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The financial crisis that began in August 2007 has been the most severe of the post-World War II era and, very possibly – once one takes into account the global scope of the crisis, its broad effects on a range of markets and institutions, and the number of systemically critical financial institutions that failed or came close to failure – the worst in modern history. Although forceful responses by policymakers around the world avoided an utter collapse of the global financial system in the fall of 2008, the crisis was nevertheless sufficiently intense to spark a deep global recession from which we are only now beginning to recover.

Ben S. Bernanke
Address to the Annual Meeting of the American Economic Association
January 3, 2010

The Northeastern University Law Journal is devoted to intellectual rigor and to enriching legal discourse. The Journal is unique, however, in that each issue is dedicated to a single topic and features articles regarding representation, advocacy, and legal strategy, as well as legal theory and analysis. Written by both academics and practicing attorneys, our articles meld legal theory with legal practice while addressing societal challenges and discussing progressive issues in the law. Northeastern University School of Law is often referred to as the nation’s premier public interest law school and the Journal shares the school’s focus on social justice, public service, and the practice of law in the public interest.

This year we present a volume of the Journal focused on advocacy amidst the fallout of the subprime mortgage foreclosure crisis. When we selected this topic in late 2008, the United States was in one the deepest financial crises in its history. The mortgage foreclosure rate had increased more than eighty percent in one year, causing almost one million families to lose their homes.¹ The fallout was not isolated to the United States

residential mortgage lending market. What followed was the collapse of the global financial market that affected not only the residents on Main Street, but also crushed large established investment banks on Wall Street.

The price gains in the United States housing market that eventually led to the subprime mortgage foreclosure crisis began over a decade ago. After years of slow growth, United States house prices rose more rapidly in the late 1990s. The most accelerated price gains were in the mid 2000s, when the annual rate of house price appreciation was between fifteen and seventeen percent. As the price of housing increased, a greater percentage of mortgage applications involved adjustable-rate mortgage products. The widespread issuance of variable-rate mortgages coupled with the belief by many borrowers and lenders that the price of real estate could only go up led to the demise of the housing market. The availability of these alternative mortgage products and the mistaken beliefs that the real estate markets would continue to soar is likely a key explanation of the housing bubble explosion that led to the current fallout. In addition to the alternative mortgage products, some believe that the deterioration in mortgage underwriting standards, which was exacerbated by practices such as the use of zero-money-down and no-documentation loans, led to the fallout. What remains of the United States housing market in the aftermath of the fallout is a very different landscape than what it has been over the past decade.

As the economy begins to stabilize, lawyers and the court system must take leading roles to ensure that the mistakes of the past decade are not repeated. As a journal of legal practice, the Northeastern University Law Journal provided a forum for attorneys who are charting their course in the aftermath of the subprime mortgage foreclosure crisis to discuss the challenges they face.

We were honored to host a symposium in the spring of 2009 at which legal practitioners from across the nation came together to share

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3 Id.

4 Id. at 14.

5 Id. at 16.

Editors’ Introduction

ideass about the legal policies and practices that would best facilitate a successful emergence from the subprime mortgage foreclosure crisis. Following the symposium, we selected submissions for this issue of the Journal from Deborah Goldstein and Matthew Brinegar, Carolyn Grose, Gary Klein and Shennan Kavanagh, Robert Kubica, and Michelle Weinberg, as well as student comments from Meg Rehrauer. Although the subprime mortgage foreclosure crisis is subsiding, it is our belief that the articles in this issue will have profound and lasting value for both practitioners and policy makers. The articles focus on a wide range of topics from policy and litigation barriers to fighting predatory lending to defending foreclosure actions by bringing third party claims.

Deborah Goldstein and Matthew Brinegar address the policy choices, laws, and judicial opinions that led to the subprime mortgage foreclosure crisis. The authors’ analysis of the Holder in Due Course doctrine, the preemption of state anti-predatory lending statutes, the Truth in Lending Act, and mortgage underwriting standards offer ideas for reform that could help strengthen the mortgage market and keep many borrowers in their homes. Carolyn Grose’s article offers practice tips for attorneys working with clients affected by predatory lending and encourages lawyers to work collectively with their clients to construct client narratives in which the client is recognized as more than a victim. This piece urges lawyers to seek a deeper understanding of their clients’ stories, with a goal toward creating new narratives that address their clients’ needs and concerns.

Gary Klein and Shennan Kavanagh analyze the history and causes of the subprime mortgage foreclosure crisis and focus on class action litigation as a valuable mechanism for remedying the foreclosure crisis. Robert Kubica’s piece focuses on the judicial response to the subprime lending crisis by showing how the Commonwealth v. Fremont Investment & Loan decision in Massachusetts provides a framework for individuals examining mortgage loans to determine which loans qualify for restructuring. Michelle Weinberg’s article offers a wealth of practical information for attorneys defending foreclosure, as well as innovative ideas for clients’ potential third party claims.

We believe that each article in this edition of the Journal offers unique insight into the subprime mortgage foreclosure crisis that can be

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7 897 N.E.2d 548 (Mass. 2008).
used to guide the continued legislative response to the subprime fallout and the representation of residents in the shadow of foreclosure, as well as assist in preventing a similar catastrophe from occurring in the future.

We are proud of our articles, our authors, and our staff. We would like to extend thanks to previous editorial boards of the Northeastern University Law Journal, our faculty advisors Professors Michael Meltsner, David Phillips, and Sonia Rolland, the Northeastern University School of Law administration, faculty and staff, our symposium participants, and our keynote speaker, Stuart Rossman of the National Consumer Law Center.

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REGAINING THE WONDERFUL LIFE OF HOMEOWNERSHIP POST-FORECLOSURE

DEFENDING HOMEOWNERS FROM EVICTION AFTER FORECLOSURE BY ATTACKING THE OWNERSHIP RIGHTS OF THE FORECLOSING ENTITY

Meg Rehrauer

“But he did help a few people get out of your slums, Mr. Potter. And what’s wrong with that? Why... Here, you’re all businessmen here. Doesn’t it make them better citizens? Doesn’t it make them better customers? You... you said... What’d you say just a minute ago?... They had to wait and save their money before they even ought to think of a decent home. Wait! Wait for what? Until their children grow up and leave them? Until they’re so old and broken-down that they... Do you know how long it takes a working man to save five thousand dollars? Just remember this, Mr. Potter, that this rabble you’re talking about... they do most of the working and paying and living and dying in this community. Well, is it too much to have them work and pay and live and die in a couple of decent rooms and a bath? Anyway, my father didn’t think so. People were human beings to him, but to you, a warped, frustrated old man, they’re cattle.”

Jimmy Stewart as George Bailey, It’s a Wonderful Life (Liberty Films (II) 1946)

I. Overview

In It’s a Wonderful Life, George Bailey, a local businessman and

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hero, supported the community by offering townsfolk affordable loans from his Bedford Building and Loan. As Steven M. Cohen, the Counselor and Chief of Staff at the Office of the New York State Attorney General, explains:

There’s that great scene where there’s the run on the bank…and the Jimmy Stewart character explains, “Your money isn’t with me. It’s not here behind the counter. It’s in Harvey’s home. That’s where your money is. And Harvey’s money is in Gretchen’s home.” That model ceased to exist. I don’t know when it ceased to exist, but at some point it did.²

As Mr. Cohen aptly described, the originating lender, or originator, in the modern mortgage business will likely not hold mortgages for the life of the loan. Today, originators commonly sell mortgages, especially at-risk mortgages, to other institutions as part of a securitization process.³ When securitized, the individual mortgages are pooled together and offered as an investment security.⁴ Mortgage companies benefit from recouping their investments and eliminating the risk of non-payment, while investors benefit from the mortgage companies’ reduced transaction costs due to economies of scale and reduced initial capital requirements.⁵ To illustrate, Investor Ian has $5,000 that he wants to invest in residential mortgages. Ian does not have enough capital to offer a full mortgage directly to Borrower Betty, and it will likely be cost prohibitive for Betty to seek many smaller loans. Therefore, Betty seeks out Originator Owen, a lender who will loan Betty all of the necessary funds, and Betty enter into a mortgage transaction with Owen. Owen, however, does not want to wait to recoup his investment and also does not want to bear the risk of Betty’s non-payment. Therefore, after the transaction with Betty closes,

⁴ Id. at 2188.
⁵ Id.
Owen assigns Betty’s loan to Securitizer Steve who will issue mortgage-backed securities. Ian can purchase these securities, satisfying his desire to participate in residential mortgages, and Owen can eliminate his risk of loss, while recouping his investment quickly. With this mutually beneficial relationship in place, many originators became “assignment production companies.” Accordingly, in many foreclosure cases, the foreclosing entity is not the originator.

