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THE IMPACT OF THE CAPITAL MARKETS ON REAL ESTATE LAW AND PRACTICE

MICHAEL H. SCHILL*

Over the past twenty years, the real estate markets of the United States have been swept by enormous change. A sector of the economy that had long been resistant to change, real estate has been and is continuing to be transformed by the process of securitization on both the debt and equity side. Just twenty years ago, the vast majority of single family residential mortgage loans were provided by local banks or savings and loan associations that held the debt in their portfolios until maturity or prepayment. Today, most single family mortgage debt is sold into the secondary mortgage market and converted into securities. Ten years ago, mortgage loans for commercial properties were largely originated and held by commercial banks, pension funds or insurance companies. In recent years, with the exception of the meltdown of the commercial mortgage-backed securities market in the summer of 1998, the proportion of commercial loans that were securitized rapidly grew. Just six or seven years ago, real estate investment trusts (REITs) were commonly thought of as the investment entity that crashed and burned in the 1970s. In the last two or three years, however, REITs have increasingly come to be seen as a dominant, if not pre-eminent ownership vehicle in many real estate markets throughout the nation.

In this article, I describe how capital markets have changed the real estate industry and provide data which illustrate how impressive the growth of securitization of debt and equity have been. I also describe competing theories about what the growth of real estate capital markets might mean for the future of the industry. In many ways, the forces that have transformed the way real estate is bought, sold and financed have also dramatically changed the way real estate law is practiced in the United States. However, the black letter law of real estate (i.e., statutes and common law) has

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remained rather static. I conclude by discussing why the black letter law of real estate has been resistant to change and what the chances are for transformation in the future.

THE GROWTH OF DEBT SECURITIZATION IN REAL ESTATE

The securitization of real estate debt has roots that stretch back to the Great Depression. At the time, mortgage loans were typically originated by local banks and had short terms.¹ Originators typically held these mortgages until maturity. In 1934, during the Depression, the federal government created the Federal Housing Administration (FHA) to induce thrift institutions to originate long-term loans with relatively low down-payments. The FHA's main function was to insure lenders against the risk of default.²

To provide greater liquidity for these loans, the federal government also created the first secondary mortgage market agency—the Federal National Mortgage Association (Fannie Mae)—whose mission was to buy and sell federally insured mortgages.³ In 1968, another secondary mortgage market agency called the Government National Mortgage Association (Ginnie Mae) was created to take over the low income housing programs previously run by Fannie Mae.⁴ Fannie Mae was then restructured as a private corporation with ties to the federal government.⁵ Fannie Mae was also given the authority to buy and sell conventional (non-federally insured) home mortgage loans.⁶

In 1970, Congress established the third major secondary mortgage market agency—the Federal Home Loan Mortgage Corporation (Freddie Mac).⁷ Like Fannie Mae, Freddie Mac was empowered to buy and sell conventional loans.⁸ In the 1970s, the secondary mortgage market agencies became instrumental in promoting the growth of securitization. Issuers of mortgage-backed securities pool hundreds of loans together, obtain credit enhancement, usually in the form of guarantees, from a secondary market agency and sell their interests in the pool of mortgages to investors.

1. Michael H. Schill, *Uniformity or Diversity: Residential Real Estate Finance Law in the 1990s and the Implications of Changing Financial Markets*, 64 S. CAL. L. REV. 1261, 1263-64 (1991).

2. *Id.* at 1264.

3. C. EDSON & B. JACOBS, *SECONDARY MORTGAGE MARKET GUIDE* § 5.01, at 5-3 (1990).

4. *See* 12 U.S.C. § 1716b (1989).

5. Schill, *supra* note 1, at 1267.

6. Emergency Home Finance Act of 1970, Pub. L. No. 91-351, § 201, 84 Stat. 450, 450-51 (1971) (codified as amended at 12 U.S.C. § 1717 (1970)).

7. Federal Home Loan Mortgage Corporation Act, Pub. L. No. 91-351, § 301-10, 84 Stat. 451 (1970).

8. Schill, *supra* note 1, at 1267 & n.27.

The first generation of mortgage-backed securities were pass-through certificates that entitled the holders to a proportionate share of interest and principal as these amounts were paid by mortgagors.⁹ Recognizing that investors have varying time horizons and tolerances for risk, issuers of mortgage-backed securities subsequently divided the flow of mortgage interest and principal from the pool to create debt instruments of varying maturities and levels of risk. These mortgage-backed securities were initially structured as collateralized mortgage obligations and then, after the Tax Reform Act of 1986, as Real Estate Mortgage Investment Conduits or REMICs.¹⁰

The growth of residential mortgage-backed securities has been phenomenal. As Figure 1 indicates, in 1984, the three secondary mortgage market agencies together issued \$58.6 billion in pass-through securities backed by one-to-four family home conventional mortgages.¹¹ This annual level of origination grew to a peak of over \$550 billion in 1993.¹² In 1997, total issuance by the agencies was 358.3 billion, constituting more than a 500% increase over the thirteen year period.¹³

The growth of securities backed by mortgage loans on one-to-four family homes as a proportion of all mortgage debt outstanding is even more impressive. As shown in Figure 2, in 1984, \$1.3 trillion of debt secured by mortgages on one-to-four family homes was outstanding.¹⁴ Of this total debt outstanding, only \$303.6 billion or 23% was securitized.¹⁵ By the end of the first quarter of 1998, the total debt outstanding had grown to \$4.1 trillion, \$2.1 trillion or 52% of which had been securitized.¹⁶ Indeed, in 1997, 56.6% of all newly originated home mortgage loans found their way into the mortgage-backed securities market.¹⁷

9. *Id.* at 1270.

10. See 26 U.S.C. §§ 860A-860G (1994) (defining real estate mortgage investment conduit (REMIC) as a type of mortgage-backed security in which the interest paid by the borrower escapes taxation at the entity level).

11. 14 SECONDARY MORTGAGE MARKETS: MORTGAGE MARKET TRENDS 1997, July 1997, at 47 tbl.A-8.

