# PREDATORY STRUCTURED FINANCE

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ABSTRACT

*Predatory lending is a real, pervasive, and destructive problem as demonstrated by record settlements, jury awards, media exposes, and a large body of empirical scholarship. Currently the national debate over predatory mortgage lending is shifting to the controversial question of who should bear liability for predatory lending practices.. In today's subprime mortgage market, originators and brokers quickly assign home loans through a complex and opaque series of transactions involving as many as a dozen different strategically organized companies. Loans are typically transferred into large pools, and then income from those loans is "structured" to appeal to different types of investors. This process, usually referred to as securitization, can lower the cost of funds for lenders, allowing them to offer better prices. But, it can also capitalize fly-by-night companies that specialize in fraud, deceptive practices, abusive collections, and other predatory behavior. This article makes three intellectual contributions to this national debate: First, it argues that the current notion of predatory lending has been cast too narrowly. Some of the businesses that sponsor securitization of residential mortgage loans are aware of and capable of preventing mortgage predation. Accordingly, the label "predatory structured finance" is suggested as a necessary addendum to the lexicon of predatory lending. Second, this article tracks the evolution of structured finance of home loans, suggesting that as our financial technology has outpaced consumer protection law, it has effectively deregulated much of the consumer mortgage market. Third, this article argues that the reform strategy favored by many legislators and a growing number of scholars—assignee liability law— is only a partial solution. While a necessary component of the law, these rules are by themselves inadequate because they excuse many of the most culpable parties from accountability. An efficient legal response to predatory structured finance must include further development in an emerging trend of common law imputed liability theories.*

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## INTRODUCTION

Predatory home loans, like all home mortgages, are increasingly subject to assignment. Now, more than ever before, a market in assignment of loans casts a shadow over how those loans are originated and serviced. While assignment of loans has always been common, relatively new and complex patterns, alternatively referred to as structured finance or securitization, have rendered the assumptions of traditional assignment law quaintly over-generalized.[1] Today mortgage loans, particularly more expensive loans marketed to those with poor credit histories, are likely to be purchased by investment trusts, bundled into large geographically diverse pools with many other loans, and sold as securities to investors.[2] Unlike the law, which has been slow to react to this trend, mortgage lenders, brokers, and servicers now actively bargain with a shrewd eye on the ultimate destination of the loans they facilitate.[3] Many scholars of mortgage lending and secured credit have for the past several years gone about the project of explaining, predicting, and attempting to influence this secondary market in home mortgages.[4] Some have pointed out that lenders no longer "lend" in the sense that they

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[1]The finance industry does not have a universally agreed upon definition of the terms securitization or structured finance, Henry A. Davis, *The Definition of Structured Finance: Results from a Survey*, J. OF STRUCTURED FIN., Fall 2005, at 5, 5. However, for purposes of this article securitization will refer to the process of pooling assets, such as mortgage loans, and then reselling them to investors. ANDREW DAVIDSON, ET AL., SECURITIZATION: STRUCTURING AND INVESTMENT ANALYSIS 3 (2003). Structured finance, in turn, refers to the process by which securitized assets are made more desirable to investors, such as by dividing the income into securities with different credit risks and maturation dates, or by isolating the assets from the risk that the originator of the assets will declare bankruptcy. *Id.* In practice, the notion of securitizing and structuring often used interchangeably. *See, e.g.,* STEVEN L. SCHWARCZ, STRUCTURED FINANCE: A GUIDE TO THE PRINCIPLES OF ASSET SECURITIZATION, (3d. ed. 2002 & Supp 2005); JAMES A ROSENTHAL & JUAN M. OCAMPO, SECURITIZATION OF CREDIT: INSIDE THE NEW TECHNOLOGY OF FINANCE 3-5 (1988) ("Credit securitization is the carefully structured process whereby loans and other receivables are packaged, underwritten, and sold in the form of securities (instruments called asset-backed securities)."). *Cf* Providing capital to companies in financial stress is one of the central motivations of securitization. SECURITIZATION OF FINANCIAL ASSETS, at § 1.02 (Jason H.P. Kravitt, ed., 2002 & Supp.).

[2]Jeremy Carter, *Highlights from Securitization News: ABS Mart Enjoyed Stellar Year*, J. OF STRUCTURED FINANCE, Winter 2005, at 97, 97.

[3]*See, e.g.,* Maura B O'Connor & James Bryce Clark, *Ten Easy Ways to Make a Loan Nonsecuritizable,* PRACTICING LAW INSTITUTE: REAL ESTATE LAW AND PRACTICE COURSE HANDBOOK SERIES, PLI Order No. N0-0063, March 2001, at 13-14 (describing common broker and originator documentation errors); Henry T. Greely, *Contracts as Commodities: The Influence of Secondary Purchasers on the Form of Contracts*, 42 VAND. L. REV. 133, 147-48, 168-70 (1989) (emphasizing the influence of secondary market purchasers on the form and terms of residential mortgage loans); Jess Lederman, *Techniques for Selling Loans to Conduits*, *in* THE SECONDARY MORTGAGE MARKET: A HANDBOOK OF STRATEGIES, TECHNIQUES AND CRITICAL ISSUES IN CONTEMPORARY MORTGAGE FINANCE 77 (ed. Jess Lederman, 1987) (discussing the profitability of different strategies in assigning mortgages to private label mortgage securitization structures).

[4]Anupam Chander, *Odious Securitization,* 53 EMORY L.J. 924 (2004); Rafael Diaz-Granados,, *A Comparative Approach to Securitization in the United States, Japan, Germany, and France*, 4 WILLAMETTE BULL. INT'L L. & POL'Y 1 (1996); Kurt Eggert, *Held Up in Due Course: Codification and the Victory of Form Over Intent in Negotiable Instrument Law*, 35 CREIGHTON L. REV. 363 (2002) *and* Kurt Eggert, *Held Up in Due Course: Predatory Lending, Securitization, and the Holder in Due Course Doctrine*, 35 CREIGHTON L. REV. 503 (2002);

themselves expect repayment.[5] Rather they manufacture a commercial product—borrowers—that are measured, sold, and at times discarded by a consuming capital market. Many of today's mortgage lenders are assignment production companies that create income streams for the nation's capital markets.

Several scholars have demonstrated significant benefits from this process.[6] Collectively, investors have large amounts of capital, but a limited ability to originate and monitor individual loans. Conversely, mortgage lenders are well situated to make loans, but are typically constrained in the number of loans they can make by their limited access to capital. Provided they can surmount hurdles like trust, information asymmetry, transaction costs, and taxes, these two groups have much to offer each other by way of mutually beneficial exchange. The engineering of securitization conduits is a financial science of overcoming the hurdles separating these two groups.[7] All this is well and good in that homeowners receive new access to cheap capital making, other things being equal, home ownership more affordable at the

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Robert Dean Ellis, *Securitization Vehicles, Fiduciary Duties, and Bondholders' Rights*, 24 J. CORP. L. 295 (1999); Kathleen C. Engel & Patricia A. McCoy, *A Tale of Three Markets: The Law and Economics of Predatory Lending*, 80 TEX. L. REV. 1255, 1317-37 (2002); Kathleen C. Engel & Patricia A. McCoy, *Predatory Lending: What Does Wall Street Have to Do with It?* 15 HOUSING POL'Y DEBATE 715 (2004); Thomas J. Gordon, *Securitization of Executory Future Flows as Bankruptcy Remote True Sales*, 67 U. CHI. L. REV. 1317 (2000); Greely, *supra* note 3; Lynn M. Lopucki, *The Death of Liability*, 106 YALE L. J. 1, 23-30 (1996); Stephen Lubben, *Beyond True Sales—Securitization and Chapter 11*, 1 N.Y.U. J.L. & BUS. 89 (2004); Louis R. Lupica, *Revised Article 9, Securitization Transactions and the Bankruptcy Dynamic*, 9 AM. BR. INST. L. REV. 287 (2001); Louis R. Lupica, *Circumvention of the Bankruptcy Process: The Statutory Institutionalization of Securitization*, 33 CONN. L. REV. 199 (2000); Louis R. Lupica, *Asset Securitization: The Unsecured Creditors' Perspective*, 76 TEXAS L. REV 595 (1997); Robin Paul Malloy, *The Secondary Mortgage Market—A Catalyst for Change in Real Estate Transactions*, 39 SW. L. J. 991, 992 (1986); Peter L. Mancini, *Bankruptcy and the UCC as Applied to Securitization: Characterizing a Mortgage Loan Transfer as a Sale or a Secured Loan*, 73 B.U. L. REV. 873 (1993); Jonathan Remy Nash, *Environmental Superliens and the Problem of Mortgage-Backed Securitization*, 59 WASH. & LEE L. REV. 127 (200); Thomas E. Plank, *The Security of Securitization and the Future of Security*, 25 CARDOZO L. REV. 1655 (2003); Georgette C. Poindexter, *Subordinated Rolling Equity: Analyzing Real Estate Loan Default in the Era of Securitization*, 50 EMORY L.J. 519 (2001); Steven L. Schwarz, *Securitization Post-Enron*, 25 CARDOZO L. REV. 1539 (2004); Steven L. Schwarz, *Structured Finance: The New Way to Securitize Assets*, 11 CARDOZO L. REV. 607 (1990); Steven L. Schwarz, *The Alchemy of Asset Securitization*, 1 STAN. J.L. BUS. & FIN. 133 (1994); Steven L. Schwarcz, *The Parts are Greater Than the Whole: How Securitization Can Revolutionize Structured Finance and Open The Capital markets To Middle Market Companies*, Joseph C. Shenker & Anthony J. Colletta, *Asset Securitization: Evolution, Current Issues and New Frontiers*, 69 TEX. L. REV. 1369 (1991).

[5] *See, e.g.,* Maura B. O'Connor & James Bryce Clark, *Ten Easy Ways to Make a Loan Nonsecuritizable*, 470 PRACTICING LAW INSTITUTE, REAL ESTATE LAW AND PRACTICE COURSE HANDBOOK SERIES 11, 16-17 (PLI Order No. N0-006E, March 2001) ("A traditional lender lends money from its own balance sheet. . . . A securitizing lender, on the other hand, goes out into the capital markets to get someone else's money to lend to the borrower.").

[6] Plank, *supra* note 4, at 1667; SCHWARTZ, STRUCTURED FINANCE, *supra* note 1, at § 11-1; Shenker & Colletta, *supra* note 4, at 1428-29.

[7] Rosenthal & Ocampo, *supra* note 1, at 3-5 (suggesting credit securitization is a technological advance comparable to "superconductors, gene-splicing, artificial intelligence, [and] robotic-driven manufacturing"); Manuel Utset, *Producing Information: Initial Public Offerings, Production Costs, and the Producing Lawyer*, 74 OREGON L. REV. 275, 310 (1995) (arguing lawyers act as "production cost engineers" in bringing initial public offerings of securities to market).

margins.[8] When everything goes according to plan, society has much to gain from securitization of home mortgage loans.

But sadly, like many new technologies, securitization comes with a dark side. The contours of this side began to emerge, like so many other consumer problems, in the case loads of legal aid lawyers serving the working poor. In the late 1980s and early 1990s legal aid lawyers began seeing growth in the volume of families and senior citizens losing their homes to loan terms and marketing practices removed in degree from theft only ever so slightly by the black magic of boilerplate. Horror stories of breathtaking creditor avarice became common features in newspapers around the country: A 76-year-old Georgia widower with monthly mortgage payment in excess of his social security income;[9] a blind Ohio couple duped with a fraudulent appraisal, forged paperwork, and thousands of dollars in kickbacks to a deceitful broker;[10] and, a New York retiree with two amputated legs, $472 in monthly social security income, and a $424 mortgage payment.[11] For years these stories were dismissed as either anecdotal or impossible since, after all, Adam Smith's great invisible hand must inevitably protect consumers through forcing bad actors from the marketplace with the Darwin-like natural selection born of rational, self-interested, autonomous market behavior.[12] Who are you going to believe, the local legal aid lawyer or Adam Smith?

Since then facts have forced a consensus that the term predatory lending—which no longer needs to be surrounded by quotation marks—is real, pervasive, and destructive.[13] A host of empirical studies leave no serious doubt that predatory mortgage lending is a significant problem for American society.[14] More controversial is this: who should bear the liability for predatory lending practices? Predatory lenders and brokers themselves specialize in maintaining judgment proof operations. In fact predatory lenders operate on the edge of bankruptcy, quickly folding up and moving on whenever the heat gets close. This is possible because in today's market, mortgage originators and brokers quickly assign predatory loans through a complex and opaque series of transactions involving nearly a dozen different litigation savvy companies. Predatory lending victims (as well as courts) are left mystified when each blames the others and no one takes responsibility for unfair commercial practices.

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[8] SCHWARCZ, STRUCTURED FINANCE, *supra* note 1, at §11-2; Rosenthal & Ocampo, *supra* note 1, at 12-13.

[9] Duane D. Stafford, *Lending Bill Gives Victims Legal Clout: Triggers Kick in on High Fees, Rates,* ATLANTA J. & CONST., April 14, 2002, at C4

[10] Jill Ripenhoff, *Baited with Promises, They Refinanced: Now they're Fighting to Save their House*, COLUMBUS POST DISPATCH, Feb. 19, 2006.

[11] Emma D. Sapong, *'Don't Borrow Trouble' Raises Awareness of Predatory Lenders*, BUFFALO NEWS, April 13, 2002, B1

[12] *See, e.g.,* ROSENTHAL & OCAMPO, *supra* note 1, at 21 (expressing the conviction that "[c]redit securitization permits the orderly reduction of low skilled excess lending capacity.").

[13] No less than eleven different federal agencies have publically used word "predatory" to describe harsh terms and behavior in consumer lending markets. Christopher L. Peterson, *Federalism and Predatory Lending: Unmasking the Deregulatory Agenda*, 78 TEMPLE L. REV. 1, 5 n.8 (2005).

[14] *See infra* note 29 and accompanying text.

Often victims are left asserting predatory lending claims as defenses against a faceless investment trust when it attempts to foreclose on their family home. Universally, this trust claims ignorance of predatory practices committed by other parties to the transaction.

This scenario, seen again and again by consumer attorneys all around the country, has forced policy makers to ask whether investors in subprime mortgages have the opportunity and ability to screen their portfolios for predatory practices, and in effect police the behavior of originators, brokers, and servicers. Indeed, this question—should investors be required to monitor lenders for predatory practices—has become the most controversial and important in the debate over substantive mortgage lending regulatory reform. This article hopes to make three contributions to that national debate. First, it argues that the concept of predatory lending has been cast too narrowly. I suggest that some of the institutions that sponsor and administer mortgage securitization are complicit in predatory lending. By encouraging, facilitating, and profiting from predatory loans, these financiers have themselves slipped into predation. The notion of "predatory structured finance" is a necessary addendum to the lexicon of predatory lending. Second, this article makes a historical argument that structured finance has rendered much of the existing fabric of consumer credit protection law obsolete. Most of the consumer protection statutes were adopted before Wall Street learned to securitize home mortgages. As a result, the terminology of those statutes frequently leaves predatory home mortgage loans beyond their scope. Developing within these conceptual cracks in the nation's consumer protection edifice, securitization has allowed much of the subprime mortgage market to evolve unconfined by many of the substantive standards in consumer protection law. A closer look at the history of structured finance reveals that organizational technology has outpaced our consumer protection law, in effect deregulating much of the consumer mortgage market. Third, this article argues that the reform strategy favored by many legislators and a growing number of scholars—assignee liability law— is only a partial solution. Assignee liability rules render the holder of an assigned mortgage loan liable for legal violations made in the origination of the loan. I argue that this strategy, while necessary component of the law, is by itself inadequate because it excuses many of the most culpable parties from accountability. In addition to limited assignee liability, this article advocates further maturation in an emerging common law trend of using imputed liability theories to hold structured financiers liable for their own predatory behavior.

Part I begins with the crucial back-story of how the simple two party mortgage market evolved into today's complex financial machine. It focuses on the technological and organizational developments that facilitated private structured finance of residential mortgage loans. The purpose of this section is twofold: first, to explain the daunting complexity of mortgage securitization structures; and second to lay a foundation for a historical argument on how much of this market has evolved outside the scope of our consumer protection laws. Part II introduces the predatory lending problem, examines how capital market financiers are involved in predatory lending, and briefly surveys the legal claims and defenses consumers have at their disposal in protecting themselves from predatory lending. Part III surveys the current state of the law allowing assertion of these claims and defenses against various businesses involved in structured finance of predatory loans. These laws include both assignee liability theories and imputed liability theories. Part IV brings together the previous sections into a three part critique of how existing law does not sufficiently impede securitization of predatory loans. Part V discusses reforms which would improve the efficiency and fairness of the subprime mortgage industry.

## II. BACKGROUND: THE ORIGIN AND OPERATION OF SECURITIZATION

This Part provides the necessary background for what follows. Section A sets the stage with a short explanation of the origins and early evolution of our secondary mortgage lending market. This is necessary since later on this article contrasts the dynamic changes in mortgage finance with the relatively slow evolution of the law governing that market. Section B of this part first explains what mortgage securitization is and how it evolved. Then, Section B focuses on subprime mortgage securitization, describing the major parties and how they coordinate distribution of Wall Street capital to individual families.

### *A. The Early Secondary Residential Mortgage Market*

#### 1. Simple Origins: Two Party Mortgage Finance

The earliest American home mortgage lending institutions were small cooperative groups of neighbors and friends called building societies. Modeled after similar British institutions formed in the late eighteenth century, American building societies first appeared in the 1831.[15] In the first building societies members of the group agreed to make a weekly contribution to a common building fund.[16] In return, the society paid for the construction of a home for each member of the group one family at a time.[17] All members were obliged to continue making contributions until every member obtained a home, at which time the society terminated.[18] Throughout the nineteenth century building societies became more popular, eventually shedding their terminal nature, employing professional management, and taking savings deposits instead mutual contributions.[19] By the late nineteenth century, U.S. building societies were more commonly referred to as "building and loans," a label which later morphed into "savings and loans", and eventually into today's term "thrifts".[20] Commercial banks generally refused to make mortgages eschewing the liquidity and risk problems of this type of

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[15] M. MANFRED FABRITIUS & WILLIAM BORGES, SAVING THE SAVINGS & LOAN: THE U.S. THRIFT INDUSTRY AND THE TEXAS EXPERIENCE 1950-1988, at 12 (1989); Michael J. Lea, *Innovation and the Cost of Mortgage Credit: A Historical Perspective*, 7 HOUSING POL'Y DEBATE 147, 154 (1996).

[16] MARK BOLEAT, THE BUILDING SOCIETY INDUSTRY 3 (1982).

[17] Rhoda James, Cosmo Graham & Mary Seneviratne, *Building Societies, Customer Complaints, and the Ombudsman*, 23 ANGLO-AM. L. REV. 214, 214-15 (1994); Lea, *supra* note 15, at 154.

[18] BOLEAT, *supra* note 232, at 3; *Benefit Building Societies*, 29 L. MAG & L. REV. Q.J. JURIS. 3D SEV 323, 324-25 (1870). *See also* Benefit Building Societies, 14 L. REV. & Q.J. BRIT. & FOREIGN JURIS. 1 (1851) (discussing legal foundations of mid-nineteenth century building societies).

[19] Lea, *supra* note 15, at 155.

[20] *Id.* at 156. Of course today's thrifts bear little resemblance to their nineteenth century forebears. Contemporary thrifts are often indistinguishable from banks and engage in a virtually unlimited range of business and consumer financial services. For more thorough treatment of this commercial evolution *see generally* BOLEAT, *supra* note 16; FABRITIUS & BORGES, *supra* note 15

credit.[21] However, in the mid-to late-1800s mutual savings banks,[22] private mortgage lending firms, and some insurance companies joined building and loans in making home mortgages.[23]

Despite these sources of credit, by the beginning of the 20th century consumers hoping to own a home had quite limited financing options. Most mortgages required a large down payment of around 40 percent of the home purchase price.[24] Moreover, early 20th century mortgage loans had terms typically averaging between three and six years.[25] These short repayment durations necessitated high monthly payments often followed by a large balloon payment of the remaining balance due at the end of the loan term.[26] Relatively few families could overcome these financial hurdles. Moreover, lenders had both formal and informal policies discriminating against minorities and women. As a result, none but the most affluent men of European ancestry had reliable and widespread access to home finance.[27]

Early home mortgage lenders themselves had limited options in acquiring the capital to make home mortgage loans. By far the most common mortgage lender were individual non-professional landowners who usually accepted a mortgage along with partial payment in connection with the sale of property.[28] Building societies only had the funds they could gather in deposits from their local community and had little opportunity to assign their loans.[29] Insurance companies made mortgage loans out of the funds gathered from insurance premiums and then held those loans in their portfolio.[30] The earliest efforts to form a secondary market

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[21]DAN IMMERGLUCK, CREDIT TO THE COMMUNITY: COMMUNITY REINVESTMENT AND FAIR LENDING POLICY IN THE UNITED STATES 33 (2004).

[22]Some state legislatures chartered mutual savings banks which had some characteristics of building and loans and some characteristics of traditional commercial banks. Marvell, *supra* note 40, at 4. The primary focus of the first savings banks was to take small deposits to encourage thrift in working class communities. Immergluck, *supra* note 21, at 34-35. By the late 1800s, they had also become an important source of mortgage finance. Lea, *supra* note 15, at 156.

[23]Lea, *supra* note 15, at 156.

[24]Kenneth A. Snowden, *Mortgage Rates and American Capital Market Development in the Late Nineteenth Century*, 47 J. ECON. HIST. 671, 675 (1987).

[25]*See* D. M. Frederiksen, *Mortgage Banking in America*, 2 J. POL. ECON 203, 206 (1894); Snowden, *supra* note 24, at 675.

[26]OFFICE OF FEDERAL HOUSING ENTERPRISE OVERSIGHT, REPORT TO CONGRESS: CELEBRATING 10 YEARS OF EXCELLENCE 1993-2003, at 11 (June 2003) (hereinafter OFHEO Report to Congress).

[27]CHRISTOPHER L. PETERSON, TAMING THE SHARKS: TOWARDS A CURE FOR THE HIGH COST CREDIT MARKET 81 (2004) (discussing origins of American credit discrimination).

[28]Frederiksen, *supra* note 25, at 209 (mortgages taken by local and non-local individuals constituted 73 percent of American residential mortgages recorded between 1879 and 1890 ).

[29]Building society loans constituted about 7 percent of recorded mortgages. *Id.* We should expect that few businesses would be willing to take building society loan assignments since these potential assignees would have a debilitating comparative disadvantage in evaluating the likelihood of default.

[30]Insurance company loans constituted about 5 percent of recorded mortgages. *Id.*

came out private mortgage companies which, by the 1880s were making mortgage loans around the country through local agents.[31] Some of these companies raised funds by issuing bonds to East coast and European investors.[32] Called mortgage backed bonds, these loans included not only a promise to pay a fixed amount, but also security agreements where the mortgage company pledged its loans as collateral for the bond.[33] Foreshadowing some of the problems in today's market, this system proved extremely unstable. Because distant and uninformed investors bore the ultimate risk on individual home mortgages, lenders and their local agents had an incentive to use inflated appraisals and fraudulent origination practices to generate up front profits.[34] When recessions in the 1890s produced widespread consumer defaults, all of these mortgages companies folded and their investors took horrendous losses.[35] Thus, with the exception of a few fitful experiments, early American mortgage loans were two party transactions with lenders holding their own notes, collecting payments, and foreclosing on defaulting borrowers when necessary. As will be discussed in Part IV, this two party system of mortgage finance engendered many of the assumptions which still underlie contemporary mortgage assignment law.

### 2. The Government as Assignee: Three Party Mortgage Finance After the Great Depression

The defining event shaping the secondary mortgage market in 20th century was the Great Depression. When millions of people lost their jobs in the early 1930s prices for goods, services, and land all dramatically declined.[36] Agricultural prices were so low, family farmers could not profit from selling their crops.[37] Demand for goods and the investment capital from the stock market both dried up, forcing manufacturers to lay off workers.[38] In the mortgage lending market, lenders were forced to call in their loans as *half* of all single-family mortgages

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[31]Fredericksen, *supra* note 25, at 210-13; Lea, *supra* note 15, at 156. Some of these companies specialized in lending to settlers taking advantage of the homestead laws. Fredericksen, *supra* note 25, at 213.

[32]Frederiksen, *supra* note 25, at 207; Lea, *supra* note 15, at 156-58.

[33]Often ownership of the mortgages was held in a trust, not dissimilar to today's special purpose vehicles. Fredericksen, *supra* note 25, at 210.

[34]Lea, *supra* note 15, at 158. Much like today's mortgage brokers, mortgage loan company agents in the 1880s received up front commissions which amounted to around as much as an interest rate point over the life of the loan. Frederiksen, *supra* note 25, at 206. Loan agents cased in on land speculation as settlers in the Dakotas, Nebraska, Kansas and other territories made claims to land, borrowed money, and defaulted without making any improvements or establishing successful homesteads. *Id.* at 213.

[35]*Id.*; CHRISTINE A. PAVEL, SECURITIZATION: THE ANALYSIS AND DEVELOPMENT OF THE LOAN-BASED/ASSET BACKED SECURITIES MARKET 56 n.2 (1989).

[36]Edwin F. Gay, *The Great Depression*, 10 FOREIGN AFFAIRS 529, 530 (July 1932).

[37]*Id.*

[38]Arthur E. Wilmarth, Jr., *Did Universal Banks Play a Significant role in the U.S. Economy's Boom-and-Bust Cycle of the 1921-33? A Preliminary Assessment*, 4 CURRENT DEV. IN MONETARY & FIN. L. 559, 582 (2006).

fell into default.[39] In foreclosure, real estate prices were so low lenders could not recoup their investment by selling seized homes.[40] Because lenders were understandably reluctant to continue make uncollectible loans, the mortgage finance and housing construction industries ground to a halt.[41]

Throughout the 1930s the federal government took a series of steps to restart and expand these industries. This depression era legislation established an infrastructure for mortgage lending which, in addition to helping establish the American middle class, is crucial for understanding the playing field within which today's predatory lenders operate. First, during the Hoover administration, Congress created the twelve regional Federal Home Loan Banks ("FHLBs").[42] Analogous to the federal reserve banks, the FHLBs loaned money to thrifts, who in turn lent these funds to consumers.[43] Although started with government capital, the FHLBs gradually accumulated private funds and eventually became wholly owned by their member thrifts. The FHLBs gave thrifts a reliable and inexpensive source of funds to supplement consumer deposits which allowed thrifts to develop into the most significant source of home mortgage credit in the mid-twentieth century.

Nevertheless, at the beginning of the Roosevelt administration lenders were still reluctant to re-enter the market. FDR backed three important legislative initiatives all of which pushed the federal government further into the residential mortgage lending.[44] First, in 1933 Congress created the Home Owners Loan Corporation ("HOLC"). HOLC used taxpayer funds to buy mortgages owed by financially distressed families.[45] HOLC then refinanced these borrowers into more affordable government loans with longer terms.[46] Second, in 1934

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[39] OFHEO REPORT TO CONGRESS, *supra* note 26, at 11.

[40] THOMAS B. MARVELL, THE FEDERAL HOME LOAN BANK BOARD 19 (1969).

[41] Gay, *supra* note 36, at 533.

[42] IMMERGLUCK, *supra* note 21, at 36.

[43] Marvell, *supra* note 40, at 20-21.

[44] *See* Franklin D. Roosevelt, Message Asking for Legislation to Save Small Home Mortgages from Foreclosure (Apr. 13, 1933), *in* 2 THE PUBLIC PAPERS AND ADDRESSES OF FRANKLIN D. ROOSEVELT, at 135 (1938) (illustrating FDR's vision for government leadership in mortgage lending markets).

[45] Although HOLC's refinanced mortgages were initially funded by taxpayers, homeowners eventually paid back all the money used by the agency. Marvell, *supra* note 40, at 24. HOLC was created as a temporary agency to help the country out of the depression. It stopped refinancing loans in 1936 and was altogether out of business by the early 1950s. Marvell, *supra* note 40, at 25.

[46] Steven A. Ramirez, *The Law and Macroeconomics of the New Deal at 70*, 62 MD. L. REV. 515, 560 (2003). In about two years HOLC refinanced over a million loans amounting to approximately ten percent of the country's outstanding residential non-farm mortgages. Kenneth T. Jackson, *Race, Ethnicity, and Real Estate Appraisal: The Home Owners Loan Corporation and the Federal Housing Administration*, 6 J. URB. HIST. 419, 421 (1980). Conversely, HOLC also used overtly racist underwriting and appraisal practices, such as rating minority neighborhoods much more unfavorably than white neighborhoods. Michael H. Schill & Susan M. Wachter, *The Spatial Bias of Federal Housing Law and Policy: Concentrated Poverty in Urban America*, 143 U. PENN. L. REV. 1285, 1309 (1995). This federal leadership set a dangerous discriminatory precedent which far outlived the agency itself. Peter P. Swire, *The Persistent Problem of Lending Discrimination: A Law and Economic Analysis*, 73 TEX. L.

Congress created the Federal Housing Administration ("FHA") tasking it with offering government guaranteed insurance to home mortgage lenders.[47] For loans that met FHA's underwriting criteria, the government agreed to pay mortgage lenders the difference between the price fetched by a repossessed home and its outstanding loan balance.[48] In effect, this insurance protected the lender from the borrower's credit risk and from downward movement in realty prices. FHA's insurance facilitated mortgage loans with much longer durations, down payments of only 20 percent of the home value, and more affordable monthly installments.[49] With loan terms of up to thirty years, families could now purchase a home over the duration of an adult's working life. FHA's underwriting guidelines also created industry standards which encouraged cautious and professional behavior in loan origination.[50] Finally, in 1938 Congress created the Federal National Mortgage Association ("FNMA"), now more popularly known as "Fannie Mae".[51] Fannie Mae's function was to act as an assignee by purchasing FHA's "nonconventional" insured loans.[52] Not only was a qualifying mortgage guaranteed, but the lender, if it chose, could assign the loan to Fannie Mae for cash, quickly recouping its investment plus a premium.[53] This secondary market outlet alleviated fears of illiquidity, inducing many mortgage loan companies, insurance companies, and even commercial banks back into consumer home loan business.

Collectively, these government initiatives (along with millions of cheap automobiles cranked out by the post WWII industrial base) facilitated migration of the nesting white middle class to rapidly expanding suburbs surrounding American cities.[54] In effect, the depression era

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REV. 787, 799-802 (1995).

[47]Malloy, *supra* note 4, at 992; IMMERGLUCK, *supra* note 21, at 38.

[48]Malloy, *supra* note 4, at 992.

[49]Immergulck, *supra* note 21, at 38.

[50]FHA did not, however, encourage equal treatment of all groups. Like HOLC, FHA not only tolerated but encouraged exclusion of ethnic minorities. IMMERGLUCK, *supra* note 21, at 93-95.

[51]Malloy, *supra* note 4, at 993.

[52]Malloy, *supra* note 4, at 993. Residential mortgages are still usually divided into two categories: "conventional" and "non-conventional" loans. Anand K. Bhattacharya, Frank J. Fabozzi, & S. Esther Chang, *Overview of the Mortgage Market*, *in* THE HANDBOOK OF MORTGAGE BACKED SECURITIES 3, 3 (Frank J. Fabozzi, ed., 5th ed., 2001). In a conventional loan, if the borrower defaults and the loan becomes uncollectible, then the lender or the lender's assignee suffers the loss. *Id.* In contrast, nonconventional loans are insured by the federal government. *Id.* Such insurance is still provided by the FHA, the VA or the Rural Development Administration ("RDA"). *Id.* The Reconstruction Finance Corporation ("RFC") actually preceded Fannie Mae in purchasing FHA insured loans. However, like HOLC, it was another temporary agency which disbanded in 1948. Malloy, *supra* note 52, at 993.

[53]Malloy, *supra* note 4, at 992-93

[54]Jackson, CRABGRASS FRONTIER, *supra* note , at 195, 200. Excluded yet again, were many white working class families, families headed by single women, and families of color, all of whom tended to lack the credit profile Fannie Mae and the thrifts required to participate in this new "prime" home mortgage lending market. Swire, *supra* note 46, at 798-99.

legislation created what Diamond and Lea have described as two housing finance "circuits".[55] Thrifts and the twelve regional Federal Home Loan Banks constituted the first circuit. The second circuit included mortgage loan companies, insurance companies, and banks—all of whom relied on FHA insurance (as well as analogous Veterans Administration insurance offered World War II)[56] and assigned their loans to Fannie Mae. While the thrift circuit was the larger of the two until the 1980s, the Fannie Mae circuit proved more influential in determining today's secondary market structure.[57]

What both circuits shared, and continue to share, is a unifying theme of federal government sponsorship.[58] In the thrift circuit, even after member thrifts became the sole owners of the regional Federal Home Loan Banks, the federal government still "backstopped" them with authorization to borrow from the U.S. Treasury.[59] In the second home finance circuit, the government purchased and held consumer borrowers' promissory notes.[60] Both circuits are best conceptualized as a three party model—borrower, lender, and the government as a guarantor or assignee. Moreover, as discussed further in Part IV, the fact that a federal agency was the most important assignee of home mortgages exerted significant influence on the mortgage loan assignment laws that now govern trafficking in predatory loans.

3. The Government as Issuer: The Innovation of Public Residential Mortgage Securities

In the post war years the two circuits provided historically unprecedented levels of secured credit to Americans. The larger thrift circuit focused primarily on conventional mortgages that were either uninsured or underwritten with private mortgage insurance.[61] The

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[55]Douglas B. Diamond, Jr. And Michael J. Lea, *The Decline of Special Circuits in Developed Country Housing Finance*, 3 HOUSING POL'Y DEBATE 747, 756-57 (1992).

[56]Malloy, *supra* note 4, at 992.

[57]Diamond & Lea, *supra* note 55, at 76-61.

[58]*See* Federal National Mortgage Association, *Federal National Association Background*, *in* 1 REAL ESTATE SECURITIES REGULATION SOURCEBOOK 1087, 1087-88 (1975) (providing a characterization of different levels of government sponsorship in quasi-governmental agencies). Dan Immergluck has explained that:

> In both circuits, the public sector has seeded, nurtured, and been largely responsible for the size and functioning of mortgage markets now and in the foreseeable future. Without federal involvement, we would today have far fewer home owners or potential home owners. Thus, the size of the home lending market to day and for the foreseeable future rests on a federally initiated, supported, and sponsored infrastructure.