In Massachusetts, the originator or subsequent mortgagee may rightfully assign a mortgage to a third party without informing the borrower. In many situations, the borrower continues to make payments to the same servicing lender, or servicer, and thus remains blissfully unaware of the transfer of ownership. Therefore, the borrower is often surprised by foreclosure notices from an unknown lender or a party called Mortgage Electronic Registration Systems (“MERS”). Over half of residential mortgages in the United States, list MERS as nominee and mortgagee of record. When MERS is listed as the nominee on the mortgage, MERS can continue to act as mortgagee of record through subsequent assignments. Although the lender was fully aware of the involvement of MERS, the borrower often is unaware of MERS’s involvement in the mortgage until she defaults or the lender is moving for foreclosure because the language designating MERS as nominee is usually buried in legalese. Due to a lack of familiarity with MERS or an assignee, a notice from unknown party can surprise the borrower. This surprise, coupled with the emotional distress from foreclosure and the prospect of homelessness, leads to confusion regarding the next step.

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7 The Helping Families Save Their Home Act of 2009 called for the amendment of the Truth in Lending Act so that homeowners must be notified of a change in mortgage ownership within 30 days of the transfer. See Helping Families Save Their Homes Act, Pub. L. No. 111-22, 132 Stat. 1632 (2009) (codified at 15 U.S.C.S. § 1641(g)(1) (2009)). Therefore, this issue may be mitigated in the future, but remains problematic for many current clients.
Confusion can lead to inaction or ineffective action, which ultimately leads to foreclosure, as Massachusetts does not require a judicial process for mortgage foreclosure.

The process of foreclosure in Massachusetts, as opposed to a judicial process, formally begins with a ninety day notice to cure letter that describes the nature of the default and the date by which the default should be cured.\textsuperscript{13} This notice to cure letter may come from the servicer, an originator or assignee mortgagee, or MERS. In order to cure the default, the borrower usually must pay the unpaid principal and interest, a per-diem interest charge, and applicable late fees.\textsuperscript{14} The borrower does not need to pay the accelerated balance on the mortgage, fees relating to the exercise of a right to cure or attorney fees.\textsuperscript{15} Despite the limitations on what the mortgagee can require in order for the borrower to cure the default, the borrower may not have sufficient funds to cure several months of mortgage payments, along with applicable late fees and interest. Assuming an inability to cure the default, the foreclosure process continues.

After the ninety day notice to cure has expired, the lender must give twenty-one days notice before foreclosure.\textsuperscript{16} The foreclosing entity must publish this foreclosure notice in the local newspapers once per week after giving the twenty-one days notice, resulting in three publications.\textsuperscript{17} After these publications, the foreclosing entity has the authority to act under a power of sale and can sell the mortgaged property at a public auction held on or near the premises.\textsuperscript{18, 19} Any person who purchases the property, including a foreclosing entity that sells the property to itself, can move to evict the former homeowner from the newly acquired property.

When receiving the multiple notices from an unknown lender or...
MERS, the borrower is often unsure of what she should do next: Who should I negotiate with? What do I do without being able to afford a lawyer? How can I come up with enough money to cure a default? While the borrower contemplates these questions, the lender may foreclose on the property and move to evict the former homeowner. Since Massachusetts is a non-judicial foreclosure state, the borrower will not necessarily have her day in court to defend against the foreclosure.\textsuperscript{20, 21}

In some cases it can take several years to complete the foreclosure process, from the first ninety day notice to the foreclosure sale.\textsuperscript{22} From the borrower’s perspective, the lender’s threats of foreclosure loom harmlessly on the horizon until the borrower is served an eviction notice. When the foreclosure process lags for months, the homeowners may begin to believe that someone or something has intervened, that the lender forgot about the foreclosure, or that the lender has decided to give them a break. Unfortunately, the lender will eventually foreclose on the mortgage and move for eviction.

At this point, the homeowners may seek legal counsel, at a time generally considered too late. It is not, however, too late for some homeowners, because a process that is confusing and complicated for borrowers is equally complicated for lenders. When challenged, some lenders have been unable to show an unblemished ownership interest.\textsuperscript{23} Without an unblemished ownership interest in the mortgage prior to foreclosure, the foreclosing entity may not have a clear title to the underlying property.\textsuperscript{24} Therefore, when a homeowner faces eviction after

\begin{itemize}
\item \textsuperscript{20} See ch. 244, § 1.
\item \textsuperscript{21} The entity must comply with the Service Members Civil Relief Act and file a complaint in land court to ensure that the borrower is not on active military duty. See Francis J. Nolan, \textit{Massachusetts Foreclosures} § 3.2 (MCLE 2003). This does not operate as a full hearing. Rather, it merely provides notice to those on active military duty that a foreclosure is imminent. \textit{Id.}
\item \textsuperscript{24} See generally U.S. Bank National Assoc. v. Ibanez, Nos. 08 MISC 384283, 08 MISC 386755, 2009 WL 3297551 (Mass. Land Ct. Oct. 14, 2009) (refusing to “remove a cloud from the title” pursuant to Mass. Gen. Laws ch. 240, § 6 on several homes purchased after foreclosure due to defects in assignment of
\end{itemize}
foreclosure, it is important to ensure that the foreclosing entity properly owned the mortgage prior to foreclosure. If the entity does not own the mortgage prior to foreclosure, the homeowner may be able to overturn the foreclosure and ultimately remain in her home.

What colloquially is thought of as a mortgage is comprised of two separate legal documents – the note and the mortgage. The note evidences the debt agreed upon determined from the mortgage transaction. This note grants the mortgagee the right to collect payment. The note is a negotiable instrument that is typically not recorded on the registry of deeds. On the other hand, the mortgage evidences the security interest arising from the mortgage transaction. This mortgage typically grants the mortgagee the right to foreclose and must be recorded with the registry of deeds. Therefore, the right to foreclose arises from the contractual language in the mortgage.\(^{25}\) Despite the fact that the mortgage grants the right to foreclose, the entity must own both the mortgage and the note in order to do so.\(^{26}\) Therefore, an assignee must have a valid assignment of mortgage with an indorsement of note in order to assert an ownership interest and have the authority to foreclose.\(^{27}\) In Massachusetts, the distinction between the mortgage and the note is important because requirements for assigning the mortgage are dictated by property law principles, while the requirements for transferring the note are dictated by Uniform Commercial Code ("UCC") principles.\(^{28}\)

Accordingly the originator must fulfill certain requirements in order to properly assign the mortgage and indorse the note. First, the Statute of Frauds dictates that contracts relating to land, including


\(^{26}\) See Kluge v. Fugazy, 536 N.Y.S.2d 92, 93 (N.Y. App. Div. 1988) (finding that “absent transfer of the debt, the assignment of the mortgage is a nullity”); see also Robert L. Marzelli & Elizabeth S. Marzelli, Massachusetts Real Estate 2d § 5.1 (Lexis 2003) (stating that “[p]rior to instituting foreclosure proceedings it is wise to examine the note and the mortgage”).


\(^{28}\) See generally Ibanez, 2009 WL 3297551 (refusing to recognize an assignment “in blank” as a valid assignment, despite the fact that an indorsement in blank is a valid method to transfer a note).
assignments of mortgage, must be in writing.\textsuperscript{29} Moreover, when challenged, the foreclosing entity must produce a properly indorsed note to assert ownership of the mortgage.\textsuperscript{30} In practice, however, the foreclosing entity may not be able to produce sufficient evidence of its ownership of the mortgage.\textsuperscript{31} Thus, an effective consumer law practitioner should carefully evaluate the documentation produced by the lender to determine if the lender fulfilled the requirements for a valid transfer of ownership.