12. *Id.*

13. Communication to the author from Freddie Mac (October 2, 1998).

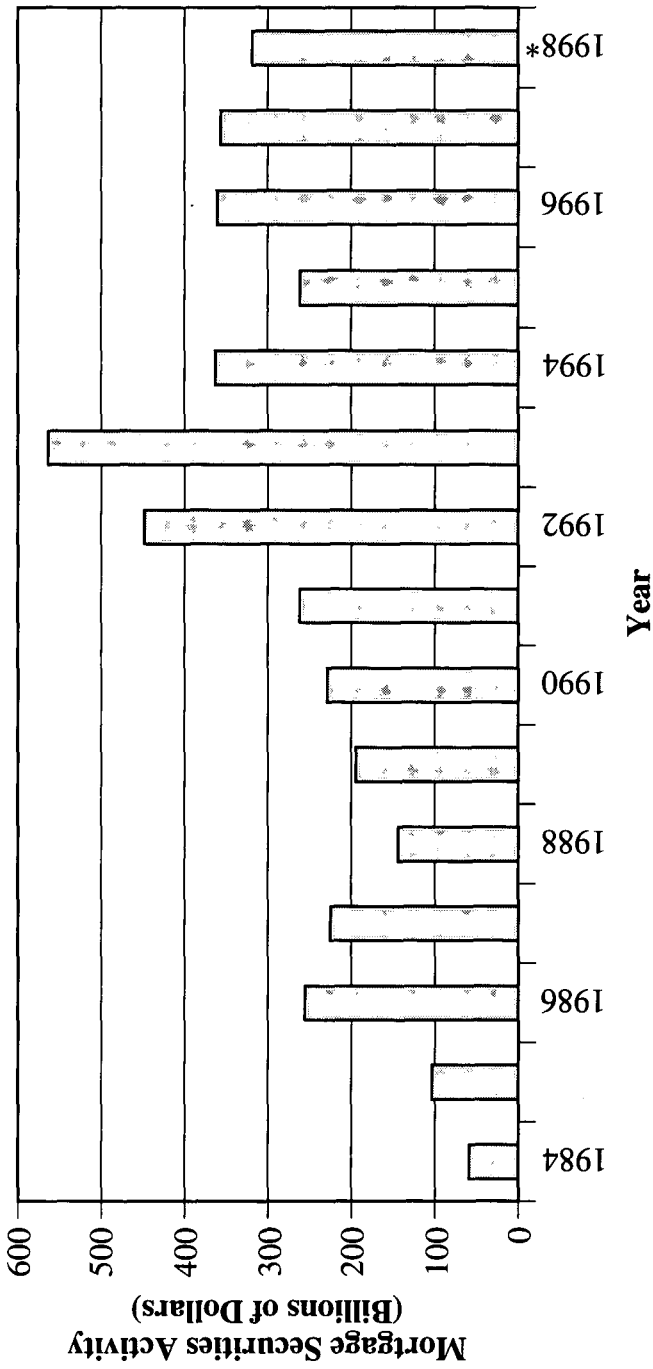
14. *Mortgage Debt Outstanding*, 73 FED. RESERVE BULL. A39 tbl.1.54 (June 1987).

15. *Id.*

16. *Mortgage Debt Outstanding*, 84 FED. RESERVE BULL. A35 tbl.1.54 (Aug. 1998).

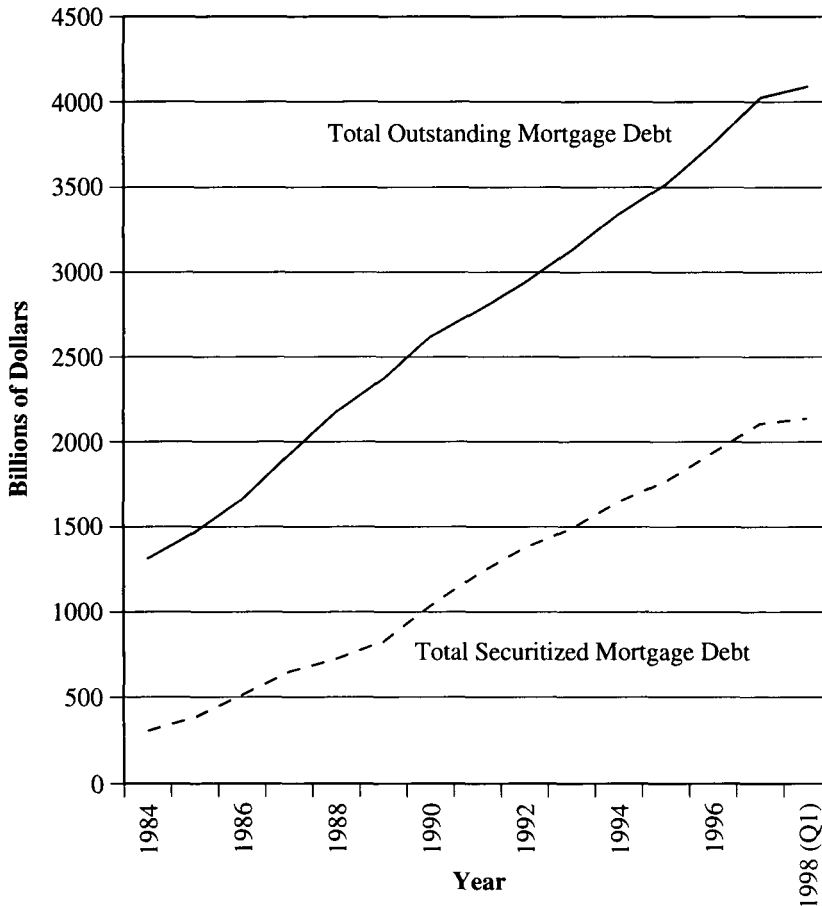
17. *Id.*

FIGURE 1
ISSUANCE OF PASSTHROUGH MORTGAGE-BACKED SECURITIES



Source: Freddie Mac
*Based upon data for only the first half of 1998

FIGURE 2
THE RELATIONSHIP BETWEEN MORTGAGE-BACKED SECURITIES AND
ALL OUTSTANDING MORTGAGE DEBT ON 1-4 FAMILY HOMES
(1984-1998)



Source: Federal Reserve

As the securitization of home mortgage loans exploded in the 1980s, the commercial mortgage debt market was much slower to join the securitization bandwagon. A number of factors accounted for the relatively slow growth of commercial mortgage-backed securities during this period. Perhaps most importantly, no secondary mortgage market for commercial mortgage loans was created by the federal government. Thus, the secondary mortgage market for commercial mortgages had to be created in a piecemeal fashion by a variety of institutional investors and Wall Street. In addition, certain characteristics of commercial mortgages made them a bit more difficult to securitize. Commercial mortgage loans tend to be much larger than residential loans. Therefore, the number of loans

in a pool tends to be smaller, creating greater risk due to less opportunity for diversification.