Immergluck, *supra* note 21, at 40.

[59]*Id.*

[60]Sivesind explains, "Since low-risk FHA-VA loans could be sold to investors across the country, the programs facilitated the early development of an integrated, national mortgage market at little direct cost to the government." Charles M. Sivesind, *Mortgage-Backed Securities: The Revolution in Real Estate Finance, in* HOUSING AND THE NEW FINANCIAL MARKETS 311, 312-13 (Richard L. Florida, ed., 1986).

[61]Diamond & Lea, *supra* note 55, at 76-61. *See also* infra note 52 (explaining origin of the term "conventional" in mortgage lending).

second circuit became increasingly reliant on mortgage companies that focused on nonconventional FHA and VA insured loans which were then assigned to Fannie Mae. By the 1960s growth in the Fannie Mae circuit was limited by the policy objectives of government insurance programs. The federal government directed its mortgage insurance programs with policy objectives in mind, such as "increasing military housing, national defense housing, urban renewal housing, nursing homes, mobile home parks, and housing for the elderly, among others."[62] Many mortgage bankers wanted to penetrate into the conventional market dominated by the thrifts, but lacked the reliable and inexpensive capital necessary to do so.[63] The result was pressure on the federal government to provide a source of liquidity for conventional loans made by non-depository mortgage lenders.

Once again the federal government responded by facilitating the development of new home mortgage finance infrastructure. In 1968 Congress partitioned Fannie Mae into two separate organizations. The first organization retained the original function, but operated under a new name: The Government National Mortgage Association.[64] Ginnie Mae, as it became known, continued to purchase nonconventional FHA and VA insured mortgages.[65] The second organization kept the old name, but received a new mission. Fannie Mae became a private federally chartered corporation whose primary function would be to purchase conventional home mortgages from private lenders.[66] At this point Fannie Mae still held home mortgages in its own portfolio, and in turn borrowed money in its own name to finance its operations. The hope was that this new private incarnation of Fannie Mae would provide a reliable low cost source of funds for lenders wishing to offer conventional non-government insured mortgages. In 1970, Congress created Freddie Mac to serve a similar role as Fannie Mae.[67]

A short time later, a fundamentally new method of obtaining funds for mortgage loans developed: securitization. Rather than holding mortgages themselves, both Ginnie Mae and then Freddie Mac began issuing mortgage backed securities that "passed through" interest income to investors.[68] The agencies would purchase home mortgages, deposit large numbers of them in "pools", and sell participations in the pools to investors on Wall Street. With these new pass-through investment vehicles, investors could hold a share of large (and diversified)

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[62] Immergluck, *supra* note 21, at 39 (citing Kerry Vandell, *FHA Restructuring Proposals: Alternatives and Implications*, 6 HOUSING POL'Y DEBATE 299-383 (1995)).

[63] Richard S. Landau, *The Evolution of Mortgage Backed Securities*, *in* THE SECONDARY MORTGAGE MARKET: A HANDBOOK OF TECHNIQUES AND CRITICAL ISSUES IN CONTEMPORARY MORTGAGE FINANCE 135, 135-36 (Jess Lederman, ed., 1987).

[64] Sivesind, *supra* note ?, at 317.

[65] *Id.*

[66] Sivesind, *supra* note ?, at 315-16.

[67] Sivesind, *supra* note ?, at 318-19.

[68] Schwarcz, *Structured Finance*, *supra* note X, at 609. *See also* Linda Lowell, *Mortgage Pass-Through Securities*, *in* THE HANDBOOK OF MORTGAGE-BACKED SECURITIES 25, 26 (Frank J. Fabozzi, ed., 5th ed., 2001) ("Pass-through securities are created when mortgages are pooled together and undivided interests or participations in the pool are sold.").

number of mortgages insured by the government in the case of Ginnie Mae, or guaranteed by the large stable government sponsored enterprises ("GSEs") in the case of Freddie Mac and Fannie Mae (who also began securitizing shortly thereafter).[69] Because the agencies now guaranteed the principal and interest income of their securities even when mortgagors defaulted, investors saw the securities as a low risk investment even without the assurances of a rating organization, such as Standard and Poors or Moody's.[70] Investors could buy and easily resell their investments in order to best suit their portfolios and investment strategies.[71] These mortgage backed securities had stability and liquidity which generated greater spreads over comparable term treasury obligations than securities of similar risk.[72] Securitization of mortgage loans by the GSEs allowed the larger capital markets to directly invest in American home ownership at a lower cost than the older depository lending model of business.[73]

### *B. Private Label Securitization*

#### 1. The Evolution of Private Securitization

Like the GSEs, purely private institutions saw the potential benefits of pooling home mortgages into mortgage-backed securities and soon began attempting to channel capital into home mortgage lending in similar ways.[74] In the early 1970s the baby boom generation was just reaching the age and means necessary to buy homes.[75] Private financiers wanted to mobilize capital to serve this enormous potential demand for credit.[76] Moreover, because the GSEs

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[69]Richard S. Landau, *The Evolution of Mortgage-Backed Securities, in* THE SECONDARY MORTGAGE MARKET: A HANDBOOK OF STRATEGIES, TECHNIQUES AND CRITICAL ISSUES IN CONTEMPORARY MORTGAGE FINANCE 135, 135 (Jess Lederman, ed., 1987).

[70]Although Ginnie Mae securities are guaranteed by the full faith and credit of the U.S. government, Fannie Mae and Freddie Mac securities are not. Nevertheless, many investors have traditionally regarded the two GSEs are "too big to fail,"— the view that there is an implicit government guarantee of agency securities, if not an actual one. Richard Scott Carnell, *Handling the Failure of a Government-Sponsored Enterprise*, 80 WASH. L. REV. 565, 630-31 (2005). Whether investors are correct in this view is a matter of growing debate. See id; Wayne Passmore & Roger W. Sparks, *Automated Underwriting and the Profitability of Mortgage Securitization,* 28 REAL ESTATE ECON. 285, 303 (2000).

[71]Sivesind, *supra* note ?, at 313.

[72]Loan pools insured by Fannie Mae and Freddie Mac must meet relatively strict underwriting guidelines and must be originated on standardized forms designated by the agencies. Anand K. Bhattacharya et al., *Overview of the Mortgage Market, in* THE HANDBOOK OF MORTGAGE-BACKED SECURITIES 3, 22 (Frank J. Fabozzi ed., 5th ed. 2001). These procedures help homogenize the risk from different loans with agency loan pools, in turn alleviating the concerns of all but the most risk averse investors.

[73]Shenker & Colletta, *supra* note 4, at 1383.

[74]Sivesind, *supra* note ?, at 320.

[75]Lewis S. Ranieri, *The Origins of Securitization, Sources of Its Growth, and Its Future Potential*, *in* A PRIMER ON SECURITIZATION 31, 31.

[76]Ranieri, *supra* note 75, at 31-32.

invested in mortgages with specific middle class oriented policy objectives in mind, they would not purchase unusually large ("jumbo") mortgages, mortgages with variable interest rates ("ARMs"), home equity loans, or—most importantly for our purposes—subprime mortgages.[77] Unmet demand in these market segments left enticing (and large) niches for private investors.[78]

In 1977 Bank of America and Salomon Brothers (with some limited cooperation from Freddie Mac) moved to take advantage these potential markets by issuing a security where outstanding loans were held in trust, with investors as beneficiaries.[79] The trust itself was entirely passive — it had no employees or assets aside from the home mortgages themselves.[80] Participations in this trust are generally recognized as the first mortgage back securities issued by the private sector—now called "private label" mortgage-backed securities.[81]

Initially, investment in these "securitized" mortgages suffered from legal and pricing problems stemming in part from the novelty of the new method of finance.[82] For instance, some large public investment funds were effectively precluded from investing in mortgage backed securities by laws meant to prevent purchases of undiversified or risky investments.[83] The New York State Retirement System, for example, could not invest in mortgages of less than a million dollars on the theory that the risks from smaller individual consumer home mortgages were too great.[84] Also, investors and brokers alike had difficulty comparing the present value of bundles of thirty year home mortgages. Since few investors were willing to keep their money tied up for thirty years, they needed a relatively reliable method for predicting what actual yields would be, so investors could compare those yields to those of other potential

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[77]MEIR KOHN, FINANCIAL INSTITUTIONS AND MARKETS 623-24 (1994).

[78]Claire A. Hill, *Securitization: A Low-Cost Sweetener for Lemons*, 74 WA. U. L. Q. 1061, 1121 (1996). One result of these trends was that thrifts began to more aggressively use their home mortgage portfolios as security for long term bond issues. Ranieri, *supra* note 75, at 32. These bonds, sometimes called mortgage-backed bonds, are different than mortgage back securities. Shenker & Colletta, *supra* note 4, at 1380-81. Income from the underlying mortgages in mortgage-backed bonds is not passed through to bond investors. *Id.* Rather the mortgages simply serve as collateral subject to foreclosure in the event of default on the bond. *Id.* The principal disadvantage of this financing structure is that the bond must be overcollateralized to cover the costs of foreclosure in the event of default on the bond. Ranirei, *supra* note 75, at 32. This creates a pocket of swamped resources in comparison to pass through mortgage backed securities. Much older than mortgage backed securities, mortgage-backed bonds date at least as far back as the late nineteenth century mortgage companies that were wiped out in the recessions of the 1890s. Shenker & Colletta, *supra* note 4, at 1380-81.

[79]Ranieri, *supra* note 75, at 33-34; Sivesind, *supra* note ?, at 321.

[80]Ranieri, *supra* note 75, at 32-33.

[81]Richard A. Brown & Susan E. Burnhouse, *Implications of the Supply-Side Revolution in Consumer Lending*, 24 ST. LOUIS U. PUBL. L. REV. 363, 392 (2005). Private label mortgage backed securities are also sometimes called non-agency securities in contrast to the older "agency" securitized mortgage loans issued by the GSEs. DAVIDSON ET AL., *supra* note 1, at 288-89. Some commentators also refer to private label mortgage backed securities as "nonconforming", since they do not meet the underwriting standards of the GSEs. *Id.*

[82]Ranieri, *supra* note 75, at 36.

[83]Ranieri, *supra* note 75, at 33.

[84]Ranieri, *supra* note 75, at 33.

investments. Without such a method, mortgage backed securities suffered from liquidity problems and were accordingly artificially undervalued.[85] Eventually, the market , along with some help from Congress in the mid-1980s,[86] succeeded in developing financial tools to overcome these hurdles. For purposes of this article, three key innovations facilitated growth in private label home mortgage backed securities.

The first crucial innovation facilitating securitization was the development of pricing models that could estimate the present value of the right to receive a portion the revenue from a pool of loans. Because mortgage backed securities issued by the government sponsored enterprises held an implicit federal guarantee, investors felt comfortable in using the face value of those securities to make investment decisions.[87] But in the private mortgage backed securities market, there were no comparable assurances for investors. They had to carefully consider the possibility that securities would not pay out as promised when deciding whether or not to invest. When private label mortgage backed securities first evolved, there was great uncertainty on how to go about making these judgments.[88] Initially, investment brokers used generalized rules of thumb to estimate value.[89] But, these estimations quickly gave way when mathematical models backed with empirical data became available.[90] First, academics and investment analysts came up with satisfactory pricing models.[91] Some of the early pricing models relied on public records of FHA mortgage histories. As mortgage-backed securities became more complex, Wall Street spent millions of dollars refining these models and

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[85]Shenker & Colletta, *supra* note 4, at 1380.

[86]Following lobbying efforts of investment bankers, Congress passed legislation to clear out the legal obstacles to private securitization of home mortgages. Ranieri, *supra* note 75, at 37. The most important legal development was passage of the Secondary Mortgage Market Enhancement Act of 1984 ("SMMEA") in which Congress preempted a variety of state laws that inhibited private home mortgage securitization, including state retirement fund laws which prevented public pension funds from investing in private home mortgage securities. Pub. L. No. 98-440, § 106(a), 98 Stat. 1689, 1691-92 (1984) (codified at 15 U.S.C. §77r-1). SMMEA also preempted state blue sky laws to allow securitizers to avoid registering under state securities laws to the same extent that securities issued by Fannie Mae, Freddie Mac, or Ginnie Mae were exempt. *Id.* § 106©, 98 Stat. at 1689 (codified at 15 U.S.C. § 77r-1©. In addition to preempting state laws, SMMEA authorized delayed delivery of home mortgage backed securities in order to facilitate forward trading. *Id.* § 102-04, 98 Stat. at 1690-91 (codified at 15 U.S.C. §§ 78g(g), 78h(a), 78k(d)(1)). And, it permitted national banks, federal credit unions, and federal savings and loans associations to invest in privately issued home mortgage backed securities. *Id.* § 105, 98 Stat. at 1691 (codified at 12 U.S.C. §§ 24, 1757). *See* Shenker & Colletta, *supra* note 4, at 1386 (summarizing key SMMEA provisions).

[87]*See infra* note 70.

[88]Ranieri, *supra* note 75, at 35-36.

[89]Ranieri, *supra* note 75, at 35.

[90]*See* DAVIDSON, ET AL., *supra* note 1, at 131-180 (introducing mortgage backed security price modeling).

[91]Ranieri, *supra* note 75, at 35-36.

generally researching ways to estimate the value of pools of home mortgages.[92] Ultimately investment analysts and academics succeeded in creating models which gave investors sufficient confidence to create tradeable securities.[93]

A second innovation was the development of risk and term partitioned securities.[94] Early home mortgage backed securities would simply transfer, or "pass through" consumer payments on each loan in the pool to investors.[95] Each investor received income from the investment as if they owned a small piece of each loan in the pool of mortgages. This created two key disadvantages for investors. First, investors could not specify ahead of time when they would be paid. For investors who had certain financial obligations, the long and uncertain return horizon on pass through mortgage securities was a serious draw back. Taking an insurance company as an example, if it stored customers' premiums in mortgage backed securities, it would run the risk that the company might need to liquify its participations in unfavorable market conditions in order to pay out insurance claims or satisfy state insurance regulatory reserve requirements. Similarly, if many borrowers in a pool of mortgages were to pay off their loans early (perhaps because declining interest rates induced refinancing), investors would not only get a smaller return than hoped for (because less interest would have accrued on the prepaid mortgages), but they would also get their money back sooner than expected. This development would force the insurance company to search for new investment options that often carry transaction costs that cut into their marginal return on assets. Furthermore, pass-through mortgage backed securities offered only one equally shared credit risk to each investor. Different investors have widely varying tolerances of risk. Some choose aggressive higher-risk/higher return investment strategies, while others choose to play it safe. Pass-through mortgage backed securities issued from a large pool of mortgages offered each of these investors only one potential investment: ownership of the income streams as paid by loans in the pool.

Partitioned securities were a response to these problems.[96] Instead of directly passing through loan payments to investors, the income created by loans in the pool was divided into different income streams suited to the time and risk preferences of investors.[97] Thus, investment bankers learned to tailor securities to the needs of different investors, making

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[92]Joel W. Brown & William M. Wadden IV, *Mortgage Credit Analysis*, *in* THE HANDBOOK OF MORTGAGE-BACKED SECURITIES 315, 315 (Frank J. Fabozzi, ed., 5th ed., 2001). Early pricing models often relied on data collected on actual performance of FHA loans, giving a limited empirical foundation to pricing models. Lowell, *supra* note 68, at 39-40.

[93]Eggert, *Predatory Lending*, *supra* note ?, at 537; Ranieri, *supra* note 75, at 35.

[94]Brown & Burnhouse, *supra* note 81, at 392.

[95]PAVEL, *supra* note 35, at 4.

[96]Lowell, *supra* note 68, at 25.

[97]Leon T. Kendall, *Securitization: A New Era in American Finance*, *in* A PRIMER ON SECURITIZATION 1,8-9 (Leon T. Kendall & Michael J. Fishman, eds., 1996).

investment in mortgage backed securities desirable to a broader range of potential investors.[98] Partitioned mortgage securities divide the income of mortgage pools into different "tranches" or "strips" each of which can be purchased by investors.[99]

By way of illustration, one security might entitle an investor to receive all the interest income—an "interest-only tranche"— from a pool of mortgages, while another security might entitle investors to receive all payment toward loan principle—a "principle-only tranche."[100] Because borrowers tend to refinance when interest rates go down, an investor who expects interest rates to drop will prefer to invest in a principle-only tranche over an interest-only tranche, since the investor is likely to quickly recoup her investment as borrowers pay their mortgages off in full.[101] An interest-only tranche would be less desirable because interest income would suffer as borrowers prepay and the outstanding number of loans within the pool generating interest declines.[102] Thus, by offering a variety of separate investment vehicles, security tranches allow investors to take strong market positions on expected movement in prepayment and interest rates.[103]

Mortgage pool trustees also learned to tailor tranches to appeal to investors that prefer investing at a variety of maturation levels.[104] For instance, insurance companies often know beforehand when the window will close on customer claims against a given insurance policy. These insurance companies may be particularly interested in a mortgage-backed security tranche with maturation dates designed to coincide with the closing of the insurance company's policy liability window.[105] Similarly, stripped mortgage backed securities with short term maturations allow banks to invest in securities that match their short term deposit liabilities.[106] Investors sometimes call issuing of these investment vehicles as "time tranching" in comparison to "credit tranching" which is based upon investment risk.[107] Collectively, different types of tranching allowed mortgage pool trustees to attract a wider variety of investors to their securities than would have been possible using "pass through" vehicles.

A final development facilitating a private label home mortgage securitization market,

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[98] *Id.*

[99] Eggert, *Predatory Lending*, *supra* note 4, at 540. "Tranche" is French for "slice." Larousse French-English/English-French Dictionary 922-23 (Faye Carney ed., 1993).

[100] Eggert, *Predatory Lending*, *supra* note 4, at 540.

[101] Hayre, et al., *supra* note ?, at 151.

[102] Eggert, *Predatory Lending*, *supra* note 4, at 540.

[103] Hayre, et al., *supra* note ?, at 151.

[104] Ranieri, *supra* note 75, at 36-37.

[105] Hayre, et al., *supra* note ?, at 155.

[106] Mortgage Research Group, *supra* note ?, at 169-170.

[107] Brown & Wadden, *supra* note 92, at 315.

was the introduction of rating agencies and credit enhancements. Most investors were willing to purchase agency issued mortgage-backed securities purely on the strength of agency reputations and assurances.[108] But, investors in private label mortgage-backed securities needed some additional assurance on whether private mortgage tranches would actually pay out as promised. For this information, investors turned to rating agencies.[109] Today the three national rating agencies, Standard and Poor's, Moody's, and Fitch Investment Company, assist investors by collecting information and research on the risk posed by various investments.[110] After doing due diligence, ratings agencies issue a credit rating on each tranch signaling to potential investors the likelihood that a particular instrument will pay interest and principle according to its terms.[111] In order to receive investment grade credit ratings on some tranches of the mortgage pool, credit rating agencies usually require the issuer to augment the reliability of those tranches through "credit enhancements."[112] Credit enhancements are contractual arrangements that increase the likelihood that a particular participation in the pool of loans will pay out according to its terms.[113]

Some analysts classify two basic types of credit enhancement: internal and external.[114] Internal credit enhancements manipulate the characteristics of the loan pool to make on-time repayment of some tranches more likely. Senior/subordinated credit structures, for example, enhance the credit risk of senior tranches by allocating losses to subordinate or junior tranches first.[115] Thus, senior tranche investors can expect on-time payment unless pool losses are so

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[108]Ranieri, *supra* note 75, at 36

[109]DAVIDSON, ET AL., *supra* note 1, at 24-25.

[110]Neil D. Baron, *The Role of Rating Agencies in the Securitization Process*, *in* A PRIMER ON SECURITIZATION 81, 81-83 (Leon T. Kendall & Michael J. Fishman, eds., 1996).

[111]*Id.* Investment credit ratings do not assess whether an investment will be profitable, but merely whether an instrument will pay according to its terms. *Id.* For instance, if an investor invests in mortgage-backed securities, and interest rates subsequently rise, then the investor will be stuck with a relatively low rate of return. Credit ratings do not address this sort of investment risk. *Id.*

[112]Daniel Singer, *Securitization Basics*, *in* ACCESSING CAPITAL MARKETS THROUGH SECURITIZATION 13, 17 (Frank J. Fabozzi, ed., 2001).

[113]DAVIDSON, ET AL., *supra* note 1, at 24-25.

[114]*See* Singer, *supra* note 112, at 17-8; Frank J. Fabozzi, et al., *Nonagency CMOs*, *in* THE HANDBOOK OF MORTGAGE BACKED SECURITIES 267, 268 (Frank J. Fabozzi, ed., 5th ed., 2001); Lina Hsu & Cyrus Mohebbi, *Credit Enhancement in ABS Structures*, *in* ACCESSING CAPITAL MARKETS THROUGH SECURITIZATION 35, 35-38 (Frank J. Fabozzi, ed., 2001); DAVIDSON, ET AL.,, *supra* note 1, at 25.

[115]Singer, *supra* note 112, at 18. This form of internal credit enhancement relies on the participation of investors that specialize in subordinated tranche investment. Schwarcz explains, "[t]he originator . . . allocates certain repayment risks to these investors, who are in the business of assessing and accepting such risks and who consequently are willing to accept a higher level of risk than the average investor." One hopes he is correct. Another possibility is that residual tranche investors are making uninformed investment decisions. Passmore & Sparks, *supra* note 70, at 285-86. Still another possibility is that residual tranche investors are managers of servicing or origination companies that derive sufficient short term profit from fees excluded from the pooling and servicing agreement.

severe that junior tranches become saturated.[116] Another internal credit enhancement is commonly known as a "turbo structure."[117] Here investors purchase a promised pay out on a tranche that is less than the aggregate assets of the underlying mortgages.[118] A turbo structure is secured by more collateral than would be necessary to pay on-time if none of the underlying mortgages underperform.[119] If the mortgages perform well, then the turbo tranches are retired early. If the mortgages underperform, the turbo tranche still pays off on time so long as the losses do not exceed the level of over-collateralization.[120] A final internal credit enhancement is a simple cash collateral account.[121] Here the security issuer funds a cash account which is held in trust for the benefit of investors who collect any tranche payout deficit out of the cash account. After all the enhanced tranches pay out, any remaining cash in the account is returned to the issuer.[122]

Conversely, external credit enhancement relies on some third party who is willing to guarantee some or all of the loan pool's returns.[123] External credit enhancement can take the form of insurance, letters of credit, or contractual guarantees.[124] External credit enhancement will usually cover tranche losses up to a written dollar amount for the duration of the life of the pool.[125] One limitation of this strategy is that, other things being equal, the credit rating given to the mortgage-backed securities will only be as high as the third party enhancer's credit rating.[126] Nevertheless, the potential rewards from home mortgage securitization are such that many companies, including some with outstanding credit ratings, have been willing to insure or

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These fees might be sufficiently profitable that managers would accept poor performance on longer term securities.

[116]Hsu & Mohebbi, *supra* note 114, at 37.

[117]Hsu & Mohebbi, *supra* note 114, at 38.

[118]Hsu & Mohebbi, *supra* note 114, at 38.

[119]*Id.*

[120]*Id.*

[121]Singer, *supra* note 112, at 18.

[122]Singer, *supra* note 112, at 18.

[123]Fabozzi, et al., *supra* note 114, at 268; Hsu & Mohebbi, *supra* note 114, at 35. *See also* Robert D. Aicher, et al., *Credit Enhancement: Letters of Credit, Guaranties, Insurance, and Swaps (The Clash of Cultures)*, 59 BUS. LAW. 897 (2004) (comparing litigation advantages of different forms of third party external credit enhancement).

[124]Aicher, *supra* note 123, at 898.

[125]Fabozzi, et al., *supra* note 114, at 268.

[126]Hsu & Mohebbi, *supra* note 114, at 36.

guarantee senior tranches.[127]

### 2. Securitization in Action: A Typical Contemporary Home Mortgage Securitization Conduit

These developments in the private label home mortgage backed securities market facilitated a rapid increase in securitization.[128] Expanding far beyond home mortgages, Wall Street now securitizes credit card debt, automobile loans, commercial loans, equipment leases, and loans to developing countries.[129] Indeed receivables from virtually any income producing asset can securitized,[130] including physician and hospital accounts,[131] oil exploration,[132] lawsuit settlement proceeds,[133] entire business ventures,[134] or even baseball stadiums.[135] One firm famously led the way in intellectual property securitization by issuing "Bowie Bonds" with future royalties expected from pop-musician David Bowie's music portfolio.[136] More important for our purposes, throughout the 1990s Wall Street investment banking firms created a host of

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[127] Hsu & Mohebbi, *supra* note 114, at 36; Fabozzi, et al., *supra* note 114, at 268.

[128]Between 1994 and 1998 alone outstanding U.S. private label mortgage backed securities doubled from approximately 200 billion to 400 billion. Davidson, et al., *supra* note 1, at 288.

[129]Kendall, *supra* note 97, at 7.

[130]*You Can Securitize Virtually Everything*, BUS. WK., July 20, 1992, at 78.

[131]Charles E. Harrell & Mark D. Folk, *Financing American Health Security: The Securitization of Healthcare Receivables*, 50 Bus. Law. 47 (1994); Gregory R. Salathe, *Reducing Health Care Costs through Hospital Accounts Receivable Securitization*, 80 VA. L. REV. 549 (1994).

[132]Charles E. Harell, et al., *Securitization of Oil, Gas, and Other Natural Resource Assets: Emerging Financing Techniques*, 52 Bus. Law. 885 (1997).

[133]Walter Henry Clay McKay, *Reaping the Tobacco Settlement Windfall: The Viability of Future Settlement Payment Securitization as an Option for State Legislatures*, 52 ALA. L. REV. 705 (2002).

[134]Claire A. Hill, *Whole Business Securitizations in Emerging Markets*, 12 DUKE J. COMP& INT'L L. 521 (2002); Vinod Kothari, *Whole Business Securitization: Secured Lending Repackaged–A Comment on Hill*, 12 DUKE J. COMP. & INT'L L. 537 (2002).

[135]Cynthia A. Baker & J. Paul Forrester, *Home Run! A Case Study of Financing the New Stadium for the St. Louis Cardinals*, 10(2) J. STRUCTURED FINANCE 69 (Summer 2004).

[136]Sam Adler, *David Bowie $55 Million Haul: Using a Musician's Assets to Structure a Bond Offering*, 13 ENTER. L. & FIN. 1 (Aug 1997); Lisa M. Fairfax, *When You Wish Upon a Star: Explaining the Cautious Growth of Royalty-Backed Securitization*, 1999 COLUM. BUS. L. REV. 441, 442 (1999); Jennifer Burke Sylva, *Bowie Bonds Sold for Far More than a Song: The Securitization of Intellectual property As a Super-Charged Vehicle for High Technology Financing,* 15 SANTA CLARA COMPUTER. & HIGH TECH L.J.195 (1999). *See also* Jay E. Eisbruck, *Blockbuster or Flop? The History and Evolution of film Receivables Securitization, 1995-2005*, 11 J. STRUCTURED FINANCE 11 (2005); Andrew E. Katz, *Financial Alchemy Turns Intellectual Property Into Cash: Securitization of Trademarks, Copyrights, and Other Intellectual Property Assets*, 8(4) J. OF STRUCTURED AND PROJECT FINANCE 59 (Winter 2003).

complex and innovative financial conduits that funneled vast amounts money through modestly capitalized consumer financial services companies into home mortgage loans.[137] Much of this new credit was extended to borrowers with problematic credit histories (or borrowers with good credit histories that were nevertheless treated like borrowers with problematic credit histories). Although there is substantial variety in actual securitization conduits,[138] Figure A provides a graphic depiction that attempts to summarize the flow of capital and information in a typical contemporary private label securitization of subprime home mortgage loans.

Initially, a mortgage broker identifies a potential borrower through a variety of marketing approaches including direct mail, telemarketing, door-to-door solicitation, and television or radio advertising. The originator and broker together identify a loan which may or may not be suitable to the borrower's needs. The home mortgage will consolidate the borrower's other unsecured debts, refinance a pre-existing home mortgage, or possibly fund the purchase price of a home. In determining the interest rate and other pricing variables, the broker and the originator rely on one or more consumer credit reporting agencies that compile database of information about on past credit performance, currently outstanding debt, prior civil judgements, bankruptcies. Consumers are given a credit score, often based on the statistical models of the Fair Issacson & Co, a firm that specializes in evaluating consumer repayment. Then, the borrower formally applies for the loan. At closing, which typically takes place a week or two later, the borrower signs all the necessary paperwork binding herself to a loan which may or may not have the terms originally described. Some brokers fund the loan directly using her own funds or a warehouse line of credit, while other brokers act as an agent using the originator's capital to fund the loan.[139] In any case, the originator establishes its right to payment by giving public notice of the mortgage through recording it with a county recorders office.[140] Then, in a typical conduit the originator will quickly transfer the loan to a subsidiary of an investment banking firm.[141] This subsidiary which is alternatively called the securitization sponsor, or seller, then transfers the loan and hundreds of others like it into a

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[137]Securitization of Financial Assets, *supra* note 1, at §3.02[D].

[138]Schwarcz goes so far as to say they are "limited only by the creativity of the professionals involved." Schwarcz, *supra* note ?, at 138. While this may go too far, it is certainly well beyond the scope of this article to classify all of them. This exposition of securitization conduits is necessarily a generalization.

[139]There are a variety of methods lenders and brokers use to initially fund home mortgage loans. Professor Eggert explains, "[m]ortgage brokers may originate the loans in their own names in three ways: (1) by using 'table funding' provided by the pre-arranged buyer of the loan; (2) by access to a warehouse line of credit; or (3) by supplying the broker's own funds." Eggert, *Predatory Lending*, *supra* note 4, at 538 (citations omitted).

[140]Unrecorded mortgage loans may become uncollectible if a subsequent creditor lends against same residence or if the is sold without permission from mortgagee. *See* Lynn M. LoPucki & Elizabeth Warren, Secured Credit: A Systems Approach 337-352 (5th ed. 2005) (providing introduction to mortgage recording system). Typically, when a mortgage lender assigns one if its loans, the assignee must re-record its mortgage (and pay another fee) with the county recording office or risk losing its priority vis-a-vis other creditors or purchasers. *Id.*

[141]Eggert, *Predatory Lending*, *supra* note 4, at 538.

pool of loans.[142] This pool of loans will become its own business entity, called a special purpose vehicle ("SPV").[143] The SPV can be a corporation, partnership, or limited liability company, but most often is a trust.[144] Aside from the mortgages, the SPV has no other assets, employees, or function beyond the act of owning the loans. Under the agreement transferring the loans into the pool, the SPV agrees to sell pieces of itself to investors.[145] In a typical transaction, an underwriter purchases all the "securities"—here meaning derivative income streams drawn from payments on the underlying mortgages—issued by the pool.[146] Usually employing one or more placement agents who work on commission, the underwriter then sells securities to a variety of investors with different portfolio needs.

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[142]Sometimes the loan will be held in special purpose vehicle that is a wholly owned subsidiary of the originator or the underwriter while awaiting assignment into an independent SPV that will issue securities. *See, e.g.,* Schwarcz, *supra* note ?, at 142 (describing advantages of "two tier" securitization conduit structures).

[143]Shenker & Colletta, *supra* note 4, at 1377-78. Some commentators use the equivalent term special purpose entity, or "SPE".

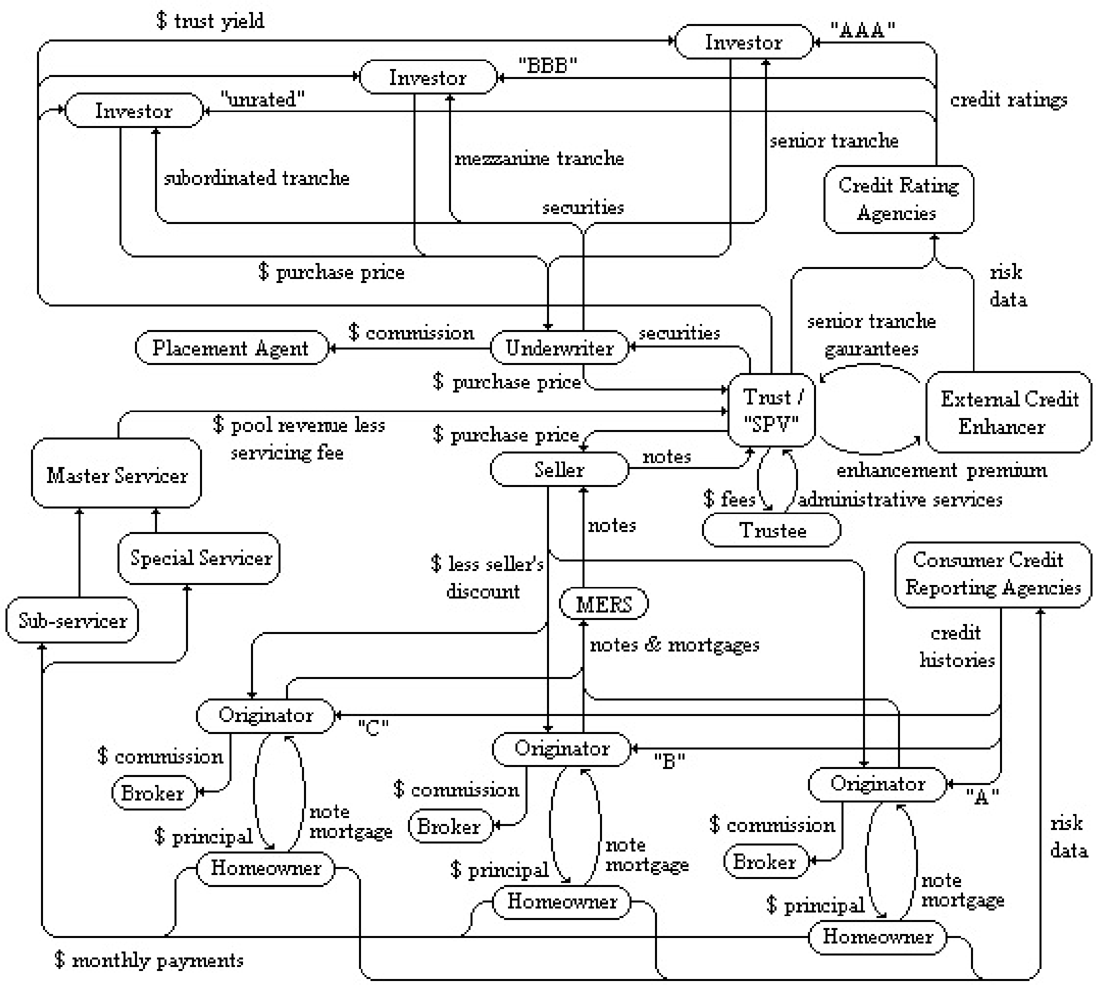
[144]Hill, *supra* note 78, at 1067n.25, 1098 n.162.

