank's poor and improper business practices, Plaintiff brings an improper attempt to collect a debt that violates the New Mexico Unfair Trade Practices Act. That violation entitles Mr. Khalsa to the statutorily defined punitive damages that Plaintiff describes.

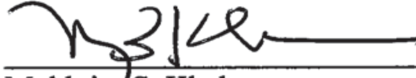
There is no "windfall" here for Defendant.

CONCLUSION

Within the four corners of the MTD it is argued that four conditions exist that make this Mortgage an unconscionable contract. Plaintiff raises no genuine issue to oppose that those material facts show that those four conditions exist.

The pleadings, and admissions on file, show that there is no genuine issue to oppose any material fact and Defendant as the moving party is entitled to a judgment as a matter of law, the judgment sought should be rendered forthwith.

Respectfully submitted:



Mukhtiar S. Khalsa
P.O. Box 593
Santa Cruz, NM 87567
505-450-2802

I hereby certify that a true and correct copy of the foregoing pleading was mailed on this 8th day of April, 2016 to opposing counsel.

Mukhtiar S. Khalsa

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COMMENT: In Defense of "Free Houses"

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Authors

MEGAN WACHSPRESS, JESSIE AGATSTEIN and CHRISTIAN MOTT*

In Defense of "Free Houses"

Megan Wachspress, Jessie Agatstein & Christian Mott

Eight years after the start of America's housing crisis, state courts are increasingly confronting an unanticipated consequence: what happens when a bank brings a foreclosure suit and loses? Well-established legal principles seem to provide a clear answer: the homeowner keeps her house, and res judicata bars any future suit to foreclose on the home. Yet state courts around the country resist this outcome.

Banks have lost many foreclosure cases for two reasons, both resulting from recent changes in the mortgage market. First, securitization has created widespread errors in mortgage notes' chains of assignment, making it difficult for banks to prove that they in fact own any particular mortgage. Second, securitization contracts incentivize banks to use "foreclosure mill" law firms to keep up with the flood of defaults, despite the fact that these firms are unable and sometimes unwilling to detect and rectify basic legal errors.

When addressing faulty foreclosures, courts are afraid to bar future attempts to foreclose—that is, afraid of giving borrowers "free houses." While courts rarely explain the reasoning behind this aversion, it seems to arise from a reflexive belief that such an outcome would be unjust.[1] Courts are therefore quick to sidestep well-established principles of res judicata in favor of ad hoc measures meant to protect banks against the specter of "free houses."

This Comment argues that this approach is misguided; courts should issue final judgments in favor of homeowners in cases where banks fail to prove the elements required for foreclosure. Furthermore, these judgments should have res judicata effect—thus giving homeowners "free houses." This approach has several benefits: it is consistent with longstanding res judicata principles in other forms

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1 See, e.g., Washington v. Specialized Loan Servicing, LLC (In re Washington), No. 14-14573-TBA, 201

EXHIBIT B

of civil litigation, it provides a necessary market-correcting incentive to promote greater responsibility among foreclosure litigators, and it alleviates the tremendous costs of successive foreclosure proceedings.

This Comment proceeds as follows. Part I explains basic foreclosure and mortgage-acceleration law. Part II describes how systemic banking behaviors and market forces have resulted in banks increasingly losing foreclosure suits after the 2008 financial crisis. Part III then describes how state courts have struggled to develop their jurisprudence on "free houses," often ignoring these significant market problems. Finally, Part IV contends that the application of res judicata in foreclosure litigation is essential for two reasons: (1) it would uniformly apply civil rules of finality to foreclosure cases, and (2) it would have a much-needed positive behavioral effect on a mortgage-foreclosure market run amok.