Commercial mortgage loans are also more idiosyncratic than residential loans. Commercial properties are typically quite different from each other, requiring much more due diligence than pools based upon relatively similar single family loans. Moreover, the loan documentation for commercial properties tends to be much more voluminous and non-uniform as compared to residential properties. Finally, without a secondary mortgage market backed by federal or quasi-federal guarantees, the commercial mortgage-backed securities market required experimentation with different methods of credit enhancement such as letters of credit and overcollateralization.

Nevertheless, throughout the late 1980s and 1990s, the commercial mortgage-backed securities market grew significantly. As Figure 3 indicates, in 1991, \$4.3 billion in commercial mortgage-backed securities were issued.¹⁸ This volume of issuance increased by 850% to \$41.0 billion in 1997.¹⁹ As a proportion of outstanding commercial mortgage debt, the growth in number of commercial mortgage-backed securities has also been strong. According to Figure 4, in 1990, \$758 billion of mortgages secured by commercial properties were outstanding of which less than \$5 billion had been securitized.²⁰ By the first quarter of 1998, \$855 billion of commercial mortgages were outstanding and over \$102 billion had been securitized (a 20-fold increase).²¹

As compared to residential mortgages, commercial mortgage-backed securities have a way to go. The absolute volume of one-to-four family loans that have been securitized is much greater than that for commercial loans.²² Although as a proportion of mortgage debt outstanding, the residential mortgage-backed securities market far exceeds the proportion of commercial mortgage-backed securities, the rate of growth for commercial mortgage-backed securities is much steeper.²³

18. THE MORTGAGE MARKET STATISTICAL ANNUAL FOR 1998, 409 (1998).

19. *Id.*

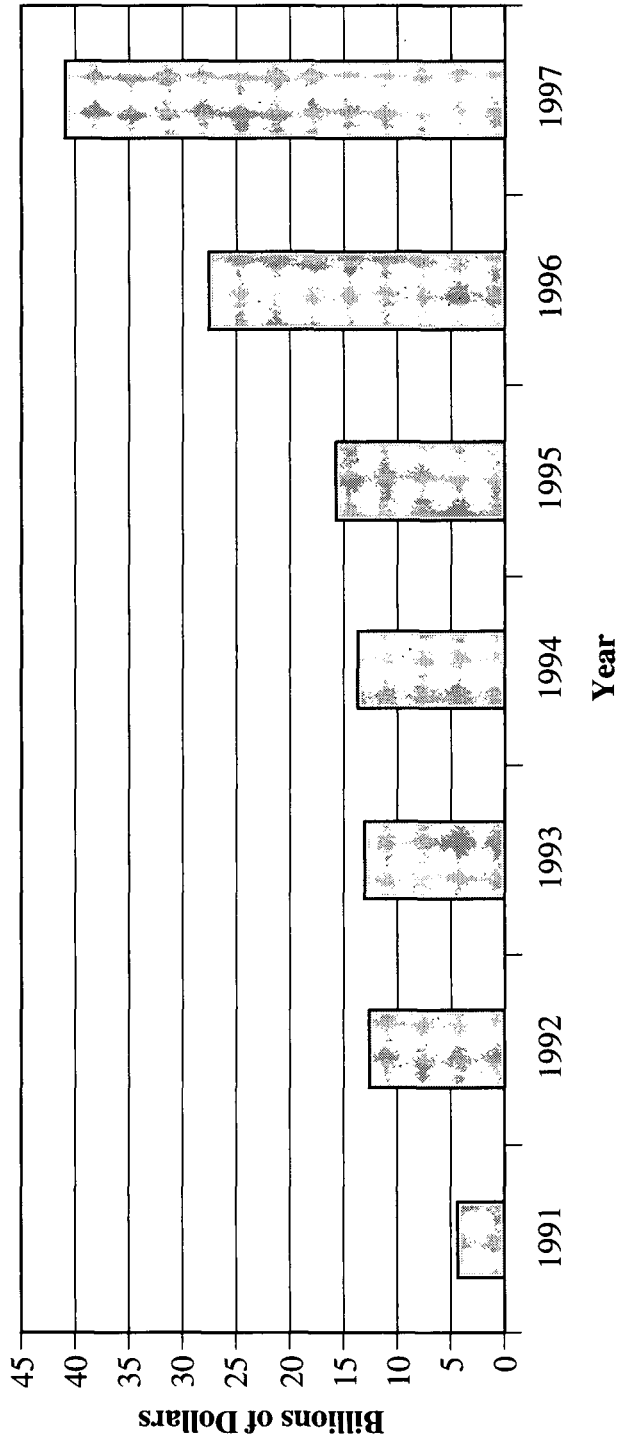
20. *Mortgage Debt Outstanding*, 80 FED. RESERVE BULL. A38 tbl.1.54 (June 1994).

21. *Mortgage Debt Outstanding*, *supra* note 16, at A35 tbl.1.54.

22. *Id.* *Mortgage Debt Outstanding*, *supra* note 20, at A38 tbl.1.54.

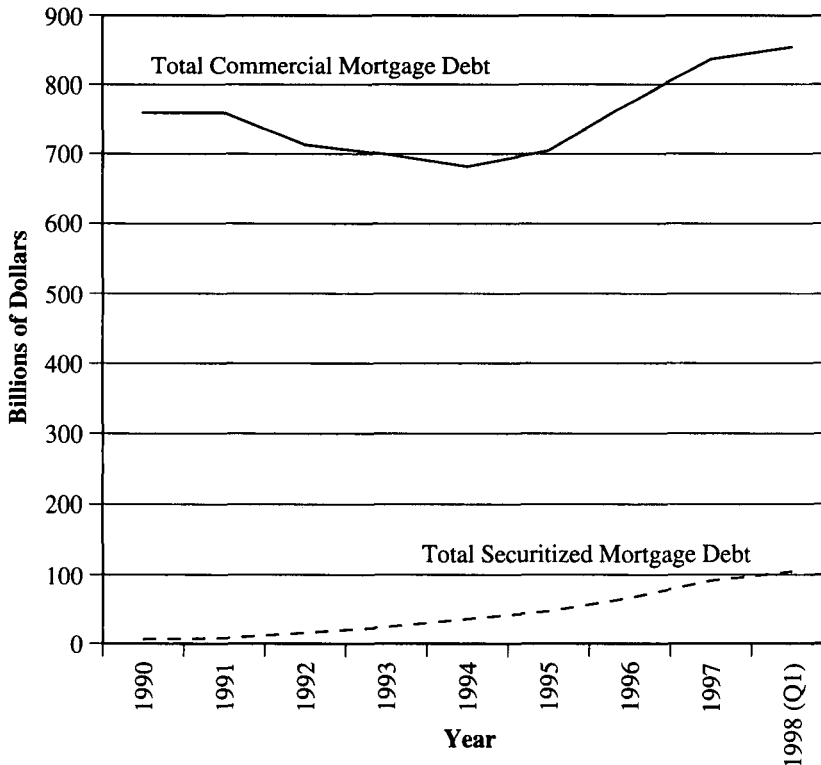
23. *Mortgage Debt Outstanding*, *supra* note 16, at A35 tbl.1.54.