[145]Eggert, *supra* note 4, at 539n.156.

[146]Although the term "securities" is commonly used to describe investors' participations interests in asset pools, the actual legal rights may or may not be securities for purposes of federal and state securities laws. Hill, *supra* note 78, at 1067-68; Shenker & Colletta, *supra* note 4, at 1378-79.

In designing the SPV and its investment tranches, the seller typically works closely

Figure A -- Subprime Home Mortgage Securitization Structure




with a credit rating agency that will rate the credit risk of each tranche.[147] The credit rating agency investigates credit risk of the underlying mortgages as well as the risks posed from

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> [147]A Kirkland and Ellis partner specializing in securitization colorfully summarizes this processes: Obtaining rating agency approval is no mean feat. The rating agencies are thorough and cautious, and they can be idiosyncratic. Rating agency bashing is a popular sport in asset-backed circles, but it must be admitted that the rating agencies have a difficult assignment. They are provided with reams of data and documents and are put under a lot of time pressure. It is reasonable to assume that at any given time the average rating agency analyst has more deals than fingers. Even the best intentioned analyst may have so many deals ahead of yours that delay is inevitable.

Kenneth P. Morrison, *Observations on Effecting Your First Asset-Backed Securities Offering*, *in* ACCESSING CAPITAL MARKETS THROUGH SECURITIZATION 41, 44-45 (Frank J. Fabozzi, ed., 2001).

pooling the mortgages together.[148] Inquiry as to the former, known as "mortgage risk", focuses above all upon borrower net equity over time—which is to say, the risk that foreclosure on a defaulting mortgage will not recoup invested funds.[149] Evaluation of "pool risk" looks at factors such as the size of the loan pool and the geographic diversity of underlying mortgages.[150] Credit ratings on each tranche are essential, since they obviate the need for each individual investor to do due diligence on the underlying mortgages in the pool.[151] The rating agency will typically require some form of credit enhancement on some tranches to assign them higher investment ratings. Often this enhancement will take the form of a third party guarantee from an insurance company on losses from mortgage defaults and prepayments.[152]

The seller also arranges to sell the rights to service the loan pool to a company which will correspond with consumers, receive monthly payments, monitor collateral, and when necessary foreclose on homes.[153] Sometimes the originator retains servicing rights which has the advantage of maintaining a business relationship with homeowners.[154] But often servicing is done by a company specializing in this activity.[155] Increasingly, pooling and servicing agreements allow for several different servicing companies with different debt collection roles. A master servicer may have management responsibility for the entire loan pool. Similar to a subcontractor in construction, the master servicer may subcontract to subservicers with a loan type or geographic specialty.[156] The pooling and servicing agreement may also allow for a special servicer that focuses exclusively in loans that fall into default or have some other

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[148]Michael F. Molesky, *An Overview of Mortgage Credit Risks from a Rating Agency Perspective*, *in* THE SECONDARY MORTGAGE MARKET: A HANDBOOK OF STRATEGIES, TECHNIQUES, AND CRITICAL ISSUES IN CONTEMPORARY MORTGAGE FINANCE 317, 318, 324 (Jess Lederman, ed., 1987); Georgette C. Poindexter, *Subordinated Rolling Equity: Analysis of Real Estate Loan Default in an Era of Securitization*, 50 EMORY L.J. 519, 544 (2001).

[149]Molesky, *supra* note 148, at 318. Net equity is defined as "the market value of the home less the outstanding balance of the mortgage less the selling costs." *Id.*

[150]Larger loan pools are less likely to vary from credit rating agency pricing models, which are based on loan performance data from extremely large populations. *See* Molesky, *supra* note 148, at 334; Schwarcz, *Alchemy of Asset Securitization*, *supra* note 4, at 136. Geographic diversity of homes securing the loan pool protects investors from sever losses due to regional economic downturns. Anthony B. Sanders, *Commercial Mortgage-Backed Securities*, *in* THE HANDBOOK OF MORTGAGE BACKED SECURITIES 661, 667 (Frank J. Fabozzi, ed., 5th ed., 2001).

[151]*See* Eggert, *Predatory Lending*, *supra* note 4, at 540; Morrison, *supra* note 147, at 45; Schwarcz, *Alchemy of Asset Securitization*, *supra* note 4, at 136.

[152]*See infra* note X and accompanying text.

[153]R.K. Arnold, *Is There Life on MERS*, 11 PROPERTY AND PROBATE 32, 34 (July/August 1997);

[154]Shenker & Colletta, *supra* note 4, 1376.

[155]Arnold, *supra* note 153, at 34; Eggert, *Predatory Lending*, *supra* note 4, at 544.

[156]SECURITIZATION OF FINANCIAL ASSETS, *supra* note 1, at § 16.05[A][6].

characteristics making repayment unlikely.[157] Some servicing agreements require servicers to purchase subordinated tranches issued from the mortgage pool in order to preserve the incentive to aggressively collect on the loans.[158] Servicing rights also often change hands, "in some cases several times a year for the same loan."[159] If, for instance, a servicing company is not meeting collection goals or is charging the trust too much, the trustee may contract with a new servicer.

Many securitization deals sellers and trustees agree to hire a document custodian to keep track of the mountains of paperwork on loans in the pool.[160] A related role is commonly played by a unique company called Mortgage Electronic Registration System, Inc. ("MERS, Inc.").[161] MERS, Inc. is a corporation registered in Delaware and headquartered in the Virginia suburbs of Washington, D.C.[162] With the cooperation of the Mortgage Bankers Association of America and several leading mortgage banking firms, MERS, Inc. developed and maintains a national computer networked database known as the MERS. Originators and secondary market players pay membership dues and per transaction fees to MERS Inc. in exchange for the right to use and access MERS records. The system itself electronically tracks ownership and servicing rights of mortgages.[163] Currently more than half of all home mortgage loans originated in the United States are registered on the MERS system.[164]

In addition to keeping track of ownership and servicing rights, MERS has attempted to take on a different, more aggressive legal role. When closing on a home mortgage participating originators now often list MERS as the "mortgagee of record" on the paper mortgage.[165] The mortgage is then recorded with the county property recorder's office under MERS, Inc.'s name, rather than the originator's name—even though MERS does not solicit, fund, service, or

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[157]Poindexter, *supra* note 148, at 537-38; Eggert, *Predatory Lending*, *supra* note 4, at 544.

[158]Poindexter, *supra* note 148, at 537-38.

[159]Arnold, *supra* note 153, at 35.

[160]Poindexter, *supra* note 148, at 539.

[161]In the past few years MERS registration has grown very rapidly. At the beginning of 2001 MERS had registered 3.5 million mortgages in its system—"less than five percent of all the outstanding mortgages in America." Whitman, *supra* note 163, at 61. But, by September of 2002, this figure rose to ten million. *MERS registers 10 Million Loans*, INSIDE MERS 1 (November/December 2002).In November of 2003 MERS registered its 20 millionth loan—a growth rate in loans registered of almost 200% per year. *MERS Registers 20 Million Loans*, INSIDE MERS 1 (January/February, 2004). The MERS website proclaims that the corporation's "mission" is to "register every loan in the United States." *About MERS*, available at http://www.mersinc.org/about/index.aspx (last visited 6/9/2004).

[162]Arnold, *supra* note 153, at 33.

[163]MERS, Inc. does not currently handle notes as an agent for holders. Dale A. Whitman, *Chinese Mortgage Law: An American Perspective*, 15 COLUM. J. ASIAN L. 35, 61 (2001).

[164]R.K. Arnold, *Viewpoint*, INSIDE MERS 1 (May/June 2004).

[165]Alternatively, the originator may close in its own name and then record an assignment to MERS. Phyllis K. Slesinger & Daniel McLaughlin, *Mortgage Electronic Registration System*, 31 ID. L. REV. 805, 806-7 (1995).

ever actually own the loan. MERS then purports to remain the mortgagee of record for the duration of the loan even after the originator or a subsequent assignee transfers the loan into an SPV for securitization. MERS justifies its role by explaining that it is acting as a "nominee" for the parties.[166]

The parties obtain two principle benefits from attempting to use MERS as a "mortgagee of record in nominee capacity." First, under state secured credit laws, when a mortgage is assigned, the assignee must record the assignment with the county recording office, or risk losing priority *vis-a-vis* other creditors, buyers, or lienors.[167] Most counties charge a fee to record the assignment, and use these fees to cover the cost of maintaining the real property records. Some counties also use recording fees to fund their court systems, legal aid organizations, or schools. In this respect, MERS role in acting as a mortgagee of record in nominee capacity is simply a tax evasion tool. By paying MERS a fee, the parties to a securitization lower their operating costs.[168] The second advantage MERS offers to its customers comes later when homeowners fall behind on their monthly payments. In addition to its document custodial role, and its tax evasive role, MERS also frequently attempts to bring home foreclosure proceedings in its own name.[169] This eliminates the need for the trust—which actually owns the loan—to foreclose in its own name, or to reassign the loan to a servicer or the originator to bring the foreclosure.[170]

Altogether, these businesses have created an extremely powerful and lucrative device for marshaling capital into home mortgage loans. Securitization can decrease the information costs for investors interested in investing in home mortgages. By pooling mortgages together and relying on a rating agency to assess the securities funded by the pool, investors can have a relatively reliable prediction of expected returns without investigating each individual originator and each individual loan.[171] Also, securitization allows loan originators to make great profit from origination fees by leveraging limited access to capital into many loans. Even lenders with modest capital can quickly assign their loans into a securitization conduit, and use

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[166]Slesinger and McLaughlin attempt to explain:

Consistent with mortgage participations where a lead participant holds legal title on behalf of the other participants, and with secondary market transactions where mortgage servicers hold legal title on behalf of the other investors, MERS will serve as mortgagee of record in a nominee capacity only. After registration, all subsequent interests will be established electronically.

Slesinger & McLaughlin, *supra* note 165, at 806-7.

[167]Arnold, *supra* note 153, at 35-36.

[168]Whitman, *supra* note 163, at 61.

[169]BAXTER DUNAWAY, 2 LAW OF DISTRESSED REAL ESTATE § 24:20 (2003).

[170]Arnold, *supra* note 153, at 35. (asserting "foreclosures can be done in the name of MERS without the need to reassign the mortgage."). There remain significant unsettled legal issues regarding MERS' authority to foreclose. Some courts have dismissed foreclosure suits brought by MERS insisting that the foreclosure must be brought by the actual owner of the loan. *See* Mortgage Electronic Registration Systems, Inc. v Dewinter, Case No. 16-2004-CA-002440-XXXX-MA, Division CV-H, Fourth Judicial Circuit, Florida (2005).

[171]Hill, *supra* note 78, at 1086-87.

the proceeds of the sale to make a new round of loans.[172] These advantages have increased consumer access to purchase money mortgages, home equity lines of credit, and cash-out refinancing. And while, in general, this is a positive development for American consumers, it has had profound and less beneficial consequences for some borrowers. In the next Part, I turn to the nexus between home mortgage-backed securities and predatory lending.

## II. SECURITIZATION AND PREDATORY LENDING

### *A. Predatory Structured Finance: Are Predatory Lenders Funded by Predatory Financiers?*

By the early 1990s private label securitization conduits became an entrenched and accepted method of home mortgage finance. It was also in this period that the country saw an "explosion" in a relatively new and aggressive form of "supprime" mortgage lending.[173] In the parlance of mortgage lending industry, "prime mortgages" are generally those that qualify to be resold to Fannie Mae or Freddie Mac. Both GSEs have strict automated underwriting standards, use widely accepted financial models, require standardized documentation, and pay similar prices for all the loans they purchase.[174] All of these factors stabilize and homogenize prime mortgage loans allowing the secondary market to treat prime loans like a commodity, rather than long term, tenuous financial relationships.[175] In contrast, "subprime" mortgages are typically—though by no means always—made to borrowers with problematic credit histories that do not meet the guidelines of the GSEs.[176] Unlike prime lenders, subprime lenders usually

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[172] Eggert, *Predatory Lending*, *supra* note 4, at 546.

[173] Dan Immergluck, *Stark Differences: Explosion of the Subprime Industry and Racial Hypersegmentation in Home Equity Lending*, *in* HOUSING POLICY IN THE NEW MILLENNIUM, 257, 257 (Susan M. Wachter & R. Leo Penne, eds. 2001). Between 1993 and 1999 the number of subprime refinance loans increased from approximately 80,000 to 790,000. Harold L. Bunce, et al., *Subprime Foreclosures: The Somking Gun of Predatory Lending*, *in* HOUSING POLICY IN THE NEW MILLENNIUM, 257, 257 (Susan M. Wachter & R. Leo Penne, eds. 2001). *See also* Cathy Lesser Mansfield, *The Road to Subprime "HEL" Was Paved with Good Congressional Intentions: Usury Deregulation and the Subprime Home Equity Market*, 51 S.C. L. REV. 473, 473 (2000) (discussing legal origins of growth in subprime lending).

[174] Bhattacharya, et al., *Overview of the Mortgage Market*, *supra* note ?, at 22; FREDDIE MAC, AUTOMATED UNDERWRITING: MAKING MORTGAGE LENDING SIMPLER AND FAIRER FOR AMERICA'S FAMILIES, at Ch. 1 (1996) available at http://www.freddiemac.com/corporate/reports/moseley/mosehome.htm (last viewed August 18, 2004).; Ronald J. Mann, *Searching for Negotiability in Payment and Credit Systems*, 44 UCLA L. REV. 951, 971 (1997); Greely, *supra* note 2, at 169-70.

[175] Greely, *supra* note 2, at 169-70.

[176] One Freddie Mac study of 15,000 consumer credit histories reportedly found that between 10 to 50 percent of subprime borrowers actually qualified for prime loans. FREDDIE MAC, AUTOMATED UNDERWRITING, *supra* note 174, 176, at Ch. 5 n.5 (1996) available at http://www.freddiemac.com/corporate/reports/moseley/mosehome.htm (last viewed August 18, 2004). More recently, U.S. Housing and Urban Development Economist found that over a third of all borrowers paying the highest interest rates did so despite the fact that they were high quality borrowers. Darryl E. Getter, *Consumer Credit Risk and Pricing*, 40 J. CONSUMER AFFAIRS 41, 50 (2006).

securitize their loans. "That means subprime originators have much more leeway when it comes to setting rates and underwriting standards. As a result, rates, fees, and program guidelines vary drastically depending on which broker or lender a consumer visits."[177] In the rush originate new loans, some lenders have even disregarded their *own* underwriting guidelines.[178] Unlike prime loans where access to the secondary market is guarded by the play-it-safe GSEs, the secondary subprime market is filled with aggressive investors and businesses looking to maximize their profits by any possible means.

One advantage of non-uniform underwriting in the subprime market is the ability to penetrate into markets not served well by prime lenders. For example, some small business owners have difficulty documenting their income, while other potential borrowers' income may come in irregular or seasonal intervals.[179] Both of these factors tend to lower the borrower's risk profile as evaluated by the GSES's automated underwriting guidelines.[180] Similarly, many subprime borrowers want to finance non-traditional housing stock, including especially manufactured homes, which are often located on leased real estate.[181] Moreover, subprime borrowers often lack strong relationships with depository institutions, and thus tend to be more amenable to alternative marketing strategies, such as direct mail, telephone solicitation, email spam, internet advertizing, and even door-to-door sales. These characteristics have facilitated the commercial practices and contract terms that too often create ethically and legally questionable loans.

The result has been a steady stream of consumer horror stories from this segment of the mortgage market and widespread accusations of "predatory lending."[182] While agreement

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[177]Michael D. Larson, *It's buyer beware when you're shopping for a subprime loan*, Bankrate.com, (Feb. 2, 2001), available at <http://www.bankrate.com> (visited May 31, 2001). *See also* Neil J. Morse, *Coping with a wild market*, 62(4) MORTGAGE BANKING 107 (1 January 2002). Evan M. Gilreath, *The Entrance of Banks into Subprime Lending: First Union and the Money Store*, 3 N.C. BANKING INST. 149, 152-53 (1999). *See also* WEICHER, *supra* note ?, at 13 ("In sharp contrast to the prime mortgage market, there are no generally accepted underwriting guidelines for subprime home equity lenders. Individual firms set their own guidelines. . . For this reason, subprime loans cannot be treated as a standard commodity, again in contrast to loans in the prime market.").

[178]*See, e.g.,* Jesse Eisinger, *Mortgage Market Begins to See Cracks as Subprime-Loan Problems Emerge*, WALL ST. J., Aug. 30, 2006, at C1 (in 2004-05 Washington Mutual originated $30 billion in non-conforming mortgage loans without adjusting its underwriting guidelines for rising interest rates during the period).

[179]Daniel P. Lindsey, *Mortgage Loans that Invite Fraud*, CHI. TRIB., Nov. 15, 2005, at 22.

[180]*Id.*

[181]Ranieri, *supra* note 75, at 39-40.

[182]*See infra* notes 9 to 11 and accompanying text. In previous research I have defined and described predatory mortgage lending practices. *See* PETERSON, TAMING THE SHARKS, *supra* note 27, at 29-36, 178-79, 214-18; Peterson, *Federalism and Predatory Lending, supra* note 13, at 12-25. For purposes of this discussion predatory mortgage lending involves one or more of the origination or servicing practices:

- fraud, misleading terms, false estimates, and inadequate disclosure
- excessive rates and fees
- broker commissions for loans that exceed a risk adjusted price
- high pressure sales
- inclusion of overpriced or unnecessary insurance

on what constitutes a predatory loan has been notoriously difficult to establish, a national consensus has emerged that at least some loans in some situations are fairly characterized as predatory. Indeed, federal administrative agencies under both Republican and Democratic leadership have relied on the term in describing harsh lending practices.[183] An impressive and growing corpus of empirical research buttresses predatory lending horror stories as much more than mere anecdote.[184] In the legal

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- unnecessarily harsh prepayment penalties
- inflated appraisals, forgery
- collusion with disreputable home improvement contractors or other vendors
- targeting of vulnerable groups, including racial minorities, immigrants, the elderly, persons with visual impairment, or persons with mental impairment
- distorting loan structure to avoid the application of consumer statutes
- allocating insufficient time to review documents at closing
- mark ups on third party services
- repeated refinancing of loans over a short period of time to capture closing costs
- extending credit without regard to the borrower's ability to repay
- engineering servicing systems that encourage late payment to generate fee revenue
- incorrect calculation of interest and other charges
- ignoring correspondence, telephone calls, and otherwise refusing to provide account information
- abusive or harassing collections
- excessive and unnecessary attorney fees to borrowers in arrears
- engineering servicing systems that encourage foreclosure to generate fee revenue
- failure to properly maintain tax and insurance escrow accounts
- delay and obstruction of judicial, administrative, and consumer investigations and discovery
- unfair arbitration terms

For further exposition of predatory mortgage lending practices *see infra* note 185.

[183]*See, e.g.,* John Ashcroft, Attorney General, *Remarks Commemorating the 33rd Anniversary of the Fair Housing Act* (April 11, 2001) reprinted at: <http://www.usdoj.gov/crt/housing/ashcroft_april01.htm> (visited Oct. 9, 2003).

[184]ACORN, The High Cost of Credit: Disparities in High-Priced Refinance Loans to Minority Homeowners in 125 American Cities (2005) www.acorn.org (compiling Home Mortgage Disclosure Act data to show that Blacks were 2.7 times more likely than whites to have interest rates three percentage points higher than comparable term treasures for first lien loans); William C. Apgar, Jr. & Christopher E. Herbert, Abt Associates, Subprime Lending and Alternative Financial Service Providers (2005), http://abtassociates.com/reports/final_abt_subprime_Feb_17.pdf ("[E]ven after including a variety of controls for neighborhood credit risk, neighborhoods where blacks account for a majority of households had much higher subprime shares of originations."); Paul Bellamy, Ohio Community Reinvestment Project, The Expanding Role of Subprime Lending in Ohio's Burgeoning Foreclosure Problem, http://www.cohioh.org/projects/ocrp/SuprimeLendingReoprt.pdf (increases in foreclosure suggests "[m]ortgage brokers who connect borrowers with subprime lenders are not currently held responsible for the quality of the loans that they are originating."); Debbie Gruenstein Bocian, et, al., *Unfair Lending: The Effect of Race and Ethnicity on the Price of Subprime Mortgages*, Center for Responsible Lending, May 31, 2006, www.responsiblelending.org (African American and Latino borrowers are more likely to receive higher-rate subprime home loans than whites even when controlled for legitimate risk factors); Calvin Bradford, Center for Community Change, Risk or Race: Racial Disparities in the Subprime Refinance Market (2002); Steven Bourassa, Predatory Lending in Jefferson County: A Report to the Urban League (2003), www.ulu.org/Predatory%20Lending%20Report.pdf (used court records to demonstrate one-third of residential foreclosures involved loans with predatory features); Harold L. Bunce, et al., *Subprime Foreclosures: The Somking Gun of Predatory Lending*, *supra* note 173, 184 (finding that high foreclosure rates in black and low income communities may be suggestive of predatory lending); Keith Ernst et al., *North Carolina's Subprime Home Loan Market After Predatory Lending Reform: A Report from the Center for*

academy outrage over the narrative and empirical evidence of predatory mortgage lending has also led to a large body of legal scholarship on the issue. Many articles have identified or defined predatory lending and advocated substantive legal rules or standards for controlling it.[185] Several commentators have focused on the racial undertones to the issue.[186] Others have

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*Responsible Lending* at iv (Aug. 13, 2002) (concluding that "reductions in predatory lending are estimated to have generated considerable savings to consumers while preserving continued access to credit under fair terms"), *available at* http://www.responsiblelending.org; Steven R. Holloway, *Exploring the Neighborhood Contingency of Race Discrimination in Mortgage Lending in Columbus, Ohio*, 88 ANNALS OF ASS'N OF AM. GEOGRAPHERS 252, 253 (1998) (arguing that race-based and place-based discrimination, though distinct, remain fundamentally intertwined); Daniel Immergluck & Marti Wiles, Woodstock Institute, Two Steps Back: The Dual Mortgage Market, Predatory Lending, and the Undoing of Community Development (1999); Dan Immergluck & Geoff Smith, *Measuring the Effect of Subprime Lending on Neighborhood Foreclosures: Evidence from Chicago*, 40 Urb. Aff. Rev. 362 (2005) (subprime loans lead to clusters of foreclosure in vulnerable neighborhoods); Howard Lax, et al., Subprime Lending: An Investigation of Economic Efficiency, Unpublished article (2000) (finding private label subprime loans have higher interest rates than loan purchased by Freddie Mac and Fannie Mae with the same credit risk); We Li & Kieth Ernst, Center for Responsible Lending, The Best Value in the Subprime Market: State Predatory Lending Reforms (2006), www.responsiblelending.org/pdfs/rr010-State_Effects-0206.pdf (showing state predatory lending legislation reduces abusive terms without drying up subprime credit availability); National Training Information Center, Preying on Neighborhoods: Subprime Mortgage Lenders and Chicagoland Foreclosures (1999) (subprime loans lead to a disproportionate number of foreclosures); Jane S. Pollard, *Banking on the Margins: A Geography of Financial Exclusion in Los Angeles*, 28 ENV'T AND PLAN. 1209, 1209 (1996) (examining the relationship between "the eroding competitive position of the banking industry and an unfolding geography of financial exclusion affecting one low-income community in Los Angeles"); Michael Reibel, *Geographic Variation in Mortgage Discrimination: Evidence from Los Angeles*, 21 URB. GEOGRAPHY 45, 45 (2000) (stating that "the joint contingency of applicant race/ethnicity and neighborhood race/ethnic context plays a significant role in determining mortgage application outcomes"); The Reinvestment Fund, A Study of Mortgage Foreclosures in Monroe County and the Commonwealth's Response (2004), http://www.banking.state.pa.us (Pennsylvania county's foreclosures are geographically concentrated, disproportionately involve subprime loans, and frequently involve inflated appraisals); Randall M. Scheessele, Black and White Disparities in Subprime Mortgage Refinance Lending, Housing Finance Working Paper Series, HF-014, U.S. Department of Housing and Urban Development (2002); Zach Schiller, Policy Matters Ohio, Foreclosure Growth in Ohio (2006) www.policymattersohio.org/pdf/foreclosure_growth_ohio_2006.pdf (survey of Sherif foreclosure personnel cites predatory lending as number one cause of rise in foreclosures); Eric Stein, *Quantifying the Economic Cost of Predatory Lending: A Report from the Coalition for Responsible Lending* 2 (Oct. 30, 2001) (concluding that the cost of predatory lending is $9.1 billion each year in terms of lost homeowner equity, back-end penalties, and excess interest), *available at* http://www.responsiblelending.org; Richard D. Stock , Center for Business and Economic Research, Predation in the Sub-Prime Lending Market: Montgomery County (2001) http://www.mvfairhousing.com/cber/pdf/Report.PDF (study of court records, county auditor property appraisal data, and 231 interviews suggested increase in foreclosure due to predatory practices); U.S. Department of the Treasury and the U.S. Department of Housing and Urban Development, Curbing Predatory Home Lending: A Joint Report (2000) (finding a disparate number of subprime borrowers are African American or senior citizens, suggesting a greater incidence of predatory lending to members of these groups); Ken Zimmerman, et al., New Jersey Institute for Social Justice, *Predatory Lending in New Jersey: The Rising Threat to Low-Income Homeowners*, www.njisj.org/reports/predatory_lending.pdf (2002) (compiling state specific evidence of predatory lending).

[185]Daniel S. Ehrenberg, *If the Loan Doesn't Fit, Don't Take It: Applying the Suitability Doctrine to the Mortgage Industry to Eliminate Predatory Lending*, 10 J. AFFORDABLE HOUSING & COMMUNITY DEV. L. 117, 129-30 (2001) (advocating the suitability doctrine as a solution to predatory lending); Kathleen C. Engel & Patricia A. McCoy, *A Tale of Three Markets: The Law and Economics of Predatory Lending*, 80 TEX. L. REV. 1255, 1337-57 (2002) (promoting a three-prong approach to reform, including an SRO requirement, new cause of action for breach of duty of suitability and agency enforcement); Julia Patterson Forrester, *Mortgaging the American Dream: A Critical Evaluation of the Federal Government's Promotion of Home Equity Financing*, 69 TUL. L. REV. 373, 456 (1994) (noting that a more open credit market, together with prohibitions against certain unconscionable credit

focused on the impact on the elderly.[187] Some commentators have focused on disclosure law,

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terms, would make fair credit available and provide adequate protection to homeowners); Celeste M. Hammond, *Predatory Lending: A Legal Definition and Update*, 34 REAL EST. L.J. 176 (2005) (summarizing predatory practices, law, and proposed reforms); Cassandra Jones Havard, *Invisible Markets Netting Visible Results: When Sub-Prime Lending Becomes Predatory*, 26 OKLA. CITY U. L. REV. 1057, 1080 (2001) (advocating closer scrutiny of risk-based pricing and market segmentation); Donald C. Lampe, *Wrong From the Start? North Carolina's "Predatory Lending" Law and the Practice vs. Product Debate*, 48 CHAP. L. REV. 135, 152 (2004) (arguing against price threshold based state predatory lending statutes in favor of national broker licensing); Cathy Lesser Mansfield, *The Road to Subprime "HEL" Was Paved with Good Congressional Intentions: Usury Deregulation and the Subprime Home Equity Market*, 51 S.C. L. REV. 473, 575 (2000) (calling for the regulation of mortgage loan rates in the subprime home equity market); Patricia A. McCoy, *A Behavioral Analysis of Predatory Lending*, 38 AKRON L. REV. 725 (2005) (challenging traditional microeconomic account of loan origination); Patricia E. Obara, *Predatory Lending*, 118 BANKING L.J. 541, 542 (2001) (advocating "common sense" regulation because costs of predatory lending laws are passed on to consumers); Dee Pridgen, *Predatory Lending: The Hidden Scourge of the Housing Boom*, 28 WYO. LAW. 18, 21 (2005) (summarizing predatory practices and calling for stronger legislation); Margot Saunders, *The Increase in Predatory Lending and Appropriate Remedial Actions*, 6 N.C. BANKING INST. 111, 142-43 (2002) (noting that, in addition to amending current predatory lending legislation, tax reforms to encourage preserving home equity and federal protection in foreclosure proceedings are necessary); Tania Davenport, Note, *An American Nightmare: Predatory Lending in the Subprime Mortgage Industry*, 36 SUFFOLK L. REV. 531, 535 (2003) (defining predatory lending and advocating more aggressive regulation); Jessica Fogel, Comment, *State Consumer Protection Statutes: An Alternative Approach to Solving the Problem of Predatory Lending*, 28 SEATTLE U. L. REV. 435 (2005) ( advocating expanded use of state deceptive trade practices statutes); Deborah Goldstein, Note, *Protecting Consumers from Predatory Lenders: Defining the Problem and Moving Toward Workable Solutions*, 35 HARV. C.R.-C.L. L. REV. 225, 255 (2000) (suggesting that current laws should be improved to require that disclosed information be clear and that lenders educate consumers regarding financial transactions and choices); Anne-Marie Motto, Comment, *Skirting the Law: How Predatory Mortgage Lenders are Destroying the American Dream*, 18 GA. ST. U. L. REV. 859, 900 (2002) (concluding that current federal predatory lending laws are ineffective and proposing a comprehensive effort to enact a new federal predatory lending law and encourage responsible lending); Abraham B. Putney, Comment, *Rules, Standards, and Suitability: Finding the Correct Approach to Predatory Lending*, 71 FORDHAM L. REV. 2101, 2139 (2003) (advocating objective rules rather than subjective standards); Michael J. Pyle, Comment, *A "Flip" Look at Predatory Lending: Will the Fed's Revised Regulation Z End Abusive Refinancing Practices?*, 112 YALE L.J. 1919, 1926 (2003) (arguing that anti-flipping provisions are only effective if they are combined with a policy of policing for abuses);

[186]Regina Austin, *Of Predatory Lending and the Democratization of Credit: Preserving the Social Safety Net in Small Loan Transactions*, 53 AM. U.L. REV. 1217 (2004) (predatory lenders exploit minority customers' preferences for informal transactions); Cecil J. Hunt, II, *In the Racial Crosshairs: Reconsidering Racially Targeted Predatory Lending Under a New Theory of Economic Hate Crime*, 35 U. TOL. L. REV. 211, 313 (2003) (arguing acceptable reform will occur only through understanding the core problem of reverse redlining and racialized predatory lending); Frank Lopez, Comment, *Using the Fair Housing Act to Combat Predatory Lending*, 6 GEO. J. ON POVERTY L. & POL'Y 73, 108-09 (1999) (arguing that the FHA is the most viable means to remedy discriminatory lending practices);

[187]Kurt Eggert, *Lashed to the Mast and Crying for Help: How Self-Limitation of Autonomy Can Protect Ellders from Predatory Lending*, 36 LOY. L.A. L. REV. 693 (2003) (advocating law allowing seniors to record an instrument providing *ex-ante* limits on their ability to create liens against their home); Harkness, *Predatory Lending Prevention Project*, *supra* note 188 (advocating mandatory counseling for some senior loan applicants); Odette Williamson, *Protecting Elderly Homeowners from Predatory Mortgage Lenders*, 2000 J. POVERTY L. & POL'Y 297, 310 (describing vulnerability of seniors and calling for stronger regulation).

counseling, or education as potential responses to the problem.[188] A few commentators particularly interested in the role of mortgage brokers.[189] Other commentators have discussed policy that might create acceptable alternatives to predatory mortgage loans.[190] Some papers evaluate and describe state specific regulation.[191] The controversial nature of the topic has

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[188] CHRISTOPHER L. PETERSON, TAMING THE SHARKS: TOWARDS A CURE FOR THE HIGH-COST CREDIT MARKET ch. 7, 8 (2004) (prescribing theoretical criteria upon which any useful price disclosure law must be based); Donna S. Harkness, *Predatory Lending Prevention Project: Prescribing a Cure for the Home Equity Loss Ailing the Elderly*, 10 B.U. PUB. INT. L.J. 1, 45 (2000) (suggesting that expansion of mandatory housing counseling into the area of home equity, non-purchase lending for borrowers over 60 would be the most effective reform); Christopher L. Peterson, *Truth, Understanding, and High-Cost Consumer Credit: The Historical Context of the Truth in Lending Act*, 55 FLA. L. REV. 807 (2003) (discussing theoretical inadequacy of price disclosure law); Alan M. White & Cathy Lesser Mansfield, *Literacy and Contract*, 13 STAN. L. & POL'Y REV. 233, 266 (2002) (asserting that consumer protection legislation should not be based on a false notion that documentary disclosure provides adequate protection); Lauren E. Willis, *Decision Making and the Limits of Disclosure: The Problem of Predatory Lending*, 65 MD. L. REV. 707 (2006) (discussing the behavioral and cognitive impediments to effective disclosure law); Donita Judge, Note, *Predatory Lending: Legalized Theft of Home Equity*, 5 RUTGERS RACE & L. REV. 293, 320-21 (2003) (advocating Congress should increase funding for programs that promote consumer awareness);

[189] Lawrence Hansen, *In Brokers We Trust–Mortgage Licensing Statutes Address Predatory Lending*, 14 J. OF AFFORDABLE HOUSING & COM. DEV. 332 (2005) (advocating broker licensing, rather than substantive rules); Lloyd T. Wilson, Jr., *Effecting responsibility in the Mortgage Broker-Borrower Relationship: A Role for Agency Principles in Predatory Lending Regulation*, 73 U.CIN. L. REV. 1471 (2005) (arguing mortgage brokers should be treated as borrower agents, rather than creditor agents);