I. THE FORECLOSURE LAW BACKDROP

Foreclosures begin with a mortgage note's "acceleration clause." Under a mortgage note, the homeowner is required to make a certain payment every month for a fixed period.[2] In judicial-foreclosure states, if the homeowner defaults on at least one payment for a specified amount of time,[3] the bank has a choice: it can bring suit to recover just the missed payments,[4] or it can exercise the acceleration clause[5] in the note and bring the entire remaining loan balance due.[6] Under the mortgage contract, only acceleration allows the bank to foreclose on the mortgage.[7]

In a foreclosure suit, the bank must generally prove the following: (1) the homeowner has signed both the note (the underlying loan) and the mortgage assigning the house as collateral for that note; (2) the bank owns the note and mortgage; (3) the homeowner still owes a debt to the bank; (4) the homeowner is behind on that debt; and (5) the bank has accelerated that remaining debt in accordance with the terms of the note itself.[8] When a bank fails to prove these elements, a judge is

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2 The standard home mortgage is thirty years. See Annamaria Andriotis, Picking the Right Mortgage, W

3 This time period may be specified in the note itself or it may be fixed by statute. See, e.g., CAI

4 This is the lender's only remedy in contracts without acceleration clauses. SeeRESTATEMENT (THIRD

5 Acceleration clauses are routine in mortgage notes. Id. ("Virtually all mortgages today contain

6 This option only exists where the acceleration clause is discretionary. In some rare cases, the no

7 Foreclosure can be either judicial or nonjudicial; judicial foreclosures require a successful suit

8 See, e.g., GMAC Mortg., LLC v. Ford, 73 A.3d 742, 751 (Conn. App. Ct. 2013) (setting out what Conn...

legally required to rule in favor of the homeowner.
Recently, courts have been inundated with suits where homeowners question the bank's ability to prove the second element. Litigation over "proof-of-ownership" issues in foreclosures is a growing nationwide problem; sampling suggests a ten-fold increase between the periods immediately preceding and following the 2007 collapse of the housing market.[9] Cases addressing this kind of "failed foreclosure" have reached state supreme and appellate courts, including—recently—the Maine Supreme Court.[10] In certain states, including Florida,[11] New Jersey,[12] and New York,[13] courts have also been confronted with cases where, after accelerating the note and initiating a foreclosure proceeding, the bank abandons the proceeding and the statute of limitations on the accelerated debt expires, calling the third element into question.[14]

This massive increase in cases where banks' prima faciecase is challenged or outright fails is not the product of novel foreclosure law or changes in its application. Rather, we argue, it is due to fundamental changes in how banks handle mortgages—the same changes that facilitated the financial crisis of 2008—and banks' unwillingness to invest in sufficient legal services to adapt to these underlying structural changes when pursuing foreclosures.

II. WHY HOMEOWNERS WIN THEIR FORECLOSURE CASES: SECURITIZATION AND ITS MARKET FAILURES

To successfully bring a foreclosure suit a bank must produce very little evidence. Why has this proven so difficult? The answer lies with banks' own practices. In the last twenty years, banks have significantly altered how they profit from mortgages; however, they failed to adequately adapt their record keeping and customer-service practices.

In the 1990s, banks began to convert long-term mortgages, familiar to most Americans, into short-term financial commodities, a process called securitization. Rather than keep mortgages on the books, mortgagees (banks) sought to sell the mortgages immediately to financial entities that would transform thousands of individual mortgages into securities—financial instruments that entitled the

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9 A search on March 5, 2015 of the Lexis State & Federal Cases database for "(foreclosure w/s stan..

10 See Bank of Am., 96 A.3d at 700;see also, e.g., Lizio v. McCullom, 36 So. 3d 927, 928 (Fla. Dist....

11 U.S. Bank Nat'l Ass'n v. Bartram, 140 So. 3d 1007, 1008-09 (Fla. Dist. Ct. App.), review granted,

12 See, e.g., Washington v. Specialized Loan Servicing, LLC(In re Washington), No. 14-14573-TBA, 201..

13 Argent Mortg. Co., 958 N.Y.S.2d 306

14 See, e.g., Bartram, 140 So. 3d at 1008; In re Washington, 2014 WL 5714586, at *1; see alsoMichael..

bearer to homeowners' mortgage payments and that could be arbitrarily restructured or resold.[15] After securitization, although a homeowner would continue to make mortgage payments to the originating bank, that bank ceased to have a financial interest in receiving these payments. Instead, a variety of investors owned an interest in the pool of mortgage payments of which the homeowner's is a part.[16]