Finally, consumer law practitioners may challenge the foreclosing entities’ ownership at any stage of the foreclosure, but in post-foreclosure pre-eviction cases, it is often attractive to challenge ownership in order to invalidate the prior foreclosure. This strategy is attractive in post-foreclosure cases because it is likely too late to raise other objections that could be properly raised during the foreclosure proceedings. It may seem nonsensical to invalidate a foreclosure when the borrower was verifiably in default and the lender may simply initiate new proceedings, taking more care to closely follow the law and foreclose on the mortgage.\textsuperscript{32} Invalidating the foreclosure, however, may be the first step to attacking the mortgage terms for violations of state consumer protection, Truth in Lending Act violations, or discriminatory lending.\textsuperscript{33} A successful invalidation of foreclosure may also open negotiations with the lender, or give the borrower more time to find another living accommodation.

This comment has three parts. Part I briefly describes the elements of effective assignments of mortgages and indorsements of notes. Part II illustrates the challenges that can be raised based on ineffective assignments of mortgage or indorsement of notes by highlighting objections to MERS as assignor. Part III details theories designed to challenge entities who wrongfully assert ownership in a post-foreclosure, pre-eviction case.


\textsuperscript{30} See Kluge, 536 N.Y.S.2d at 93.


\textsuperscript{32} But see Ibanez 2009 WL 3297551 at *12 (“The issues … are not merely problems with paperwork or a matter of dotting i’s and crossing t’s. Instead they lie at the heart of the protections given to homeowners and borrowers by the Massachusetts legislature.”).

I. Legal Requirements for Assignments of Mortgages and Indorsement of Notes

Massachusetts imposes two different sets of requirements on mortgagees when transferring a mortgage interest – one for the assignment of the mortgage and another for the indorsement of the note. The mortgagee must follow the basic common law principles of contracts when assigning the mortgage. Meanwhile, the mortgagee must follow the indorsement rules imposed by the UCC in order to transfer the note. These requirements apply to all mortgages related to land located in Massachusetts. In addition to state law requirements, other requirements may arise when the mortgage is purportedly assigned to a Real Estate Mortgage Investment Conduit (“REMIC”) trust as a part of the securitization process. If a foreclosing entity is a REMIC trust, then the assignment of mortgage must comply with the REMIC rules, promulgated by the IRS, and the rules proscribed in the Pooling and Servicing Agreement (“PSA”), which serves as the governing agreement for the trust.

A. Requirements under Massachusetts Law

The mortgage and note are governed by different bodies of Massachusetts law. Property and common law contract principles govern any transaction to assign the mortgage. Accordingly, the assignment must contain the traditional elements of a contract: offer, acceptance, and consideration. Moreover, since assignments of mortgage constitute contracts concerning land, the Statute of Frauds applies. On the other hand, the UCC governs the note, as it is a negotiable instrument. Because Massachusetts is a non-judicial foreclosure state, the foreclosing entity must show that it is the holder of the mortgage and the note only after the foreclosing entity’s authority has been challenged. Therefore,

35 See ch. 106, § 3-104(e); see also id. § 9-109(b).
36 In re Nosek, 386 B.R. 374, 382 (D. Mass. 2008) (“It is the creditor’s responsibility to keep a borrower and the Court informed as to who owns the note and mortgage and is servicing the loan, not the borrower’s or the Court’s responsibility to ferret out the truth.”), aff’d in part and vacated in part, 406 B.R. 434 (D. Mass. 2009). This is in contrast to New York, which is a judicial
many homeowners facing foreclosure may allow the unknown entity to foreclose, thinking that it must have the proper authority, just as the homeowners trusted brokers and real estate agents who assured them that the mortgage was affordable and appropriate. The lender, however, must comply with Massachusetts law when transferring a mortgage interest.

1. Property Principles and the Statute of Frauds Relevant to Assignments of Mortgage

An assignment of mortgage is a contract between the current mortgagee and a third party assignee. The third party becomes the assignee mortgagee, assuming the right to payment, the right to foreclose, and any other right granted to the mortgagee under the original mortgage. In order for an assignment to be effective, there must be an offer, acceptance, and consideration. Under chapter 259, section one of the Massachusetts General Laws, an assignment of mortgage must be “in writing and signed by the party to be charged therewith, or by some person thereunto by him lawfully authorized.” The required writing must contain the essential terms of the agreement, which sometimes includes the price. The statute does not define what terms must be included; but in one case, the court found that a contract for the sale of land satisfied the Statute of Frauds, as a matter of law when it included “the names and signatures of the parties, a sufficient description of the property, the price, and the time when it is to be performed.”


37 See Ibanez, 2009 WL 32977551 at *10 (finding that in order to have authority to foreclose, one must have an assignment of mortgage).

38 The mortgagee has the right to receive payment when it holds the note, as discussed above.

39 ch. 259, § 1.

40 Des Brisay v. Foss, 162 N.E. 4, 6 (Mass. 1928); but see Bogigian v. Booklovers Library, 79 N.E. 769, 769 (Mass. 1907) (finding that consideration does not necessarily mean price).

assignment. Moreover, the assignment of mortgage must be produced by the foreclosing entity when ownership is challenged.

In addition to the writing requirement, the contract must be “signed by the party to be charged therewith, or by some person thereunto by him lawfully authorized.” Because mortgagees are generally corporations, the assignments must be signed by an authorized person within the corporation. As lenders cope with increased numbers of foreclosures around the country, lenders have heavily relied on servicers and local foreclosure counsel to execute documents in order to foreclose. These third parties assert authorization to execute assignments of mortgage by the foreclosing entities.

This raises the question: can a third party sign on behalf of another corporation in order to assign a mortgage? In In re Hayes, Argent Mortgage Company, LLC, granted a limited power of attorney to Citi Residential Lending, Inc. The court found that this limited power of attorney did not authorize Citi Residential Lending to assign this mortgage because the power of attorney limited actions to those explicitly listed. The court did not address whether a third party agent could ever have this authority. However, even if a corporation can grant authority to a third party agent, it may create a conflict of interest for foreclosure counsel to execute documents identifying itself as an employee of its own client. Thus, the question remains unanswered.

A final element relating to the assignment of mortgages is the timing of the assignment. The foreclosing entity may produce an assignment signed after the initiation of foreclosure proceedings, but purporting to have retroactive effect. A Massachusetts Land Court recently rejected an ownership claim based on a retroactive assignment. In U.S. Bank

42 See ch. 244, § 14.
44 ch. 259, § 1.
45 See Morrison v. Tremont Trust, 147 N.E. 870, 871 (Mass. 1925) (“A corporation can act only by agents duly authorized.”).
47 Id. at 268.
48 See Model Rules of Prof’l Conduct R. 1.17 cmt. 1, 9, 10 (2002); see also Model Rules of Prof’l Conduct R. 1.8 cmt. 3 (2002).
50 See id. at *3.
Nat'l Assoc. v. Ibanez, the court refused to clear a cloud on the title of several properties purchased after foreclosures because the lenders failed to produce valid assignments of mortgage prior to foreclosure. As a result of Ibanez, at least one practitioner believes that thousands of foreclosures in Massachusetts may be invalid and that insurance companies will be very wary to give title insurance on foreclosed property. Accordingly, the Ibanez decision will likely be appealed to the Supreme Judicial Court of Massachusetts. At the date of publication of this comment, however, Ibanez supports the idea that courts should not recognize retroactive assignments as valid.

In Ibanez, several lenders brought an action to clear a cloud on title pursuant to chapter 240, section six of the Massachusetts General Laws, after purchasing several properties at a foreclosure auction, where they also acted as foreclosing entities. In each foreclosure, the lender could not produce assignments that were dated prior to the foreclosure sales. The lenders argued that because they had “assignments in blank” and properly indorsed notes, they had the right to foreclose despite the defect. The court found that the assignments in blank did not meet the statutory requirements for an assignment for failure to name an assignee as required. Further, the court rejected the assignments, holding “retroactive assignments, long after notice and sale have taken place, do not cure the statutory defects.”

To further support the argument that retroactive assignments should not be valid, a New York court held that a retroactive assignment cannot grant an ownership interest to the foreclosing entity.

51 Id. at *11-12.
53 Id.
54 Id. at *1.
55 Id. at *3.
56 Id. at *8.
57 Id. at *5.
58 Id. at *4.
Countrywide Home Loans, Inc. v. Taylor, MERS executed an assignment of mortgage as nominee for the lender. The assignment was signed one month after the assignee filed a foreclosure complaint. The purported assignment stated that the assignment “shall be deemed effective August 1, 2006.” The Taylor Court found that “[s]uch attempt at retroactivity, however, is insufficient to establish Countrywide’s ownership interest at the time the action was commenced.” Several Massachusetts District Court cases also require the lender to produce an assignment signed prior to asserting an ownership interest. In conjunction with Taylor, these cases strongly suggest that backdated assignments will not withstand a legal challenge, nor support a defense of valid assignment.