FIGURE 3
ISSUANCE OF COMMERCIAL MORTGAGE-BACKED SECURITIES (1991-1997)



Source: Inside Mortgage Finance

FIGURE 4
THE RELATIONSHIP BETWEEN OUTSTANDING MORTGAGE-BACKED
SECURITIES AND ALL OUTSTANDING MORTGAGE DEBT ON
COMMERCIAL PROPERTIES (1990-1997)



Source: Federal Reserve

THE SECURITIZATION OF EQUITY IN REAL ESTATE

Just as the capital markets have dramatically affected the debt structure of real estate, they have also had a tremendous impact on equity. In recent years, REITs have taken the real estate market by storm. A REIT is typically formed as a corporation or trust under state law. To qualify as a REIT under the Internal Revenue Code, the REIT must meet a long list of requirements concerning its investments and beneficial owners. Most important, a REIT must distribute 95% of its net earnings each year to its owners in the form of dividends.²⁴ Failure to do this will result in financial penalties or loss of its status under the tax law.²⁵ As long as a REIT adheres to these requirements, it will be subject to only one layer of taxation, a distinct advantage over organizing as a corpora-

24. See 26 U.S.C. §§ 856-859 (1988).

25. See *id.* §§ 856-859.

tion. Like a corporation, however, the beneficial owners of the REIT are insulated from liability. In addition the REIT is an extremely liquid investment vehicle with shares of many REITs trading freely in the stock market.

REITs are not a new invention. In the late 1960s and early 1970s, REITs grew rapidly. Unlike today, the majority of REIT assets were in land and construction loans rather than in equity interests in real estate.²⁶ Mortgage REITs typically borrowed short-term to finance these loans and were caught as market interest rates rapidly increased in the early 1970s.²⁷ As a result, many REITs failed during this period and it has taken over a decade for the industry to rebound.²⁸

The current resurgence of REITs began in the 1980s with the growth of equity REITs and took off during the early 1990s.²⁹ This corresponds to the period following the slump in real estate that occurred during the recession of 1989-1991. During this period, traditional sources of real estate capital dried up as banks, pension funds and life insurance companies overreacted to the lax credit standards and losses of the 1980s and early 1990s. The REIT became a way for real estate to amass capital as the nation emerged from the recession. Indeed, as depicted in Figure 5, the number of equity REITs rose from 25 in 1984 to 176 in 1997, a 600% increase.³⁰ In addition, the capitalization of REITs (defined as the price of shares multiplied by the number of shares outstanding) shot up by an astounding factor of 55, increasing from \$2.3 billion in 1984 to \$127.8 billion in 1997.³¹

26. Barry Ziering et al., *The Evolution of Public and Private Market Investing in the New Real Estate Capital Markets*, 14 REAL EST. FIN. 22 (1997).

27. *Id.*

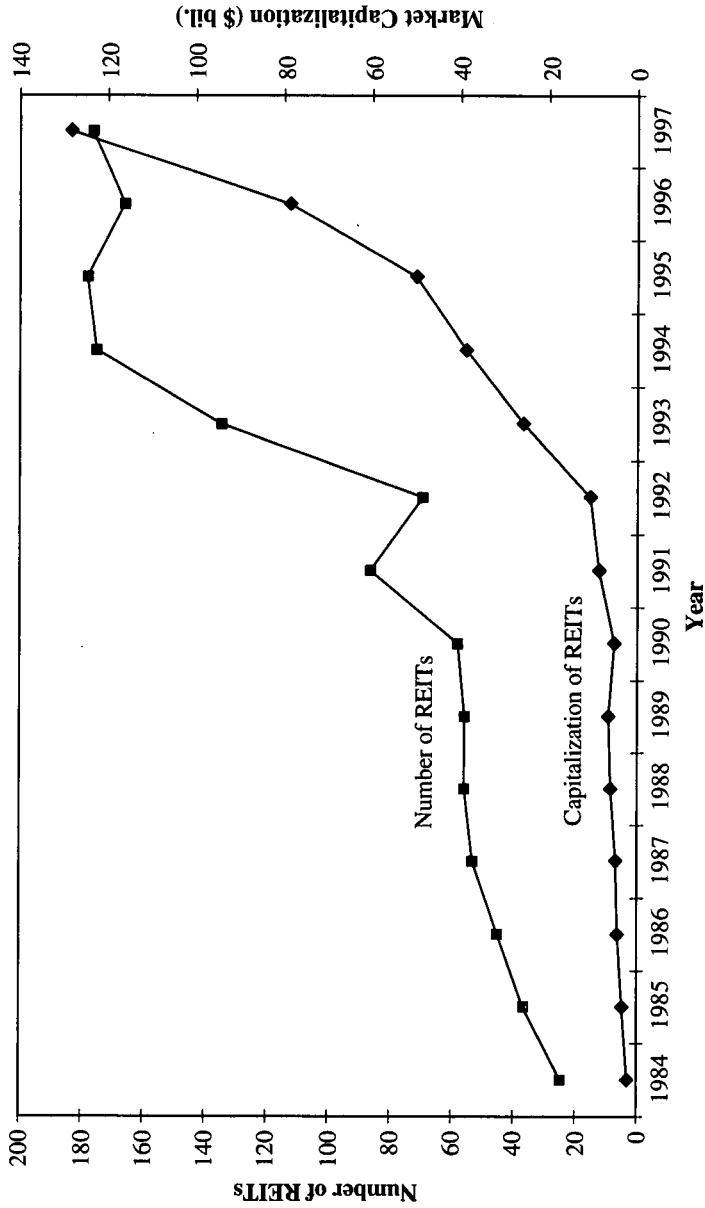
28. *Id.*

29. National Association of Real Estate Investment Trusts, *Annual Market Capitalization Table* (visited Jan. 28, 1999) <<http://www.nareit.com/faxondem/211.html>>.