[190] Kathleen C. Engel & Patricia A. McCoy, *The CRA Implications of Predatory Lending*, 29 FORDHAM URB. L.J. 1571 (2002) (justifying regulatory pressure under the Community Reinvestment Act on banks that engage in predatory lending); Michelle W. Lewis, *Perspectives on Predatory Lending: The Philadelphia Experience*, 12 J. AFFORDABLE HOUSING & COMMUNITY DEV. L. 491, 513-15 (2003) (advocating consumer education and the development of responsible mortgage products to help reduce the number of predatory mortgage victims); Richard D. Marisco, *Subprime Lending, Predatory Lending, and the Community Reinvestment Act Obligations of Banks*, 22 N.Y.L.SCH. J. INT'L & COMP. L. 365 (2003) (discussing standards for evaluating when subprime lending should satisfies Community Reinvestment Act obligations of depository institutions); Ronald H. Silverman, *Toward Curing Predatory Lending*, 122 BANKING L.J. 483 (2005) (advocating displacement of predatory mortgage lenders through federal support of credit unions);

[191] Kent H. Barnett, *Lending a Helping Hand?: A Guide to Kentucky's New Predatory Lending Law*, 93 KY. L.J. 473 (2004) (defending Kentucky legislature's statute); C. Lincoln Combs, Comment, *Banking Law and Regulation: Predatory Lending in Arizona*, 38 AZ. ST. L.J. 617 (2006) (advocating adoption of state predatory lending statute modeled of North Carolina law); Richard Daugherty, Note, *Will North Carolina's Predatory Home Lending Act Protect Borrowers From the Vulnerability Caused by the Inadequacy of Federal Law*, 4 N.C. BANKING INST. 569 (2000) (defending N.C. legislation); Anna Beth Ferguson, Note, *Predatory Lending: Practices, Remedies and Lack of Adequate Protection for Ohio Consumers*, 48 CLEV. ST. L REV. 607, 636 (2000) (advocating Ohio legislation based on N.C. and N.Y. law); Dan Niedzwiecki, Note, *The Massachusetts High Cost Home Loan regulations: Is This the End of Predatory Lending in the Commonwealth?,* 21 ANN. REV. BANKING L. 335, 396 (2002) (suggesting consumer protective amendments to Massachusetts predatory lending regulation); Dan Reynolds, Comment, *Predatory Lending in Oregon: Does Oregon Need an Anti-Predatory Lending Law, or Do Current Laws and Remedies Suffice?*, 83 OR. L. REV. 1081 (2004) (advocating additional state predatory lending rules); Quite a few pieces, indeed too many to list, describe various state and local predatory lending laws. *See, e.g.,* Theresa G. Franzen & Leslie M. Howell, *Predatory Lending Law Changes in 2005*, 61 BUS. LAW. 855 (2006); Ned Giles, *The Colorado Equity Protection Act: A Response to Predatory Lending Practices* 32 COLO. LAW. 79 (2003); Stephen F.J. Ornstein & Mathew S. Yoon, *Update on Cook County Predatory Lending Database*, 60 CONS. FIN. L.Q. REP. 132 (2006),

created political competition (and commentary thereon) for regulatory control over the predatory lending policy.[192]

Finally, several pieces discuss assignment of predatory loans, usually advocating a variety of limitations on the holder-in-due-course doctrine.[193] For example, Professor Eggert has pointed to the strong association between predatory lending and securitization, arguing that securitization allows originators with limited capital to "churn" a large number of loans.[194] Because securitizing originators quickly assign their loans, their own capital is only invested in any given loan for a short period of time. Once a loan is sold, the originator can use the proceeds of the sale to find a new consumer for another loan, and so on. In effect, securitization uses Wall Street capital to transform relatively small businesses into multi-million dollar institutions with a tremendous impact on the lives of entire communities. Similarly, Professors Engel and McCoy have suggested that the secondary market is fully

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[192]Baher Azmy, *Squaring the Predatory Lending Circle*, 57 FLA. L. REV. 295 (2005) (arguing against federal preemption of state predatory lending laws); Marcel C. Duhamel, *Predatory Lending and National Banks: The New Visitorial Powers, Preemption and Predatory Lending Regulations*, 121 BANKING L.J 455 (2004) (suggesting the need for uniform regulation of national banks justifies preemption of state predatory lending statutes by the OCC); Kathleen C. Engel, *Do Cities Have Standing? Redressing the Externalities of Predatory Lending*, 38 CONN. L. REV. 355 (2006) (advocating municipal litigation against predatory lenders); Christopher L. Peterson, *Federalism and Predatory Lending*, *supra* note 4 (political economy of banking regulation magnifies the effect of federal preemption of predatory lending law suggesting a deregulatory agenda); Frank J. Lopez, *Examining the Viability of Bringing a Predatory Lending Class Action*, 9 J. AFFORDABLE HOUSING & COM. DEV. L. 258 (2000) (punitive damage deterrent makes class action litigation appropriate vehicle for preventing predatory lending); Elizabeth R. Schiltz, *The Amazing, Elastic, Ever-Expanding Exportation Doctrine and its Effect on Predatory Lending Regulation*, 88 MINN. L. REV. 518 (2004) (arguing federal preemption could be used to protect consumers); Julie L. Williams & Michael S. Bylsma, *Federal Preemption and Federal Bank Agency Response to Predatory Lending*, 59 BUS. LAW. 1193 (2004) (national bank regulators respond to criticism); Nicholas Bagley, Comment, *The Unwarranted Preemption of Predatory Lending Laws*, 79 N.Y.U .L. REV. 2274 (2004) (challenging legality of federal banking regulatory preemption of state predatory lending statutes); Laura Dietrich, *Massachusetts' New Predatory Lending Law and the Expanding Rift Between Federal and State Lending Protection*, 26 B.C. Third World L.J. 169, 205 (2006) (advocating Congress deflect OCC preemption and cede regulatory power to states) Diana McMonagle, *In Pursuit of Safety and Soundness: An Analysis of the OCC's Anti-Predatory Lending Standard*, 31 FORDHAM URB. L.J. 1533 (2004) (criticizing effectiveness of national bank oversight);

[193]Kurt Eggert, *Held Up in Due Course: Predatory Lending, Securitization, and the Holder in Due Course Doctrine*, 35 CREIGHTON L. REV. 503, 640 (2002) (claiming that the holder in due course is no longer necessary in commercial loans); Kathleen C. Engel & Patricia A. McCoy, *Predatory Lending: What Does Wall Street Have to Do With It?*, 15 HOUSING POL'Y DEBATE 715 (2004) (advocating punitive damage assignee liability for predatory origination in the absence of federally mandated due diligence); Julia Patterson Forrester, *Constructing a New Theoretical Framework for Home Improvement Financing*, 75 OR. L. REV. 1095, 1138 (1996) (concluding that promissory notes and power of sale foreclosure must be prohibited in contractor-connected home improvements loans to protect vulnerable homeowners); Cassandra Jones Havard, *To Lend or Not to Lend: What the CRA Ought to Say About Sub-Prime and Predatory Lending*, 7 FLA. COSTAL L. REV. 1 (2005) (arguing mortgage assignees that do not do appropriate due diligence should be denied holder in due course status); David G. Weiner, Comment, *Assignee Liability in State Predatory Lending Laws: How Uncapped Punitive Damages Threaten the Secondary Mortgage Market*, 55 EMORY L.J 535 (2006) (attacking assignment rules that provider unlimited assignee punitive damage liability); Siddhartha Venkatesan, Note, *Abrogating the Holder in Due Course Doctrine in Subprime Mortgage Transactions to More Effectively Police Predatory Lending*, 7 N.Y.U. J. LEGIS. & PUB. POL'Y 177, 177 (2003) (advocating an affirmative cause of action against assignees for predatory lending victims).

[194]Eggert, *supra* note 4, at 546.

capable of recognizing which loans include predatory terms and behaviors.[195] Several media exposes have pointed a finger of blame at Wall Street.[196] And, a growing chorus regulators, consumer advocates, student groups, faith based investment companies have all alleged that secondary mortgage market participants are willfully profiting from predatory lending.[197] Indeed, the national debate over predatory lending is currently shifting away disputes over the definition of predatory lending and the question of whether "something" should be done. Instead discussion amongst policy makers and most academics has more recently focused on who should be held responsible for predatory practices. The result has been a trend (discussed further in Part III) amongst both state legislatures and the judiciary of experimenting with the outer boundaries of liability for predatory lending.

Of the businesses fueling this search for responsibility, perhaps no secondary market participant has drawn more criticism than the investment banking firm of Lehman Brothers. For over a hundred years Lehman has been recognized as one of the nation's leading firms in providing financial services to corporations, governments, and individuals with large financial holdings.[198] But in the past decade Lehman's reputation has suffered from its business dealings with mortgage originators and servicers. In at least five separate episodes Lehman Brothers has been involved in predatory lending scandals—albeit in each instance through indirect involvement. First, Lehman assisted Household Finance in securitizing subprime mortgage loans during a period when Household was indisputably engaging in predatory lending.[199] A coalition of state attorneys general sued Household accusing it of a raft of deceptive, fraudulent, unconscionable, and statutorily prohibited lending practices.[200] While Lehman escaped liability, Household eventually agreed to the largest predatory lending settlement —nearly half a billion dollars—in U.S. history.[201] Second, Lehman was a major underwriter of

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[195]Engel & McCoy, *Wall Street*, *supra* note 193, at 741-42.

[196]Diana Henriques with Lowell Bergman, *Mortgaged Lives: A Special Report: Profiting From Fine Print With Wall Street's Help*, N.Y. TIMES, March 15, 2000; Bobbi Murray, *Wall Street's Soiled Hands*, THE NATION, July 15, 2002, available at http://www.thenation.com/doc/20020715/murray2.

[197]*See, e.g.,* Michael Gregory, *The Predatory Lending Fracas: Wall Street Comes Under Scrutiny in the Subprime Market as Liquidity Suffers and Regulation Looms*, INVESTMENT DEALERS' DIGEST, June 26, 2000 ("Just last week Senator Charles Schumer, D-N.Y., . . . [said] 'The bottom feeders of society, these predatory lenders, reach up to the highest economic titans in society, and the two work together, and we have to break that link.").

[198]Lehman Brothers, Fact Book 2 (2005), http://www.lehman.com/who/factbook/pdf/2005_Fact_Book.pdf.

[199]*See* Jonathan Finer & Charles R. Babcock, *The Lure of High-Risk Loans; Huge Profits Drive Practice's Spread Despite Lawsuits*, WASH. POST, July 12, 2004, at E01

[200]Editorial, *Borrowed Trouble*, RALEIGH NEWS & OBSERVER, April 12, 2004, A10.

[201]Jonathan Finer & Charles R. Babcock, *The Lure of High-Risk Loans; Huge Profits Drive Practice's Spread Despite Lawsuits*, WASH. POST, July 12, 2004, at E01 ("In the past few years, regulators and prosecutors have cracked down on some predatory lending practices. In 2002, Household International Inc. agreed to pay borrowers $484 million, a few weeks after a division of Citigroup Corp. settled a case with the Federal Trade Commission for $215 million.").

Delta Funding Corporation, a firm that specializes in subprime mortgage lending.[202] During Lehman's business relationship with Delta Funding, Delta settled a predatory lending lawsuit with the New York Attorney General for targeting low income minorities in Brooklyn and Queens.[203] In addition to a variety of other predatory terms, the company had been making loans with monthly payments larger than customers' monthly income—"virtually guaranteeing default on the loan."[204] Third, Lehman became closely involved with First Government Mortgage another company frequently accused of predatory lending and eventually signed an enforcement agreement with the Department of Housing and Urban Development.[205] Instead of shunning First Government, Lehman bought one of its subsidiaries after convincing the Office of Thrift Supervision to allow Lehman to keep the subsidiary's savings and loan charter despite protests by consumer organizations over predatory lending.[206] Fourth, Lehman Brothers was the primary underwriter for Conseco Finance Company which was a subsidiary of a large insurance company.[207] Conseco Finance, once the nation's largest originator of mobile home

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[202] *If Trusts Were to Break Open: The Shake-Up in Subprime Lending and Its Impact on ABS*, ASSET SALES REP., June 26, 2000.

[203] Office of New York State Attorney General Eliot Spitzer, Press Release, Spitzer Announces Landmark $6 Million Settlement with Long Island Mortgage Company: A.G Had Charged that Delta Funding Was Targeting Low Income, Minority Neighborhoods With High Interest, Illegal Home Loans, June 23, 1999, http://www.oag.state.ny.us/press/1999/jun/jun23a_99.html.

[204] Ron Howell and Randi Feigenbaum, *Loans of Contention: Customers, Attorney General Say Mortgage Firm Uses Unfair Tactics*, NEWSDAY, Oct. 31, 1999, at A08; Paul D. Davies, *Housed in Debt: They are Poor, In Debt, and Have Bad Credit: Lenders Prey on them to Cash in on their Homes*, PHIL. DAILY NEWS, February 5, 2001, at 3.

[205] Heather Timmons, *Lenders to Less-than-Perfect Risks Tarnished by Rising Fraud Claims*, AM. BANKER, September 3, 1997, at 1 (discussing predatory First Government loans to 59-year-old disabled military veteran); *HEL Originators Draw Scrutiny*, ASSET SALES REPORT, September 8, 1997, 1997 WLNR 3347335 (discussing five different predatory lending suits against First Government); Julie Hyman, *Officials Aim to Curb Loan Sharks*, WASH. TIMES, July 10, 2000, at D10 (discussing predatory lending suit against First Government by 63-year-old, partially literate, retired painter ); Michael D. Larson, *Predatory Lending: One Victim's Story*, Bankrate.com, April 13, 2000, http://www.bankrate.com/brm/news/mtg/20000413.asp (discussing predatory lending lawsuit against First Government by 78-year-old widow).

[206] David Harrison, *Capital Briefs: Activists Question Lehman's Loan Record*, AM. BANKER, May 17, 1999, at 2.

[207] *A Disaster in Slow Motion: Conseco's Likely Bankruptcy is No Surprise to ABS Professionals*, INVESTMENT DEALERS' DIGEST, August 19, 2002. A trade journal explained:

> Conseco also helped a number of securitized debt underwriters climb the league tables. Lehman Brothers and CSFB [Credit Suisse First Boston] were the two underwriters that benefitted most from Conseco deals. Of the Conseco debt deals issued since 1999, Lehman has a 31.9% market shar on 13 issues underwritten, while CSFB brought 23% of the Conseco deals to market, according to Thompson. Such deals may have helped Lehman secure its standing in U.S. ABS, where the firm is in a tight battle for position with such rivals as Morgan Stanley and Bear, Stearns & Co.

*Id.*

loans,[208] was the subject of dozens of media exposes and lawsuits for predatory lending.[209] Among other predatory practices, Conseco chronically used inflated appraisals of mobile homes to justify loans packed with unnecessary fees and vulturous insurance policies.[210] When families could not pay their loans back, they discovered they were trapped in the loans because their loan balances were larger than the resale value of their homes.[211] Investors in the loans took large hits when the credit rating agencies downgraded Conseco backed mortgage securities. Eventually Conseco Finance's lawsuits and bad loans dragged its parent company into bankruptcy.[212] But not just any bankruptcy—Conseco was the third largest corporate bankruptcy in U.S. history, after the scandal plagued World Com and Enron bankruptcies.[213]

And finally fifth, Lehman Brothers was the primary financier for First Alliance, a company regarded by consumer advocates as one of the nation's worst predatory lenders.[214] Lehman gave First Alliance a warehouse line of credit from which to originate loans, and then purchased those loans immediately after First Alliance made them.[215] Then Lehman Brothers packaged First Alliances loans and sold them to investors.[216] Throughout the late 1990s First Alliance was the subject of multiple individual and class action lawsuits as well as lawsuits

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[208]Frank J. Fabozzi, *The Structured Finance Market: An Investor's Perspective*, FIN. ANALYSTS J., May 5, 2005, at 27.

[209]*See, e.g.,* Dana Ambrosini, *Consumer Organizations Try to Fight 'Predatory Lending' Practices*, CONN. POST, May 25, 2002; Deb Gruver, *Conseco Clients Demand Action: A Group of Homeonwers Turns to State and Federal Officials for Action on Predatory-Lending Complaints Against the Company*, WICHITA EAGLE, January 18, 2002, at 3B; Deb Gruver, *Agency, State Fight Predatory Lending with $36,000 Grant*, WICHITA EAGLE, Sept. 8, 2002, at 3C; Ken Ward, Jr., *'Predatory Lenders' Foreclose on Hundreds, Law Firm Says*, SUNDAY GAZZETT MAIL (W.V.), Sept. 28, 2003, at 1; *Loan Shark Attack: A Bill in Congress Would Address Predatory Lending Complaints — By Throwing Them Out of Court*, PITTSBURGH CITY PAPER, April 12, 2003, at 12.

[210]Ken Ward, Jr., *Couple Wins $450,000 in Lawsuit Conseco Misrepresented terms of Home Equity Loan, Suit Alleges*, CHARLESTON GAZETTE (WV), November 9, 2002, at 10C.

[211]Pittsburgh City Paper, *supra* note 209, at 12.

[212]*Daily Briefing*, ATLANTA J. & CONST., March 6, 2003, at F2.

[213]Fabozzi, *Structured Finance Market*, *supra* note 208, at 27.

[214]Liz Pullman, *California Lehman Bros. Sued Over Ties to Sub-Prime Lender*, L.A. TIMES, May 3, 2000, at 2. ("Consumer groups and other critics of predatory lending practices had targeted First Alliance as one of the nation's worst offenders. Not only were its rates usually higher than those charged by other sub-prime lenders, its loan fees typically ran 10% or more of the loan amount, while other sub-prime lenders charged 3% to 5%."). First Alliance systematically hired used-car salesmen and actively trained them to use fraudulent, deceptive, and high pressure sales tactics. Henriques & Bergman, *supra* note 196. First Alliance regularly took thousands of dollars from its low income customers using bogus fees and insurance policies. *Id.* First Alliance's high interest, high fee loans regularly set up vulnerable families to loose their homes. Carol Hazord, *Predatory Loans Often Set Up Borrowers for Failure and Can Cost Them The Biggest Investment: Their Homes*, RICHMOND TIMES DISPATCH, October 9, 2000, at A1.

[215]*Lehman Not Liable for Predatory Client*, ASSET BACKED ALERT, August 8, 2003, at 1.

[216]*Id.*

brought by the American Association of Retired Persons, attorneys general in Arizona, Florida, Illinois, Massachusetts, Minnesota, New York and Washington, and the U.S. Justice Department—all alleging predatory lending.[217] Both the New York Times and the ABC News program 20/20 ran exposes on First Alliance.[218] Despite all this, Lehman continued to provide First Alliance millions on its warehouse line of credit as well as securitization services without which First Alliance could not do business.[219] In the words of the bankruptcy judge that later presided over First Alliance's inevitable bankruptcy, "Lehman knew that First Alliance was engaged in fraudulent practices designed to induce consumers to obtain loans from First Alliance . . . ."[220]

Although Lehman has escaped significant liability for its business relationships with predatory lenders, its reiterative appearances in the background of our nation's predatory lending dramas must not be dismissed without some suspicion.[221] Indeed can a firm both intimately involved with the nation's largest predatory lending settlement ever and the third largest corporate bankruptcy in American history—all the while specializing in the type of off balance sheet financing familiarized by Enron—bear no responsibility for illicit behavior? Perhaps. But Lehman is by no means alone with respect to these allegations. For example, Consumer activists recently stormed the lobby of Salomon, Smith, Barney over its underwriting for Ameriquest Mortgage Co.[222] The Lehman Brothers example and others like it raise the possibility that the current concept of "predatory lending" has been cast too narrowly. Is a firm that knowingly profits from predatory loans itself a predator? Is a firm that intentionally closes its eyes to predation justly considered responsible for that behavior? If the answer to these questions is yes, then perhaps the label "predatory structured finance" is a needed addition to the legal scholarship challenging unfair and deceptive home mortgage lending.

### *B. The Law of Predatory Lending: Consumer Claims and Defenses*

In order to discuss a legal response to predatory structured finance, it is first necessary

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[217]In re First Alliance, 652 B.R. at 659.

[218]In re First Alliance, 652 B.R. at 659.

[219]In re First Alliance, 652 B.R. at 668. Lehman also directly invested in First Alliance taking a small equity position in the firm. Henriques & Bergman, *supra* note 196.

[220]*Id. See also* Complaint for Injunction, Civil Penalties, and Other Statutory Relief, Florida v. Lehman Commercial Paper, Inc., 17th Judicial Circuit, Broward County, Florida, Case No. 0310116, June 11, 2003 (Florida attorney general complaint quoting Lehman Bros. employee report stating that "In a sense and more so than any other lender I have seen, it is a requirement to leave your ethics at the Door. Brian {Chisick, CEO of First Alliance,} will never admit it, but I am sure they make loans where the borrower has no real capacity for repayment but their property has a lot of equity.") (alterations in original).

[221]The one exception is a federal jury trial where Lehman was found liable for five million dollars of damages sustained by First Alliance customers. The implications of this decision are discussed in Part V.B.2 *infra*.

[222]Gregory, *supra* note ?; *Lehman to Take Fall for Predatory Lender*, ASSET SALES REPORT, May 8, 2000.

to have a working familiarity with law governing predatory origination and servicing practices. Accordingly, this section provides a brief survey of the patchwork of legal claims and defenses that purport to deter predatory mortgage originators, brokers and servicers—laying a foundation for analysis of how those claims and defenses might be transferred to the financiers that facilitated them. At the federal level, the Federal Trade Commission Act,[223] the Real Estate Settlement Procedures Act,[224] the Truth in Lending Act[225] along with its 1994 Amendments in the Home Ownership and Settlement Procedures Act,[226] The Equal Credit Opportunity Act,[227] and The Fair Housing Act[228] all have provisions which address predatory practices in mortgage loan origination. At the state level a variety of common law theories as well as state unfair and deceptive trade practices statutes address predatory lending. Many states have also recently passed predatory mortgage lending statutes which, to one degree or another, address the issue.

The Federal Trade Commission Act bans the use of unfair or deceptive trade practices.[229] While the statute does not give consumers a private cause of action to assert claims or defenses in litigation, it endows the Federal Trade Commission with broad discretion to define what practices are unfair or deceptive.[230] The FTC is also charged with bringing enforcement actions against non-compliant lenders under its jurisdiction.[231] And, while the FTC has had some success in doing so, most agree its enforcement efforts only scratch the surface of the predatory lending problem.[232]

The Real Estate Settlement Procedures Act is Congress' attempt to prevent unfair costs and practices in closing mortgage loans.[233] RESPA requires both lenders and mortgage brokers give borrowers a "good faith estimate" of settlement costs and a government pamphlet on real

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[223]Federal Trade Commission Act 1974, 15 U.S.C. §§ 41 *et seq.* (2006).

[224]Real Estate Settlement Procedures Act, 12 U.S.C. §§ 2601-16 (2006).

[225]Truth in Lending Act, 15 U.S.C. §§ 1601 et seq. (2006).

[226]Home Ownership and Equity Protection Act of 1994, Pub. L. No. 103-325, subtit. B of tit. I, §§ 151-58, 108 Stat. 2160, codified as amended in scattered sections of 15 U.S.C.).

[227]Equal Credit Opportunity Act, 15 U.S.C. §§ 1691 et seq. (2006).

[228]Fair Housing Act, 42 U.S.C. §§ 3601-3619 (2006).

[229]15 U.S.C. § 45(a)(1) (2006).

[230]DEE PRIDGEN, CONSUMER PROTECTION AND THE LAW § 3:2, 3:31 (2005)

[231]The FTC's jurisdiction over lenders is actually rather limited. Depository lenders are all regulated by agencies that focus primarily on the safety and soundness of the banking system and preventing claims federal deposit insurance claims. 15 U.S.C. § 57(a)(f); NATIONAL CONSUMER LAW CENTER, UNFAIR AND DECEPTIVE TRADE PRACTICES §2.2.1.6 (2001 & Supp.).

[232]Pridgen, *supra* note 230, at 3:2.

[233]12 U.S.C. § 2601 et seq. (2005).

estate closing costs no later than three business days after a borrower applies for a loan.[234] The pamphlet attempts to explain the nature and costs of real estate services.[235] At closing, RESPA requires settlement agents provide a complete settlement statement that itemizes all settlement charges imposed on the borrower. Lenders are usually required to use a particular uniform government form, the HUD-1 settlement statement, in providing this information.[236] In particular, the statement must include all discount points, real estate agent fees, loan broker fees, and other miscellaneous closing costs.[237] In addition to these disclosures, RESPA aims to prohibit kickbacks or referral fees that tend to unnecessarily increase the costs of settlement services. Violations of the statute expose the lender and broker to a penalty of three times the amount of any charge paid for unlawful settlement services.[238]

The Truth in Lending Act attempts to create a uniform terminology for all consumer credit contracts that facilitates comparison shopping and informed decision making.[239] The Act requires lenders give consumers a disclosure statement which expresses some of the most important provisions of a credit contract in federally defined terminology.[240] Pursuant to the statute the Federal Reserve Board of Governors has published standard forms which most lenders use in providing TILA disclosures.[241] The statute requires mortgage lenders to give borrowers a notice informing them of their right to back out of the loan for up to three days after the loan is consummated.[242] If the lender commits a material violations of the statute, TILA extends this three day period for up to three years.[243] Other violations of the statute are subject to statutory damage awards of up to $2000.[244] In class action cases, statutory damages

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[234] 12 U.S.C. § 2603, 2604.; 24 C.F.R. § 3500.7

[235] *Id.*

[236] 12 U.S.C. § 2603(a); 24 C.F.R. § 3500.8(a). The HUD-1A for is used for refinances and for junior lien mortgages. *Id.*

[237] *Id.*

[238] 12 U.S.C. § 2607(d)(2) (2005). Both the party offering a kickback and the party receiving the kickback are jointly and severally liable for the damages. *Id.*

[239] *See* Peterson, *supra* note 188, at 875-80 (discussing historical origin of Truth in Lending).

[240] 15 U.S.C. § 1632 (2006). The most important two disclosures under the statute are the finance charge and the annual percentage rate. The Finance charge is the total cost the consumer will pay for borrowing money expressed as a dollar amount. Similar to an interest rate, the annual percentage rate is a yearly expression of finance charge. Peterson, *supra* note 188, at 880.

[241] 15 U.S.C. § 1604 (2006).

[242] 15 U.S.C. § 1635(a). The three day rescission rule does not apply to purchase money mortgages. *Id.* § 1635(e), 1602(w).

[243] *Id.* at §1635(f).

[244] 15 U.S.C. § 1640(a) (2006).

are allowed of up to the lesser $500,000 or one percent of the creditor's net worth.[245]

The Home Ownership and Equity Protection Act amended the TILA to more directly respond to the problem predatory home mortgage lending. The 1994 amendments created a special class of high cost mortgages which are subject to additional regulation.[246] Non-purchase money mortgage loans are covered under the act if their terms exceed either one of two price threshold triggers.[247] The first price threshold is based on the interest rate while the second is based on the points and fees associated with closing the loan. If a mortgage loan is covered by the relatively narrow scope of the Act, then the lender must deliver a special advance warning at least three days prior to consummation.[248] This advance disclosure must include an annual percentage rate disclosure, a notice that it is not too late for the borrower to back out of the transaction, the size of any balloon payments, and the cost of credit insurance charges.[249] The advance disclosure also includes a warning that the consumer could loose her home if she does not meet her obligations.[250] In addition to these disclosure rules, HOEPA loans must conform to several substantive requirements. First, HOEPA loans must amortize,[251] may not include penalty interest rate increases activated by late payments or other forms of default,[252] and may note include balloon payments where the loan term is greater than five years.[253] HOEPA attempts to address flipping by allowing prepayment penalties only if they are exercised within the first five years of the loan term, the loan does not cause the borrower to devote more than half of her gross monthly income to the debt, and the lender itself is not the source of the prepaying funds.[254] Responding to home repair abuses, lenders also may not make HOEPA loan proceeds payable only to a home improvement contractor.[255] Finally, Lenders are

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[245]*Id.* at 1640(b).

[246]DEE PRIDGEN, CONSUMER CREDIT AND THE LAW §9:25 (2006).

[247]Pridgen, Consumer Credit, *supra* note 246, at 9:26; 15 U.S.C. § 1602(aa)(1); HOEPA does not apply to mortgages which are used to finance the acquisition or construction of a home. 15 U.S.C. § 1602(aa)(1) & (w) (2006).

[248]15 U.S.C. § 1639.

[249]*Id.*

[250]*Id.*

[251]12 C.F.R. §226.32 (d)(2).

[252]12 C.F.R. §226.32 (d)(4).

[253]12 C.F.R. §226.32 (d)(1)(I).

[254]12 C.F.R. § 226.32(d)(7). Lenders must verify the gross monthly income of the debtor with a signed financial statement, a credit report and payment records. 12 C.F.R. § 226.32(d)(7)(iii). Furthermore, it is clear that this provision allowing some prepayment penalties under HOEPA does not preempt contrary state rules, since the provision only authorizes prepayment penalties "otherwise permitted by law." *Id.*

[255]12 C.F.R. § 226.32(e)(2).

prohibited from engaging in a pattern or practice of offering HOEPA covered loans based on the consumers' collateral rather than their ability to repay the debts.[256] HOEPA remedies trigger the TILA damage provision, including the three year right to rescind, and are also eligible for an additional statutory penalty equivalent to the finance charge in the loan contract.

The Equal Credit Opportunity Act and the Fair Housing Act both attempt to provide a remedy for discriminatory lending behavior. The statutes prohibit the discrimination in the provision of financing relating to housing based on the basis of a protected classification such as race, gender, or religion.[257] Credit discrimination can be proven either by showing disparate treatment or disparate impact. And, the statutes apply both to mortgage loan originators as well as brokers. The ECOA also has prophylactic procedural rules creditors must follow while deciding whether to grant credit. For instance, the Act requires creditors provide credit applicants with notices stating the reasons for denying an application as well as retaining records supporting those reasons.[258] Moreover, creditors may not inquire about the race, color, religion, or national origin of a credit applicant, and may only inquire about the gender of the credit applicant in limited situations.[259] Creditors may not request information about an individual's intentions to bear or raise children.[260] Both acts provide a private cause of action for actual and punitive damages.[261]

The primary federal statute governing abusive practices in debt collection is the federal Fair Debt Collection Practices Act ("FDCPA").[262] This statute aims to provide standards of public decency and civilized behavior in the collection of debts. For example, the statute forbids harassment, false or misleading representations, and a variety of other unfair collection tactics, including threatening foreclosure when not legally entitled to do so.[263] The statute also includes disclosure provisions, such as a requirement that debt collectors give consumers written validation and verification of the debt in order to prevent collection of debts not

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[256]15 U.S.C. § 1639(h).

[257]42 U.S.C. § 1691; 12 C.F.R. §§ 202.2(z), 202.4. It is worth noting the prohibited bases of discrimination in the FHA and ECOA are not always parallel. Race, color, religion, creed, political affiliation, national origin, and sex/gender are prohibited bases in both acts. Bases covered by the ECOA but not the FHA include age, public assistance status, and exercise of Consumer Credit Protection Act rights. Bases covered by the FHA, but not the ECOA include familial status and disability. *Id.*

[258]NATIONAL CONSUMER LAW CENTER, CREDIT DISCRIMINATION, *supra* note ?.

[259]12 C.F.R. §202.5(d)(5) & (d)(3). *See also* NATIONAL CONSUMER LAW CENTER, CREDIT DISCRIMINATION, *supra* note ?, at 83.

[260]12 C.F.R. § 202.5(d)(4).

[261]15 U.S.C. § 1691e(a)-(d).

[262]Pub. L. No. 95-109, 91 Stat. 874, *codified at* 15 U.S.C. § 1692 *et seq*.

[263]5 U.S.C. §§ 1692d-1692f.

actually owed.[264] The statute is enforced by the Federal Trade Commission, banking regulators, and a private right of action allowing consumers to sue for statutory punitive damages, costs, and attorney's fees.[265]

At the state level, the common law includes several theories which govern predatory lending practices and terms. Most significantly, the law of fraud purports to provide a remedy for lender misrepresentations in mortgage origination. While some courts have been reluctant to use it, the unconscionability doctrine can also be an effective tool in predatory lending cases as well. Moreover, breach of fiduciary duty can may govern behavior of mortgage brokers who purport to represent the interests of consumer borrowers.

In addition to common law theories, most states have Unfair or Deceptive Trade Practices statutes modeled off the Federal Trade Commission Act which may govern predatory mortgage lending practices and terms.[266] Sometimes called "little FTC Acts" these statutes give consumers a private cause of action allowing them to assert claims or defenses against lenders that violate recognized trade standards.[267] Most importantly, these statutes typically treat federal trade commission regulations and opinions as presumptive evidence of a deceptive or unfair trade practice.[268] Thus, the rules and standards used by the FTC in its high profile cases against the largest predatory lenders are available through private state causes of action in some jurisdictions against some types of lenders.[269]

Furthermore, in recent years a wave of states, counties, and municipalities have passed a variety of statutes and ordinances attempting to prevent predatory mortgage lending. North Carolina is generally recognized to have led this trend and is home to the most influential example of this type of statute.[270] North Carolina's Predatory Lending Act of 1999 is similar in approach to the federal Home Ownership and Equity Protection Act, in that the North Carolina statute uses price thresholds to create different tiers of regulation.[271] However, North Carolina's price thresholds are significantly lower than the federal statute making the definition of more strictly regulated "high cost" mortgages more inclusive. For these high-cost

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[264] 15 U.S.C. § 1692g(a); Hubbard v. National Bond and Collection Associates, Inc., 126 B.R. 422, 427-28 (D.Del. 1991).

[265] 15 U.S.C. § 1692k, l.

[266] NATIONAL CONSUMER LAW CENTER, UNFAIR ACTS AND DECEPTIVE PRACTICES § 1.1 (6th ed. 2004).

[267] *Id.*

[268] *See, e.g.,* FLA. STAT. § 501.203 (2005) ("'Violation of this part' means any violation of this act . . . and may be based upon . . . [t]he standards of unfairness and deception set for and interpreted by the Federal Trade Commission . . . .").

[269] *Id.*

[270] *Id.*

[271] Daugherty, *supra* note 191, at 593-94.

loans, the statute prohibits a variety of contract restrictions including call provisions,[272] balloon payments,[273] negative amortization,[274] penalty interest rates,[275] and lenders generally may not finance prepayment penalties from a previous loan.[276] Lenders are precluded from making a high-cost loan without due regard to the borrower's repayment ability.[277] The North Carolina statute also prohibits financing of yield spread premiums in high-cost loans by prohibiting financing of any charge payable to a third party.[278] The act builds a bridge between its contract restrictive provisions and anti-deception law by explicitly defining violations of the act to be unfair and deceptive trade practices under the North Carolina UDAP law.[279] Finally, the act employs a disclosure and consumer education component by requiring that would-be borrowers of high-cost home mortgages receive financial counseling before entering into the transaction.[280] Over thirty states have passed statutes which to some degree or another reflect the North Carolina approach.[281] Numerous counties and municipalities have also attempted to

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[272]N.C. GEN. STAT. § 24-1.1E(b)(1) ("No high-cost home loan may contain a provision which permits the lender in its sole discretion, to accelerate the indebtedness.").