Accordingly, practitioners should ensure that any assignment of mortgage produced by the foreclosing entity meets the common law elements of a contract. Moreover, an appropriate party should have authorized the assignment of mortgage. It is also important to examine the purported assignment to ascertain whether the parties are attempting to create a retroactive assignment. Since the foreclosing entity must own both the mortgage and the note, it is equally important to examine the validity of a transferred note.

2. The UCC Relevant to Notes

While property and common law contract principles govern the mortgage, the UCC negotiable instrument principles govern the note. Additionally, it is essential that the note is transferred along with the mortgage in order to transfer the entire mortgage interest. The note does not have to be recorded in the registry of deeds and may be sold to any third party as a negotiable instrument. Article 3 of the UCC provides

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60 Id. at 497.
61 Id.
62 Id.
63 Id.
65 See Taylor, 843 N.Y.S.2d at 495; See also In re Schwartz, 366 B.R. at 269; In re Hayes, 393 B.R. at 268.
the indorsement rules for the note. It is also generally accepted that the mortgage follows the note. Therefore, if a note is properly transferred to the foreclosing entity without a valid assignment of mortgage, a court may create an equitable assignment of mortgage. As a result, determining that the note has been validly indorsed to an assignee mortgagee may establish that the mortgage interest was transferred properly. Thus, examining the note to see if the parties fulfilled the indorsement requirements may be essential to a claim that the foreclosing entity did not have an ownership interest prior to the foreclosure.

Unlike the assignment of mortgage, which should be publicized in the foreclosure notice, it is essential for the practitioner to request the properly indorsed note in order to examine the note and to challenge the foreclosing entity’s ownership. A note can be properly indorsed two different ways. First, a note is properly transferred if it is indorsed specifically to the party claiming an ownership interest. Second, a note can have a blank indorsement, and thus becomes payable to the bearer. If the note is payable to the bearer, the party with physical possession alone can assert ownership. Therefore, ascertaining who has physical possession of the note may be essential to determining who has ownership of the note.

Because it is generally accepted that the mortgage follows the note, a foreclosing entity which produces a properly indorsed note, without producing a lawful assignment, may succeed in asserting an ownership claim. This success arises from the fact that a court may employ the doctrine of equitable assignment by implying a proper assignment of mortgage, circumventing the requirements of the Statute of Frauds. In Massachusetts, courts have employed an equitable assignment of

68  See ch. 106, § 3-205.
70  See Commonwealth v. Reading Savings Bank, 137 Mass. 431, 443 (1884) (“If, by the defective execution of the assignment, the intention is not completely carried out, a court of equity should correct it.”); but see U.S. Bank National Assoc. v. Ibanez, Nos. 08 MISC 384283, 08 MISC 386755, 2009 WL 3297551, at *11 (Mass. Land Ct. Oct. 14, 2009) (“But even a valid transfer of the note does not automatically transfer the mortgage.”).
71  See ch. 106, § 3-204.
72  See id. § 3-205 (b); see also In re Samuels, No. 06-11656-FJB, 2009 Bankr. LEXIS 1954, at *28 (E.D. Mass. July 6, 2009).
73  See ch. 106, § 3-205(b).
mortgage when the note is properly transferred, but the assignment of mortgage was defective. 74 The purported assignor, however, must make some attempt to assign the mortgage, as the courts will not automatically create an equitable assignment with the mere transfer of the note. 75 Therefore, without a properly indorsed note and purported, yet imperfect, assignment of mortgage, it is unlikely that an equitable assignment of mortgage defense will prevail.

Given that banks frequently assigned mortgages in the past few years, a court may be willing to reduce the requirements for an equitable assignment, akin to the court’s practical decision in Beal Bank SSB v. Eurich. 76 The Eurich court was willing to slightly lessen the restrictions for the business records exception to hearsay, recognizing that banks frequently assign mortgages. 77 In Eurich, Beal Bank wanted to admit another bank’s computer printouts under the business records exception to hearsay, without satisfying the personal knowledge requirement of the hearsay exception. 78 In determining that the printouts were admissible as business records, the Eurich court recognized that mortgages are commonly and frequently assigned several times. 79 The court also noted, that the debtor did not provide any evidence or calculation that the records were inaccurate and, thus, the court presumed the records were more likely to be accurate. 80 For these reasons, the court concluded that the trial court did not abuse its discretion by admitting the printouts. 81

Unlike the Eurich court’s disregard of the personal knowledge requirement, it would not be fair, nor in the public’s interest, to disregard the Statute of Frauds and to grant equitable assignments of mortgage

74 See Reading Savings Bank, 137 Mass. at 443.

75 See Barnes v. Boardman, 21 N.E. 308, 309 (Mass. 1889) (“The general rule is familiar that an assignment or transfer of a mortgage debt carries with it an equitable right to an assignment of the mortgage”); see also Wolcott v. Winchester, 81 Mass. (15 Gray) 461, 464 (1860) (“Our doctrine has not gone to the extent that the mere purchase of the debt drew with it the mortgage security, so far as to vest the legal interest in the purchaser so that he might enforce the same by a suit in his own name.”).

76 See 831 N.E.2d 909, 914 (Mass. 2005).

77 Id.

78 Id. at 910-11.

79 Id. at 914.

80 Id. at 914 n.4.

81 Id. at 914.
to banks. This disregard would not be fair because the banks profited from their lax protocol and ignored their due diligence requirements when granting these often predatory or unaffordable loans to borrowers. Moreover, the banks, who profited from the original transactions, are now seeking to foreclose on people’s homes, arguably those people’s most precious asset, because these very transactions are no longer profitable to the banks. Furthermore, at least one federal judge has frequently held banks to the usual standard, not granting any leeway for the increased volume of foreclosures. In In re Maisel, Judge Rosenthal commented that “[u]nfortunately, concomitant with the increase in foreclosures is an increase in lenders who, in their rush to foreclose, haphazardly fail to comply with even the most basic legal requirements of the bankruptcy system.”

In Maisel, the purported mortgagee produced an assignment of mortgage dated four days after the mortgagee filed a Motion for Relief from Stay. Judge Rosenthal referred to the purported assignee as an “unrelated third party that had no interest in the mortgage or note until after the Motion for Relief was filed and, therefore, Movant did not have standing to seek relief from stay.” Likewise in In re Schwartz, Judge Rosenthal would not give weight to an assignment that had not been signed until after the foreclosure sale. Judge Rosenthal concluded that “HomEq and Deutsche were careless in their documentation, a problem that falls squarely upon them.” With Judge Rosenthal’s condemnation of sloppy lenders and a clear public policy argument, it is unlikely that a court will lightly employ the equitable assignment doctrine. Moreover, in Ibanez, Judge Long refused to grant an equitable assignment, rejecting the argument that the law should change to “reflect ‘industry standards and practice.’” Judge Long based his refusal on the lenders failure to follow the statutes and their own standards, echoing Judge Rosenthal’s sentiments when he stated that “the responsibility for the consequences is theirs.” Therefore, challenging the foreclosing entity’s ownership

83 Id. at 20.
84 Id. at 22.
86 Id.
88 Id.
based on defects in the indorsement of note and assignment of mortgage may be a successful means to protect the homeowner’s interest.

B. Special Requirements for Assignments of Mortgage and Transfers of Note to REMIC Trusts

Many mortgages have been assigned to REMIC trusts as a part of the securitization process. The Internal Revenue Service (“IRS”) created REMICs to enable the bundling of residential mortgages into segregated asset pools, so that individuals could invest in these asset-backed securities, which were thought to be stable investments. REMICs are tax “pass-through” entities, meaning that the REMICs themselves are not taxed on income, rather only the investors are taxed on income received. This tax incentive further promoted investment in mortgage backed securities. Moreover, many investors believed that pooling mortgages reduced the overall risk of default because the individual risk of default could be spread across the trust and any individual default would represent a miniscule loss to the investors. As a result, many residential mortgages were assigned, or purported to be assigned into REMIC trusts that continue to play a prominent role in foreclosure cases.