30. *Id.*

31. *Id.*

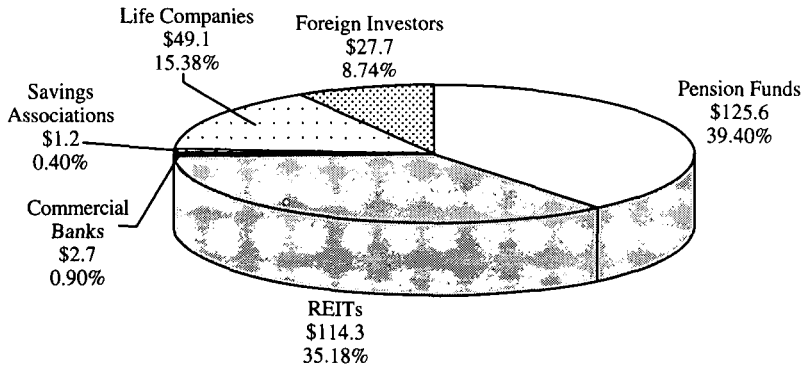
FIGURE 5
EQUITY REAL ESTATE INVESTMENT TRUSTS (REITs) (1984-1997)



Source: NAREIT

According to the estimates of one real estate analyst set forth in Figure 6, as of June 30, 1997, REITs accounted for over one-third (35.2%) of all institutional real estate in the United States.³² Only pension funds had a greater share (39.4%) of equity interests in the sector.

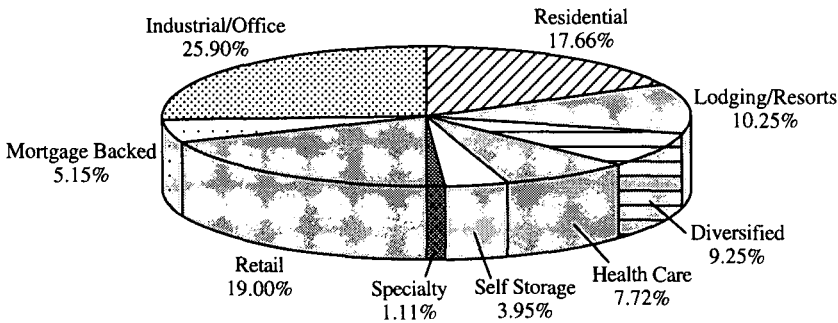
FIGURE 6
INSTITUTIONAL EQUITY INVESTMENT IN REAL ESTATE (1997)
(DOLLARS IN BILLIONS)



Source: ERE Yarmouth Investment Research

REITs invest in a variety of real estate.³³ As Figure 7 shows, in 1997, the largest proportion (25.9%) of REIT capitalization was invested in industrial and office buildings.³⁴ The third largest sector invested in was apartment buildings (17.7%).³⁵

FIGURE 7
REIT CAPITALIZATION BY PROPERTY TYPE (1997)



Source: ERE Yarmouth Investment Research

32. ERE YARMOUTH AND REAL ESTATE RESEARCH CORPORATION, EMERGING TRENDS IN REAL ESTATE 1998 (1998), available in (last modified July 10, 1998) <<http://www.208.240.92.174/rsch/trends1998/index.htm>>.

33. *Id.*

34. *Id.*

35. *Id.*

THE IMPLICATIONS OF SECURITIZATION OF DEBT AND EQUITY FOR
THE REAL ESTATE INDUSTRY

Despite the disruptions of 1998,³⁶ the capital markets have had and will continue to have a tremendous impact on the nation's real estate industry. Indeed, the federal government fostered securitization of the single family mortgage market to achieve a number of public policy objectives. Prior to the creation of an effective secondary mortgage market and securitization, capital flows throughout the United States were not uniform. During this period of segmented markets, capital shortages periodically developed in fast growing areas where the funds deposited in local banks were outstripped by demand. In other parts of the country, surpluses in capital existed.³⁷

The growth of the secondary mortgage market and securitization evened out the flow of capital in the nation. Financial institutions became increasingly willing to originate home loans when they knew that a secondary mortgage market agency such as Fannie Mae or Freddie Mac stood ready to purchase them. The secondary mortgage market enabled investors in one part of the country to invest in mortgages originated in another region, effectively ending the geographic segmentation of credit.

The growth in the supply of capital had the beneficial impact of reducing mortgage interest rates.³⁸ In addition, securitization, by tying real estate credit markets to the nation's general capital markets, increased the total amount of capital flowing into real estate. Institutional investors who would have stayed away from investing in whole mortgages due to the risk of default and high information and transaction costs, were much more likely to purchase credit-enhanced multi-class mortgage-backed securities that resembled corporate bonds. Although the growth of commercial mortgage-backed securities has been slower than for residential mortgages, the same types of effects are likely to occur—increased liquidity and lower costs of credit.

The growth of REITs has also had a major impact on the face of the real estate industry. Real estate has always been an area that was the province of the individual entrepreneur. The growth of REITs and their apparent willingness in many markets to bid up the prices of real estate promises to reduce the dominance of indi-

36. See *infra* notes 61-63 and accompanying text.

37. Schill, *supra* note 1, at 1267-71.

38. See, e.g., Patric H. Hendershott & James D. Shilling, *The Impact of the Agencies on Conventional Fixed-Rate Mortgage Yields*, 2 J. REAL EST. FIN. & ECON. 101 (1989) (finding that interest rates on loans that did not qualify for purchase by secondary mortgage market agencies had interest rates that were 15 to 30 basis points higher than loans that did).

vidual entrepreneurs and increase the role of technocrats in real estate.