[273]N.C. GEN. STAT. § 24-1.1E(b)(2) ("No high-cost home loan may contain a scheduled payment that is more than twice as large as the average of earlier scheduled payments.").

[274]N.C. GEN. STAT. § 24-1.1E(b)(3) ("No high-cost home loan may contain a payment schedule with regular periodic payments that cause the principal balance to increase.").

[275]N.C. GEN. STAT. § 24-1.1E(b)(4) ("No high-cost home loan may contain a provision which increases the interest rate after default.").

[276]N.C. GEN. STAT. § 24-1.1E(c)(3)(a).

[277]N.C. GEN. STAT. § 24-1.1E(c)(2)

[278]N.C. GEN. STAT. § 24-1.1E(c)(3)©.

[279]N.C. GEN. STAT. § 24-1.1E(d).

[280]N.C. GEN. STAT. § 24-1.1E(c)(1) ("A lender my not make a high-cost home loan without first receiving certification from a counselor approved by the North Carolina Housing Finance Agency that the borrower has received counseling on the advisability of the loan transaction and the appropriate loan for the borrower.").

[281]*See* Arkansas Home Loan Protection Act, ARK. CODE. ANN. §§ 25-53-101 et seq.; CAL. FIN. CODE §§ 4970-4979.7 (West 2003); Consumer Equity Protection Act, COL. STAT. § 5-3.5-201 et seq.; Connecticut Abusive Home Loan Lending Practices Act, CONN. GEN. STAT. ANN. §§ 36a-746-747, 754 ; Home Loan Protection Act, D.C. CODE § 26.1151.01 et seq.; Fair Lending Act, FLA. STAT. ANN. §§ 494.0079-.00797; Georgia Fair Lending Act, GA. CODE ANN. §§ 7-6A-1 et seq (as amended); *Idaho House Bill 28*, ID. Stat. § 26-3103 *et seq.* (Idaho); High Risk Home Loan Act Ill. Comp. Stat. §§ 137/1-137/175; Indiana Home Loan Practices Act, Ind. Code §§ 24-9-4-1 *et seq.*; Consumer Credit Code, Kan. Stat. Ann. §§ 16a-1-101 et seq.; High Cost Home Loan Act, KY. Rev. Stat. § 360.100; Truth in Lending, Me. Rev. Stat. Titl 9-A, §§ 8-101 et seq.; X (Maryland); Massachusetts Predatory Home Loan Practices Act, Mass. Gen. Laws ch. 183C, §§ 1 et seq.; MICH. COMP. LAWS. ANN. Ch. 445, §§ 1631-1645 (Michigan); Nevada Assembly Bill No. 284, Nev. Rev. Stat. §§ 598D.010 et seq.; New Jersey Home Ownership Security Act of 2002, N.J. STAT. ANN. §§ 46:10B-22 *et seq.*; Home Loan Protection Act, N.M. REV. STAT. §§ 58-21A-1 et seq.; N.Y. BANKING LAW § 6-L (McKinney 2003) (New York); Restrictions and Limitations on High Cost Home Loans, N.C. Gen Stat. §§ 24-1.1E et seq.; Ohio H.B. 386, OHIO REV. CODE ANN. §§ 1349.25- 1349.39;

prevent predatory lending by ordinance.[282]

Altogether, even an abbreviated description of the federal, state, and local laws addressing predatory lending suggests a not insignificant arsenal of potential claims and defenses. Yet, this is by no means to suggest that this legal net is sufficient to catch every predatory loan. Previous research has chronicled significant drawbacks to each of these potential predatory lending claims and defenses.[283] For example, most federal statutes have narrow technical causes of action and/or relatively insignificant remedies. In contrast, while the tort of fraud is flexible in application and has the potential for punitive damages, it also has very high evidentiary hurdles, is generally not amenable to class action lawsuits, and does not usually provide attorney fee shifting—all of which are serious drawbacks for consumers litigating from the brink of home foreclosure. Deceptive Trade Practices statutes often do not apply to financial institutions and, at least according to the controversial interpretation of federal banking regulators, may be preempted with respect to federally chartered depository institutions and possibly even their operating subsidiaries and agents. In Part III this article will explore the extent to which these many claims and defenses can impose liability which might deter predatory structured finance

## III. INDIRECT LIABILITY FOR PREDATORY CONSUMER LENDING PRACTICES

While the law governing predatory lending is primarily focused on holding predatory lenders liable for their terms and practices, it does contemplate holding secondary mortgage market participants liable for predatory lending practices in some situations. However, the complexity and seemingly random organizational structure of predatory lending assignee liability law strongly suggests that secondary market accountability has been something of an

Consumer Credit Code, 14A OKL. ST. § 79.0404.; Omnibus Mortgage Bankers and Brokers and Consumer Equity Protection Act, 63 PA. CONS. STAT. ANN. §§ 456.501- 456.524 (2003); Sough Carolina High Cost and Consumer Home Loans Act, S.C. Code Ann. §§ 37-23-10 et seq.; Tex. Fin. Code § 343.001 *et seq*.; X (Utah); West Virginia Residential Mortgage Lender, Broker, and Servicer Act, W.VA. CODE ANN. §§ 31-17-1 et seq.; WIS. STAT. §§ 428.101 - 428.211 (2004) (Wisconsin); X (Wyoming).

[282] CHICAGO, ILL., MUNICIPAL CODE OF CHICAGO, PREDATORY LENDING ORDINANCE §§ 2-32-4545, 2-92-325, 4-4-155, 8-4-325 So2000-2145 of 2000 (Aug. 8, 30, 2000); PROTECTION FROM PREDATORY LENDING AND MORTGAGE FORECLOSURE IMPROVEMENTS ACT OF 2002, 48 D.C. REG. 3505 (2001); PHILADELPHIA, PA., PROHIBITION AGAINST PREDATORY LENDING, PHILADELPHIA CODE §§ 9-2400 to 9-2408 *et seq* (April 9, 2001); DAYTON, OH., ORDINANCE 29990-01 (July 11, 2001) (codified at REV. CODE OF GEN. ORDINANCES §§ 112.40-.44); ATLANTA, GA., ORDINANCE 01-O-0843 (June 6, 2001) (codified at CODE OF ORDINANCES §§ 58-100 to -102); OAKLAND, CA., ORDINANCE 12361 C.M.S. (October 2, 2001); CLEVELAND, OH., ORDINANCE 737-02 (March 4, 2002), *amended at* Ordinance 45-03 (April 22, 2002); TOLEDO, OH., ANTI-PREDATORY LENDING ORDINANCE, 291-02 (Nov. 5, 2002).; LOS ANGELES, CAL., CAL. FIN. CODE DIVISION §§ 1.6 *et seq*. (December 18, 2002).

[283] Engel & McCoy, *Tale of Three Markets*, *supra* note 3, at 1298-1316; Saunders, *supra* note 185, at 128-39.

afterthought for courts, legislators, and administrative agencies.[284] This part surveys two types of legal theories which courts might use to hold secondary mortgage market participants liable for predatory origination and servicing. First discussed are assignee liability theories, and second are still emerging common law theories of imputed liability.

### *A. Predatory Lending Assignee Liability*

A description of consumer loan assignee liability law must begin with the Uniform Commercial Code and the holder in due course doctrine. This rule is significantly modified for consumers by the Federal Trade Commission Regulation and other federal consumer protection statutes discussed in part III.A.2. Moreover, recently enacted state statutes have modified assignee liability rules for loans covered within their scope.

#### 1. Assignee Liability Under the Uniform Commercial Code

The default rule for consumer and commercial mortgages alike is that a mortgage lender's assignee takes subject to the claims and defenses which the borrower might assert against the original lender.[285] The Restatement (Second) of Contracts explains that "[b]y an assignment the assignee acquires a right against the obligor only to the extent that the obligor is under a duty to the assignor."[286] However, this rule is significantly constrained by two important exceptions. First, lenders have frequently attempted to contract around this default rule with provisions waiving the right of borrowers to assert claims or defenses against an assignee of the lender. The UCC explicitly recognizes and authorizes these "waiver of defense clauses."[287]

A second qualification to the common law assignee liability rule is the holder in due course exception. This controversial rule states that if the assignee in good faith paid value for a negotiable promissory note and lacked notice that the loan is in default or is subject to a short list of specified consumer claims or defenses, then the assignee is considered a holder in due

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[284]Bill Emerson, *The Predatory Lending Maze*, 62(12) MORTGAGE BANKING 101 (Sept. 2002) ("As the predatory lending debate continues, more and more states, counties and municipalities have adopted their own regulations to address the issue. Taken together, they form a confusing regulatory labyrinth that makes it extremely difficult for regional and national lenders to conduct business."); Neil J. Morse, *The Predatory Lending Obstacle Course*, 62(7) MORTGAGE BANKING (April 2002) ("Frustration with the thicket of local—and often disparate—predatory lending laws has driven all sides of the issue to explore whether a single federal statute ought to be enacted to settle the matter once and for all . . . .").

[285]4 Corbin, Corbin on Contracts §§ 892, 892A (1996 & Supp.); 3 Williston, Williston on Contracts § 432 (1960 & Supp.); Farnsworth, Farnsworth on Contracts § 11.8 (1990 & Supp.);

[286]Restatement (Second) of Contracts § 336 (1981). Section 336 continues:
The right of an assignee is subject to any defense or claim of the obligor which accrues before the obligor receives notification of the assignment, but not to defenses or claims which accrue thereafter . . . ." *Id.* at § 336(2).

[287]U.C.C. §9-403 (2005) (formerly at § 9-206).

course.[288] As a holder in due course the assignee will still be subject to a limited list of "real defenses" which include infancy and duress.[289] But more importantly a holder in due course takes free of the much larger and more important class of "personal" claims and defenses which include many of the most important weapons in a predatory lending victim's arsenal.[290] These personal claims and defenses include fraud, unconcscionability, and in some states unfair and deceptive trade practice statutory claims.[291] If an assignee is considered a holder in due course, courts have tended to be reluctant to allow consumers to offset predatory lending damages against the amounts owing on their loans.[292] Rather consumers are required to pay their mortgage loans (or forfeit their homes in foreclosure), and seek redress for predatory lending claims against the original lender.[293]

Both waiver of defense clauses and the holder in due course exception have suffered withering academic criticism and somewhat reluctant enforcement by most courts over the past several decades.[294] Scholars have for years made compelling economic and historical arguments against variation in the common law rule of assignee liability in consumer loans. For example, Vern Countryman argued that the holder in due course exception should be eliminated since as between an innocent consumer and an innocent financier, the financier is better suited to bear the risk of an originator's reliability.[295] Walter Navin pointed out the inability of the courts to create a uniform and consistently applied rule with respect to waiver of defense clauses.[296] Grant Gilmore, Ronald Mann, Albert Rosenthal, and M.B.W. Sinclair have all argued that the historical justifications behind the holder in due course rule no longer apply in contemporary finance transactions.[297] And more particularly, the recent predatory

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[288] U.C.C. § 3-302(2).

[289] JAMES J. WHITE AND ROBERT S. SUMMERS, UNIFORM COMMERCIAL CODE § 14-10 (5th ed. 2000).

[290] *Id.*

[291] *Id.*

[292] *See* Eggert, *Form Over Intent, supra* note 4, at 423-24.

[293] In some cases, consumers are required to forfeit their home *and* continue to pay their mortgage, since the home was worth less than the outstanding balance of the loan and the creditor succeeds in obtaining a deficiency judgment.

[294] DEE PRIDGEN, CONSUMER CREDIT AND THE LAW §14:1 (2006).

[295] Vern Countryman, *The Holder in Due Course and Other Anachronisms in Consumer Credit*, 52 TEX. L. REV. 1, 10 (1973).

[296] Walter D. Navin, Jr., *Waiver of Defense Clauses in Consumer Contracts*, 48 N.C. REV. 505, 550 (1970).

[297] Grant Gilmore, *Formalism and the Law of Negotiable Instruments*, 13 CREIGHTON L. REV. 441, 461 (1979); M.B.W. Sinclair, *Codification of Negotiable Instruments Law: A Tale of Reiterated Anachronism*, 21 U. TOL. L. REV. 625 (1990); Edward L. Rubin, *Learning from Lord Mansfield: Toward a Transferability Law for Modern Commercial Practice*, 31 IDAHO L. REV. 775, 776 (1995); Ronald Mann, *Searching for Negotiability in Payment and Credit Systems*, 44 UCLA L. REV. 951, 1007 (1997); Albert J. Rosenthal, *Negotiability—Who Needs*

mortgage lending scholarship of Kurt Eggert, Karen Engel, Pat McCoy, and Julia Patterson Forrester has argued that assignee immunity creates an especially troubling incentive for creditor dishonesty in the current subprime mortgage lending market.[298]

For their part, courts have developed a variety of mechanisms for allowing consumers to prevent enforcement of a waiver of defense clause or deprive a loan assignee of holder in due course status. With respect to the former, some courts have refused to enforce these clauses on public policy grounds.[299] The great majority of courts have refused to enforce waiver of defense clauses where the consumer complains of fraud.[300] But some courts have been willing to enforce the waiver where other claims, such as breach of warranty have been alleged without fraud.[301] Where fraud and non-fraud defenses were inextricably interwoven by the facts, some courts would allow all of the defenses.[302] Moreover, many states bypassed common law rules in the 1960s with statutes compelling courts to ignore waiver of defense clauses in various contexts, such as home-improvement transactions.[303]

With respect to the holder in due course rule, some consumers' counsel have had success in preventing assignees from claiming holder in due course by carefully policing the somewhat arcane technical criteria for establishing that status. For instance, only the holder of a negotiable instrument can claim holder in due course status.[304] Lenders that do not carefully draw up their promissory notes in the required language will be denied negotiable status.[305]

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*It?*, 71 COLUM. L. REV. 375, (1971).

[298] Eggert, *Predatory Lending, supra* note 4, at 366; Engel & McCoy, *supra* note 193, at 730-31; Forrester, *supra* note 193, at 1138 .

[299] Fairfield Credit Corp. v. Donnelly, 264 A.2d 547 (1969); Condor Capital Corp. v. Michaud, 27 Conn. L. Rptr. 697 (Conn. Super. Ct. 2000); Quality Finance Co. v. Hurley, 148 N.E.2d 385 (Mass. 1958). *See also* White & Summers, *supra* note X, at § 14-9.

[300] Navin, *supra* note X, at 527.

[301] *See, e.g.,* Anglo-California Trust Co. v. Hall, 211 P. 991 (Utah 1922); San Francisco Sec. Corp. V. Phoenix Motor Co., 220 P. 229 (Az. 1923); Nassau Discount Corp. V. Allen, 255 N.YS.2d 608 (N.Y. City Civ. Ct. 1965).

[302] American Plan Corp. v. Woods, N.E.2d 886 (Ohio Ct. App. 1968); Schow v. Gaurdtone, Inc., 417 P.2d 643 (Utah 1966). *See also* Navin, *supra* note X, at 527 (collecting additional cases).

[303] WHITE & SUMMERS, *supra* note 305, at 14-9; Navin, *supra* note X, 531-32; Federal Trade Commission, Preservation of Consumers' Claims and Defenses: Final Regulations, Proposed Amendment and Statement of Basis and Purpose, 40 FED. REG. 53506, 53512 (Nov. 18, 1975).

[304] U.C.C. § 3-302.

[305] To create a negotiable promissory note there must be a signed writing that memorializes an unconditional promise to pay money that is payable to bearer or order. U.C.C. § 3-104. Mortgage loan promissory notes must use carefully defined language to have negotiable status. "More than any other symbols, the words 'order' and 'bearer' are supposed to put parties on notice that they are dealing with negotiable instruments." WHITE & SUMMERS, *supra* note 305, at §14-4. Since residential mortgage loans are virtually never payable at a time of the creditor's choice, to qualify for negotiable status (and thus treatment as a holder in due course) an assignee's

Lenders must also carefully comply with the technical rules governing transfer of a negotiable instrument or risk losing holder in due course status.[306] For example, the transferor of the instrument must "endorse" it either by writing on the paper itself or firmly affixing an "allonge" to the instrument.[307] Where there are multiple assignments of a loan, any missing, forged, or unaffixed indorsement in the chain will destroy the note's negotiability, and in turn, the ability of the final assignee to claim holder in due course status.[308] In the subprime mortgage market, some businesses have been less than perfect in correctly endorsing their notes giving consumer counsel the occasional open window to assert predatory lending claims against the current assignee.[309]

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promissory note must state "pay to the order of" the creditor. *See, e.g.,* Universal Premium Acceptance Corp. v. York Bank & Trust Co., 69 F.3d 695 (3rd. Cir. 1995) (language stating "pay and deposit only to the credit of: Great American Insurance Company" did not create a negotiable instrument). Moreover, the promise must be payable on demand or at a specific time, and must include no other undertaking except one authorized by 3-104(a)(3) of the UCC. U.C.C. § 3-104. The instrument must generally only include a duty on the part of the borrower to pay money. There is a small list of excepted undertakings such as preserving collateral on the loan. *Id.* Inclusion of other promises or undertakings will render the writing non-negotiable. *See, e.g.,* Geiger Finance Co. v. Graham, 182 S.E.2d 521, 524 (Ga. Ct. App. 1971) (clause waiving real defenses in promissory note rendered writing non-negotiable). *See also* Mann, *supra* note X, at 971-72 (making a provocative argument that Fannie Mae and Freddie Mac model loan promissory notes may not be negotiable because they impose a duty on consumers to give notice when they prepay on their mortgage).

[306]Insurance Agency Mangers v. Gonzales, 578 S.W.2d 803 (Civ. Ct. App. Tex, 1st Dist., 1979). In *Insurance Agency Mangers* the court held that a mortgage loan contract which financed home improvements was not a negotiable instrument. *Id.* at 807. The court reasoned that a variety contractual provisions including a covenant to use home only for personal family or household purposes rendered the document a mere contract rather than an instrument. *Id.*

[307]For a transferee of an instrument to obtain holder in due course the instrument must "negotiated" to the assignee, rather than merely assigned. To negotiate a mortgage loan promissory note, the transferor must transfer possession and indorse the writing. *See, e.g., In re Governor's Island*, 518 B.R. 417 (Bankr. E.D.N.C. 1984) (assignment instrument without an indorsement deprived assignee of holder in due course status). While indorsement can have different functions, in this context the term refers to the signature of the transferor which signals to future holders that the instrument retains its negotiable status. U.C.C. § 3-204. Mortgage loan notes are usually indorsed with a special indorsement that names the new holder, preserving both the negotiable status of the instrument and its status as order paper. The transferee can also negotiate the note with a blank endorsement which does not name the new holder, but this converts the instrument to bearer paper which, at least theoretically, can be converted into cash by any one in possession of the writing.

[308]Adams v. Madison Realty & Development, Inc., 6 U.C.C.Rep. Serv.2d 732, 853 F.2d 163 (3rd Cir. 1998) (negotiable status destroyed where indorsement was on a separate sheet of paper loosely inserted within notes rather than firmly affixed to the notes); Crossland Sav. Bank FSB v. Constant, 737 S.W.2d 19 (Tex.Ct.App. 1987) (negotiable status destroyed where paper with indorsement was taped to eight pages of documents which included note); Priesmeyer, Pacific Southwest Bank, F.S.B., 917 S.W.2d 937 (Tex.Ct.App. 1996). Some courts and commentators further insist that an allonge may only be used where there is no space available on the instrument itself. Pribus v. Bush, 118 Cal.App.3d 1003 (1981); HAWKLAND UNIFORM COMMERCIAL CODE SERIES § 3-202:5 (2005).

[309]*See, e.g., Dyck-O'Neal, Inc. v. Pungilore*, 800 N.E.2d 727, 20003 WL 2299879, 52 UCC Rep.Serv.2d 717 (Mass. Ct. App. 2003) (unpublished disposition) (mortgage loan assignee deprived of holder in due course status because endorsements were not written on the instrument or firmly affixed thereto).

Moreover, there is also a body of case law ignoring waiver of defense clauses and denying assignees holder in due course status because in one way or another the assignee had notice of the consumer's defenses or was otherwise culpable in the originator's unlawful behavior. Section 3-302 of the UCC lists a variety of potential facts of which the assignee must have lacked actual or implied knowledge. This list includes knowledge that the loan is overdue, that the instrument contains an unauthorized signature or some other alteration, that there is a title dispute over the instrument, and that the consumer has a "real" defense.[310] Conspicuously absent in this list is notice of a more common personal defense. Still, section 3-302 also requires the assignee to take the instrument in good faith.[311] Courts generally agree that the assignee lacks good faith where it has a close connection with the originator on the theory that the assignee is considered part of the initial transaction.[312] Other courts have found the potential for assignee liability on a joint venture theory or an aiding and abetting theory.[313] Courts have used similar theories in refusing to enforce waiver of defense clauses.[314]

2. Assignee Liability Rules in Federal Consumer Protection Statutes

Assignee liability law in predatory home mortgage lending cases is complicated by the fact that the Federal Trade Commission and Congress have significantly modified the general common law assignee liability and UCC holder in due course rules. Initially, a celebrated Federal Trade Commission regulation creates a complex wrinkle tempering the blunt UCC rule in somewhat arbitrarily defined class consumer loans. In the mid-1970s the FTC used its power under the Federal Trade Commission Act to define unfair and deceptive trade practices to create a requirement that all financiers of consumer goods or services include a language in their contracts which renders those contracts non-negotiable.[315] In a round-a-bout way, FTC

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[310] U.C.C. § 3-302.

[311] U.C.C. § 3-302.

[312] *Unico v. Owen,* 232 A.2d 405 (N.J. 1967); Rehurek v. Chrysler Credit Corp., 262 S.2d 452, 454 (Fla. Dist. Ct. App. 1972); First New England Financial Corp. v Woffard, 421 So.2d 590, 593 n.4 (Fla. Dist. Ct. App. 1982); *See generally* Constance G. Clark, Comment, *The Close-Connectedness Doctrine: Prserving Consumer Rights in Credit Transactions*, 33 ARK. L. REV. 490 (1980). *Cf* Fidelity Bank, NA v. Avrutick, 740 F.Supp. 222 (S.D.N.Y. 1990) (close connection between originator and assignee does not overcome holder in due course without actual notice).

[313] Short v. Wells Fargo Bank of Minn., N.A., Civ. Action No. 3:04-1096, slip op. at 25-26 (S.D.W.Va. filed Nov. 18, 2005); George v. Capital South Mortgage Investments, Inc., 961 P.2d 32, 44-45 (Kan. 1998).

[314] Rehurek, 262 So.2d at 452.

[315] Federal Trade Commission, Preservation of Consumers' Claims and Defenses: Final Regulations, Proposed Amendment and Statement of Basis and Purpose, 40 FED. REG. 53506, 53512 (Nov. 18, 1975). The required contract provision states:

NOTICE

ANY HOLDER OF THIS CONSUMER CREDIT CONTRACT IS SUBJECT TO ALL CLAIMS AND DEFENSES WHICH THE DEBTOR COULD ASSERT AGAINST THE SELLER OF GOODS OR SERVICES OBTAINED PURSUANT HERETO OR WITH THE regulation did away with both waiver of defense clauses and the holder in due course exception for most non-real estate related consumer loans.[316] The FTC lacked jurisdiction to actually change state commercial law. But it did have the power to force lenders to include language in their contracts or risk be exposed to deceptive trade practice lawsuits. In loans governed by the regulation, the original lender commits a unfair or deceptive trade practice if its contract fails to include a contract provision. Unlike a Truth-in-Lending Disclosure, which aims to inform the consumer about contract provisions, the FTC legend, itself *becomes* a contract provision.[317] The legend states that any assignee of the original lender takes the contract subject to all claims and defenses that the consumer might have asserted against the original lender. The legend also includes a damage cap, which limits the assignees liability for the original lenders behavior to no more than the amount the borrower has paid out under the assigned obligation. Since an assignee can only be a holder in due course if it takes an instrument, and since a contractual obligation can only be an instrument if it is an unconditional promise to pay, contracts that include the FTC legend are *never* negotiable instruments governed by the holder in due course rule. Thus, the language required by the FTC has the effect of rendering credit contracts non-negotiable as a matter of the contractually expressed intentions of the parties as enforced through state contract law.[318]

Despite dire predictions by consumer finance industry beforehand, the FTC's holder legend has generally been well received. During the George H. W. Bush administration, the FTC did conducted an extensive review of the rule eventually concluding it should be left in place.[319] Moreover, the American Law Institute and the National Conference of Commissioners on Uniform State Laws subsequently buttressed the FTC regulation by amending Article 3 of the UCC to require that whenever a FTC legend is called for under federal law, state UCC law will treat the contract as though the legend were present, even when it is not.[320] With a few exceptional and erroneously decided cases, the rule "carefully tie[d] the liability of assignees to

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> PROCEEDS HEREOF. RECOVERY HEREUNDER BY THE DEBTOR SHALL NOT EXCEED AMOUNTS PAID BY THE DEBTOR HEREUNDER.

16 C.F.R. §433.2.

[316] NATIONAL CONSUMER LAW CENTER, UNFAIR AND DECEPTIVE TRADE PRACTICES § 6.6.1.2 (5th ed. 2001 & Supp.).

[317] Thomas v. Ford Motor Credit Co., 429 A.2d 277 (Md. App. 1981).

[318] White & Summers, *supra* note 305, at 14-9.

[319] 53 Fed. Reg. 44456 (Nov. 3, 1988); 57 Fed. Reg. 28814 (June 29, 1992).

[320] U.C.C. § 3-305(e). One counterintuitive consequence of the FTC's regulation was that consumers often lack protection from the regulation whenever the lender fails to put the FTC required notice in the contract. (After all, the FTC's language only disrupts the negotiability of a purported instrument, if the language is, in fact, included in the writing, irrespective of federal regulations. The policy behind the amendment is to prevent assignees who disregard the FTC rule from claiming holder in due course status when their note would, on its face, appear to be negotiable. *Id.* cmt.6. This amendment is particularly necessary given that some states exempt creditors in general and banks in particular from their deceptive trade practices statute. *See, e.g.,* Vannoy v. Capital Lincoln-Mercury Sales, Inc., 623 N.E.2d 177 (1993) (bank that financed car sale was exempt from state UDAP statute). Unfortunately, some states have not yet adopted this amendment to the U.C.C. *See, e.g.,* FLA. STAT. ANN. § 673.3051 (2005).

the liability of a consumer under an instrument held by the assignee."[321]

Unfortunately, the subprime mortgage lending market still suffers from many of the same problems found in the personal property marketplace prior to the FTC's holder rule. Since the FTC's holder regulations only applies where the lender finances the "sale or lease of goods or services" as defined in the regulation, the rule does not reach mortgages used to purchase a home, nor does it apply to most mortgage refinance loans.[322] In the mortgage market, the rule only applies when the loan finances home improvements—which are a consumer service.[323] The past decade, which has seen such astonishing growth in subprime home mortgage lending, has exposed the narrow application of the Federal Trade Commission's holder rule as a glaring oversight.

In addition to the Federal Trade Commission's holder in due course notice regulation, several other federal consumer protection statutes have special assignee liability rules. Unlike the holder in due course doctrine, these independent statutory assignee liability rules are not contingent upon the negotiability of the paper, nor do they have the same notice or good faith standards as Section 3-302 of the UCC. Federal statutes which define predatory lending assignee liability on their own terms include anti-discrimination statutes, the Truth in Lending Act, and the Home Ownership and Equity Protection Act.

Initially, anti-discrimination statutes generally hold assignees liable if they engage in the wrongdoing contemplated by the statute. Thus, under the Fair Housing Act an assignee could be liable for imposing different terms or conditions on the purchase of loans based on a protected class.[324] Or, where the assignee takes some part in the decision of whether to extend credit, the assignee can be liable even though the assignee did not actually make the loan.[325] Equal Credit Opportunity Act regulations suggest an assignee can only be liable if it knew or should have known of the original lender's discriminatory behavior.[326] However, the Fair Housing Act includes no such regulation.[327] Under either statute, one would expect that the holder in due course doctrine should not protect the assignee from liability, since liability under the statute is not derivative of the actions of another party, but based on the assignee's own involvement in a discriminatory behavior. Moreover, under these statutes a waiver of

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[321]Michael M. Greenfield & Nina L. Ross *Limits on a Consumer's Ability to Assert Claims and Defenses Under the FTC's Holder in Due Course Rule*, 46 BUS. LAW. 1135 (May 1991).

[322]Federal Trade Commission, Preservation of Consumers' Claims and Defenses: Final Regulations, Proposed Amendment and Statement of Basis and Purpose, 40 FED. REG. 53506, 53512 (Nov. 18, 1975).

[323]Federal Trade Commission, Staff Guidelines on Trade Regulation Rule Concerning Preservation of Consumers' Claims and Defenses, at 9 (May 4, 1976).

[324]42 U.S.C. § 3605; 24 C.F.R. § 100.115(a)

[325]15 U.S.C. § 1691a(3); Reg. B, 12 C.F.R. § 202.2(1).

[326]Reg. B, 12 C.F.R. § 202.2(l).

[327]NATIONAL CONSUMER LAW CENTER, CREDIT DISCRIMINATION § 2.3.2.3.3 (3d. ed. 2002 & Supp.)

defense clause does not excuse an assignee from its own discrimination.[328] Case law is unsettled on whether a mortgage contract containing the FTC's legend stating that an assignee is liable for "all claims and defenses" creates liability for the assignee independent of the assignees own discrimination.[329] At least one court has refused to impose ECOA assignee liability based on the FTC's contract language because the assignee lacked actual or constructive knowledge of the original lenders discrimination.[330] It would seem there is a better case for FTC holder rule assignee liability under the Fair Housing Act, since it lacks ECOA's knowledge requirement.[331] In any case, the relative paucity of successful discrimination lawsuits in predatory mortgage lending cases makes any assignee liability theory of only limited use.

Assignee liability under the Truth in Lending Act is governed by section 132 of the Act.[332] Assignees of residential loans are liable if the disclosure violation was "apparent on the face of the disclosure statement" provided by the original creditor.[333] The statute specifies that violations are apparent on the face of the statement if it does not use the terms or format required by the statute, or if a comparison of the disclosure to other supporting documents would reveal that the disclosure is incomplete or inaccurate.[334] Moreover, when a loan has been assigned multiple times, consumers can sue any assignee in the chain of ownership.[335] While these rules govern assignee liability for statutory damages, in predatory mortgage lending cases the statute's rescission remedy is often much more important. Here, TILA provides that consumers may assert their rescission rights against any assignee irrespective of whether the violation was apparent from the documents.[336] Waiver of defense clauses and the holder in due

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[328]Courts do not allow lenders to excuse compliance with consumer protection statutes simply by including boilerplate contract language to the contrary. *See, e.g.,* Gray v. American Express Co., 743 F.2d 10 (D.C. Cir. 1984) (dismissing credit card contract boilerplate absolving the creditor of Fair Credit Billing Act obligations as "imputing nonsense to a Congress intent on correcting abuses in the marketplace.").

[329]ANDREW L. SANDLER, STACIE E. MCGINN, & BENJAMIN B. KLUBES, CONSUMER FINANCIAL SERVICES § 1.09A (2005).

[330]Coleman v. General Motors Acceptance Corp., 196 F.R.D. 315, 327 (M.D. Tenn. 2000) (discriminatory automobile financing), *vacated on other grounds by* 296 F.3d 443 (6th Cir. 2002).

[331]Of course, this potential assignee liability theory would only apply to mortgages used to finance the acquisition of consumer goods or services, such as household repairs. *See infra* note 323 and accompanying text.

[332]Pub. L. 90-321, Title I, § 132, May 29, 1968 *codified at* 15 U.S.C. § 1641 (2006).

[333]15 U.S.C. § 1641(e)(1)(A).

[334]*Id.* at § 1641(e)(2)(A) & (B).

[335]The statute provides that a civil action "may be maintained against any assignee of [the] creditor" 15 U.S.C. § 1641(e)(1). *See also* Myers v. Citicorp Mortg., Inc., 878 F.Supp. 1553 (M.D. Ala. 1995), *aff'd*, 208 F.3d 1011 (11th Cir. 2000) (holding a mortgage company liable for originator's apparent TILA violations where the company held the mortgage for only a brief period prior to additional assignment).

[336]15 U.S.C. § 1641©.

course exception are both trumped by these congressionally mandated rules. Courts have split on whether assignees are liable for non-apparent TILA violations when the loan contract includes the Federal Trade Commission's holder notice. Some courts have been persuaded that as a matter of contract law, assignees agree to take loans with the FTC notice subject to "all claims and defenses."[337] For these courts, the assignee is held liable for TILA remedies as a matter of contract law because the assignee agreed to purchase a loan subject to consumer claims and defenses. Other courts have held that a Federal Trade Commission regulation cannot overrule a more specific federal statute.[338] Commentators have similarly disagreed on this point.[339]

The Home Ownership and Equity Protection Act goes further than any other federal statute in creating assignee liability for predatory mortgage lending. HOEPA assignee liability rules have at least three salient features. First, when a consumer is attempting to use the TILA rescission remedy against an assignee, the assignee is subject to the remedy irrespective of whether the contract was negotiable and irrespective of whether the TILA or HOEPA violations were apparent from the face of the document.[340] When the consumer is attempting to assert TILA recision remedy, the consumer need not even demonstrate that th assignee failed to exercise due diligence. Under this statute, an assignee of a high cost loan covered by HOEPA carries with it liability for all claims and defenses, rather than merely TILA and/or HOEPA remedies. Thus, for mortgages governed by HOEPA consumers can assert against assignees claims such as fraud, unconscionability, state deceptive trade practice, and ECOA or FHA claims.[341] Assignees can only escape liability for the full range of available claims and defenses if the assignee proves that a reasonable person, exercising due diligence could not determine

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[337]Cox v. First Nat'l Bank of Cincinnati, 633 F.Supp. 236 (S.D. Ohio 1986); *In re* Sterwart, 93 B.R. 878, 888-89 (Bankr. E.D. Pa. 1988); Chandler v. MVM Construction, Inc., 501 S.E.2d 533 (Ga. App. 1998).