1. Requirements Imposed by the Internal Revenue Code

Due to the favorable tax treatment, the IRS imposes strict rules upon REMICs, as codified in the Internal Revenue Code, section 860A-G. As a general rule, a qualified mortgage must be an obligation principally secured by an interest in real property and purchased by the

89 When a mortgage is owned by a REMIC trust, the trust may be more unwilling to modify the loan because of negative implications in the tax code and possible litigation with shareholders. This additional issue does not relate to assignments but may be a concern when negotiating with a REMIC trust.

90 This is in contrast to “double taxation” which occurs when the entity is taxed on income and the investor is also taxed on its share of income.

91 REMICs are a type of Real Estate Investment Trust (“REIT”) and the REMIC rules sometimes adopt the REIT definitions. For example, the REMIC rules adopt the REIT definition of “foreclosure property” found in 26 C.F.R. § 1.856-6 (2009).
REMIC within three months of the startup date. If the mortgage is contributed to the REMIC after the three month window, it may be contributed properly if it is a “qualified replacement mortgage.” A qualified replacement mortgage is an obligation that would have been qualified if transferred in the proper time, but is received outside the three month window in exchange for a defective obligation. The REMIC can only engage in qualified replacement mortgage transactions for up to two years following the startup date.

A mortgage may also be properly contributed to the trust after the three-month window if the mortgage qualifies as “foreclosure property,” a permitted investment for REMICs. Foreclosure property is property acquired at a foreclosure sale or by agreement after there has been a default. The mortgage is not eligible for foreclosure property treatment if the trustee knew or had reason to know that default would occur. This information is termed “improper knowledge.” If the REMIC trust cannot show either that the purchase of the mortgage was part of the qualified replacement mortgage, or that the mortgage qualifies as foreclosure property, the trust violated the REMIC rules by executing a prohibited transaction. The IRS imposes a 100% tax on net income derived from prohibited transactions.

If a mortgage is transferred to the trust as part of a prohibited transaction, a private right of action does not arise automatically under the REMIC rules. Additionally, solely violating the REMIC rules does not show a defect in ownership of the mortgage. The violation may, however, increase the bargaining power of the borrower or may augment an argument that the REMIC trust is not the proper owner of the mortgage.

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94 Id.
96 Id. § 860G(a)(5)(C).
97 26 C.F.R. § 1.856-6 (b) (2009).
98 Id. § 1.856-6 (b)(3).
99 Id.
101 See generally id. at § 860A-G.
if it is one of several defects. Thus, it is advantageous to evaluate whether there has been a violation of the REMIC rules if the assignee is a REMIC Trust. Moreover, determining whether there has been a REMIC rule violation is easily ascertained by public records. Pooling and Servicing Agreements ("PSAs") of any REMIC trust are available on the U.S. Securities and Exchange Commission’s website and will list the startup date of the particular trust.\textsuperscript{103} With the startup date, a practitioner can determine the three month window for proper contribution, as well as the two year period when mortgages may be contributed as qualified replacement mortgages. Finally, the date of the purported assignment can indicate whether the trust had “improper knowledge” with regard to the mortgage as to whether it could be properly attributed as foreclosure property. Because the possible violation is determined through scanning the public records and may increase the strength of an argument that an assignee does not own the mortgage, it is wise to evaluate whether there have been violations of the REMIC rules.

2. Requirements Imposed by Pooling and Servicing Agreements

In addition to following the REMIC rules, any securitized trusts must comply with the procedures outlined in its Pooling and Servicing Agreement ("PSA"). The PSA describes how the trust will operate, setting the ground rules for the trust so that the trust can induce investment from third parties. The trust must also follow the protocol detailed in the PSA so that the individual mortgages are bankruptcy remote from the originating lender. Each trust has a unique PSA that describes how mortgages must be transferred to the trust corpus. The PSA will, at the bare minimum, require that mortgages flow first from the Depositor, to the trust corpus. Other PSAs employ more parties, such as requiring the transfer from a Depositor, to a Sponsor, to the trust corpus. If the trust fails to meet its own standards when acquiring a mortgage, it may not be able to successfully claim an ownership interest in the mortgage.\textsuperscript{104}


\textsuperscript{104} See In re Hayes, 393 B.R. 259, 268 (Bankr. D. Mass. 2008) (“Deutsche Bank failed to adequately trace the loan from the original holder, Argent Mortgage Company, LLC, to it [under the rules described in the PSA].”); \textit{but see In re
But even with these detailed protocols, some assignments of mortgage purport to assign the mortgage from the originator directly to a trust. These assignments blatantly defy the terms of the PSAs, in what has been termed an “A to D” transfer because it skips the necessary steps (theoretically speaking “B” and “C”) proscribed in the PSA.

Courts have given mixed weight to the “A to D” theory. In In re Hayes, the court found that the failure of the lender to trace its ownership in the path proscribed in the PSA undermined the lender’s purported ownership interest. The Confirmatory Assignment produced by the lender was signed seven months after the lender claimed an ownership interest. Moreover, the lender failed to produce any evidence that the mortgage had been included in the trust corpus at the time the trust initially claimed an ownership interest. Finally, the court found the lender’s claim suspect because the originating lender was not a party listed in the PSA. In In re Samuels, however, the court found that physical possession of the note, coupled with a Confirmatory Assignment that transferred the mortgage directly from the originator to the trust corpus conveyed a valid ownership interest. In addition to the assignment, the mortgage had been listed in a closing schedule of the PSA. Moreover, the foreclosing entity had continuously held the mortgage and note in its collateral files, until providing the documents to the servicer in order to foreclose. It seems that a court may be more likely to ignore the “A to D” problem if the lender can show that the trust had a long-term ownership interest, rather than a short-term interest ostensibly made in order to foreclose.

This may not, however, be the rule in Massachusetts. In Ibanez, like in In re Samuels, the lenders could show that the mortgages in question

Samuels, 2009 Bankr. LEXIS 1954 at *33-34 (“Even if this direct [confirmatory] assignment were somehow violative of the PSA, giving rise to unfavorable tax, regulatory, contractual, and tort consequences, neither the PSA nor those consequences would render the assignment itself invalid.”).

105 In re Hayes, 393 B.R. at 268.
106 Id.
107 Id.
108 Id.
110 Id. at 23-24.
111 Id. at 24.
were included in the prospectus information given to investors.\textsuperscript{112} Also like the lender in \textit{In re Samuels}, the lenders in \textit{Ibanez} had held the assignment of mortgages and notes in a collateral file.\textsuperscript{113} Though not framed as an “A to D” problem, the \textit{Ibanez} court rejected the lenders assignment because the mortgages had been assigned “in blank” which was not a valid recordable form.\textsuperscript{114} The \textit{Ibanez} court held that the assignments in blank were not recordable assignments as required by the PSAs and thus were ineffective.\textsuperscript{115} This failure to follow the lender’s own requirements, coupled with an invalid retroactive assignment, led the \textit{Ibanez} court to decide that the mortgages had never been assigned to the foreclosing entity.\textsuperscript{116}

As illustrated by recent developments, Massachusetts courts have not given consistent weight to the A to D problem. These recent conflicting cases will likely be appealed at a later date. Until then, it would be wise for a practitioner to bring claims based on a failure to transfer the mortgage according to the method proscribed in the PSA.

C. \textit{Summary of Requirements for Assignment of Mortgage and Indorsement of Notes}

Ultimately, it is the lender’s burden to show that it holds the mortgage and note through an assignment and indorsement, respectively. Careful consumer practitioners, however, will examine both the assignment of mortgage and the indorsement of note to ensure that both documents comply with Massachusetts law. Additionally, there are certain other requirements for assignees that are REMIC trusts. Even if the documents appear to properly transfer ownership, the transfer will be invalidated if the assignor party was not duly authorized. This final issue is common in cases where the borrower challenges an assignment made by MERS as nominee for the mortgagee.