The long lasting impact of the securitization of debt and equity in real estate on the industry and on real estate cycles is also a subject of much debate. According to one view associated with Sam Zell, Chairman of Equity Residential Properties Trust,³⁹ the growing influence of Wall Street in real estate is positive and will lead to increasing market discipline, a consolidation of the industry, its professionalization and a dampening of real estate cycles.⁴⁰ One effect of the growth of public capital markets in real estate has been the explosion of information about real estate. No longer can property-specific information on property characteristics, returns or default rates be kept proprietary. This information, which must be disclosed under federal securities laws, together with the creation of sophisticated econometric models to estimate returns, has improved the ability of market participants to analyze current conditions and forecast the future.⁴¹

In addition, the growth of information and requirements for its disclosure provide signals for capital providers about which firms are best run.⁴² Capital will flow to firms with the highest rates of return and away from less efficient owners and developers.⁴³ The growing influence of rating agencies will further reward efficient firms with a lower cost of capital.⁴⁴ Over time, better run firms with an ability to reap economies of scale will take over less competitive firms.

According to one analyst, Peter Linneman, the consolidation of the real estate industry will also dampen the cyclical nature of real estate.⁴⁵ These cycles are typically created by oversupply.⁴⁶ According to Linneman, fewer market actors will make each company more aware of its impact on the marketplace and enable them to respond better to changing market conditions.⁴⁷

39. This view is spelled out in detail in three articles appearing in the Wharton Real Estate Review, a journal published by the Samuel Zell and Robert Lurie Real Estate Center of the University of Pennsylvania. See Douglas Crocker II, *Inside the Revolution*, WHARTON REAL EST. REV., Fall 1998, at 28; Peter Linneman, *Forces Changing the Real Estate Industry Forever*, WHARTON REAL EST. REV., Spring 1997, at 11-12; Samuel Zell, *Liquid Real Estate*, WHARTON REAL EST. REV., Fall 1997, at 44, 45.

40. Linneman, *supra* note 39, at 11-12; Zell, *supra* note 39, at 44-45.

41. Linneman, *supra* note 39, at 11-12.

42. Zell, *supra* note 39, at 44-45.

43. *Id.*

44. Linneman, *supra* note 39, at 5.

45. *Id.* at 11-12.

46. Peter Linneman, *(When) Will We Do It Again?*, WHARTON REAL EST. REV., Spring 1998, at 30-31.

47. Linneman, *supra* note 39, at 12.

The view that the growing influence of capital markets on real estate will inevitably lead to consolidation and a more disciplined market has been criticized on several fronts. A number of commentators have suggested that REITs face pressures to grow in order to increase their price-dividend multiples.⁴⁸ This growth imperative may cause them either to over-pay for properties or to support new development in markets that are close to saturation.⁴⁹ Indeed, one recent empirical study reports that REITs do not exhibit the economies of scale asserted by their proponents.⁵⁰

Some analysts also question whether security holders and ratings agencies will appropriately monitor real estate markets.⁵¹ Investors may lack information about local real estate conditions.⁵² In addition, because REITs typically operate in a number of jurisdictions, investor monitoring may not be able to deter overbuilding in certain locales.⁵³ The local nature of real estate markets may also be a disadvantage for REITs as they grow bigger and operate in more markets.⁵⁴ REIT managers may lack in depth knowledge and familiarity with the markets in which they operate.⁵⁵ Furthermore, some have argued that reliance on rating agencies may be misplaced because they must compete for the business of issuers.⁵⁶

Anthony Downs has also suggested that the growth and consolidation of REITs might have a negative long range impact on the underlying assets. In their efforts to increase current earnings and drive up share prices, REIT managers may take more of a short-run perspective than the traditional real estate entrepreneur who frequently planned to hold onto properties and transmit them to his children.⁵⁷ Furthermore, since REITs must distribute 95% of their annual earnings or face stiff penalties, they cannot retain earnings

48. See, e.g., Anthony Downs, *The Pressures on Public REITs to Grow Larger*, WHARTON REAL EST. REV., Fall 1997, at 3-7.

49. *Id.* at 13.

50. See Brent Ambrose et al., REIT Economies of Scale: Fact or Fiction? 9 (Dec. 18, 1998) (unpublished manuscript, on file with author) (finding that economies of scale did not exist for larger REITs). See also John H. Vogel Jr., *Why The New Conventional Wisdom About REITs is Wrong*, REAL EST. FIN., 7, 7-8 (1997) (observing that little evidence exists to demonstrate economies of scale in REITs). But see Brent Ambrose & Peter Linneman, Organizational Structure and REIT Operating Characteristics 10 (Nov. 19, 1998) (unpublished manuscript, on file with author) (finding that larger REITs have higher profit margins and rental revenue ratios, but not lower expense ratios).

51. Ambrose & Linneman, *supra* note 50, at 6; see also Sally Gordon, *Real Estate Capital Markets: Who's the Daddy?*, REAL EST. FIN. J., Summer 1998, at 6-7.

52. Downs, *supra* note 48, at 6.

53. *Id.*

54. See *id.* at 9; see also Gordon, *supra* note 51, at 9-10.

55. Downs, *supra* note 48, at 9.

56. Gordon, *supra* note 51, at 12.

57. Downs, *supra* note 48, at 14.

to the extent that other investors can.⁵⁸ Consequently, they may have fewer resources to ride out bad market conditions and may put off capital improvements during these periods.⁵⁹

Only time will tell whether the changes we are experiencing will sound the death knell for small real estate entrepreneurs and some of our more famous family dynasties.⁶⁰ In addition, only a recession or two will tell us whether the securitization of debt and equity has dampened the cyclical nature of real estate. One bit of anecdotal information might suggest that there is something to these theories. As spreads on mortgage-backed securities tightened over the summer of 1998, CS First Boston, one of the more aggressive lenders in the New York area, pulled the plug on certain mortgage loans it was going to make.⁶¹ Shortly thereafter, one of the leading issuers of commercial mortgage-backed securities, Capital Company of America, a subsidiary of Nomura, announced that it would abandon the business.⁶² This rather quick reaction to changing market conditions stands in marked contrast to the behavior of financial institutions ten years ago and may suggest greater discipline in the market. Although the problems in the commercial mortgage-backed securities market and the large drop in the share prices of REITs in the summer of 1998 may have been a reflection of an efficient new market structure, they may, alternatively, have been an overreaction to extrinsic economic conditions that have little to do with real estate market fundamentals.⁶³

THE IMPACT OF CAPITAL MARKETS ON THE PRACTICE OF REAL ESTATE LAW

Regardless of its ultimate impact on the structure of the real estate industry, the growing securitization of real estate equity and debt has already had a tremendous impact on the practice of real estate law. As Wall Street makes itself felt in real estate, real estate lawyers increasingly must master and apply legal principles that used to be the province of lawyers from other departments.