[338]Ramadan v. Chase Manhattan Corp., 229 F.3d 194 (3d. Cir. 2000); Taylor v. Quality Hyundai, 150 F.3d 689 (7th Cir. 1998); Ellis v. General Motors Acceptance Corp., 160 F.3d 703 (11th Cir. 1998); Brown v. Coleman Investments, 993 F.Supp. 416 (M.D. La. 1998). These decisions seem poorly reasoned, given that they do not explain why parties to a contract and an assignment of that contract cannot agree, as a matter of purely private contract law, to hold the assignee liability for TILA remedies. They also do not point to any evidence that congress intended to *prevent* the negotiation of consumer friendly contract remedies by parties to the contract. The fact that the contract provision creating assignee liability is included in contracts because of an FTC regulation does not change the fact that these provisions *are* contractual provisions enforceable based on their plain meaning.

[339]*Compare* NATIONAL CONSUMER LAW CENTER, TRUTH IN LENDING §7.3.10 n.201 (5th 3d. 2003) ("[I]t seems likely that 'all claims and defenses' in the Rule means 'all,' not 'all except Truth in Lending.'"), *with* Ralph J. Rhoner & Fred H. Miller, Truth in Lending § 12.06 (2000) ("Congress wrote the current version of section 131 of the TIL Act aware of the existence of the FTC rule, yet expressly limited assignee liability to facial violations. This must be taken as clear congressional intent to restrict the assignee's exposure to those violations described in the statute.").

[340]15 U.S.C. § 1641© ("Any consumer who has the right to rescind a transaction under section 1635 of this title may rescind the transaction against any assignee of the obligation."). *See also* Lisa Keyfetz, *The Home Ownership and Equity Protection Act of 1994: Extending Liability for Predatory Subprime Loans to Secondary Market Participants*, 18 LOY. CONSUMER L. REV. 151, 178 (2005) (providing helpful summary of HOEPA rules).

[341]*See, e.g.,* Cooper v. First Gov't Mortgage Inv. Corp., 238 F.Supp.2d 50, 55 (D.D.C. 2002)

based on the loan documents that the mortgage exceeded HOEPA's price threshold triggers.[342] Unlike other assignee liability rules, this HOEPA provision allows consumers to assert claims and defenses even where the underlying statute itself has not been violated.[343] For example, if an originating HOEPA lender complied with all Truth in Lending and HOEPA requirements, but also made fraudulent oral representations to the borrower, HOEPA would provide a federal statutory vehicle for asserting a state common law fraud claim against any assignee in the loan's chain of ownership. There is no dispute that HOEPA renders waiver of defense clauses and the holder in due course exception useless to assignees of HOEPA loans.[344] Courts have yet to confront whether HOEPA loans which were not discoverable as such with due diligence, and yet contain Federal Trade Commission's holder notice, would bear assignee liability by virtue of the contract language. Presumably courts would divide along lines similar to those in litigation regarding unapparent TILA violations. And yet, Congress explicitly contemplated contractual liability from the FTC notice in passing HOEPA, calling the assignee liability rules "similar."[345] Arguably this creates an even better case for limited FTC induced contractual assignee liability in consumer goods and services cases where the assignee did exercise due diligence in screening for HOEPA loans. In any event, where loans fall into the relatively narrow scope of HOEPA, consumers will generally have a strong case for extending liability for all predatory lending claims and defenses deep into securitization conduits.

3. Assignee Liability Under State and Local Predatory Lending Law

With the flood of over forty state and local predatory lending laws, no issue has proven to have more consequence for the protection of consumers and for the liability of secondary mortgage market than the potential liability of assignees under these statutes. The example most emblematic of the high stakes of these rules was the controversial Georgia Fair Lending

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[342] 15 U.S.C. § 1641 (d)(1). *See infra* note 247 and accompanying text (describing price threshold scope of HOEPA).

[343] The Federal Reserve Board's official staff commentary emphasizes that for HOEPA loans, "a purchaser's or assignee's liability for all claims and defenses that the consumer could assert against the creditor is not limited to violations of the act." Regulation Z, Official Staff Commentary § 226.34(a)(2)-3. *See also* NATIONAL CONSUMER LAW CENTER, TRUTH IN LENDING § 9.7.2 (4th ed. 1999 & Supp.) ("This abrogation of holder-in-due-course status also means that a consumer could sue a holder of a HOEPA loan for state law or other federal law violations that she or he could raise against the original creditor *without* raising any TILA/HOEPA claims.").

[344] A House of Representatives Conference report explains Congress intended for HOEPA to:

> eliminate[ ] holder-in-due-course protections for purchasers and assignees of . . . [covered] mortgages. Consumers maintain all claims and defenses in connection with such mortgages against assignees that can be asserted against creditors. With this provision, the Conferees intend to ensure that the market polices itself in order to eliminate abuses.

H.R. Conf. Rep. No. 652, 103d. Cong. 2d Sess. 147, 163 (1994), *reprinted in* 1994 U.S.C.C.A.N. 1987.

[345] H.R. Conf. Rep. No. 652, 103d. Cong. 2d Sess. 147, 163 (1994), *reprinted in* 1994 U.SC.C.A.N. 1987 ("Similar liability has been previously extended by the FTC to consumer installment paper, including automobile loans,- without a significant impact on credit availability.").

Act.[346] This statute imposing unrestricted liability on assignees of some Georgia loans for the violations of the statute by brokers and originators.[347] This rule was at the time the most aggressive government effort to deter secondary market funding of predatory lenders. The investment community decisively reacted, igniting a public relations firestorm for Georgia's leaders.[348] Surprisingly, Wall Street's most effective solders were the credit rating agencies, rather than its leading investment banking firms. Standard and Poor's and the other credit rating agencies announced they would no longer rate mortgage loan securities which included loans originated in Georgia.[349] This meant that mainstream investors, such as insurance companies, pension funds, and mutual funds would no longer purchase mortgage backed securities drawn from pools including Georgia loans. Loan originators explained that their loans would become unsaleable and the securitization pipeline of capital to Georgia borrowers would shut down. The credit rating agencies explained that the unrestricted liability under the statute could mean that large punitive damage awards from angry juries could be foisted on to investors who had purchased securities from the pools including Georgia loans. The agencies argued that unlike more limited forms of assignee liability, such as that imposed by the FTC's holder notice rule, the risk posed by the Georgia Fair Lending Act was unquantifiable.[350] Analysts believed that there was no way to know how much exposure investors would have from jury verdicts ahead of time. Bowing under the combined pressure from local banks, thrifts, credit unions, corporate mortgage lenders, powerful Wall Street firms, and eventually even Fannie Mae and Freddie Mac, the Georgia Legislature repealed its own law, replacing it with a more moderate statute—but only after seeking approval from Standard and Poor's.[351]

Georgia's experiences are microcosmic of the national debate. All around the country policy makers have been struggling to find some middle ground where secondary market can be deterred from investing in predation without shutting down structured finance of non-conforming, but reasonably priced loans. Assignee liability provisions for predatory lending

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[346]Georgia Fair Lending Act, 2002 Georgia Laws Act 488 (H.B. 1361) (codified as amended at Ga. Stat. §7-6A-1 *et seq.*), amended by 2003 Georgia Laws Act 1 (S.B. 53).

[347]2002 Georgia Laws Act 488, §7-6A-6 ("Notwithstanding any other provision of law, any person who purchases or is assigned a high-cost home loan shall be subject to all affirmative claims and any defenses with respect to the loan that the borrower could assert against the original creditor . . . .").

[348]Tamara Loomis, *Predatory Lending Law Has Investment Firms in Arms*, N.Y.L.J, March 27, 2003, at 1; Georgia Bankers Association, et al., Georgia Fair Lending Act: The Unintended Consequences (2003) (unpublished report on file with author); Tom Baxter, *Democrats Lost Ball on Lending Bill*, ATLANTA J.& CONST., March 4, 2003, D6.

[349]Henry Unger & Robert Luke, *Compromise Reached on Ga. Lending Law: Legislature to Move Quickly to Deal with Rating Agency*, ATLANTA J.&CONST., Feb. 1, 2003, F1.

[350]Press Release, Standard & Poor's Clarifies Position on Proposed Amendments to Georgia Fair Lending Act, February 7, 2003 (on file with author); Henry Unger & Robert Luke, *Lending Bill Sent to State Senate No Opposition: State House Votes 175-0 to Change Law After Third Rating Agency Balks*, ATLANTA J.&CONST., Feb. 5, 2003, D1.

[351]Erick Bergquist, *Georgia Amended Predatory Law After Preapproval by S&P*, AM. BANKER, March 11, 2003, at 1.

statutes can be classified into one of several categories. First are those jurisdictions which followed the original Georgia Fair Lending Act providing unrestricted assignee liability for any originator misbehavior. Both Los Angeles and Oakland took this approach, only to have the California Supreme Court find their ordinances preempted by state law.[352] On the opposite end of the spectrum are jurisdictions that explicitly preclude the possibility of assignee liability under their predatory lending law.[353] Pennsylvania's statute, for example, states that "persons engage in the purchase, sale, assignment, securitization or servicing of covered loans shall not be held liable for the action or inaction of persons originating such loans."[354] In between these two poles are a variety of different rules attempting to balance the competing interests involved. The largest group of these states echo the federal Home Ownership and Equity Protection Act's assignee liability rule, holding assignees liable where a preponderance of the evidence shows the assignee could have discovered that the loan was covered by the state statute had it exercised reasonable due diligence.[355] Another group of states including Arkansas, Illinois, New Jersey, and New Mexico use standards similar to the Home Ownership and Equity Protection Act's due diligence rule for determining assignee liability where the consumer bring's the claim offensively, but allow the consumer to defensively assert violations of the statute in offset of a collection lawsuit irrespective of the assignee's due diligence.[356] Other states have taken a variety of different approaches. For example, Kentucky, chose to echo the federal Truth in Lending Act's rule, providing assignee liability where violations of the state law are apparent from the face of the documents.[357] Nevada only allows consumers to assert claims or defenses against assignees if they can show the assignee willfully engaged in any unfair lending practice described in the act."[358] New York State's predatory lending statute creates assignee liability irrespective of the assignees due diligence in screening, but only up to the amount of the consumers debt and only when the consumer asserts the claims defensively in response to a collection lawsuit.[359] Kansas also provides for assignee liability irrespective of

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[352]Am. Fin. Serv. Ass'n v. City of Oakland, 104 P.3d 813, 829 (Cal. 2005).

[353]*See, e.g.,* CAL. FIN. CODE § 4979.8 ("The provisions of this division shall not impose liability on an assignee that is a holder in due course. The provisions of this division shall not apply to persons chartered by Congress to engage in secondary mortgage market transactions.").

[354]63 P.S. § 456.522(b).

[355] *See* Colorado's Consumer Equity Protection Act. CO ST § 5-3.5-201; The District of Columbia's Home Loan Protection Act. DC Code § 26-1153.05(a); Florida Fair Lending Act. F.S.A. § 494.00793; Maine's Truth in Lending Act. Me. Rev. Stat. tit 9-A, § 8-209; Oklahoma's Consumer Credit Code. 14A Okl. St. § 79.0404.

[356]Arkansas Home Loan Protection Act. A.C.A. § 23-53-105(a)(2)(A)(I); Illinois High Risk Home Loan Act, 815 Ill. Comp. Stat. § 135(d); New Jersey Home Ownership Security Act of 2002. N.J.S.A. 46:10B-27(b); New Mexico Home Loan Protection Act, N.M.. Stat. Ann.§ 58-21A-11.

[357]KY. REV. STAT. § 360.100(1)(B).

[358]NEV. REV. STAT. §§ 598D.050, 598D.110.

[359]NEW YORK BANKING LAW ARTICLE § 6-I(13).

due diligence, allowing consumers to collect damages from an any assignee that "undertakes direct collection of payments or enforcement of rights arising from the debt."[360] Connecticut's statute requires assignees to refund the borrower for any default charges, prepayment penalties, or prepaid finance charges which exceed the rather creditor friendly limits in the statute.[361] Ohio excuses assignees from liability if the assignee can demonstrate by a preponderance of the evidence that the compliance failure was not intentional and resulted from a bona fide error notwithstanding the maintenance of procedures reasonably adapted to avoid any such error.[362] This is a relatively limited exception since bona fide errors do not include errors of legal judgement.[363]

Interestingly, no state has explicitly addressed how its predatory lending statutory assignee liability rule should be interpreted in the context of a loan including (or construed as included) the FTC's holder notice provision. Thus, if a loan finances consumer services, such as home repairs the lender is required to include a contract provision making forcing any assignee of the loan to bear liability for "all claims and defenses" up to the amount the consumer has paid under the obligation.[364] Arguably courts should hold that where included the FTC language should transfer liability from a primary wrongdoer to an assignee with greater frequency and severity than under some state predatory lending laws. So, for example, an assignee of a home repair finance loan made within Pennsylvania's price threshold triggers should be liable for violations of the Pennsylvania statute as a matter of contract, even though the statute itself provides for a different result. Similarly, it may not be clear how state predatory lending statute assignee liability provisions should be interpreted if the underlying mortgage includes a waiver of defense clause, and the state has not banned those clauses in consumer contracts.[365]

Placing these issues arising from unexpected interaction of different assignee liability statutes to the side, some states have succeeded in creating rules which will transfer a limited amount of liability to investors that purchase mortgage backed securities. The secondary market has adjusted to these rules, as well as to HOEPA, by requiring additional credit enhancements for loan pools including loans subject to these statutes. Standard and Poors, for example, requires additional credit enhancements for pools that loans made in fifteen

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[360]KAN. STAT. ANN. § 16a-5-201.

[361]CONN. GEN. STAT. § 36a-746g. The Connecticut statute also requires that creditors include the following language in the contract: "This is a loan subject to special rules under the Connecticut Abusive Home Lending Practices Act. Purchasers or assignees of this loan *could* be liable for all claims and defenses with respect to the loan that the borrower could assert against the lender." *Id.* § 36a-746e(2) (emphasis added).

[362]OHIO REV. CODE §1349.30(B).

[363]*Id.*

[364]*See infra* note 315 and accompanying text.

[365]*See, e.g.*, OR.S. § 79.0404.

jurisdictions.[366] The debate in various state legislatures leading to this current complex and fragmented legal landscape has been the primary dispute over predatory mortgage lending in the country.

### *B. Emerging Common Law Theories of Imputed Liability for Predatory Lending*

While assignee liability and the holder in due course doctrine has tended to dominate both the academic discussion of and the state legislative agenda regarding secondary mortgage market liability, it is by no means the only body of law potentially relevant to the subject. Indeed, a relatively overlooked group of common law doctrines may in the long run hold more promise in creating a secondary market incentive to police predation by loan brokers, originators, and servicers. In reading predatory lending cases it becomes clear that the judiciary system is uncomfortable apportioning liability for predatory lending exclusively through the addlepated federal and state patchwork of assignee liability statutes. Indeed consumers and some courts have groped for common law doctrines which might provide some remedy for the concerted wrongdoing of secondary market financiers of predatory lending. It is currently unclear whether these cases promise to congeal into a more unified and systemic response to securitization of predatory loans. However, at least three possible theories have emerged which have the potential to re-apportion liability for predatory lending amongst parties to a home mortgage securitization structure: aiding and abetting liability, civil co-conspirator liability, and joint venture liability. This section describes these common law theories, focusing on the extent to which courts have and may continue to deploy them in predatory mortgage lending disputes.

#### 1. Aiding and Abetting

It is a long standing common law principle that a business or individual can be held liable for aiding and abetting the wrongful acts of another. The Restatement of Torts, Second suggests that, "[f]or harm resulting to a third person from the tortious conduct of another, a person is liable if he . . . (b) knows that the other's conduct constitutes a breach of a duty and gives substantial assistance or encouragement to the other so to conduct himself."[367] The

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[366]These jurisdictions are Arkansas, Cleveland Heights (Ohio), Colorado, the District of Columbia, Florida, Georgia, Illinois, Maine, Massachusetts, New Jersey, New Mexico, New York State, Ohio, Oklahoma, and Toledo (Ohio). Natalie Abrams, et al., Standard & Poor's Implements Credit Enhancement Criteria and Revises Representation and Warranty Criteria for Including Anti-Predatory Lending Law Loans in U.S. Rated Structured Finance Transactions, May 13, 2004, (on file with author).

[367]REST. TORTS 2d, § 876(b). The Restatement comments explain paragraph (b):

> Advice or encouragement to act operates as a moral support to a tortfeasor and if the act encouraged is known to be tortious, it has the same effect upon the liability of the adviser as participation or physical assistance. If the encouragement or assistance is a substantial factor in causing the resulting tort, the one giving it is himself a tortfeasor and is responsible for the consequences of the other's act.

*Id.* at § 876 cmt on clause (b).

alleged aider-abetter itself need not owe a duty of care to the victim.[368] And most courts agree that the alleged aider-abetter need not reap a personal financial benefit from the wrongful conduct to be liable.[369] But many courts consider financial gain by the alleged aider-abetter as evidence of knowledge of and/or assistance to the tortious behavior.[370] Moreover, the alleged aider and abetter need not even posses a wrongful intent, provided that she knows the conduct in question is tortious.[371] Courts are also amenable to use of the common law doctrine of aider-abetter liability to enforce statutes which do not by their own terms define or contemplate liability for aiding and abetting.[372] While most aider-abetter liability cases involve allegations of fraud, some courts have been receptive to applying aider-abetter liability to unfair and deceptive trade practice claims as well.[373]

A small, but growing line of cases apply aider-abetter liability to a variety of different parties involved in predatory lending. For example, in a payday lending case,[374] the New York Attorney General's office successfully argued that a bank criminally facilitated evasion of the state's usury law by allowing a non-bank agent to originate, service, and retain an ownership interest in payday loans.[375] A federal district court in New York denied a motion to dismiss an

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[368]Neilson v. Union Bank of California, 290 F.Supp.2d 1101, 1127 (2003).

[369]*Id. Cf* Bryan C. Baksdale, Redefining Obligations in Close Corporation Fiduciary Representation: Attorney Liability for Aiding and Abetting the Breach of Fiduciary Duty in Squeeze Outs, 58 WASH. & LEE L. REV. 551, 572 (2001).

[370]Alan R. Bromberg & Lewis D. Lowenfels, *Aiding and Abetting Securities Fraud: A Critical Examination*, 52 ALB. L. REV. 637, 739-48 (1988); Monsen v. Consolidated Dressed Beef Co., Inc., 579 F.2d 793, 799 (3d. Cir. 1978).

[371]Chem-Age Industries v. Glover, 652 N.W.2d 756, 775 (S.D. 2002).

[372]*See, e.g.,* Wynn v. National Broadcasting Co., Inc., 234 F.Supp.2d 1067, 1114 (C.D. Cal. 2002) (using common law aider-abetter liability to enforce the New York Human Rights statute).

[373]Banks v. Consumer Home Mortg., Inc., 2003 WL 21251584 at *12 (E.D.N.Y. March 28 2003) (allowing aider-abetter liability for New York's deceptive trade practices statute where there is "(1) the existence of the primary deceptive act or practice, (2) the aider and abettor's knowledge of the deceptive act or practice, and (3) substantial assistance by the aider and abettor.")

[374]Payday loans are small loans frequently made through use of the borrower's checking account. PETERSON, TAMING THE SHARKS, *supra* note 27, at 10-18; Richard R.W. Brooks, *Credit Past Due*, 106 COLUM. L. REV. 994, 1006-09 (2006). In a typical transaction the borrower will give the lender a post-dated personal check for $360.00, in exchange for $300.00 in cash. The lender promises to refrain from depositing the check for two weeks. When the two week loan term is up, the lender deposits the check. If the check clears, the borrower has repaid the loan. But if the check does not clear, the loan continues to accrue interest at a rate of $60 every two weeks. This amounts to an interest rate of approximately 520% per annum. Consumer advocates assert payday loans are predatory because, while consumers generally intend them to be short term, frequently they compound for much longer durations since borrowers have great difficulty repaying such a rapidly growing debt. PETERSON, TAMING THE SHARKS, *supra* note 27, at 10-11.

[375]New York, ex rel Spitzer v. County Bank of Rehoboth Beach, 1:03-CV-1320 (N.D.N.Y. May 25, 2004) (holding no interstate commerce clause preemption issue existed where a Delaware bank was accused of criminally facilitating violation of New York usury law by a non-bank payday lending company).

aider-abetter liability claim against a mortgage closing attorney who allegedly claimed to represent the borrowers when in fact he did not.[376] A Pennsylvania case held that a real estate appraiser was potentially liable for predatory lending related claims because she acting in concert with other defendants.[377] And an Illinois federal district court case refused to dismiss a common law fraud claim against an assignee of a predatory mortgage based on the allegation that the assignee "knew of th fraud, but nonetheless funded the loan."[378]

In the context of securitization of mortgage loans, the most emblematic recent aider-abetter liability case involves Lehman Brothers and First Alliance Mortgage Company. In *In re First Alliance Mortgage Co.* the central district of California held that Lehman Brothers could be liable for aiding and abetting fraudulent lending by First Alliance.[379] Throughout the mid-to late 1990s, a parade of state attorneys general, private consumers, and public interest organizations accused First Alliance of targeting senior citizens with misleading and fraudulent home refinance loans.[380] Discovery revealed that Lehman Brothers was fully aware of these allegations. Nevertheless, Lehman Brothers extended First Alliance a large secured warehouse line of credit to initially fund predatory loans. After originating the mortgage loans, First Alliance then used Lehman Brothers' services to securitize the loans for resale to investors on Wall Street. First Alliance used the proceeds of loans sold into securitization pools to pay down its line of credit, cover overhead costs, and initially reap handsome profits. First Alliance also retained the servicing rights to the loans, which gave the company the opportunity to make additional profits from servicing compensation paid by the trust as well as other servicing related revenue, such as that gathered from late fees and refinancing delinquent loans. But, when predatory lending litigation brought by state attorneys general and the Federal Trade Commission (along with exposes in the Wall Street Journal and on national television) began to make First Alliance's prospects look dim, First Alliance filed for bankruptcy. But before petitioning the bankruptcy courts for protection, First Alliance drew down 77 million dollars on its warehouse line of credit with Lehman Brothers.[381] In bankruptcy proceedings the bankruptcy trustee argued that because Lehman aided and abetted First Alliance's fraudulent lending, Lehman's security interest on the warehouse credit line should be equitably subordinated to other creditors, including First Alliance's predatory lending victims.[382] Ultimately the district court concluded that Lehman Brother's security interest would not be subordinated since the 77 million dollars Lehman had already coughed up had enriched the

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[376]Coveal v. Consumer Home Mortg., Inc., No. 04-CV-4755(ILG), 2005 WL 704835, at *2, *10 (E.D.N.Y March 29, 2005 ).

[377]Pennsylvania v. Parisi, 873 A.2d 3, 10-11 (Pa. Cmwlth, 2005).

[378]Mason v. Fieldstone Mortgage Co., No. 00 C 0228, 2000 WL 1643589, at *1 (N.D.Ill., 2000).

[379]*In re First Alliance Mortgage Co.,* 298 B.R. 652, 668 (2003).

[380]*Id.* at 658-59.

[381]*Id*. at 664.

[382]*Id.* at 666.

bankrupt company's estate.[383] But, before doing so, the court made clear that Lehman *had* aided and abetted fraud against the First Alliance's customers.[384] Given this finding, it is unsurprising that when this article went to press, class action litigation against Lehman Brothers was still pending. For their part, consumers involved in the class action have still not been compensated for fraudulent loans many of which led to the loss of a family home. Lehman, who was a secured creditor, had their bankruptcy claim paid in full.[385]

2. Conspiracy

A second possible avenue of asserting liability for concerted wrongdoing in predatory lending securitization is civil coconspirator liability. Generally a civil conspiracy is defined as "a malicious combination of two or more persons to injure another in person or property, in a way not competent for one alone, resulting in actual damages."[386] A conspiracy requires demonstration of an underlying unlawful act upon which the claim is based as well as some form of combination or agreement between the coconspirators. It is well settled that where a conspiracy exits, liability for actions by one coconspirator taken in furtherance of the conspiracy can be attributed to every co-conspirator, making each equally liable for the other's acts.[387] Courts treat parties to a civil conspiracy as joint tortfeasors with joint and several liability for all damages "ensuing or naturally flowing" from the act.[388] Moreover, courts hold coconspirators liable irrespective of whether they are the direct actor and irrespective of the degree of involvement.[389] Courts distinguish coconspirator liability from aider-abetter liability because unlike a coconspirator, an aider-abetter does not adopt as her own the wrongful act of the primary violator through concerted action or agreement.[390]

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[383]*Id* at 668-69.

[384]*Id.* at 668 ("Lehman's financing constituted significant, active and knowing participation by Lehman in the First Alliance fraud, thereby substantially assisting First Alliance in its fraudulent lending practices").

[385]298 B.R. at 665.

[386]Mathews v. New Century Mortgage Corp., 185 F.Supp.2d 874, 889 (S.D.Ohio 2002) (quoting Williams v. Aetna Fin. Co., 700 N.E.2d 859, 868 (1998)).

[387]PROSSER & KEETON, TORTS § 46 (5th Ed. 1984).

[388]15A C.J.S. Conspiracy § 21 (2005). *See* Weinbaum v. Goldfarb, Whitman & Cohen, 46 Cal. App. 4th 1310 2d Dist (1996).

[389]*In re American Continental Corporation*, 794 F.Supp. 1424, 1437 (D. Ariz. 1992).

[390]Neilson v. Union Bank of California, NA, 290 F.Supp.2d 1101, 1134 (C.D.Cal. 2003). The D.C. Circuit has explained:

> Aiding-abetting focuses on whether a defendant knowingly gave "substantial assistance" to someone who performed wrongful conduct, not on whether the defendant agreed to join the wrongful conduct . . . . There is a qualitative difference between proving an agreement to participate in a tortious line of conduct, and proving knowing action that substantially aids tortious conduct.

Coconspirator liability seems to have some promise in attributing wrongful actions of front line players to behind the scenes financiers in securitization. In *Williams v. Aetna Finance Company* the Supreme Court of Ohio found a mortgage lender liable for fraud committed by a door to door salesman. The mortgage lender had an agreement to give the salesman a commission for loans he facilitated with the lender. a case where a tin man pursued senior citizens who owned their homes free and clear. The "pitchman" targeted neighborhoods with senior citizens who owned their homes free and clear, convincing them to borrow money for home repairs. The lender was liable for the pitchman's behavior because it gave "access to loan money that was necessary to further his fraudulent actions against customers...."[391] Other decisions have denied dismissal of civil coconspirator liability claims for range of mortgage lending industry participants including brokers, home sellers, lenders, appraiser, and attorneys.[392] In *Herrod v. First Republic Mortgage*, the Supreme Court of Appeals of West Virginia rejected the notion that the mere fact of securitization changes the application of coconspirator liability rules, explaining that "[a] securitization model—a system wherein parties that provide the money for loans and drive the entire origination process from afar and behind the scenes—does nothing to abolish the basic right of a borrower to assert a defense to the enforcement of a fraudulent loan, regardless of whether it was induced by another party involved in the origination of the loan transaction, be it a broker, appraiser, closing agent, or another."[393]

While none of these cases involved extending liability to a seller, underwriter, or trustee in a securitization deal, the notion of a "pitchman" and a "financier" seems plausibly applicable to a lender and a seller or underwriter respectively. Although a pooling and servicing agreement will never explicitly *say* that an investment bank agrees to a deal despite an originator, broker, or servicer's *modus operandi* of violating predatory lending laws, agreement can be shown through circumstantial evidence such as the financial incentives, available information, and tacit understanding amongst the parties.

### 3. Joint Venture

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Halberstam v. Welch, 705 F.2d 472, 478 (D.C. Cir. 1983). Thus, courts generally agree that aider-abetter liability and coconspirator liability are closely related but distinct common law theories. Janken v. GM Hughes Electronics, 46 Cal.App.4th 55, 78 (1996).

[391] Williams, 700 N.E.2d at 868. *See also* Mathews v. New Century Mortg. Corp., 185 F.Supp.2d 874, 890 (S.D.Ohio, 2002) (refusing to dismiss conspiracy claim against lender for home improvement contractor's fraud because lender "approved the allegedly fraudulent loan applications of each of the plaintiffs").

[392] Coveal v. Consumer Home Mortg., Inc., No. 04-CV-4755(ILG), 2005 WL 704835, at *1, *8-*9 (E.D.N.Y March 29, 2005 ); M&T Mortg. Corp. v. Miller, 323 F.Supp.2d 405 (E.D.N.Y. 2004).

[393] Herod v. First Republic Mortgage Corp., 625 S.E.2d 373, 388 (W.Va. 2005) (starcher, J., concurring) (arguing fraud may be asserted as a contractual defense to a loan note up to the amount of the note irrespective of whether the loan has been assigned into a securitization conduit). In the *Herod* case, the consumers sued a mortgage broker and a mortgage alleging that the latter aided and abetted, conspired with, and was a co-venturer with the former. *Id.* at 383-84. The court held that sufficient facts existed to impute the wrongful behavior of the broker to the lender on each of these three theories. *Id.*

A final common law doctrine which may hold promise in creating greater accountability for structured financing of predatory lending is joint venture liability. A joint venture is an association of two or more persons designed to carry out a single business enterprise for profit, for which purpose they combine their property, money, effects, skill, and knowledge.[394] Joint ventures arise out of contractual relationships, be they oral, written, express, or implied. While the precise formulation of elements varies, generally to form a joint venture:

> (1) two or more persons must enter into a specific agreement to carry on an enterprise for profit; (2) their agreement must evidence their intent to be joint venturers; (3) each must make a contribution of property, financing, skill, knowledge, or effort; (4) each must have some degree of joint control over the venture; and (5) there must be a provision for the sharing of both profits and losses.[395]

Where a joint venture does exists courts generally rely on partnership law in judging the rights of the parties. Thus, courts hold joint venturers may be jointly and severally liable for debts of the venture including those incurred from tortious conduct.[396] In general a co-venturer is not liable for willfully unlawful acts of other another. But, where the unlawful act was within the actual or apparent scope of the joint venture, or where the co-venturer gave express or implied consent to the act, or even where the co-venturer failed to protect the victim from the act, he or she can be liable for the primary wrongdoer's behavior.[397]

As with aider-abetter and coconspirator liability, a growing line of cases find co-venturer liability with respect to predatory lending allegations. For example, in *George v. Capital South Mortgage Investments*, the Kansas Supreme Court considered a large punitive damage award against a mortgage lender and an assignee.[398] The case involved a mortgage defunct mortgage brokerage called Creative Capital Investment Bankers. The consumer-

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[394]Shell Oil Co. v. Psetridge, 249 F.2d 413, 414-15 (9th Cir. 1957). Some argue that the definition of joint venture should vary given the legal context within which the concept is being applied. For example, the definition of joint venture for anti-trust purposes may or may not be the same as for tort or consumer protection statute liability. *See* Brodley, Joint Ventures and Antitrust Policy, 95 HARV. L. REV. 1523, 1525 (1982); Deborah L.E. Green, Note, *A Definitional Test for Joint Ventures*, 31 WAYNE L. REV. 1251, 1258 (1985).

[395]46 AM.JUR.2d *Joint Ventures* § 9, n.82 (citing *ITEL Containers Int'l Corp. V. Atlanttrafik Express Service, Ltd.* 909 F.2d 698 (2d Cir. 1990). See also Pownall v. Cearfoss, 40 S.E.2d 886 (W.Va. 1946) (providing similar elements). The agreement to share in the profits and losses of the venture may be implicit rather than explicit. Marco v. Miele, 418 So.2d 1158, 1158 (Fla. App. D4 1982) (per curiam). However, sharing of loss and profits is generally a prerequisite of the establishment of a joint venture. Hyman v. Regenstein, 258 F.2d 502 (5th Cir. 1958). The existence of a joint venture is usually a question for the trier of fact. Bowers v. Wurzburg, 528 S.E.2d 475, 484 (W.Va. 1999).

[396]Myers v. Lillard, 220 SW2d 608 (Ark 1949); Armor v. Lantz, 535 S.E.2d 737, 742 (W.Va. 2000); Friedman v. Wilson Freight Forwarding Co., 181 F.Supp. 327 (W.D.Pa. 1960); Clifton v. Van Dresser Corp. Ben. Plans Risk Management, Inc., 596 N.E.2d 1075 (Oh. Ct. App. 1991); 46 Am. Jur.2d *Joint Venture* § 42.

[397]Donohoe v. Consolidated Operating and Production Corp. 982 F.2d 1130 (7th cir. 1992); Knepper v. Genstar Corp, 537 So.2d 619 (Fla. Dist. Ct. App. 3rd 1988); Vrabel v. Acri, 103 N.E.2d 564 (Ohio 1952).

[398]George v. Capital South Mortgage Investments, Inc., 961 P.2d 32, 32-39, 44-45 (Kan. 1998).

plaintiffs in the case hired Creative to assist them in obtaining a loan to purchase a home from a relative for $40,000. After swamping the family with a parade of silly and unnecessary documents, the mortgage broker obtained a signature on a loan contract with a principle of $60,000. The broker then instructed a closing agent to distribute *less* than the agreed purchase price for the home to the seller. The lender, who was apparently aware of the unusual terms, assigned the loan to a private individual at closing and gave the closing agent instructions to not inform the borrowers of the assignment. When the family learned that they had borrowed $20,000 that they never wanted nor received, they sued. Creative Capital did not appear at trial and the court gave the family a default judgement, which in all likelihood was uncollectible. Of more import was the family's claim that the lender and the broker were engaged in a joint venture to profit from the broker's fraud and usury. At trial the jury agreed. On appeal, the Kansas Supreme court found that sufficient evidence to sustain the co-venturer verdict against the lender and assignee. The lender's arguments that it was a distinct corporation, located in a different state, and did not share office space, administrative services, or telephone lines. Looking past these arguments the court pointed to frequent contact between the lender and the broker, as well as the lender's insolvent in structuring the loan immediately preceding closing.[399] The court sustained the jury verdict against the assignee by pointing to the undisclosed assignment at closing as evidence that the assignee was a participant in the joint venture. Moreover, the court pointed out that the fact that assignee received much of the financial benefit from the unlawful charges suggested that assignee had agreed to the joint venture.[400]

While the *George* case did not involve securitization, there does not appear to be a principled reason why joint venture rules would be inapplicable to structured finance. In securitization deals the pooling and servicing agreement is an explicit agreement to carry on an enterprise for profit by the different businesses involved in the conduit, including mortgage brokers, lenders, MERS, servicers, sellers, underwriters, trustees, and trusts or an SPV taking a different legal form. Each of these parties fulfill a specific function within a structured finance deal and all have control over their own particular role. At least some of the parties in some cases agree to share in the losses and profits of the venture. For example, mortgage lenders frequently agree to repurchase non-performing loans from the trust. Mortgage brokers are only paid if any given loan closes and conforms to the underwriting standards of the loan pool. Servicers agree that their fees are contingent on performance aspects of the loan, such as whether borrowers pay on time. Sellers and underwriters agree to accept the price they can receive from selling securities, which is in turn dependent on the reputation and behavior of the originators, brokers, and servicers. Trustees agree to share in profits and losses since they accept compensation out of the proceeds of consumers' monthly payments. And certainly a trust (or other type of SPV) itself agrees to share in profits and losses, given that trust income is completely dependent on performance of the loans it houses.