Securitization gave rise to widespread errors in the documentation of mortgage ownership. To allow a variety of investors to own portions of a mortgage pool, originating banks entered into pooling and servicing agreements, which authorized "servicers"—sometimes large commercial banks, but often companies who were primarily or exclusively engaged in servicing—to act as the diffuse investors' agents in receiving payments from and pursuing foreclosures against homeowners. Because actual ownership of the mortgage note became independent of servicing and the relationship with the mortgagor, a loan, or the right to receive part of the payments on that loan, might be sold several times while the homeowner still interacted with the same servicer. Conversely, the servicer might change while the loan remained part of the same investment pool. Throughout this reshuffling of title ownership and servicing, banks frequently made errors in how they documented and recorded their ownership of mortgages.[17]

Common mortgage fee structures set up in pooling and servicing agreements also disincentivized servicers and their attorneys from devoting adequate resources to foreclosures. Each servicing agreement paid servicers a flat annual fee of around 0.25% of the loan's total value (for example, $500 per year on a $200,000 loan), but the cost of pursuing a single foreclosure cost servicers around $2,500.[18] When foreclosures began climbing precipitously in 2007,[19] servicers were unprepared to handle the sudden increase in volume and had no incentives to devote additional resources to prove their banks' ownership over each mortgage.[20] To demonstrate ownership without expending more resources than pooling and servicing agreements allotted, bank employees signed hundreds of thousands of affidavits asserting that they had seen and could attest to the contents of original documents demonstrating ownership of the underlying mortgage. Although such affidavits were a

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15 Eamonn K. Moran. Wall Street Meets Main Street: Understanding the Financial Crisis, 13 N.C. BANKIN

16 An excellent explanation of the process by which securitization took place, and of its role in the...

17 See, e.g . Molly Rose Goodman,The Buck Stops Here: Toxic Titles and Title Insurance. 42 REAL EST...

18 Eric Dash & Nelson D. Schwartz,Bankers Ignored Signs of Trouble on Foreclosures, N.Y. TIMES (Oct....

19 Fed. Hous. Fin. Agency Office of Inspector Gen., FHFA's Oversight of Fannie Mae's Default-Rela...

20 See Ariana Eunjung Cha & Brady Dennis, Under Piles of Paperwork, A Foreclosure System in Chaos. WA...

legally acceptable means of demonstrating such ownership, a significant number of them were actually fraudulent.[21]

Similarly, servicers' attorneys also relied on sloppy paperwork—and, at times, on fraudulent and unethical practices in foreclosure proceedings. For example, one New Jersey foreclosure law firm operated without any method of contacting its mortgage-servicer clients. Instead, the firm received all work orders through a one-way computer system, along with a requested timeline and documents the servicer had determined were necessary.[22] This underresourcing and the resulting ethical transgressions have affected hundreds of thousands of foreclosures.[23]

The result of securitization contracts' underresourcing of mortgage servicers and their attorneys has been a "factory-line approach to litigation," rife with abuses.[24] In many individual cases, these litigation strategies have been unsuccessful. Homeowners, their attorneys, and sometimes judges have successfully prevented foreclosure by demonstrating the falsity of an affidavit or simply by forcing the mortgagee to produce actual documentation that it owned the mortgage.[25] As an increasing number of foreclosure suits are lost on the merits for lack of documentation, or for failure to prosecute within the statute of limitations, courts face a new problem: what happens next?

III. THE COURTROOM SOLUTION: ANYTHING BUT "FREE HOUSES"

In many states, longstanding principles of res judicata, when taken with the state law's treatment of acceleration clauses, require courts to grant homeowners "free houses" when banks lose their foreclosure cases. But many courts have declined to give these cases preclusive effect.

Whether servicers lose because they fail to prove ownership or because their lawyers simply stop litigating, the first choice courts face is whether to dismiss the case with prejudice. Typically, once parties have a full and fair opportunity to present their cases, failure to prove one's case results in

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21 See Fed. Nat'l Mortg. Ass'n v. Bradbury, 2011 ME 120, ¶¶ 2-7, 32 A.3d 1014, 1015-16.