58. Linneman, *supra* note 39, at 7.

59. Downs, *supra* note 48, at 3.

60. For an entertaining and informative history of the real estate families of New York City, see TOM SHACHTMAN, *SKYSCRAPER DREAMS: THE GREAT REAL ESTATE DYNASTIES OF NEW YORK* (1991).

61. Steve Bergsman, *After the Fall*, *MORTGAGE BANKING*, Nov. 1998, at 52; Peter Slatin, *The Ground Floor*, *BARRON'S*, Sept. 14, 1998, at 62.

62. See Joseph Kahn, *Nomura Subsidiary in U.S. Ending Real Estate Venture*, *N.Y. TIMES*, Dec. 12, 1998, at C5.

63. There was some indication by the end of 1998 that the commercial mortgage-backed securities market was on the road to recovery. See Steve Bergsman, *Searching For A New Balance: In the Past 12 Months, Wall Street's Role in Real Estate Finance Has Boomed, Gone Bust, and May be Showing Signs of Life Again*, *INVESTMENT DEALERS DIG.*, Dec. 7, 1998; *CMBS Market Back On The Good Foot*, *MORTGAGE-BACKED SECURITIES LETTER*, Nov. 23, 1998.

Among the many new areas real estate lawyers must understand are the disclosure requirements mandated by federal securities laws, the practices and requirements of ratings agencies, how to structure deals in entities that are bankruptcy-remote, and how to advise REIT clients to structure transactions so as to preserve their favorable tax treatment.

In addition to mastering and applying the principles that used to be the province of lawyers from different departments, the practice of real estate law itself has changed. For example, in real estate financing transactions, the days when every firm had its own idiosyncratic forms for mortgage transactions are rapidly coming to an end. The use of relatively standard documents and deal structures first became commonplace in single family home mortgage transactions. Indeed, with respect to mortgages on single family homes, most lawyers have typically given up trying to get originators to accept provisions that vary from the Fannie Mae or Freddie Mac forms because such provisions would make the loans unsaleable in the secondary mortgage market.

This rigidity over terms is also beginning to find its way into commercial mortgages. More often the requirements of the rating agencies are dictating the form and content of commercial mortgages. To veer away from these requirements could potentially cost the issuer of mortgage-backed securities an investment grade and thereby have an adverse impact on returns.

Indeed, in 1996, the Capital Consortium, a joint effort of the National Realty Committee, the Mortgage Bankers Association and the National Realtors Association, did the heretofore unthinkable by issuing model mortgage forms to be used in commercial mortgage transactions.⁶⁴ The forms contain a number of provisions that are designed to make the mortgage loan acceptable to rating agencies.⁶⁵ Among the provisions that vary most from those used in many mortgages are: 1) absolute prohibitions on secondary financing;⁶⁶ 2) single-purpose entity/bankruptcy remote covenants;⁶⁷ 3) extensive covenants to provide information about the property;⁶⁸ and 4) requirements to use proceeds from casualty or condemnation awards for restoration.⁶⁹ The forms have not caused lawyers to entirely abandon their idiosyncratic forms or favorite representations

64. See THE CAPITAL CONSORTIUM, CAPITAL MARKETS INITIATIVES, June 25, 1996, at 15-57. For a description of the Capital Consortium's proposed mortgage forms see Joseph Philip Forte, *A Capital Markets Mortgage: A Ratable Model For Main Street and Wall Street*, 31 REAL PROP. PROB. & TR. J. 489 (1996).

65. See THE CAPITAL CONSORTIUM, *supra* note 64, at 15-57.

66. *Id.* at 38.

67. *Id.* at 27.

68. *Id.* at 25-6.

69. *Id.* at 22-3.

or warranties. However, they have formed the basis for greater uniformity of terms in commercial lending transactions.

THE IMPACT OF THE CAPITAL MARKETS ON THE SUBSTANTIVE LAW
OF REAL ESTATE

Although there can be no doubt that the securitization of real estate debt and equity has changed the form of real estate transactions as well as the way real estate lawyers practice their profession, the same cannot be said for the underlying substantive law of real estate. For years, commentators have argued that the linkage of real estate markets to national securities markets would mark the end of the divergent legal rules that apply from state to state, governing much including conveyancing practices, title and the law of mortgage foreclosure.⁷⁰ According to these arguments, idiosyncratic state real estate laws would add transaction costs to increasingly interstate transactions concerning real estate.⁷¹ The successful linkage of real estate credit and equity markets to national capital markets would therefore create incentives for eliminating differences among the states.⁷²

The growth of the national capital markets for real estate has been used to justify the adoption of uniform laws. However, the track record among states in voluntarily adopting the uniform laws promulgated by the National Commissioners on Uniform Laws has been dismal.⁷³ The Uniform Land Transaction Act (ULTA) was not adopted by a single state.⁷⁴ Efforts to carve out the Uniform Land Security Interest Act (ULSIA) similarly failed to succeed.⁷⁵ In light of the overwhelming success of the Uniform Commercial Code, the resistance of states to uniform real estate laws has puzzled both the advocates of uniform laws as well as many academic commentators.⁷⁶

Uniformity was forced on states, however, in certain instances by the federal government. Among the notable legislation was Congress's passage of the Depository Institutions Deregulation and

70. Robin P. Malloy, *The Secondary Mortgage Market - A Catalyst for Change in Real Estate Transactions*, 39 Sw. L.J. 991, 991-92 (1986).

71. *Id.*

72. *Id.*

73. Patrick A. Randolph, Jr., *The Future of American Real Estate Law: Uniform Foreclosure Laws and Uniform Land Security Interest Act*, 20 NOVA L. REV. 1109, 1128 (1996).

74. See Ronald Benton Brown, *Whatever Happened to ULTA?*, 20 NOVA L. REV. 1017, 1018 (1996).

75. Randolph, *supra* note 73, at 1128.

76. See 20 NOVA L. REV. 1017 (1996) (a recent volume of the Nova Law Review devoted to a symposium entitled, "Whatever Happened to the Uniform Land Transactions Act?").