II. \textbf{Illustrating the Importance of Examining the Assignment of}

\begin{itemize}
\item \textsuperscript{113} \textit{Id.} at *6.
\item \textsuperscript{114} \textit{Id.} at *5.
\item \textsuperscript{115} \textit{Id.} at *8.
\item \textsuperscript{116} \textit{Id.} at *10.
\end{itemize}
Mortgage and Indorsement of Note: MERS As Assignor

All mortgages must have two parties – the mortgagor and the mortgagee. In over fifty percent of mortgages in the United States, MERS is a third party on the mortgage, as nominee and mortgagee of record. Generally, the mortgage will explicitly give MERS, as nominee for the mortgagee lender, the power to foreclose on the property upon default and to act when necessary on the lender’s behalf. The formulaic MERS mortgage does not, however, explicitly grant the right to assign the mortgage on behalf of the lender. The absence of the right to assign may indicate that the parties did not intend to give MERS this right. Additionally, MERS itself claims that it has no real ownership interest in mortgages. Therefore, MERS lacks the authority to assign mortgages or transfer notes.

Moreover, MERS can only assign the rights that it has and no more. When MERS is a party to a mortgage, it has only nominee rights. Black’s Law Dictionary defines a nominee as either a “person designated to act in place of another, usu[ally] in a very limited way,” or a “party who holds bare legal title for the benefit of others or who receives and distributes funds for the benefit of others.” Therefore, MERS, as nominee, may act on behalf of the true mortgage holder for the limited purposes listed in the mortgage – the right to foreclose, the right to release and cancel the mortgage, and the right to take any action required by the lender – and no more. Hence, a challenge based on MERS as assignor rests on the fact that MERS was not duly authorized as required by Massachusetts law.

Building on this logic, a New York court held that MERS did not have the authority to assign mortgages. In LaSalle Bank Nat’l Ass’n

117 Peterson, supra note 3, at 2211.
119 See Dolben v. Kauffman, 170 N.E. 400, 400-01 (Mass. 1930) (explaining that a plaintiff’s rights are not greater than those of his assignor).
120 Black’s Law Dictionary 1149 (9th ed. 2009).
122 Unlike Massachusetts, New York is a judicial foreclosure state. See Bergman on New York Mortgage Foreclosures § 2.01 (MB 2009). Therefore, the plaintiff in Lamy is the lender wishing to foreclose and it must prove its ownership to the
v. Lamy, the plaintiff proffered an assignment of mortgage that alleged to show its ownership interest. According to this assignment, the purported assignor was MERS. The Lamy court held that MERS, as nominee, does not have the authority to assign mortgages because it does not have the requisite ownership interest.

In In re Huggins, the court considered the Lamy holding while interpreting Massachusetts’ law. The Huggins court distinguished MERS’ ability to foreclose from its ability to assign because the mortgage explicitly granted MERS the authority to foreclose. Explaining the distinction, the Huggins court found that:

Lamy thus rests on a defect in the title of the assignee, arising from an inability of MERS, as nominee, to transfer the rights of the owner of the mortgage, not on a defect in the standing of MERS as nominee to foreclose on behalf of a valid holder of the mortgage note.

Therefore, the Huggins court did not accept nor reject the Lamy court’s holding that MERS as nominee cannot assign the mortgage. Consequently, whether MERS has the ability to assign mortgages based on its nominee rights has yet to be determined in Massachusetts.

Assuming arguendo that MERS has the authority to assign mortgages, it clearly has no authority to transfer the note because it has no ownership interest in the underlying note. In Saxon Mortgage Servs. Inc. v. Hillery, MERS as nominee for New Century purportedly assigned

court. LaSalle Bank Nat’l Ass’n, 2006 WL 2251721, at *1. Because borrowers in Massachusetts must challenge the lender’s ownership claim before a court can determine the validity of such a claim, New York has a more in-depth body of case law in this area. See generally id.; see also Kluge v. Fugazy, 536 N.Y.S.2d 92, 93 (N.Y. App. Div. 1988).

123 LaSalle Bank Nat’l Ass’n, 2006 WL 2251721, at *1.
124 Id.
125 Id. at *2.
127 Id. at 183.
128 Id. at 184.
the mortgage and note to Consumer.\textsuperscript{130} There was no evidence that New Century assigned the note to MERS, nor evidence that it granted MERS as nominee the authority to transfer the note.\textsuperscript{131} The court found that even if MERS had the authority to assign the mortgage, it never had the authority to transfer the note, and thus, Consumer could not show a valid ownership interest.\textsuperscript{132}

Because MERS likely does not have the authority to assign mortgages, and does not have the authority to transfer notes, a court is unlikely to find that MERS effectuated a valid transfer of ownership. This lack of authority to assign goes to the fundamental basis of the purported assignee’s ownership interest. Therefore, it may be fruitful to challenge any ownership claim that arises from a transfer from MERS due to an invalid assignment of mortgage and indorsment of note.

\section*{III. Legal Theories That Can Be Utilized to Challenge the Foreclosing Entity’s Ownership Interest}

In order to foreclose upon the mortgage, the foreclosing entity must have legal title to the mortgage and the note.\textsuperscript{133} If the foreclosing entity is not the originator or servicer and the homeowner challenges the entity’s ownership, the foreclosing entity must produce a valid assignment of mortgage and properly indorsed note to show that it has the requisite ownership interest.\textsuperscript{134} The foreclosing entity must also be able to show that it received its interest from a party legally entitled to transfer ownership. Furthermore, the foreclosing entity must have acquired its interest in the mortgage prior to the foreclosure sale.\textsuperscript{135} If the foreclosing entity fails to produce unblemished documentation of ownership, a court

\begin{itemize}
\item \textsuperscript{130} \textit{Id.} at *3.
\item \textsuperscript{131} \textit{Id.}
\item \textsuperscript{132} \textit{Id.} at *16.
\item \textsuperscript{133} See generally Adams v. Parker, 78 Mass. (12 Gray) 53 (1858) (establishing that a plaintiff must prove legal title in real estate in order to maintain an action to foreclose a mortgage).
\item \textsuperscript{134} See \textit{In re Maisel}, 378 B.R. 19, 22 (Bankr. D. Mass. 2007) (“It is the [lender’s] burden to bring information regarding the relationship between the parties to the Court.”).
\item \textsuperscript{135} See \textit{In re Schwartz}, 366 B.R. 265, 269 (Bankr. D. Mass. 2007) (“Acquiring the mortgage after the entry and foreclosure sale does not satisfy the Massachusetts statute.”).
\end{itemize}
may invalidate the foreclosure. This section will detail the different theories that may be utilized to challenge the foreclosing entity’s claim, or to challenge the foreclosure itself, in order to defend the homeowner’s interest in a post-foreclosure, pre-eviction case.

A. The Foreclosing Entity is Not a Real Party in Interest, Nor Does it Have Standing

Massachusetts courts require that every claim “be prosecuted by a real party in interest.” A real party in interest is the “party who, by the substantive law, has the right sought to be enforced.” In a foreclosure related action, a real party in interest must show an ownership interest in the mortgage, which can be demonstrated by holding the note and mortgage, or being the servicer for the holder of the note and mortgage. If an assignment of mortgage fails, the purported assignee by definition cannot hold the note and mortgage. Without such an ownership interest, the purported assignee cannot be the real party in interest.

Challenging the foreclosing entity’s real party in interest status arises where the foreclosing entity is attempting to evict the former homeowner in housing court. When an entity acts to evict the former owner after a foreclosure, the party must be a real party in interest in the housing court. Accordingly, a homeowner facing post-foreclosure eviction may be able to file a motion to dismiss for failure to be a real party in interest. Unfortunately, the case will not be dismissed until a

136 See In re Maisel, 378 B.R. 19,22 (Bankr. D. Mass. 2007)(“It is the [lender’s] burden to bring information regarding the relationship between the parties to the Court.”).
139 See In re Nosek, 386 B.R. 374, 380 (Bankr. D. Mass. 2008); see also In re Huggins, 357 B.R. 180, 183 (Bankr. D. Mass. 2006) (portraying a real party in interest as the entity which has a property or ownership interest).
140 See Kenrich Corp. v. Miller, 256 F. Supp. 15, 17-18 (E.D. Pa. 1966) (“Under Pennsylvania law, the attempted assignment from Kenrich to Jerome Kline is void as champertous and against public policy, and vested no rights in Kline sufficient to maintain this cause of action.”), aff’d, 377 F.2d 312 (3rd Cir. 1967).
141 See Mass. R. Civ. P. 17(a).
“reasonable time has been allowed after objection for ratification.” Therefore, challenging the foreclosing entity on the basis that it is not the real party in interest will only delay the proceedings.