22 In re Taylor, 407 B.R. 618, 623 (Bankr. E.D. Pa. 2009), aff'd, 655 F.3d 274 (3d Cir. 2011).

23 For example, in 2012, New York Attorney General Eric Schneiderman announced a four-million-dollar

24 Morgenson & Glater, supra note 23.

25 See, e.g., In re Foreclosure Cases, No. 07CV2532, 2007 WL 3232430, at *2-3 (N.D. Ohio Oct. 31, 200

dismissal with prejudice.[26] In addition, dismissal with prejudice can be used as a sanction. Judges in foreclosure cases have issued dismissals with prejudice due to a lender's failure to appear at case-management conferences[27] or mediation,[28] lack of prosecution,[29] or a lender's failure to meet court-imposed deadlines.[30] If banks attempt a subsequent foreclosure, courts must then determine whether that dismissal with prejudice bars only an attempt to collect on the particular missed payments that led to the initial foreclosure suit, or whether the dismissal bars a future attempt to collect on any default on the debt.

While the latter holding may seem extreme, it is in accordance with settled principles of lending law in many states. In these states, acceleration is irrevocable—exercising the acceleration clause in the mortgage note turns an obligation to make installment payments into an "indivisible" obligation.[31] Logically, after acceleration, there are no more monthly payments. A foreclosure is an action to recover the entire loan balance, and a loss bars any future attempt to collect on the note. In effect, the borrower gets to keep his house without being subject to a continuing obligation on the mortgage—a "free house."[32] Courts in irrevocable acceleration states that considered the issue before the 2008 financial crisis applied res judicata to subsequent foreclosures in this way.[33]

Recently, however, judges have avoided applying res judicata to foreclosure cases and have bent the rules to favor banks. For example, in Maine, where longstanding precedent established that a failed foreclosure bars any future attempt to collect on the debt,[34] two trial courts recently refused to

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26 RESTATEMENT (SECOND) OF JUDGMENTSch. 1, at 6 (AM. LAW. INST. 1982) ("The principle underlying t

27 See, e.g., Singleton v. Greymar Assocs., 882 So. 2d 1004, 1005 (Fla. 2004) (noting the lower court ..

28 See, e.g., Bayview Loan Servicing, LLC v. Bartlett, 2014 ME 37, ¶ 4, 87 A.3d 741, 745 (noting the

29 See, e.g., Washington v. Specialized Loan Servicing, LLC (In re Washington), No. 14-14573-TBA, 201…

30 See, e.g., Johnson v. Samson Constr. Corp., 1997 ME 220, ¶ 4, 704 A.2d 866, 868 (noting the lower…

31 See id. ¶ 8, 704 A.2d at 869; U.S. Bank Nat'l Ass'n v. Gullotta, 120 Ohio St. 3d 399, 2008-Oh..

32 Although we refer colloquially to these houses as "free," the homeowner may have paid the equi

33 See, e.g., Stadler v. Cherry Hill Developers, Inc., 150 So. 2d 468, 472 (Fla. Dist. Ct. App. 1963) .

34 See Johnson, 1997 ME 220, ¶ 8, 704 A.2d at 869.

dismiss cases with prejudice, even after the cases were tried to completion and the banks had lost. The judges in those cases were explicit that they did so to allow any subsequent actions the banks might want to bring and to avoid giving the homeowners a windfall.[35]

On appeals from those cases, the Maine Supreme Court went even further than the trial courts in changing the law to favor foreclosing banks. The court held that the bank's ownership of the mortgage, which has long been recognized as an element of the bank's prima facie case for foreclosure,[36] is actually an element of standing.[37] Thus, whenever a bank fails to prove ownership of the mortgage, even if that occurs after a full trial on the merits, the complaint must be dismissed without prejudice for lack of subject-matter jurisdiction.[38] In other words, the court's ruling granted banks potentially infinite bites at the apple in foreclosure proceedings.[39]

In Florida, where intermediate courts had similarly barred subsequent foreclosures on res judicata grounds,[40] the state supreme court in 2004 determined that irrevocable accelerations did not bar subsequent foreclosures. Instead, in Singleton v. Greymar Associates, the court held that the second action could go forward because it was based on a "subsequent default."[41] In other words, despite the acceleration of the mortgage, the court presumed a continuing obligation by the homeowner to make monthly payments.[42]

In Singleton, the Florida Supreme Court declared without analysis that barring subsequent foreclosures would produce inequitable results.[43] In the next Part, we argue that state courts like the Singleton court are wrong on this score. By focusing on the immediate consequence of a ruling for homeowners, the courts ignore perverse incentives created by allowing banks to continue to externalize the costs of their mistakes.