Monetary Control Act of 1980,⁷⁷ which preempted state anti-usury laws on loans secured by first mortgages on residential properties; the Garn-St. Germain Depository Institutions Act of 1982,⁷⁸ which preempted state laws limiting the right of lenders to enforce due-on-sale clauses in mortgages; and two statutes in 1981 and 1994 substituting a federal law of mortgage foreclosure for mortgages held by the federal government.⁷⁹

In 1991, I wrote two law review articles that addressed both the prospects for uniform law as well as the wisdom of federal preemption.⁸⁰ My view then as well as today is that the case for uniform laws governing real estate foreclosure and borrower protections has not yet been convincingly made by proponents.⁸¹ In addition, even if I were convinced that uniform laws were desirable, I believe that we would be well advised to let market forces create the pressure for change rather than have the federal government step in and preempt state law.

Briefly, I argued that non-uniform mortgagor protection laws in the context of residential real estate were likely to generate only modest costs.⁸² I supported this argument by estimating the effect of anti-deficiency judgment laws and statutory rights of redemption on interest rates.⁸³ I found that the effect of anti-deficiency laws was statistically insignificant and that an eleven month statutory right of redemption was associated with an increase in interest of only seven basis points.⁸⁴ I further simulated a variety of costs for foreclosure and the expected delays attributable to these laws and found that their impact on interest rates was likely minimal.⁸⁵

I took this information about low costs and speculated that the benefits of these non-uniform mortgagor protections might conceivably exceed their costs, particularly for risk-averse borrowers.⁸⁶ I also concluded that the demand for these laws might vary among states either because of geographic variations in real estate cycles or differences in political culture.⁸⁷ Furthermore, even if the laws

⁷⁷ Pub. L. No. 96-221, tit. V, § 501(a)(1), 94 Stat. 132, 161 (codified at 12 U.S.C. § 1735f-7 (1980)).

⁷⁸ Pub. L. No. 97-320, 96 Stat. 1469 (1982) (codified as amended in scattered sections of 12 U.S.C.).

⁷⁹ See Multifamily Mortgage Foreclosure Act of 1981, Pub. L. No. 97-35, §§ 361-369I, 95 Stat. 422, 422-31 (codified as amended in 12 U.S.C. §§ 3701-17 (1988)); Single Family Mortgage Foreclosure Act of 1994, 12 U.S.C. §§ 3751-68 (1994).

⁸⁰ Schill, *supra* note 1; see also Michael Schill, *An Economic Analysis of Mortgagor Protection Laws*, 77 VA. L. REV. 498 (1991).

⁸¹ Schill, *supra* note 1, at 1262.

⁸² Schill, *supra* note 80, at 512-14.

⁸³ *Id.*

⁸⁴ *Id.*

⁸⁵ *Id.*

⁸⁶ *Id.* at 523.

⁸⁷ Schill, *supra* note 1, at 1299-1304.

were costly and inefficient, there was no reason for the federal government to supplant the judgment of the citizens of states that had these laws, at least in the absence of significant externalities.⁸⁸

Today, my views essentially remain the same. The exponential growth of REITs and mortgage-backed securities despite the persistence of these non-uniform laws suggests to me that they are not major impediments to the capital markets. Nevertheless, the growth of the market for commercial mortgage-backed securities probably increases the likelihood that these laws will gradually be forced out by competitive forces. With respect to home mortgage loans, to the extent that non-uniform laws generate costs, it is likely that these costs are not entirely borne by citizens of the states that enacted them, but instead a portion of the costs are likely to be externalized. Externalities result because Fannie Mae and Freddie Mac do not price loans differentially to account for the risk of state laws. It is unclear why they do not do this since information and technology exists that would permit the practice. One possibility is that the costs of the non-uniform laws are so low that the cost to the agencies of pricing the risk would exceed the benefits. Alternatively Fannie Mae and Freddie Mac, as quasi-federal agencies subject to political forces and Congressional oversight may be wary of angering members of Congress from particular states. No similar political impediment would exist to state-by-state pricing in the commercial mortgage-backed securities market if such pricing were efficient and would generate higher profits.

There is also some reason to believe that the costs of these types of laws would be higher for commercial as compared to residential mortgage-backed securities and that the corresponding benefits of the laws to borrowers might be lower. The size of an individual residential loan or set of loans from a state with costly borrower protection laws is likely to be insignificant when considered in the context of the entire pool of mortgages backing a particular issue of securities. As Professor Randolph correctly noted in a recent article, however, the number of loans in a commercial mortgage-backed security pool is much smaller and any one loan is likely to have a far greater impact.⁸⁹ Therefore, if non-uniform mortgage foreclosure laws were to raise costs significantly, they would likely have a much bigger impact now than they would have had before the recent growth of commercial mortgage-backed securities. In addition, rates of foreclosure for commercial mortgages are typically higher than those for single family loans.⁹⁰ Since non-

88. *Id.* at 1286-1318.

89. Randolph, *supra* note 73, at 1129.

90. See INSIDE MORTGAGE FINANCE PUBLICATIONS, THE MORTGAGE MARKET STATISTICAL ANNUAL FOR 1998 422-23 (1998). In December 1996, the proportion of commercial mortgage loans that were in the process of foreclosure

uniform mortgage foreclosure and borrower protection laws generate costs only when foreclosure takes place, the costs are therefore likely to be greater in the context of commercial mortgage-backed securities.

Finally, the benefits of non-uniform mortgagor protection laws are likely to be less for commercial as compared to residential borrowers. Commercial borrowers are much more likely to be sophisticated and risk neutral than are homebuyers.⁹¹ In addition, they typically are more diversified and better able to absorb the risk of foreclosure.⁹² Although I am not making an argument that these laws should be changed, I do believe that the forces that will likely challenge their continued existence are probably stronger today than at any time in our past.

CONCLUSION

In the future, real estate professionals are likely to experience a world quite different from the one we have become accustomed to. For investors, securitization of both debt and equity is likely to make real estate more like other types of commodities and subject to the same market pressures. For lawyers, the practice will never be the same. Although significant changes in the substantive law of real estate will likely be slow in coming, the practice of law has already changed forever and will continue to evolve. The real estate lawyer will have to add securities law, corporate law and bankruptcy law to his or her repertoire. Now more than ever, the term "dirt law" is a misnomer for the profession.

(1.10%) was higher than the proportion of all one to four family home loans in foreclosure (0.91%). *Id.* The disparity between the two types of loans was substantially greater in 1995 and 1994 when foreclosure rates for commercial were almost twice those of residential mortgage loans.

91. Schill, *supra* note 80, at 533-34.

92. *Id.* (highlighting the economic differences between commercial and single family home borrowers reflected in the laws of several states that limit borrower protections such as statutory rights of redemption or anti-deficiency judgment rules to the latter group).