In federal court, the foreclosing entity must be the real party in interest and have standing. Foreclosure cases in federal court are frequently litigated as a part of the borrower’s bankruptcy proceedings, and the foreclosing entity must show that it is the holder of the note and mortgage in order to establish that it has standing to seek a relief from automatic stay in order to foreclose. Additionally, homeowners may file for bankruptcy after foreclosure to prevent eviction. When in federal court, the borrower can attack standing at any time, including post-foreclosure. Attacking the foreclosing entity’s standing would not invalidate the foreclosure per se, but would extinguish the party’s right to enforce its claim in court. Again, this action may serve to increase the borrower’s bargaining power or open meaningful negotiations between the parties.

In contrast to the effects of an attack on real party in interest status or standing, where the homeowner is challenging the foreclosing entity’s right to prosecute a claim, the following theories aim to invalidate the foreclosure itself.

B. Because the Entity Foreclosed on the Property without a Valid Ownership Interest, the Court Should Void the Foreclosure Sale

Often the homeowner in a post-foreclosure, pre-eviction case

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142 Id.
145 A servicer may also have standing in federal court. See In re Hayes, 393 B.R. at 267 (“Courts have held that mortgage servicers are parties in interest with standing by virtue of their pecuniary interest in collecting payments under the terms of the notes and mortgages they service.”).
147 See In re Hayes, 393 B.R. at 266.
wishes to invalidate the foreclosure. Because an earlier action brought to invalidate the mortgage will not preclude a prospective action to set aside the mortgage, the borrower need not raise both claims in the same action. When invalidating a foreclosure sale, a court may void the foreclosure sale or declare it voidable. “Errors that go to the legal basis of power of sale make the sale totally void. Errors that involve mere irregularities in the exercise of the power of sale are only voidable.” A void sale creates a nullity. In other words, “[i]t is as if no such sale had been made.” On the other hand, a voidable sale enables “the mortgagor, or perhaps the purchaser, to avoid it, and still be effectual if all the parties interested desire to have it stand.” Based on a theory of laches, however, a mortgagor may be barred from voiding a “voidable” sale if he does not act with reasonable promptness.

Where the foreclosing entity produces an invalid assignment of mortgage, or does not hold the note, the fact that the entity cannot show an ownership interest in the mortgage likely relates to the legal basis of the power of sale. In that instance, the mortgagor will ask the court to declare the foreclosure sale void and unenforceable. To illustrate defects that relate to the power of sale, a foreclosing entity must produce notices under chapter 244, section fourteen of the Massachusetts General Laws.
that identify the holder of the mortgage. Furthermore, the foreclosing entity must publicize the valid assignment under which it derives its ownership interest with the foreclosure notice. If the foreclosing entity does not properly own the mortgage, it will fail to identify the proper mortgagee in the notices and publicize a valid assignment. This failure will result in an invalid execution of the power of sale for failure to name the holder of the mortgage and publicize a valid assignment. Because a properly executed notice of sale under chapter 244, section fourteen of the Massachusetts General Laws is a condition precedent to a valid foreclosure, a violation of chapter 244 of the Massachusetts General Laws will make the foreclosure sale void as a matter of law.

C. Because the Entity Foreclosed on the Property without a Valid Ownership Interest, It Violated Its Duty of Good Faith and Reasonable Diligence under Chapter 93A of the Massachusetts General Laws

Under chapter 93A, sections two subsection (a) and nine of the Massachusetts General Laws, mortgagees must act in good faith and with reasonable diligence when foreclosing on a mortgage. In addition to creating a duty for tort actions, chapter 93A of the Massachusetts General Laws makes violating this duty alone an unfair and deceptive act. Moreover, if a lender violates its duty of good faith and reasonable diligence, the foreclosure will be declared void. In Williams v. Resolution GGF OY, the court sought to determine whether the mortgagee acted in good faith during foreclosure by applying the factors found in PMP Assocs., Inc. v. Globe Newspaper Co. Those factors are: “(1) whether the practice...is within at least the penumbra of some common-law, statutory, or other established concept of unfairness; (2) whether it is immoral,
unethical, oppressive, or unscrupulous; (3) whether it causes substantial injury to consumers.” In *PMP Assocs., Inc.*, the court determined that courts should weigh the factors but not apply a strict calculation. Additionally, when the mortgagee acting pursuant to a power of sale is also the purchaser, “he will be held to the strictest good faith and utmost diligence for the protection of the rights of his principal.”

A court will examine whether a mortgagee violated its duty of good faith and reasonable diligence based on the individual facts. Generally, if the mortgagee follows the required notices in chapter 244, sections eleven through seventeen of the Massachusetts General Laws, the mortgagee will satisfy its duty unless “the mortgagee’s conduct manifested fraud, bad faith, or the absence of reasonable diligence in the foreclosure sale process.” Arguably, foreclosing upon a mortgage without establishing a clear ownership interest, as legal literature on foreclosure urges practitioners to do, may show a lack of reasonable diligence. Moreover, a court is more likely to invalidate a foreclosure if the “bad faith or failure of diligence has been of an active and conspicuous character.”

Showing that the foreclosing entity violated the duty of good faith and reasonable diligence may effectively invalidate a foreclosure, or may be an element in another tort cause of action.

D. *Because the Entity Foreclosed on the Property without a Valid Ownership Interest, the Foreclosure Sale Constituted an Unfair and Deceptive Act under Chapter 93A of the Massachusetts General Laws*

In addition to imposing a duty of good faith and reasonable diligence on mortgagees during foreclosure, chapter 93A of the Massachusetts General Laws provides civil relief and equitable remedies.

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166 See *id*.
169 See *Bruce E. Falby & E. Randolph Tucker, Massachusetts Real Estate Liens § 2.3.1 (MCLE 2007).*
170 *Pemstein*, 630 N.E.2d at 611.
for consumers against unfair and deceptive business practices. Unfair and deceptive practices are not defined in the statute. But rather, “[u]nfairness under G.L. c. 93A is determined from all the circumstances.” Furthermore, to evaluate whether a practice is unfair, the court will look to the equities between the parties. Additionally, “unfairness is to be measured…by analyzing the effect of the conduct on the public.” Moreover, “[a] practice may be deceptive if it reasonably could be found to have caused the plaintiff to act differently than he otherwise would have acted.”

In Kattar v. Demoulas et al., the plaintiff, Kevin Kattar (“Kattar”), challenged the foreclosure of his golf course under chapter 93A of the Massachusetts General Laws. Kattar admitted that he was in violation of the mortgage terms for failure to pay taxes, but claimed that he had arranged with the bank to sell a portion of the property to a third party and pay the debt owed to the bank in full after that transaction. Kattar argued that the lender foreclosed on the mortgage because he refused to falsely testify in another matter in support of the defendant, Arthur Demoulas (“Demoulas”). The lender and Demoulas argued that Kattar violated the mortgage terms and, therefore, the lender had the authority to foreclose on the property, regardless of any motive.

The Supreme Judicial Court affirmed the lower court’s decision, finding that the foreclosure was conducted in bad faith to the detriment of the borrower. The court found that “[e]ven if the defendants had the right to foreclose, as the judge found, it was clearly unfair within the meaning of c. 93A, to use that right for a reason so obviously against

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172 See Swanson v. Bankers Life Co., 450 N.E.2d 577, 580 (Mass. 1983) (“[w]hat a defendant knew or should have known may be relevant in determining unfairness…a plaintiff’s conduct, his knowledge, and what he reasonably should have known may be factors in determining whether an act or practice is unfair.”).
174 Duclersaint, 696 N.E.2d at 540.
176 See id.
177 See id. at 253.
178 See id. at 256.
179 Id. at 257.
The court did not find, however, that Kattar was entitled to a reconveyance of property. Although the court held that chapter 93A of the Massachusetts General Laws could provide equitable relief, the circumstances did not require a reconveyance. The court based this decision on the fact that the bank had the right to foreclose, that the property was held for investment, and that Kattar was in the process of negotiating a sale to a third party when the lender foreclosed. Accordingly, the Court imposed actual damages for the violation of chapter 93A of the Massachusetts General Laws.