Following this reasoning, at lease one court has found a triable issue of fact on the question of whether a securitization pooling and servicing agreement created joint venture with

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[399] *Id.*

[400] *Id.*

respect to predatory lending allegations. In *Short v. Wells Fargo*[401] Michael Short alleged that employees of Delta Funding, a mortgage lending company, closed a mortgage loan on his home when they came to his house with a stack of documents for him to sign. Mr. Short alleged that Delta never provided him any copies of the loan documents nor gave any explanation of them at the informal closing. Delta Funding sold Mr. Short's loan along with many others into a trust pursuant to a pooling and servicing agreement with Wells Fargo, a national bank regulated by the Office of the Comptroller of the Currency, agreeing to act as trustee. Under pooling and servicing agreement Countrywide Home Loans, Inc. agreed to service the loans. Eventually Mr. Short alleged that Countrywide gave Mr. Short notice that he owed two payments on his loan in one month. After several unsuccessful (and no doubt frustrating) attempts to contact Countrywide's customer service, Countrywide eventually informed Mr. Short that he also owed nearly a thousand dollars in attorneys fees and other penalties in addition to his regular payment plus the still unexplained extra monthly payment—all immediately due by certified check. Mr. Short also alleged that Countrywide had charged him fees that were not authorized under West Virginia statutes. Eventually Mr. Short obtained counsel and sued. The federal district court reviewed the general principles of joint venture. Then, the court pointed out that the parties explicitly divided up the revenue from various fees in the pooling and servicing agreement. The court concluded that "taking the evidence in the light most favorable to the plaintiffs, it would not be unreasonable for a jury to conclude that Delta Funding, Countrywide and Wells Fargo entered into a joint venture."[402]

## IV. THE CONSUMER PROTECTION CRITIQUE OF MORTGAGE SECURITIZATION LAW

### *A. Ambiguity: Consumer Protection Laws Presume an Antiquated Model of Finance*

Perhaps the one uniform feature of predatory lending law is its failure to recognize and account for the complex financial innovations that have facilitated securitization structures. Most consumer protection statutes including the Truth in Lending Act (1968), the Fair Debt Collection Practices Act (1977), the Equal Credit Opportunity Act (1974), the Fair Housing Act (1968), and the Federal Trade Commission's holder in due course notice rule (1975) all preceded widespread securitization of subprime mortgages by over a decade. While this time frame is not meaningful in itself, it hints at a fundamental structural problem in the law.

As discussed in Part I, early American mortgage lending tended to be a two party transaction: a lender and a borrower. After the Great Depression most mortgage loans can be characterized as three party transactions: a borrower, a lender, and a federal government sponsored institution that backstopped the lender by purchasing or guaranteeing the mortgage. In comparison, contemporary asset-backed securities conduits often have eleven or more integral parties: a borrower, a broker, an originator, a seller, an underwriter, a trust, a trustee, multiple servicers, a document custodian (which may be closely involved in foreclosure proceedings), an external credit enhancer, a securities placement agent, and investors. Yet, the consumer protection law evolved with the older two and three party mortgage systems in mind.

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[401] 401 F.Supp.2d 549 (S.D.W.Va. 2005).

[402] *Id.* at 565.

The authors of this law wrote definitions and rules which are poorly adapted to current commercial transactions. Left without a meaningful vocabulary amenable to regulation of securitized consumer loans, policy makers have struggled to crowbar satisfactory policy outcomes out of legal rules and concepts which only vaguely relate to the commercial reality they purport to govern. This section looks at four examples of how this structural ambiguity has facilitated dysfunctional, unprincipled, and arbitrary limitations to the scope of consumer protection statutes and doctrines that regulate predatory lending. Specifically, the legal definitions of "creditor", "seller", "assignee", and "debt collector" in federal law are all based on dated commercial concepts which leave glaring gaps in the law.

One would expect little controversy in a term as fundamental as "creditor". But, the word suggests a unitary notion of a single individual or business that solicits, documents, and funds a loan. For example, under the Truth in lending Act, a creditor is "the person to whom the debt arising from the consumer credit transaction is initially payable on the face of the evidence of indebtedness."[403] This definition is important since the private cause of action creating the possibility of liability under the act extends only to "any creditor who fails to comply" with the act's requirements.[404] While this definition resonates with the notion of a lender as we commonly think of it, this notion is increasingly discordant with reality. In the vast majority of subprime home mortgage loans, most of the actual tasks associated with origination of the loan, including especially face to face communication with the borrower, are conducted by a mortgage loan broker.[405] Because brokers usually do not fund the loan, they are not the party to whom the loan is initially payable. The absurd result is that the federal statute which purports to promote useful and accurate disclosure of credit prices does not govern the business or individual that actually *speaks* to a mortgage applicant. Rather liability for the statute is confined to errors in the complex paperwork which many consumers have difficulty reading and which are typically ignored in hurried loan closings long after borrowers arrive at decision on which broker and/or lender to use. Arguably the credit advertising restrictions in Part C of the statute reach mortgage loan solicitations by mortgage brokers. But these provisions are quite limited in their substantive reach—for example, they never explicitly prohibit misleading advertising or even *false* descriptions of loans.[406] And even if they did, the statute does not grant a private cause of action to sue for advertising violations anyway.[407]

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[403] 15 U.S.C. § 1602(f).

[404] 15 U.S.C. § 1640(a).

[405] Many mortgage market insiders have begun to discard terms "lender" and "broker" instead using "mortgage-makers". *See, e.g.,* Eisinger, *supra* note 178, at C1 ("The worry has been that in the rush to gain customers during the housing boom, mortgage-makers lowered their lending standards. During the boom times, investment banks overlooked these concerns because they had no problem finding buyers for their mortgage and debt products.").

[406] 15 U.S.C. §§ 1661-1665b.

[407] Section 130 of the Act, which is housed in Part B of the statute grants a private cause of action to sue creditors for noncompliance with "any requirement imposed under this part [part B], including any requirement under section 1635 of this title or part D or E of this subchapter." 15 U.S.C. § 1640(a). Because the advertising are in Part C, consumers cannot sue for advertising that violates the truth in lending act. Ironically mortgage brokers and

The failure of consumer protection statutes to adjust to the disaggregated reality of mortgage loan origination also undermines the scope of the Home Ownership and Equity Protection Act. Like TILA, HOEPA's enhanced disclosure rules only govern creditors.[408] Nothing in the statute purports to require that brokers refrain from making incomplete, misleading, or false oral statements to the borrower. Nothing in the statute purports to hold brokers accountable for failing to explain costly and disadvantageous fees which are not in the borrowers best interests. And since the civil liability provision of the statute only applies to creditors, consumers lack a private cause of action to sue brokers even if those provisions did exist.[409]

The notion of a "seller" in consumer protection law is also outdated given the reality of contemporary securitization markets. Here the most important example is the limited scope of the federal trade commission's regulation on the preservation of consumers' claims and defenses, or, the FTC holder-notice rule, as it is more commonly referred to. The regulation defines sellers as "a person who in the ordinary course of business, sells or leases goods or services to consumers."[410] Obviously the businesses labeled sellers by the FTC holder-notice rule are quite different than those so labeled in the parlance of home mortgage securitization. In the idiom of the former, a seller is essentially a retailer of consumer goods or services. In the idiom of the latter a seller is generally an investment banking firm that sells mortgage loans to a special purpose vehicle, which is usually a trust. Still, for purposes of public policy, the structural role of a "seller" in both conceptual frameworks is quite similar.

As discussed in Part II, the holder-notice rule requires that sellers include a contract provision which preserves consumer claims and defenses as against any subsequent assignee of the contract. But, because the regulation only applies to consumer goods and services, most mortgage loans are not covered by the regulation. Only mortgage loans which are extended to finance the purchase of some consumer service, such as home repairs are generally covered by the regulation. Why did the FTC design a rule allowing the vast bulk of subprime mortgage loans to remain uncovered? Nothing in the FTC's statement of basis and purpose for the regulation, enforcement policy, or staff guidelines explicitly addresses this seemingly obvious and glaring hole in the scope of the rule.[411] The statement of basis and purpose issued in 1975 does offer some clues by listing the types of consumer transactions where FTC investigations found legitimate consumer claims and defenses had been cut off by the holder in due course

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lenders who willfully violate advertising rules are subject to criminal prosecution under Section 113 of the Act. 15 U.S.C. § 1611. That provision does not use the term "creditor" but allows prosecution of "whoever" willfully and knowingly violates the TILA rules. *Id.* However, criminal prosecution for TILA violation has virtually never occurred.

[408] 15 U.S.C. 1639 (a)(1) ("the *creditor* shall provide the following disclosures. . . .") (emphasis added).

[409] 15 U.S.C. 1640 (a)(2)(B)(4).

[410] 16 C.F.R. § 433.1(j).

[411] Preservation of Consumers' Claims and Defenses: Final Regulations, Proposed Amendment and Statement of Basis and Purpose, 40 FED. REG. 53506 (1975); Statement of Enforcement Policy *In Re* Preservation of Consumers' Claims and Defenses, 41 Fed. Reg. 34595 (1976); Staff Guidelines on Trade Regulation rule Concerning Preservation of Consumers' Claims and Defenses, 41 Fed. Reg. 20022 (1976).

doctrine or waiver of defense clauses. The FTC's list included: courses of training and instruction, furniture and appliances, home improvements, freezer meats and other food plans, automobiles, carpeting, alarm systems, swimming pools, and a miscellaneous category.[412] The FTC argued that the common elements in all of these cases were:

> (1) the execution by the consumer of a promissory note or waiver of defenses and subsequent negotiation or assignment of the contract by the seller to a third party financier; (2) seller misconduct in the transaction between seller and consumer—that is, an infirmity in the original sale—or the development of a fault or a defect following the sale; (3) failure of the seller to remedy the defect or otherwise deal with the complaint of the consumer either through absolute unwillingness on the part of the seller or due to the seller's disappearance from the market; (4) interruption in payments by the consumer to the financier; and (5) assertion by the financier of its protected status in order to obtain payment on the obligation.[413]

These elements bear striking resemblance to the pattern currently seen in the subprime home mortgage lending industry. But, as the historical discussion in Part I makes clear, in the mid-1970s, when the FTC adopted its regulation the secondary home mortgage market was still dominated by reputable institutions closely monitored by government gatekeepers. The FTC did not discover the pattern of using assignment to cleanse a consumer obligation of its legal defects because private label securitization markets had not yet developed which would facilitate non-depository investment in long term home mortgages. Today the federal secondary market infrastructure no longer constrains predatory practices in mortgage loans unrelated to consumer goods and services. Unsurprisingly the pattern the identified by the FTC three decades ago has now emerged in mortgage lending. "Sellers" that market freezer food plans to consumers are a different beast than sellers that assign thousands of thirty year home mortgages to investment trusts for securitization. But, the two businesses share the common pattern of using assignment to *cleanse* financial obligations of the consumer protection claims and defenses created in originating those obligations. Just as assignment of short and medium term consumer paper facilitated capitalization of unscrupulous door-to-door retailers in the early 1970s, securitization of long term home mortgage loans has capitalized mortgage brokers and lenders who are willing to mistreat their customers. The inapplicability of the FTC's holder-notice rule to most consumer mortgage loans is a relic of older two and three party secondary mortgage markets. Moreover, it is a relic that creates economic incentive that buttress structured finance of predatory residential lending.

But even if the FTC's notice rule were modified to do away with holder in due course doctrine in all consumer mortgages—as it clearly should be—assignee liability may insufficient in the an era of securitization. The notion of an "assignee" itself has become problematic in markets funded by mortgage backed securities. As discussed in Part II, the primary mechanism for distributing liability to a secondary wrongdoer for predatory

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[412]Preservation of Consumers' Claims and Defenses, 40 FED. REG. at 53510-11. The miscellaneous category included "vacuum cleaners, kitchen utensils, encyclopedias, cemetery plots, clothing, a hearing aid, and an employment placement service." *Id.* at 53511.

[413]*Id.*

origination is by assignee liability rules including the common law of assignment, section 141 of the Truth in Lending Act, the Home Ownership and Equity Protection Act's due diligence standard, and various state predatory lending provisions. In previous generations transferring liability from the primary wrongdoer to a secondary wrongdoer through tracking ownership of the loan may have made more sense since the legal act of *owning* was so closely connected to other more problematic behaviors. The legal entity which owned a loan also tended to engage in a range other activities associated with that loan including origination, servicing, document storage, collections, and foreclosure. Accordingly, the law could apportion liability for unsavory behavior in these other processes by tracking ownership.

Again taking the Truth in Lending Act as an example, it explicitly provides liability only for two types of businesses: creditors and assignees of creditors. Assignees of creditors are liable only if disclosure mistakes are apparent from the face of the contractual documents. This made sense in 1968 since at that time it was reasonable to expect that a business taking a loan on assignment would actively be involved in screening for mistakes in origination—and thus could fairly be held accountable for those mistakes. But today many "assignees" do not screen for mistakes in origination since the assignee itself has no actual employees. After all, the ultimate assignee of a securitized loan is a purely fictional legal person: a trust with no building, no address, no telephone number, no customer service department, and certainly no one to wade through boring TILA forms. Rules conditioning liability for harmful origination acts on the concept of an "assignee"—an entity which by its nature need only engage in the simple act of owning—are incompletely adapted to structured finance. Indeed, improving assignee liability rules—the goal of the bulk of contemporary scholarship and legislative reform[414]—is not by itself enough since many of the businesses that are facilitating and profiting from predatory lending are never assignees. A trustee for the assignee can be expected to engage in due diligence in screening for violations, but that trustee's financial interests are far from coextensive with the trust itself. Indeed some of the most cutting edge recent trust and estate scholarship focuses on how trustees' economic incentives frequently diverge from the trusts they represent.[415] Yet, nothing in the Truth in Lending Act contemplates the nuanced difference between trusts and trustees, relying instead on the bulky and ill-conceived notion of an assignee to police behavior of a trustee that does not, itself, own the loan in question. Because they were drafted with the older two and three party secondary mortgage markets in mind, our current consumer protection statutes lack explicit mechanisms to hold liable *architects* of structured finance deals, such as the sellers, underwriters, and trustees, that engineer deals capitalizing predatory lending.

Finally, the current definition of a "debt collector" has become unwieldy in an era of securitization. A common understanding of the words "debt" and "collection" includes reference to home mortgage loans, which are typically the most important debt collected from a consumer in her lifetime. But as discussed in Part II, the federal Fair Debt Collection Practices Act defines the term debt collector as a person who "regularly collects or attempts to collect,

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[414]*See infra note* 34.

[415]Robert H. Sitkoff, *An Agency Costs Theory of Trust Law*, 89 CORNELL L. REV. 621 (2004).

directly or indirectly, debts owed . . . to . . . another" person.[416] Although creditors, as we commonly understand them, collect debts, they are not debt collectors for purposes of federal law because they collect debts owed to themselves, rather than to another person.[417] The purpose behind this somewhat artificial definition was to limit the scope of the statute to focus primarily on independent third party debt collection agencies which specialize in collecting loans and accounts in default.[418] The legislative history of the statute makes clear that Congress limited the scope because it believed the most serious and widespread debt collection abuses were associated with professional debt collection agencies, rather than with creditors themselves.[419]

In an era when creditors tended to hold and service their own loans, the economic incentives behind holding third party debt collectors to a higher standard than creditors themselves made some sense. Creditors that serviced their own debts were often beholden to their customers for repeat business. Moreover, even without repeat business, if a lender's reputation suffered from sharp practices, the lender could be forced to offer less favorable terms in order to attract business.[420] In lending as in other businesses, market forces can be expected to exert discipline on the behavior of a company that relies on the good will of its customers. However, third party debt collection companies are not selected by consumers. Third party debt collection agencies typically are paid by commission and fee revenue based on their success in extracting payment from debtors. Consumers do not have the option of disciplining third party debt collection agencies by refusing to do business with them. Moreover, it is unlikely that reputational shopping networks will have the information and sophistication necessary to consistently attribute the actions of a debt collection agency to a creditor which retains that company. These externalities born by consumers associated with contracts between creditors and third party debt collectors gave Congress a compelling justification for the FDCPA's intervention in credit markets.

Unfortunately, the Fair Debt Collection Practices Act's vocabulary no longer tracks

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[416] 15 U.S.C. § 1692a(6).

[417] The Fair Debt Collection Practices Act defines "creditor" as any person who offers or extends credit creating a debt or to whom a debt is owed, but such term does not include any person to the extent he receives an assignment or transfer of a debt in default solely for the purpose of facilitating collection of such a debt for another." 15 U.S.C. § 1692a(4).

[418] Senate Report No. 95-382, at 2-3.

[419] Senate Report No. 95-382, at 2. The distinction between a third party debt collector and a creditor is not always clear and has probably become even more ambiguous as more of the consumer credit market has turned to securitization. For example, creditors are governed by the statute if they attempt to obtain cow debtors by presenting themselves as debt collectors. Maguire v. Citicorp Retail Servs.,Inc. , 147 F.3d 232 (2d Cir. 1998); Taylor v. Perrin, Landry, deLaunay & Durand, 103 F.3d 1232 (5th Cir. 1997). The statute does not consider employees of a creditor to be debt collectors even if their primary job function is collecting debts. 15 U.S.C. § 1692a(6)(A). Moreover, "one subsidiary or affiliate which collects debts for another subsidiary or affiliate is not a 'debt collector' so long as the collecting affiliate collects only for other related entities and its principal business is not debt collection." Senate Report No. 95-382, at 3.

[420] Gilian K. Hadfield, et al., *Information-Based Principles for Rethinking Consumer Protection Policy*, 21 J. CONSUMER POL'Y 131, 139 (1998).

well with commercial relationships in a typical subprime home mortgage securitization conduit. In contemporary structured finance deals, the "creditor" only owns the loan for the scant period of time necessary to sell it to the secondary market. In a typical transaction, a third party company is hired to service the loan—meaning collect the debt. Much like a "debt collector" as defined under federal law, mortgage loan servicers are not chosen by consumers. A consumer does not have the right to refuse to do business with a company granted servicing rights by a securitization pooling and servicing agreement. Indeed, consumers typically never see or even learn of the existence of the pooling and servicing agreement which will control the company with which they must interact with on a monthly basis for as long as thirty years. And yet, legislative history, Federal Trade Commission interpretive guidelines, and case law are clear that mortgage loan servicing companies are generally beyond the scope of the FDCPA.[421] This rule was grounded in the fact that when Congress adopted the FDCPA, government sponsored enterprises watched over mortgage loan companies which generally serviced the loans they originated after assignment.[422] In the three party model of mortgage finance, the company that collected monthly payments, dunned, and foreclosed was generally closely beholden to a federally sponsored institution with Congressionally mandated public policy goals by the threat of losing its primary source of capital. Moreover, in the older three party system, the servicer was typically the same company that originated the loan, helping solidify reputational shopping effects.[423] Under current law servicers are usually only covered by the FDCPA if the servicer "obtained" the loan after the loan went into default.[424] Once again the language used in the law betrays the drafters' dated perception of commercial reality. In a

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[421]Senate Report No. 95-382, at 3-4 ("The Committee does not intend the definition [of debt collector] to cover the activities of . . . mortgage service companies and others who service outstanding debts for others, so long as the debts were not in default when taken for servicing."); Statements of General Policy or Interpretation Staff Commentary on the Fair Debt Collection Practices Act, 50 Fed. Reg. 50097, 50103 (Dec. 13, 1988) ("The exception [in 1692a(6)(F)(iii)] for debts not in default when obtained applies to parties such as mortgage service companies whose business is servicing current accounts."); Wagner v. American Nat'l Education Corp., Clearinghouse No. 36,132 (D. Conn. 1983) (servicing company was not a debt collector for purposes of the FDCPA).

[422]*See, e.g.,* Perry v. Stewart Title Co., 756 F.2d 1197 (5th Cir. 1985) (holding mortgage company was not a debt collector for purposes of the FDCPA when it originated a then serviced a home loan after assigning it to Fannie Mae).

[423]Greely, *supra* note 2, at 147.

[424]*See, e.g.,* Barber v. National Bank, 815 P.2d 857 (Alaska 1991) (holding mortgage servicing company which "obtained" debt before default is exempted from FDCPA coverage by § 1692a(6)(F)(ii)). There is one other way creditors, and presumably servicers, can fall within the scope of the FDCPA. It is well settled that if a creditor misrepresent itself as being a third party debt collector, then it is governed by the statute. 15 U.S.C. § 1692a(6); Domico v. Etan Industries, No. 98 C 1912, 1998 WL 765058, at *4 (N.D. Ill., Oct. 26, 1998). This creates an ironic twist in the law, since the FDCPA uses a "lease sophisticated consumer" standard to evaluate how consumers perceive creditor communications. Harrison v. NBD Inc., 968 F.3d 1052 (6th Cir. 1997); Krevsky v. Equifax Check Services, Inc., 85 F.Supp.2d 479 (M.D.Pa. 2000). Could the least sophisticated consumer mistake most dunning calls and letters from a mortgage servicing company as coming from a third party debt collector? The realistic answer is almost certainly yes. So, the logical implication seems to be that a servicing company should be governed by the statute unless its communications carefully explain the seemingly inconsequential distinction between debt collector and a mortgage servicer. And yet, there is no public policy goal served educating debtors on this point. The absurd result is a product of basing the scope of such an important statute on such a trivial distinction.

securitization conduit a servicer never "obtains" a loan as we commonly understand that term. Rather servicers obtain the right to receive a commission and fee revenue based on the success they have in extracting payment from debtors—which is precisely the role of a traditional third party debt collection agency. In today's secondary mortgage market, "creditors", as they are defined by the statute, can inflict the same externalities on consumers through outsourcing collection of securitized loans as those originally contemplated by Congress in passing the FDCPA.

A common thread links these four problematic statutory definitions making them more than a simple collection of ill-begotten drafting errors. While a theoretical debate has flourished on the economic incentives and potential effects of securitization, more simple historical facts and the legal ambiguities they have created have been neglected. Consumer loans sold into securitization conduits are subject to the same market imperfections which, through hard lessons and much national debate, once justified our consumer protection statutes. Thus, information imperfection (and the Truth in Lending Act) and debt collection externalities (and the Fair Debt Collection Practices Act) should not be neglected simply because the secondary market has found a new way to fund loans. The combination of private label securitization and the ambiguity of debtor protection law, here illustrated by ill-adapted definitions in federal statutes, have in effect unintentionally deregulated the most important segment of the consumer lending industry.

### *B. Opacity: Securitization Makes the Process of Litigating Predatory Lending More Costly for Consumers*

A second, equally important, critique of the effect of securitization lies in the impact it has on civil procedure. Discovery, negotiation, and litigation in general is more expensive for consumers with securitized loans than it is for loans funded by the traditional secondary market. Legal scholars have made a compelling case for the serious potential consequences for consumers when businesses use procedural dispute resolution costs as a hedge against enforcement of substantive law. For example, Jeff Sovern has recently pointed out that many businesses design systems that derive profit from increasing consumers' transaction costs.[425] Robert Rubinson has pointed out that only a "minute percentage" of society's dispute resolution resources are allocated to disputes regarding consumers' access to shelter even though "any principled moral or ethical analysis demonstrates that the stakes are much higher in disputes involving low-income disputants than in disputes involving affluent individuals or

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[425]Jeff Sovern, *Toward a New Model of Consumer Protection: The Problem of Inflated Transaction Costs*, 47 WM.& MARY. L. REV. 1635, 1645 ("If th e merchant can throw roadblocks in the way of the consumer seeking performance, the merchant can avoid performing and so obtain a windfall"). The classic example is providing a mail in rebate in connection with the sale of a consumer good. Instead of simply lowering the purchase price, retailers and manufacturers promise a rebate after consumers incur the transaction costs associated with gathering and mailing proofs of purchase. *Id.* at 1656-57. Retailers know that although consumers intend to mail in the rebate, many of them will fail to do so. *Id.*

organizations."[426] Moreover, an extensive literature demonstrates the great vulnerability of our civil justice system to manipulation of procedure in general and discovery in particular. For example, a federal district judge's remarks from the late 1970s seem equally resonant today:

> The civil justice system in the United States depends on the willingness of both litigants and lawyers to try in good faith to comply with the rules established for the fair and efficient administration of justice. When those rules are manipulated or violated for purposes of delay, harassment or unfair advantage, the system breaks down. . . . My experience as a participant in and observer of civil litigation has convinced me that abuse of the judicial process is widespread. Abuse of the judicial process occurs most often in connection with discovery. Unjustified demands for and refusals to provide discovery prolong litigation and drive up its costs. Fabrication and suppression of material facts are regrettably common occurrences, although lawyers and judges are often reluctant to admit it.[427]

Given these observations, we should not be surprised to find a business system which derives greater revenue from creating procedural roadblocks in the way of consumers litigating from the brink of homelessness.

One characteristic of structured finance is the erection of such barriers. In traditional two and three party mortgage markets, consumers and their counsel had a more clear idea of who they were borrowing from and who might seek to foreclose upon them if they failed to repay. Service of process, interrogatories, depositions, and negotiations could be expected to involve only one company which was responsible for all, or nearly all, the relationship functions associated with the loan. In comparison, selling a loan into a contemporary structured finance conduit can force consumers to communicate with and litigate against many more business entities. Even simple litigation tasks, such as service of process, interrogatories, and requests for production of documents can become much more complicated in structured finance. Where forty years ago, a borrower might need to serve one party, to bring the full range of predatory lending claims and defenses to bear on a securitization conduit can require

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[426]Robert Rubinson, *A Theory of Access to Justice*, 29 J. LEGAL PROF. 89, 91 (2004). Professor Rubinson's perspective is by no means universal. *Compare Id.* ("Eviction, losing minimal subsistence benefits, the welfare of children, and the risk of starvation are matters of consequence. Low-income disputants do not have the luxury of pursuing claims driven by principle or ego, or to accumulate further wealth, or to pursue greater profitability. In lives where the basics of life are at risk, disputes virtually always involve food and shelter, life and death."), *with* Frank H. Easterbrook, *Discovery as Abuse*, 69 B.U. L. REV. 635, 643 (1989) ("I am similarly unpersuaded . . . that we need special rules to protect small litigants from the large ones. . . . Sure big firms fight tooth and nail, for they stand to lose more than their smaller adversaries stand to win. . . . To prevent such consequences large firms will use many weapons, including discovery. But in a fight between the big and small, the big are more likely to be targets of impositional discovery requests; in a fight between the rich and poor, money flows in one direction only, no matter who is in the right.").

[427]Chalres B. Renfrew, *Discovery Sanctions: A Judicial Perspective*, 67 CAL. L. REV.264, 264-65 (1979) (citations omitted).

serving ten or more different businesses.[428] This is a daunting task indeed, since at the outset, the consumer will almost always have no knowledge of the name, address or other contact information for many of these firms. Indeed, counsel for the foreclosing party herself probably does not know which businesses were involved in performing the various functions associated with the loan. Phone calls to the loan's servicer are frequently ignored, subject to excruciating delays, and typically can only reach unknowledgeable staff who themselves lack information on the larger business relationships. For their part, securitization trustees are not in the business of counseling the thousands of mortgagors pooled in each of the many real estate trusts they oversee. Policy makers must not underestimate the staggering difficulty of reconstructing the facts involved in only one loan.[429] Securitization creates an opaque business structure which consumers have great difficulty forgathering.

Securitization also complicates the paper trail for a given mortgage by facilitating frequent permutations in the servicing and ownership history of the loan.[430] One of the benefits of securitization is that it allows trustees to shop for the most efficient servicer, reassigning servicing rights for loan pools when a better deal comes along. And, depending on how the securitization conduit is structured, a loan may undergo several assignments in route to its destination pool. While these changes may help insure that the pool securities pay out on time and otherwise manage risks to the businesses involved, they also raises costs for consumer counsel attempting to piece together who did what to their client.

At the same time mortgage loan documentation has become more complex, the organizational technology of securitization has displaced older, more transparent, public systems for maintaining records. Nowhere is this more apparent than the use of the Mortgage Electronic Registration System, or MERS, to circumvent county recording offices. As discussed in part II.B, MERS' primary function is to act as a document custodian. Major players in the mortgage lending industry created MERS to simplify the process of transferring mortgages by avoiding the need to re-record liens—and pay county recorder filing fees—each time a loan is assigned. "Instead, servicers record loans only once and MERS' electronic system monitors transfers and facilitates the trading of notes . . ."[431] Currently over half of all new residential mortgage loans in the United States are registered with MERS and recorded in county recording offices in MERS' name.[432] This has reduced transparency in the mortgage market in two ways. First, consumers and their counsel can no longer turn to the public recording systems to learn the identity of the holder of their note. Today, county recording

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[428]Broker, originator, MERS, master servicer, sub-servicer, special servicer, trustee, seller, underwriter, and an underwriter's due diligence contractor. If servicing rights have changed hands during the life of the loan, the consumer could require discovery from both old and new servicers.

[429]Bobbi Murray, *Wall Street's Soiled Hands*, *supra* note 35.

[430]Kevin Demarrais, *Beware the Predatory Mortgage Lender*, NEW JERSEY RECORD, October 29, 2000, at B01 ("Worst of all, they [predatory lenders] create a paper trail that hides the deceit and makes it hard to track them down.").

[431]INSIDE B&C LENDING, 14, 14 (March 3, 2006).

[432]*Infra* note 26 and accompanying text.

systems are increasingly full of one meaningless name, MERS, repeated over and over again. But more importantly, all across the country MERS now brings foreclosure proceedings in its own name—even though it is not the financial party in interest.[433] This is problematic because MERS is not prepared for or equipped to provide responses to consumers' discovery requests with respect to predatory lending claims and defenses. In effect, the securitization conduit attempts to use a faceless and seemingly innocent proxy with no knowledge of predatory origination or servicing behavior to do the dirty work of seizing the consumer's home. While up against the wall of foreclosure consumers that try to assert predatory lending defenses are often forced to *join* the party—usually an investment trust—that actually will benefit from the foreclosure. As a simple matter of logistics this can be difficult, since the investment trust is even more faceless and seemingly innocent than MERS itself. The investment trust has no customer service personnel and has probably not even retained counsel. Inquiries to the trustee—if it can be identified—are typically referred to the servicer, who will then direct counsel back to MERS. This pattern of non-response gives the securitization conduit significant leverage in forcing consumers out of their homes. The prospect of waging a protracted discovery battle with all of these well funded parties in hopes of uncovering evidence of predatory lending can be too daunting even for those victims who *know* such evidence exists. So imposing is this opaque corporate wall, that in a "vast" number of foreclosures, MERS actually succeeds in foreclosing without producing the original note—the legal *sine qua non* of foreclosure—much less documentation which could support predatory lending defenses.[434]

These characteristics of securitized residential lending are troubling because even marginal increases in the cost of dispute resolution can have a dramatic impact on subprime mortgage borrowers. Legal services organizations and law school clinics, where many predatory lending cases are litigated, uniformly lack sufficient investigatory, paralegal, administrative support. While admittedly anecdotal, the comments of one legal academic who left a lucrative large Wall Street firm to join a New York City legal aid office help illustrate the significance of this point:

> Compared to my maximum firm workload of six active cases at a time, my typical workload at Legal Aid was at least 40 active cases, and many more than that were potentially active. It was not unusual for me to handle multiple cases in Housing Court. My personal record was six. . . . The bulk of my court days thus entitled running up and down stairs (the elevators were way to crowded), collaring adversaries in stairwells and hallways, and drafting and signing settlement agreements in the frenzy of the scene. . . . Whereas my law firm had a "Managing Attorney's Office" in charge of getting forms, filing papers, and doing so many of the other clerical things that law practice requires, I was, more often than not, my own one-man Managing Attorneys

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[433]In order to overcome standing questions where MERS proceeds as the named plaintiff in foreclosure proceedings, MERS will generally have the original note endorsed in blank and obtain an affidavit from the servicer stating that MERS is the proper party to enforce the note by foreclosure. David F. Borrino, *MERS: Ten Years Old*, (May 11, 2006), http://imis.usfn.org/Resources/ArticleLibrary/1733.aspx.

[434]INSIDE B&C LENDING, *supra* note 76, at 14 (quoting MERS CEO R.K. Arnold).

> Office. There were none of the many other luxuries of Wall Street. No word processing departments, proofreaders, after-hours receptionists, or after hours secretaries. No paralegals to assist you in cases. No cars to clients, messenger deliveries, secretaries, Xerox departments, mail rooms, minimally-stocked law libraries, or on-line research tools. All of this hampered my ability to effectively represent such a huge number of clients.[435]

Mortgage-backed securities businesses can absorb higher dispute resolution costs of their disaggregated structure because they have significant revenue generated from their businesses. But, low and moderate income consumers have only modest resources to defray litigation costs.

In this regard the procedural posture of most predatory lending lawsuits significantly strengthens the hand of the predatory strategist. Most individual consumers bring their predatory lending claims not as plaintiffs, but as counterclaims in defense of foreclosure proceedings.[436] Rarely do borrowers seek out an attorney until they are on the verge of foreclosure.[437] But at this point, predatory lending victims universally lack resources—that is, after all, why they did not pay their mortgages in the first place. These participants in the legal system, who are facing the imminent prospect of homelessness, simply lack the capability to simultaneously defend a collection action brought by a faceless investment trust and to bring their own affirmative lawsuit against a broker, originator, or servicer. Even if they do have the wherewithal to bring an affirmative suit, that litigation is likely to drag on many months or even years after the assignee, often claiming to be a holder in due course, succeeds in foreclosing on the family home.