IV. THE CASE FOR "FREE HOUSES" AS MARKET CORRECTION

So what should courts do when banks lose their foreclosure cases? As described above, one

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35 See Order After Remand for Dismissal With Conditions, Bank of Am., N.A. v. Greenleaf. No. BRIDC-..

36 Chase Home Fin. LLC v. Higgins, 2009 ME 136, ¶ 11, 985 A.2d 508, 510-11

37 While this conclusion may appear reasonable on its face, consideration of other cases where elemen..

38 Homeward Residential, Inc. v. Gregor, 2015 ME 108, ¶¶ 25-26, 122 A.3d 947, 955; Bank of Am. v. G ..

39 See infra Part IV.

40 See Stadler v. Cherry Hill Developers, Inc., 150 So. 2d 468, 472 (Fla. Dist. Ct. App. 1963) ("[A

41 882 So. 2d 1004, 1008 (Fla. 2004). Some other courts have embraced the Singleton rule. SeeFairban

42 The Singleton court did not engage with the reasoning inStadler v. Cherry Hill Developers, Inc. t..

43 Id. at 1008 ("Clearly, justice would not be served if the mortgagee was barred from challenging

approach—that taken by the Florida and Maine Supreme Courts—is to bend the rules of res judicata to avoid a windfall for homeowners. This approach creates few benefits and significant economic problems. In this Part, we argue that further subsidizing banks' poor litigation practices results in deadweight loss by contributing to negative public-health outcomes and by disincentivizing banks from improving their servicing and litigation techniques. We also explain how granting winning homeowners "free houses" will not negatively affect the mortgage market.

First, giving systematic permission to mortgagees and their attorneys to engage in repeated attempts to foreclose upon properties results in a broader social subsidization of irresponsible behavior. And these subsidies are large. As economists recognize, prolonged foreclosure proceedings create negative social externalities, depressing surrounding homes' resale value, reducing local governments' tax revenues, and increasing criminal activity.[44] Foreclosures also appear to have significant effects on community members' physical and mental health, and correlate with increased rates of depression, anxiety, suicide, cardiovascular disease, and emergency-care treatment.[45]In fact, scholars who track the health effects of the 2008 crisis found that foreclosures might have even greater negative health effects than unemployment.[46] Although these studies analyze the general phenomenon of foreclosures and do not specifically address how relitigation of foreclosures might impact homeowners or their neighbors, they make clear that prolonged foreclosures can have dire economic and social effects.

Second, the threat of a "free house" also provides leverage for homeowners to negotiate a voluntary settlement, whether through a modification or a "graceful exit" like a short sale.[47] In a world where mortgagees truly risk forfeiting their claim by bringing illegitimate or rushed suits, homeowners will have more time up front to regain their financial footing and negotiate a modification or repayment plan. Enforcing finality rules may dissuade mortgagees "from filing until they have their paperwork ready" and encourage potential plaintiffs "to look favorably on loan renegotiation."[48] Servicers of

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[44] See, e.g., GEOFFRY WALSH, NAT'L CONSUMER LAW CTR., STATE AND LOCAL FORECLOSURE MEDIATION PROGRAM

[45] See Mariana Arcaya et al., Effects of Proximate Foreclosed Properties on Individuals' Systolic B...

[46] See Currie & Tekin, supra note 45, at 64 (finding "strong evidence" that increases in foreclos...

[47] See Levitin, supra note 9, at 651 ("[E]nforcement of bargained-for procedural requirements such ..

[48] Victoria V. Corder, Homeowners and Bondholders as Unlikely Allies: Allocating the Costs of Securit...

securitized loans typically believe mortgage foreclosures are faster and cheaper than loan renegotiation,[49] yet securitized-loan investors suffer greater financial losses in foreclosures than in renegotiation and repayment.[50] Courts' adhesion to traditional res judicata principles in the foreclosure process has the added benefit of making negotiated settlements with borrowers more appealing to banks. By realigning incentives through the increased risk of failure, courts can induce banks to act in their own long-term interest.

