

Outside Counsel

Foreclosure Actions: Is Federal Court a Viable Option?

With the onslaught of an unprecedented number of residential and commercial foreclosure actions filed in the past few years, state courts both in New York and elsewhere have struggled to keep up with the daily flow of newly filed actions. As a result, lenders and property owners alike have begun to consider alternatives to state courts as the venue for their cases. This article addresses both the availability and the viability of the federal courts as an alternative to state courts for foreclosure actions.

Availability of Federal Court

The first issue that lenders must address in considering whether to commence a foreclosure action in federal court, and borrowers must consider in determining whether to remove a foreclosure action filed in state court to a federal court, is whether there exists a basis for federal subject matter jurisdiction. As foreclosure actions usually involve solely state law questions, the only possible basis for federal jurisdiction is usually diversity of citizenship. Assuming that the foreclosure involves a principal indebtedness of more than \$75,000, the diversity analysis will hinge on whether there is complete diversity of citizenship between the parties.

Historically, determining diversity of citizenship in a foreclosure action was a straightforward analysis. The law is settled as to the citizenship of individuals, corporations and national banking associations for diversity purposes.¹

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However, with the mass securitization of mortgages, and an increasing number of foreclosures involving non-traditional lenders, diversity analysis has become exponentially more complex.

In the usual mortgage backed securities transaction, mortgages are deposited in a trust, and the “beneficiaries” of the trust are the holders of the bonds or certificates that are securitized by a pool of such mortgages and sold. Given this structure for loan securitization, and the law concerning how citizenship of a trust is to be determined for diversity purposes, it may be near impossible to establish that complete diversity of citizenship exists where the mortgage is part of a securitized transaction.² That is so because most mortgage pools have numerous beneficiaries making it likely that a beneficiary has the same citizenship as the individual borrower or borrower entity, thus defeating diversity.

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Before commencing a foreclosure action in federal court, or removing an

action to federal court, attorneys representing lenders and property owners should closely analyze whether complete diversity, and thus a valid basis for federal jurisdiction over the action, exists.

Benefits of a Federal Forum

Once counsel for a party has determined that federal subject matter jurisdiction over an action exists, and thus, that the party has a key to the federal courthouse, there are myriad issues that should be considered in determining whether a federal forum is actually preferable to a state forum for a particular foreclosure action.

First, lenders usually have an interest in having their foreclosure actions move as quickly as possible. While there is a general perception that an action, foreclosure or otherwise, will be disposed of more quickly in a federal rather than a state court, this is not always the case. With the exception of some federal district courts, such as the U.S. District Court for the Eastern District of Virginia, which are well-known as “rocket docket” courts, individual federal district judges exercise substantial control over the scheduling of cases assigned to them. Some judges are much more liberal with scheduling deadlines than others.

Thus, it is often impossible to predict how quickly a foreclosure action will move in federal court, because prior to filing the action, an attorney will not know which judge it will be assigned to and cannot consider that judge’s individual practices. Additionally, with respect to foreclosures of commercial properties, in New York such actions will usually be assigned to the Commercial Division of the Supreme Court. Judges sitting in the Commercial Division usually impose tight

scheduling deadlines, and demand strict adherence to such deadlines.

Therefore, before an attorney can properly analyze whether a foreclosure action is likely to move more quickly in federal court than in state court, there are numerous factors that must be considered, such as whether the foreclosure relates to residential or commercial property, and the practices not only of the federal district where the property lies, but of the individual judges within that district.

Another issue that should be considered in deciding between a federal or state forum for a foreclosure action is the availability of court assistance in settlement negotiations. Settlement, through loan modification or otherwise, would benefit all parties in most foreclosure situations. Traditionally, however, a main roadblock to settling a foreclosure action is getting a representative of the lending institution with full settlement authority to the negotiating table. This problem has only intensified during the recent economic collapse, because of the ever increasing number of loan defaults.

In New York State courts, CPLR 3408 has proven to be a very useful tool in overcoming the hurdles to settlement of residential foreclosure actions. As recently amended, CPLR 3408 mandates that a settlement conference be held in all residential foreclosure actions where the defendant is a resident of the property that is the subject of the action. In conducting such settlement conferences, Judges and Special Masters have authority to, and do, require that all parties appear by representatives with full settlement authority.

Through such conferences, the court can aid the parties in coming together to determine whether a loan modification or other settlement is a viable option. Thus, before removing an action filed in state court to federal court, property owners and their counsel should consider the fact that they will be foregoing the CPLR 3408 settlement conference.

CPLR 3408, however, applies only to residential foreclosures. With respect to commercial foreclosure actions, very often judicial assistance in settlement negotiations will be available to the parties at a much earlier stage in the litigation in a federal court than it would be in a state forum. In addition to the fact

that in some federal districts it is common for judges to order the parties to participate in mediation at a very early stage in the litigation, federal district court judges and magistrates are often very willing to hold settlement conferences very early in a case.

Indeed, it is not uncommon for the issue of settlement to be broached by a federal judge at an initial scheduling conference. While state court judges often strive to assist the parties in settlement negotiations, such efforts usually come at a later stage in the litigation. In New York State courts, a judge is not even initially assigned to a case, but is only assigned after one of the parties has filed a Request for Judicial Intervention.

With the avalanche of newly filed foreclosure actions that has accompanied the recent economic recession, and the stress that such filings have placed on state court dockets, attorneys for lenders and property owners should consider federal courts as an alternative to state courts as a venue for their foreclosure actions.

In today's world, with stagnant or falling real estate prices, it is particularly beneficial for lenders to expedite settlement because their collateral is likely to be depreciating. Thus, if a settlement can be reached, through loan modification or otherwise, sooner is usually better than later.

Finally, assuming that federal jurisdiction exists, and that a foreclosure action is not readily subject to settlement at an early stage, the parties and their counsel should consider the differences in procedures and rules that will attach to their decision to litigate in either federal or state court. For example, in commercial foreclosure actions, it is not unusual for a lender to seek the appointment of a receiver.

While both federal and state judges are perfectly competent to appoint and oversee property receivers, it is done much more frequently in state courts, and thus, is likely to be accomplished more quickly and smoothly. Indeed, pursuant to Part 36 of the Rules of the New

York State Chief Judge, a pre-approved list of eligible receivers for each county has been compiled for the judge presiding over a foreclosure action to select from. Additionally, there are differences between the procedural and evidentiary rules applied in the federal and state courts that should be considered prior to making an educated decision as to which forum is more desirable for a particular foreclosure action.

Conclusion

With the avalanche of newly filed foreclosure actions that has accompanied the recent economic recession, and the stress that such filings have placed on state court dockets, attorneys for lenders and property owners should consider federal courts as an alternative to state courts as a venue for their foreclosure actions. In doing so, however, parties should first carefully scrutinize the threshold issue of whether there is federal jurisdiction over their action.

Once satisfied that federal subject matter jurisdiction exists, rather than relying on generalized perceptions, such as that actions in federal court move faster than actions in state courts, attorneys should carefully consider the many differences in procedures and rules that exists between the various federal and state court forums, and select the venue that is likely to be most appropriate to their clients' specific case.

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1. 28 U.S.C. §1332; *Wachovia Bank, National Assoc. v. Schmidt*, 546 U.S. 303, 126 S.Ct. 941 (2006).

2. Talcott J. Franklin and Thomas F. Nealon II, *Mortgage and Asset-Backed Securities Litigation Handbook*, §2:4 (2010).