After losing the home, most borrowers and their advocates will quickly tire of the remaining lawsuit since the most important objective—saving the home—has already been defeated. The potential damages against the originator or broker will often be relatively small in comparison to the complexity of the ligation. Brokers and lenders typically have existing relationships with tough litigation savvy collection attorneys, while borrowers have great difficulty finding counsel. Private lawyers may be unable to represent the borrower because the potential damages make the claim not cost effective for their practice. And, legal services lawyers may be forced to make difficult resource allocation choices where more pressing and catastrophic legal needs such as obtaining unemployment benefits and protecting spouses from domestic violence outweigh the value of an affirmative claim against an originator that will, after all, never bring the family home back. Indeed, the value of attorney fees from discovery alone are likely to exceed altogether the value of a five year old mobile home on a leased plot of land. As a practical matter, the severance of the borrower's right to sue over claims closely connected to the home from the note holder's right to take away that home, deeply undermines the actual value of the borrower's affirmative litigation right.

The traditional civil justice system response to this type of disparity in dispute

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[435]Rubinson, *supra* note 74, at 98-99.

[436]NATIONAL CONSUMER LAW CENTER, UNFAIR AND DECEPTIVE ACTS AND PRACTICES, *supra* note ?, at §6.6.1.1.

[437]*Id.*

resolution resources has been the class action mechanism. But, class actions are not generally viable in foreclosure defense because each case has individual claims and facts that play out on unique time lines. Furthermore, courts often tend to refuse to certify classes alleging fraud on the theory that the reliance element is an individual question not common to the class. This creates a significant hurdle in pursuing consumers' most fundamental and flexible claim. Reluctance to certify fraud class actions is particularly harmful given the availability of punitive damages for fraud and its relatively comfortable adaptation to common law shared liability theories such as civil conspiracy, aiding and abetting, and joint venture. Finally, some courts have begun enforcing mandatory arbitration agreement clauses which waive consumers' rights to proceed as a class. This development denies consumers the right to match financiers' economies of scale by forcing individual lawsuits. It also undermines the development of a common law response to predatory lending since arbitrators do not publish opinions.

In consumer protection law, as in other areas of the law, substantive rights are only meaningful if there is some procedural vehicle for enforcing those rights. Even if securitization did not change the substance of consumer legal rights,[438] the fact that litigation of those rights is much more costly for consumers must be seen as a fundamental disadvantage of securitization in general. Securitization sharpens the mortgage industry's comparative advantage in managing dispute costs. Not unlike a chess grand master making even piece trades down to checkmate after gaining a slight edge, predatory lending strategists can use their advantage in managing litigation costs to hide from judicial scrutiny within large structured finance deals. Higher dispute resolution costs associated with securitization significantly corrode the substantive consumer protection rights cast by our existing law.

### *C. Immunity: Securitization Shelters Assets from Predatory Lending Judgments*

The law's first choice in awarding liability for predatory lending behavior is to hold the offending broker, lender or servicer liable for her practices. Each of the predatory lending claims and defenses discussed in Part III are designed do to just this.[439] However, in the securitization era holding a broker, lender or servicer liable for her own behavior has proven to be a remedy of only limited compensatory and deterrent value predatory strategists now tend to develop capital structures which render them judgment proof. In his landmark article on the erosion of the liability system, Professor LoPucki argues that the combination of lower clerical transactional costs in the post-computer economy interacted with longstanding cultural and legal values to give many liability generating enterprises the capability of insulating capital from court judgments.[440] Professor LoPucki argues that the secured credit system, parent-

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[438]As section A of this part attempted to show, I believe securitization has undermined substantive legal rights of consumers.

[439]These theories are discussed in Part III *infra*.

[440]Indeed Professor LoPucki goes so far as to suggest that the as cultural prejudices against judgment proofing decline, the use of liability awards to enforce law in the United States will collapse altogether. *Id.* at 6-7. He postulates that information and contract based systems, such as credit rating, will ultimately replace liability. *Id.* at 92. Professor LoPucki's systemic thesis has not, however, gone without criticism. *See* Steven L. Schwarcz, *The Inherent Irrationality of Judgment Proofing*, 52 STAN. L. REV. 1 (1999); Steven L. Schwarcz, *Judgment Proofing: A*

subsidiary and securitization ownership structures, exemption law, and foreign haven jurisdictions all allow liability producing enterprises to partition "doers" from "owners." Only "doers" are subject to judgments, but only "owners" have the capability of satisfying judgments.

While professor LoPucki drew heavily on environmental, medical, shareholder, and product liability examples, his thoughts are perhaps nowhere more prescient than the predatory lending market. In this market the most important and vexing judgment proofing strategy has become the use of private label securitization.[441] Because securitization allows an originator to quickly resale its loans, the originator can make many loans while exposing only minimal assets to liability. As Professor Eggert has explained, this "churning" of capital "allows even an institution without a great amount of fixed capital to make a huge amount of loans, lending in a year much more money than it has."[442] As a result, when a class of predatory lending victims attempts to satisfy a judgment, their damages may far exceed the value of all the lender's assets. If an individual victim succeeds, or is about to succeed in obtaining a judgment, the lender can negotiate a settlement. If an individual or class of victims obtains a large judgment, the lender's management can simply declare bankruptcy, liquidate whatever limited assets are left, and possibly reform a new company a short time later. Management of predatory lenders are indifferent because they are typically paid in full, or even give

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*Rejoinder*, 52 STAN. L. REV. 77 (1999).

[441]While securitization is the most important development in the ability of predatory lenders to render their operations judgment proof, it is by no means the only strategy available. Like many other businesses, predatory home mortgage lenders can sometimes make use of the secured credit system to distance assets from judgments. For example, a smaller home mortgage loan company might use a line of credit from a larger commercial bank to fund residential mortgages. In exchange for the line of credit, the mortgage company promises interest, and also grants a security interest in all of its assets, including its portfolio of home mortgages. The bank files a financing statement perfecting its security interest. When litigation threatens a large judgment, the mortgage company can pay out any assets which exceed the value of the bank's collateral to management or shareholders, and turn over all its remaining assets to the bank. Because the bank has a financing statement on file long before the predatory lending victims "become a lien creditor" the bank will have priority in all of the mortgage company's assets. Uniform Commercial Code § 9-317. Even if the predatory lending victims can force the mortgage company into involuntary bankruptcy, the bankruptcy code will only grant the victims the rights of an ideal lien creditor as of the time of filing, which will be long after the bank perfects its security interest in all the mortgage companies assets. 11 U.S.C. § 544. Moreover, the complexity and length of predatory lending litigation makes it highly unlikely the bank's security interest will avoidable as a preference. 11 U.S.C. § 547. Since the bank will be entitled to protection of the value of its allowed secured claim in all of the debtor's assets, there will likely be nothing left for unsecured predatory lending victims. If the commercial bank that issues the line of credit wishes to directly reap the profits, it can create a thinly capitalized subsidiary organization which itself becomes the loan originator. For the court to satisfy predatory lending liability out of the bank's assets, the court must be willing to look through not only the UCC rules, but also pierce the subsidiary's corporate veil. Some courts have been willing to do exactly this on a variety of theories. However, the litigation hurdles predatory lending victims face even under with these relatively old and simple judgment proofing strategies are nevertheless quite high. Only sagacious and patient courts are likely to see through the legal formalism erected to insulate the enterprise's assets from its misdeeds.

[442]Eggert, *Predatory Lending*, *supra* note 4, at 546 (footnotes omitted).

themselves raises, as their companies plow into bankruptcy.[443]

Moreover, because the securitization conduit divides various lending tasks into multiple corporate entities—a broker, an originator, a servicer, a document custodian, etc.—the conduit tends to prevent the accumulation of a large enough pool of at risk assets to attract the attention of class action attorneys, which tend to be the only actors capable of obtaining system impacting judgments. Legal aid attorneys and private counsel that bring individual claims often struggle with the length of litigation and the tremendous discovery problems presented in dealing with counsel for each individual entity in the conduit. The Federal Trade Commission and state attorneys general, of course, fare much better, but their limited budgets and personnel guarantee their cases only address the high profile offenders while the vast bulk of the market remain undisturbed.

These contentions are bolstered by the disturbing number of bankruptcies amongst subprime brokers and originators. Consumer advocates have complained that the subprime mortgage origination has been saturated with"fly by night" lending operations.[444] These critics argue that individual business persons have learned to flip loans and then disappear, leaving consumers with no remedy.[445] A common pattern has developed where mortgage loan originators follow a boom and bust cycle. Indeed in recent years many of the nation's largest subprime lenders have followed this model leaving "a vast number of subprime borrowers" without a remedy for predatory lending.[446] Literally "hundreds of small and mid-size mortgage banks" periodically go bankrupt.[447] As for the largest lenders, between1988 and 2000, most of them helped themselves to judgment lien immunity from borrower lawsuits with respect to a

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[443]The Orange County Register reported:

> Executives at the region's controversial subprime lenders, including BNC Mortgage and First Alliance, provided investors with fresh reasons to dislike the industry. While BNC profits fell 24 percent, CEO Evan Buckly and President Kelly Monahan took home whopping pay increases of 79 percent and 83 percent respectively. The folks at First Alliance were just as cheeky. As earnings tumbled 71 percent, and government probes into the company's allegedly predatory practices widened top executives took no pay cut.

*Generous Executive Pay Often Fails to Bring Generous Shareholder Results,* ORANGE COUNTY REG., June 12, 2000, 2000 WLNR 6366186.

[444]Countryman, *supra* note ?, at 11. Bert Caldwell, *Borrowing trouble: Predatory Lenders Rely on Consumer Desperation; Ignorance, by Deliberately Boosting Credit; and Offering Unrealistic Loan Terms*, SPOKESMAN REV. Jan. 20, 2002, D1. (Washington state housing counselor explaining that "dozens of companies move in and out of the local refinance market, doing 20 deals one year, just one the next. Some agents and brokers draw fees from multiple companies. 'It's kind of like hitting an moving target . . . .'")

[445]NATIONAL CONSUMER LAW CENTER, UNFAIR AND DECEPTIVE ACTS AND PRACTICES, *supra* note ?, at § 6.6.1.1. *See also* Tamara Loomis, *Predatory Lending Law Has Investment Firms in Arms* 229 N.Y. L. J., March 27, 2003, at 1 ("Consumer groups say assignee liability is critical in the fight against predatory lending because many of the loan originators are shady individuals who flip the loans and disappear.").

[446]Eggert, Predatory Lending, *supra* note 4, at 603. The poster child for boom-to-bust predatory lending is First Alliance Mortgage Corp. of Irvine, California. For a detailed description of First Alliance's rise and fall *Id.* at 592-603.

[447]Robert Julavits, *Home Loan Leaders: Warehouse Lenders Struggle Through Merger Boom*, AM. BANKER, Oct. 23, 2000, at 9A.

staggering 125 billion of home mortgage dollars by declaring bankruptcy.[448] Unlike consumer borrowers, investment analysts fully recognize this boom-bust cycle, and cautiously dissect where in the cycle any given lender is at a given point in time.[449] The result is that when a judgment or series of judgments might substantially shape origination practices, these judgments will be defeated by the insolvency of the offending lender.

Accordingly, securitization has significantly constrained the mechanisms by which mortgage lenders were disciplined in the past. In the era of two party mortgage lending, most lenders would have retained the victim's loan, along with many other mortgage loans, all of which would represent assets potentially subject to the debtor's judgment. Mortgage lenders often had close ties to their community increasing the reputational threat from violating consumer protection law. And because mortgage loans were generally only available to the relatively affluent, lenders may have faced more formidable opponents in litigation over sharp terms and practices. The potential of lost assets and lost customers placed predatory lenders at a competitive disadvantage. In the era of three party mortgage lending, the original lender needed less assets to lend, since government sponsored enterprises stood at the ready to purchase qualifying loans. But, the strict underwriting guidelines associated with government sponsored enterprises significantly limited the number of predatory lending victims. Why make a predatory loan if the only significant source of liquidity for the loan—the government—would refuse to purchase or guarantee it? Because predatory terms and practices would disqualify the lender from participating in the federal secondary market infrastructure, predatory lenders were still faced with a competitive disadvantage despite the dwindling necessity of closely held assets.

But in the era of securitization, these mechanisms for disciplining originators have tapered off. Liability rules by themselves are insufficient to deter lenders, since lenders have insignificant assets subject to liability relative to the potential profits available from churning loans. Today's mortgage lenders are paid out of points, fees, and commissions at closing, as well as the proceeds of assignment of the note, limiting the incentive of the lender to adopt practices which guarantee future repayment and minimize liability risk.[450] And, since the subprime mortgage lending market generally does not participate in the federal secondary market infrastructure, the government cannot exert discipline on lenders by refusing to purchase predatory loans. Seen in historical perspective, the explosion of predatory lending

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[448]*See also* Eric Berquist, *Preparing for a Bad-Loan Boom*, AM. BANKER, Oct. 6, 2000, at 1 ("Since the liquidity crisis of October 1998, most of the major subprime mortgage lenders have filed for bankruptcy. Given that these failed lenders have issued $125 billion of mortgage- and asset-backed securities over the past three years, . . . it would not be a surprise if 10% to 20% of the loans underlying those securities go bad.").

[449]*See, e.g.,* Laura Mandaro, *Wamu Goal: 500 Café Loan Sites*, AM. BANKER, June 21, 2001, at 1 (analyzing whether Washington Mutual boom will lead to a bust); Aaron Elstein, *Analysts: No End in Sight to Consolidation*, AM. BANKER, July 23, 1998, at 16 (analyzing investment credit risk from overpriced subprime mortgage loans).

[450]To protect itself from non-payment and liability, many trustees will require recourse provision before accepting an assignment from a mortgage lender. But, we should expect that this will provides little additional deterrence if the lender plans on bankruptcy anyway. A recourse provision can actually serve as one more obstacle for predatory lending victims, since the trust may at its option reassign the note back to the insolvent originator, arguing that this reassignment limits the ability of the borrower to assert claims against the trust.

practices in the past fifteen to twenty years should come as no surprise. Securitization conduits circumvented the liability and purchasing leverage used by government in the past to protect borrowers from sharp commercial practices. In the new market place, mortgage loan originators serve not only an intake function—using marketing strategies to line up borrowers— but also a filtering function. As thinly capitalized originators make more and more loans, *claims against the lender accumulate, while the lender's assets do not*. The lending entities are used like a disposable filter: absorbing and deflecting origination claims and defenses until those claims and defenses render the business structure unusable. At the point when exit costs are less than the marginal expected utility of using a business entity subject to the wrath of the court system, the lender declares bankruptcy and/or reaches a questionable settlement neither of which preserve the homes of those who were wronged nor deter future predatory conduct. The result: the individuals who engage in predatory behavior and the individuals who engineer capital structure to facilitate that behavior are judgment proof.

## V. TOWARD LIABILITY FOR PREDATORY STRUCTURED FINANCE: REFORMING CONSUMER PROTECTION LAW IN AN ERA OF SECURITIZATION

The central message of this article has been that time and organizational change have, in effect, deregulated a crucial segment of the consumer home mortgage market. The atomization of different lending functions into specialist corporate structures has rendered the definitions in our consumer protection statutes quaint and bereft of meaning. The higher costs of communicating and litigating with the many businesses involved in a securitization conduit have created unfair and unrealistic procedural hurdles for consumers hoping to assert their legal rights. And, the off balance sheet funding of consumer mortgages has facilitated judgment proof brokers, originators, and servicers that can churn out a volume of predatory loans and servicing far in excess of the limitations of their own capital. Many of the architects of structured finance deals are well aware widespread of servicing abuses, origination fraud, and unfair contractual terms, but have nevertheless facilitated, encouraged, and profited from them. To restore a civility and integrity to this market, America must come to terms with these changes in secondary market consumer finance. Consumer protection law and they way it assigns responsibility for antisocial behavior must be updated to reflect the commercial reality of securitization. Policy makers, courts, and arbitrators must come to a realization that the tools of structured finance can be put to predatory ends.

Nevertheless, time tested legal tools, if applied to these markets, could significantly improve the legal response to predatory structured finance. As many have pointed out, the first step toward meaningful reform must surely be elimination of the holder in due course doctrine. Modification of the Federal Trade Commission's holder-notice rule to include home mortgages along with other consumer loans should be the baseline from which all serious discussion of secondary mortgage market reform should proceed. The FTC's holder-notice rule has provided successful consumer protection for over thirty years. And, it has not prevented structured finance of consumer loans that fall under within its scope. Indeed, the editorial board of the Journal of Structured Finance has reported that 13% of securitization deals in 2004 were for automobile loan backed securities—all loans governed by the FTC's rule.[451] The national debate over predatory mortgage lending has also created a chance for the FTC to recapture its leadership role in consumer protection. The agency's prestige and funding have both suffered in recent years. Expanding what may well be its most successful consumer credit regulation presents a unique leadership opportunity for the agency. If the FTC continues to fail to live up to its responsibility as the primary arbiter of deceptive and unfair trade practices, Congress or state legislatures should step in.

Still, while amending the FTC holder-notice rule to include home mortgages would bring mortgage assignment law out of the nineteenth century, it would not bring the law up to date. The FTC holder-notice rule, along with proposals to create tiered assignee liability rules based on the extent to which assignees comply with due diligence standards,[452] all attempt to hold a special purpose vehicle responsible for the misdeeds of other businesses. The SPV, usually a trust, is owned by investors that generally have no knowledge of or involvement in predatory practices associated with pool loans. Stepping-up assignee liability is an improvement over the current legal system which tends to allocate losses from predatory lending to victims. But assignee liability rules merely shift predatory lending losses to investors. The change is, in effect, a transition from blaming the victim to blaming the patsy. Policy makers must come to terms with the notion that contemporary predatory mortgage lending is a economic artifice two classes of casualties: consumers *and* investors. For this reason, proposals which create unlimited assignee liability may go too far by forcing relatively innocent investors to bear the brunt of large punitive damage awards. Is it fair to punish investors with unlimited punitive damage awards because they relied on unmet promises of due diligence from sellers and underwriters? It is true that investors could, in theory at least, bring lawsuits against these architects of a securitization deals seeking indemnity for damages. But judicial economy counsels against this approach. In order to levy damages on the responsible party, two separate victim classes would be required to win two separate lawsuits. The high transaction costs of such an enforcement system seem likely to undermine its deterrent value. The FTC's holder-notice rule steers a responsible middle road on this question by capping investor liability at the amount paid by a consumer under the loan in question.

This is not to say, however, that uncapped punitive damages have no place in deterring predatory mortgage lending. Rather, the full weight of judicial sanctions against predatory commercial behavior should be born by the businesses and individuals that abet, conspire, or co-venture that behavior. Assignee liability rules are only one method by which our laws have transferred liability from a primary wrongdoer to a secondary one. Indeed over the ages the common law has developed sophisticated and measured doctrines to do precisely this in a variety of complex situations. To address predatory lending, the state and federal judiciary must continue the emerging trend of using imputed liability theories to hold financiers liable for the predatory behavior they facilitate. If Wall Street firms use the tools of structured finance to knowingly or recklessly facilitate and profit from predatory lending, surely they are as responsible as the fly by night brokers, originators, and servicers they capitalize.

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[451] Jeremy Carter, *Highlights from Securitization News: ABS Mart Enjoyed Stellar Year*, J. STRUCTURED FIN. 97, 97 (Winter 2005); *Infra* note 52 and accompanying text.

[452] Engel & McCoy, *Wall Street*, *supra* note 34, at 730-31.

Common law joint and several liability theories should not be limited to common law claims. Much of the existing precedent transferring predatory lending liability through aider-abetter, conspiracy, and joint venture theories involves fraud claims. And while fraud is perhaps the first and most important consumer protection doctrine, most of the legal innovation in consumer law over the past forty years has come from statutes. In an era of structured finance, if these statutory claims are to influence the marketplace, they must be flexible enough to apply to all to businesses that are responsible for violations—even if those businesses are not of the type originally contemplated by the statute. The legal justification for imposing aider-abetter, co-conspirator, and joint-venturer liability for statutory violations sounds in our common law—a sovereign province bequeathed to our third branch of government by antiquity. Just as a co-conspirator is liable for fraudulent acts of another with common purpose, so too should conspiring to violate a state predatory lending statute bring on liability for that unlawful act. Just as an aider-abetter can be liable for another's breach of fiduciary duty, so too should aiding and abetting truth in lending violations should induce liability. Just as a joint venturer can be liable for another's conversion of a victim's property, so too should co-venturing Fair Debt Collection Practices Act violations incur liability under that statute.

Several courts have moved in this direction holding, for example, that an aider-abetter of a violation of a state unfair and deceptive trade practice statute is liable under that statute's remedial structure.[453] Similarly, the Supreme Court of Vermont has held that an assignee of a predatory mortgage loan could be held liable under the state's UDAP law, even without an allegation that the assignee knew or was reckless with respect to deceptive practices of the mortgage originator. The court reasoned that the statute prohibited "any person . . . using . . . any method, act or practice declared ... to be unlawful. [454] The same principles have been applied in transferring liability in a variety of other contexts such as state human rights statutes and environmental protection statutes.[455] Where a statute grants a private cause of action to sue a creditor, common law vicarious liability theories supply a private cause of action to sue those who have aided and abetted, conspired, or co-ventured the violation. Aider-abetter, co-conspirator, and co-venturer liability are time tested common law doctrines which have not threatened legitimate commerce. Despite the complex nature of structured finance, this additional innovation in the law is rather simple: architects of securitization can protect themselves from liability by refusing to do business with predators. Emerging imputed liability theories do not risk a repeat of the controversy surrounding the Georgia Fair Lending Act because uncapped liability is born by sellers, underwriters, or trustees—architects of securitization deals, rather than investors in them. Accordingly, imputed liability for these

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[453]Banks v. Consumer Home Mortg., Inc., 2003 WL 21251584 at *12 (E.D.N.Y. March 28 2003) (allowing aider-abetter liability for New York's deceptive trade practices statute where there is "(1) the existence of the primary deceptive act or practice, (2) the aider and abettor's knowledge of the deceptive act or practice, and (3) substantial assistance by the aider and abettor.")

[454]State v. Custom Pools, 556 A.2d 72 (Vt. 1988); 9 V.S.A. § 2458(a).

[455]*See, e.g.,* Wynn v. National Broadcasting Co., Inc., 234 F.Supp.2d 1067, 1114 (C.D. Cal. 2002) (using common law aider-abetter liability to enforce the New York Human Rights statute).

parties does not give credit rating agencies a reason to refuse to rate pool securities. For their part state legislatures and Congress should explicitly recognize that aiding and abetting, conspiring, and co-venturing to violate consumer protection statutes gives rise to liability under those statutes.

Moreover, courts and policy makers should not be taken in by the myth that secondary market participants are unable to monitor and discipline brokers, originators, and servicers. It is true that investment decision makers, such as pension and mutual fund managers, insurance companies, individual investors may lack the time and resources to effectively monitor individual loans within mortgage pools for predatory terms and practices. But there are multiple opportunities for the secondary market to exert due diligence prior to issuance of securities. Sellers, underwriters, and trustees all have the opportunity to protect themselves and the investors to whom they will sell securities from predatory lending practices by brokers, originators, and servicers.[456] New organizational technology also has the potential to minimizing secondary market monitoring costs. For example, the Mortgage Asset Research Institute maintains a database that tracks mortgage brokers, originators, and servicers.[457] The database, called the Mortgage Industry Data Exchange, or MIDEX, collects public disciplinary, enforcement, and legal actions against mortgage lending industry participants.[458] Secondary market participants can pay a fee to obtain reports on brokers and originators which are not dissimilar to the credit reports used by mortgage originators themselves to verify the creditworthiness of loan applicants.[459] This database and others like it have the potential to significantly raise the cost of predation, but only if the legal system gives the secondary market an incentive to invest in the technology.

The development of common law consumer protection theories is hampered today by mandatory arbitration clauses in boilerplate contracts. A contentious debate has raged on whether private arbitration companies provide an impartial forum for the resolution of

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[456]For example, one White and Case attorney recently explained pooling and servicing agreements increasingly charge trustees with:

> confirmation of servicer calculations; . . . website reporting, permitting investors to download the monthly servicer reports and other communications; collection of data on the transaction; reporting on portfolio performance; random compliance testing; investment of cash balances in multiple accounts; asset management; and following the occurrence and continuation of a default, back-up servicing, collateral liquidation, and enforcement of investors' rights in a restructuring, bankruptcy, or other litigation.

Margery A. Colloff, *The Role of the Trustee in Mitigating Fraud in Structured Financing*, J. STRUCTURED FIN., Winter 2005, at 73, 77.

[457]Richard J. Landau & Kristen M. Tsangaris, *The Mortgage Fraud Epidemic: As the Incidence of Mortgage Fraud Has Grown, Financial Institutions Should be Alert to Atypical Default or Repurchase rates, and Consider Civil Actions Against Participants to Recover Loan Losses and Allocate Risk,* STANDARD & POOR'S REVIEW OF BANKING AND FIN. SERVICES, April 1, 2006, at 4, 2006 WLNR 7649271.

[458]*Id.*

[459]A sample MIDEX report is available at: http://www.mari-inc.com/pdfs/midex/reports.pdf.

consumer disputes.[460] Putting this debate to the side, there is no doubt that arbitration forestalls evolution in the common law. Arbitrators do not publish written opinions and the results of arbitration are frequently kept confidential. This prevents the application of *stare decisis* since one arbitrator will never know how another resolved a dispute with similar facts. Because arbitration clauses have become more and more prevalent in the consumer financial services industry, our legal system risks stagnation. While massive technological change has facilitated rapid evolution in financial practices and business behavior, the common law has crept along unmindful of these changes because the results of individual cases have not been compiled into an organically developing jurisprudential response. As a result, the development of theories creating liability for predatory structured finance will require an aggressive judicial posture. Today, only a small fraction of cases alleging consumer abuse ever reach appellate courts. For every predatory mortgage lending case that reaches an appellate court, many more were confidentially dispatched in arbitration or fell by the wayside when consumers were unable to find counsel willing to take on the tremendous resources of wall street firms in a complex case with only modest potential rewards. State and federal judges must realize that when they see a predatory lending case they have what has become an extremely rare and valuable opportunity to make progress in their custodial obligations to the law itself. Courts must be aggressive in developing a common law that is cognizant of predatory structured finance or risk allowing our legal heritage to languish in a time of great technological change. For their part, arbitrators have an obligation to impartially consider the involvement and responsibility of secondary market actors in facilitating violations of case and statutory consumer protection rules.

Ultimately the use of common law imputed liability theories can only improve the application of consumer protection if the underlying substantive law itself is adequate. State and federal legislatures must amend the scope of consumer protection laws to more explicitly cover the variety of business actors engaged in the structured finance of predatory lending. For example, Congress must amend the Truth in Lending Act and the Home Ownership and Equity Protection Act to explicitly govern the behavior of mortgage brokers, even where those brokers are not the party to whom a note is initially payable. Mortgage brokers have become the face of the mortgage lending industry and are often the only person a borrower will ever actually meet in the lifetime of a loan. That these statutes might not apply to thinly capitalized brokers puts the lie to industry claims of over-regulation.

Congress should also amend the Fair Debt Collection Practices Act to apply to all servicers of residential mortgage loans. Currently, most courts hold that the FDCPA only

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[460]*See, e.g.,* Richard M. Alderman, *Pre-Dispute Mandatory Arbitration in Consumer Contracts: A Call for Reform*, 38 HOUSTON L. REV. 1237 (2002) (advocating post-dispute election of arbitration in consumer cases); Mark E. Budnitz, *The High Cost of Mandatory Consumer Arbitration*, 67 L. & CONTEMP. PROBS. 133 (2004) (arguing the high cost of mandatory arbitration prevents resolution of consumer disputes); Richard E. Peidel, *consumer Arbitration of Statutory Claims: Has Pre-Dispute [Mandatory] Arbitration Outlived Its Welcome?*, 40 AZ. L. REV 1069 (1998) (advocating consumer protective amendments to the Federal Arbitration Act); Jean R. Sternlight, *Is the U.S. Out on a Limb?: Comparing the U.S. Approach to Mandatory Consumer and Employment Arbitration to that of the Rest of the World*, 56 U.MIAMI L. REV. 831 (2002) (finding no evidence of mandatory consumer arbitration outside the U.S.).

applies to mortgage servicers who "obtain" a loan after it has gone into default.[461] As a result, under the current law, consumers must engage in complex discovery to reconstruct when servicing rights were transferred in order to understand whether the statute applies. This puts virtually every aggrieved homeowner in the difficult position of deciding whether to bring a FDCPA claim with no way of knowing *ex ante* whether the law applies to the company in question. In the years since congress adopted the FDCPA state experimentation has demonstrated that a broader scope to the debt collection standards serves the economy well. Florida, for example, has a state debt collection law which essentially mirrors the federal statute in substantive terms. But, the Florida statute governs the behavior of all creditors, rather than the much smaller class of professional debt collection agencies. Despite the broader state statute, Florida has had one of the strongest local economies throughout the country. While Congress may not be prepared to follow Florida in regulating all creditors, mortgage loan servicing companies raise policy concerns virtually identical to the debt collection companies originally contemplated by Congress. In the absence of federal action on this point, state legislatures should adopt new or amend existing debt collection laws to explicitly govern residential mortgage loan servicers.

Many state unfair and deceptive trade practices statutes have exemptions for banks, financial services companies, or creditors in general. These exemptions leave large gaps in the law which facilitate predatory lending and the structured finance of predatory lending. To remedy this and many other problems, Congress should amend the federal trade commission act to include a private cause of action for violations of FTC unfair and deceptive trade practice regulations. The role of the FTC in handling the most important cases could be protected by including an administrative procedure requiring consumers consult with the FTC, giving the FTC the option of taking the case prior. If the FTC rejects the case, consumers should have the right to seek to vindicate their rights on their own, with private counsel. Until this important change is made—or congress radically expands FTC funding and jurisdiction—FTC trade practice regulations will continue to be a hollow promise. In the absence of federal leadership, state governments should enhance their deceptive trade practices rules by removing any exemptions for creditors or their agents.

The private company which maintains the Mortgage Electronic Registration System presents another growing consumer protection problem closely associated with predatory structured finance. MERS has become more than a mere document custodian. Rather it has become a hedge against consumer discovery, litigation, and public access to information. MERS creates a private corporate structure for maintaining—and concealing—crucial information in one of the nation's most important consumer markets. While ultimately a national real property recording system might be a good idea, in a democratic society the displacement of county government agencies must come from elected officials. A single corporation should not be allowed to privatize the our nation's registry of real property loan records. Or, at least it should not be allowed to do so without significant consumer protection and transparency standards.

A closely related problem is the use of servicers and MERS to bring foreclosure

[461]*See infra* note 73 and accompanying text.

proceedings. Courts should hold that only the actual party in interest with respect to a mortgage loan should be able entitled to foreclose. The use of a MERS—a document custodian—to foreclose is especially problematic. The reason an actual holder of a note should be required is that consumers need the ability to assert counter claims and defenses against a responsible party. When MERS forecloses, it uniformly refuses to acknowledge or accept responsibility for consumer claims and defenses related to the origination or servicing of the loan. Moreover, there is no fundamental reason why a loan trust, or other special purpose vehicle, cannot retain counsel to bring its own foreclosures. If a legal entity is empowered to own a note, it also clearly has the power to enforce that note. Using proxies to foreclose only serves to delay and hinder consumer litigation which in turn facilitates structured finance of predatory commercial behavior.

## V. CONCLUDING REMARKS

Structured financiers are complicit in predatory mortgage brokering, origination, and servicing. At least since passage of the Home Ownership and Equity Protection Act over ten years ago, investment banking firms have been fully aware of the what predatory lending is, of the enforcement actions that have been brought against a host of subprime originators and servicers, and that the secondary mortgage market is facilitating this behavior. Because of the atomized nature of securitization, underwriters, sellers, MERS, and trustees have all been able to systematically maintain plausible deniability with respect to any given mortgage they purchase, package, record, administer, or resale. Nevertheless, encouraging, facilitating, and profiting from predation *is* predation—even if the abetter averts her eyes to the seamy details. The notion of predatory structured finance must be part of the American dialogue in order for us to resolve the predatory mortgage lending that continues to ravage our nation's vulnerable populations.

The maladroit response of the American legal system to predatory mortgage brokering, origination, servicing, and finance owes in no small part to a consumer protection law mired in dated two and three party models of the mortgage marketplace. At least with respect to subprime mortgages, the era when a borrower could expect her lender to originate, own, and service her loan for its duration is long since past. While the government sponsored secondary market infrastructure created by Congress continues to facilitate mortgage lending to affluent and some credit worthy Americans, the subprime market no longer benefits from the gate-keeping function of this infrastructure. These antiquated presumptions reveal themselves in arbitrary limitations to the scope of consumer protection statutes. Subprime mortgage servicers are usually outside the scope of the Fair Debt Collection Practices Act. Subprime mortgage brokers are usually beyond the scope of the Truth in Lending Act. The great majority of subprime originators are beyond the scope of the Home Ownership and Equity Protection Act. And the secondary market financiers that design the capital engine generating predatory loans are usually beyond the scope of assignee liability rules which purport to create an incentive for investors to police the market. These reiterative ironies are no coincidence. Rather they represent the failure of legislators, consumer advocates, and the academy to sufficiently adapt their perception of what lending is to what it has become. Our finance technology has outpaced our consumer protection law, in effect deregulating much of the mortgage market.

While growing calls for assignee liability reform are a positive development in the law, they must not be seen as a replacement for maturation in the common law of imputed liability. Holding investors in mortgage backed securities liable for predatory lending is a second best solution to holding predatory financiers themselves directly liable. The brand of aggressive state capped assignee liability statutes are necessary because they allow consumers to offset their defenses in collection and foreclosure lawsuits. However, the justice system cannot realistically force investors—who are often mere gulls of the professional financiers—to bear the full weight of punitive damage awards necessary to deter predatory lending. For this, the legal system must turn to predators themselves and their predatory abettors, coconspirators, and co-venturers in the secondary market. State attorneys general, courts, and arbitrators must look past the front line predators to the structured financiers that with winks and nods facilitate this predation. For their part, well meaning Wall Street financiers must begin to invest in new technology, training, and personnel to scrupulously guard their deals from impropriety.