Finally, although judges have expressed concern about homeowner windfalls,[51] the alternative creates a windfall for banks that cut corners in managing and prosecuting foreclosures. The risk and costs of losing foreclosures should already be internalized in the price of current mortgages. Empirical studies suggest that greater protection for mortgagors historically corresponds to slightly higher mortgage rates among lenders.[52] These studies indicate that lenders adjust the price of mortgages based on what they anticipate the cost, and not just the likelihood, of foreclosures will be. In addition, lenders are more likely to extend subprime mortgages where there are fewer legal hurdles to foreclosure.[53] Because the requirements to bring a successful foreclosure suit and the legal rules concerning acceleration were well established at the time banks priced the mortgages currently in foreclosure, the mortgage agreements already had a chance to incorporate both the costs of pursuing foreclosure under irrevocable acceleration laws and the risks of homeowners prevailing—even though they often failed to do so.

Although a full discussion of the relationship between foreclosure procedure and mortgage costs is beyond the scope of this Comment, we reject the suggestion that lower mortgage costs and looser markets are ultimately beneficial, for at least two reasons. First, as described above, a growing body of empirical evidence suggests that the public-health and social costs of foreclosure are as widespread as the benefits of lower mortgage prices, suggesting that broader social allocation of the risk of foreclosure is appropriate. Second, the 2008 crisis that gave rise to the very problem this Comment addresses was caused in significant part by the loosening of underwriting standards and an increase in subprime lending.[54] In light of a crisis precipitated by precisely these lending practices, and given the link between the ease of foreclosures and lenders' proclivity for subprime loans, there is good reason to increase the price of socially harmful lending practices.

Therefore, a liberalization of rules governing foreclosure after the relevant loans have been issued would result in a broad windfall for lenders. When courts bypass res judicata and allow mortgagees a

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49 See Sumit Agarwal et al., The Role of Securitization in Mortgage Renegotiation, 102 J. FIN. ECON. .

50 See, e.g., Eric A. Posner & Luigi Zingales, A Loan Modification Approach to the Housing Crisis,17..

51 See supra note 1 and accompanying text.

52 See, e.g., Lawrence D. Jones,Deficiency Judgments and the Exercise of the Default Option in Home ...

53 Quinn Curtis, State Foreclosure Laws and Mortgage Origination in the Subprime, 49 J. REAL EST. FIN..

54 See generally JENNIFER TAUB, OTHER PEOPLE'S HOUSES: HOW DECADES OF BAILOUTS, CAPTIVE REGULATORS.

second shot at foreclosure, they are facilitating a shift of the risk associated with foreclosures—a risk that banks had, or should have, already priced into the cost of the mortgages themselves—onto homeowners.

Res judicata is generally justified as promoting respect for law because it tends to reduce social conflict and uncertainty.[55] These broader policy arguments for imposing claim preclusion are particularly strong in the foreclosure context, where banks have demonstrated a lack of respect for law through their reliance on "robo-signing" and where the economic, social, and public-health costs of legal uncertainty not only are especially dire for litigants but also extend well beyond the parties themselves.

CONCLUSION

Mortgagees, their servicers, and their attorneys currently face a crisis of their own making. They failed to allocate the necessary resources to maintain accurate records of homeowners' indebtedness while pursuing the profits of securitization. Then they brought foreclosures in unprecedented numbers—on compressed timeframes and on the cheap—in an attempt to recover quickly their unanticipated losses. At trial, they received forgiveness for their mistakes and abuses, obtaining a highly unusual legal outcome: judgment or dismissal of a case, fully heard on its merits, without prejudice.

In asking courts to allow subsequent foreclosure attempts, banks ask states and homeowners to bear the psychological and economic costs of lenders' self-interested behavior. But if state courts refused to create an exception to the rule of res judicata—that is, dismissed these cases with prejudice and enforced res judicata—they would do more than enforce the rule of law. They would also create a counterweight to current perverse incentives, encourage alternative dispute resolution where possible, reduce negative public-health consequences from prolonged foreclosure litigation, and ultimately promote greater social outcomes in future foreclosure suits.

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55 See RESTATEMENT (SECOND) OF JUDGMENTS ch. 1, at 11 (AM. LAW. INST. 1982) ("Indefinite continuati