Based on the reasoning in Kattar, foreclosing on a residential mortgage without proper ownership interest may be an unfair and deceptive act under chapter 93A of the Massachusetts General Laws because it violates public policy and may cause the borrower to act differently than she would otherwise. Validating foreclosures brought by improper parties violates public policy for several reasons. If the foreclosing entity can foreclose without proper authority, that foreclosure nullifies the rights and remedies of the actual mortgage and note holder. Moreover, allowing entities to foreclose on property without valid written assignments violates the Statute of Frauds, further undermining the public policy of maintaining real property rights through accurate recordkeeping. Furthermore, if mortgage ownership is unknown, it undermines the ability to buy and sell real property further contributing to depressed home values and a stagnant economy.

180 Id.
182 Id.
183 Id. at 260.
184 Id.
185 Additionally, the effect of the conduct on the public may be a factor in determining whether an act is unfair, in addition to a separate public policy argument. See Schubach v. Household Fin. Corp., 376 N.E. 2d 140, 142 (Mass. 1978).
188 See U.S. Bank National Assoc. v. Ibanez, Nos. 08 MISC 384283, 08 MISC 386755, 2009 WL 3297551, *4 n.21 (Mass. Land Ct. Oct. 14, 2009) (“It is surely a fair inference that this would make potential bidders even more
In addition to the public policy arguments, in some instances the foreclosing entity may have acted deceptively. If a purported mortgagee reasonably caused the mortgagor to act differently, the mortgagee’s action may have been deceptive.\textsuperscript{189} In the example of residential mortgages, the borrower may be attempting to negotiate with the wrong party, if the borrower does not know the true owner of the mortgage. In that instance, the borrower suffers a real injury by losing the opportunity to negotiate with the appropriate party to avoid foreclosure.

In addition to showing an unfair and deceptive act, the homeowner must show injury in order to recover under chapter 93A of the Massachusetts General Laws.\textsuperscript{190} In \textit{Iannacchino v. Ford Motor Co.}, the Court examined the injury requirement under chapter 93A, section nine of the Massachusetts General Laws.\textsuperscript{191} The \textit{Iannacchino} plaintiffs purchased cars from Ford that had defective door handles, which the plaintiffs alleged did not stay latched during certain accidents.\textsuperscript{192} The plaintiffs alleged that Ford knew about the defect and failed to recall the door handles.\textsuperscript{193} Ford argued that none of the plaintiffs had suffered an injury because they had not been involved in accidents.\textsuperscript{194} The court found that the plaintiffs alleged a cognizable injury because they paid for vehicles that met federal safety guidelines, and received ones that did not.\textsuperscript{195}

In contrast, the court in \textit{Levin v. Reliance Co-operative Bank} found that a borrower could not show an injury after a foreclosure.\textsuperscript{196} In \textit{Levin}, the bank promised the homeowners that it would give adequate notice

\textsuperscript{191} See Iannacchino, 888 N.E.2d at 885.
\textsuperscript{192} Id. at 883.
\textsuperscript{193} Id. at 882.
\textsuperscript{194} Id. at 885.
\textsuperscript{195} Id. at 886-87 (“Such an overpayment would represent an economic loss – measurable by the cost to bring the vehicles into compliance – for which the plaintiffs could seek redress under G. L. c. 93A, § 9.”).
before a foreclosure sale. The bank, however, failed to notify the homeowners before the sale. The Levin court agreed that the bank had acted in bad faith to the detriment of the mortgagor, but found that the homeowners had not shown that they suffered an injury because they could not show that they would have been the highest bidder at the sale, nor that the house was sold at a price lower than market value.

Using reasoning similar to Ford in Iannacchino and the bank in Levin, a foreclosing entity may argue that even if it acted unfairly or deceptively when foreclosing without valid ownership, the borrower did not suffer an injury because she defaulted on the mortgage and the mortgage would have been foreclosed on by the proper mortgagee. To support this argument, the lender must show that the proper mortgagee would have foreclosed if faced with the same situation. The lender may have difficulty proving that any other lender would have foreclosed on the mortgagor’s property in the current environment where servicers are regularly engaging in voluntary modification agreements and informal forbearances. On February 18, 2009, President Obama unveiled his Stability and Affordability for Homeowners Plan, a program designed to help between three and four million at-risk homeowners through loan modifications. The plan also provides refinancing options for homeowners with a mortgage through Freddie Mac or Fannie Mae, affecting an estimated fifty percent of all homes in the United States. This seventy-five billion dollar plan gives financial incentives to lenders and servicers to encourage negotiations and avoid foreclosure.

197 Id.
198 Levin predates statutory notice requirements.
199 Levin, 16 N.E.2d at 89.
200 Id.
this plan does not guarantee or force modification, the existence of this plan may help show that the proper mortgagee may not have foreclosed on the mortgage.

Ultimately, if the borrower can show that the lender engaged in an unfair and deceptive practice and that the borrower suffered an injury, the borrower may be able to invalidate the foreclosure. Furthermore, under the equitable powers of chapter 93A of the Massachusetts General Laws, the homeowner can receive a reconveyance of the property.\textsuperscript{205} Despite the \textit{Kattar} court’s unwillingness to reconvey property after finding that a foreclosure violated chapter 93A of the Massachusetts General Laws, in the case of a personal residence, there is a stronger argument for a court to order a reconveyance of the property to the borrower because a residence is the most important asset that majority of people own and in a large amount cases there is a broad inequity between the parties. Therefore, claiming that the foreclosing entity violated chapter 93A of the Massachusetts General Laws when foreclosing on the mortgage without proper ownership of the mortgage may be a very attractive option for homeowners facing eviction.

E. \textit{Because the Entity Foreclosed on the Property without a Valid Ownership Interest, It May Be Liable for the Tort of Wrongful Foreclosure}

Courts have recognized that the tort of wrongful foreclosure can arise from a mortgagee’s conduct in foreclosure. “[A]n action of tort will lie where the foreclosure was based upon an actual default but was conducted negligently or in bad faith to the detriment of the mortgagor or [those holding junior encumbrances or liens].”\textsuperscript{206} Although an action for wrongful foreclosure is similar to an action under chapter 93 A of the Massachusetts General Laws, an action in tort may be easier to prove, as one does not need to show an unfair or deceptive act.\textsuperscript{207} Like all torts, wrongful foreclosure requires showing duty, breach, causation, and injury. While breach, causation, and injury are dictated by individual facts, 

\begin{footnotes}
\end{footnotes}
chapter 93A, sections two subsection (a) and nine of the Massachusetts General Laws create a duty for all mortgagees to act in good faith and with reasonable diligence when foreclosing on a borrower’s mortgage. Like an action under chapter 93A of the Massachusetts General Laws, the borrower must show an injury. Also, like a claim under chapter 93A of the Massachusetts General Laws, the borrower may be able to show that the proper mortgagee would not have foreclosed and, thus, the foreclosure was an injury.

IV. Conclusion

The party with an ownership interest – the party that holds both the mortgage and the note – is the only party that has the authority to foreclose on its own behalf. For this reason, it is essential for practitioners to furrow through the documents provided by the foreclosing entity and raise challenges where the entity did not follow the black letter law.

In efforts to speed the vast number of defaulting borrowers through the foreclosure process, entities have engaged in haphazard assignments, treating mortgages like stocks. Despite the rampant securitization of mortgages over the last several years, the fact remains that mortgages are interests in real property. Therefore, the Statute of Frauds dictates that assignments of mortgage must be in writing and signed by an authorized agent. The UCC sets forth the rules for indorsing a note. Foreclosing entities must follow the basic principles of real property and contracts. When a foreclosing entity is a REMIC trust, the trust must comply with the REMIC rules promulgated by the IRS and comport with the chain of title set forth in the trust’s own PSA.

Luckily, there are several causes of action that practitioners may rely on to challenge a foreclosing entity’s ownership interest, and some courts have expressed favorable attitudes toward borrowers. As the recession continues, Americans grow even more nostalgic for the times when George Bailey ran the banks – when people were treated as ‘human beings,’ not ‘cattle,’ or, put another way, when mortgages were treated "See Williams v. Resolution GGF OY, 630 N.E.2d 581, 583-84 (Mass. 1994)."

"Additionally, the servicer, acting on behalf of the party that holds the mortgage and note, has the authority to foreclose on the lender’s behalf. See In re Huggins, 357 B.R. 180, 183 (Bankr. D. Mass. 2006)."

as real property interests, not securities. And while a mortgage may be viewed only as an asset that serves to back a security to an investor, the homeowner continues to view a mortgage as a gateway to homeownership. For the homeowner facing foreclosure, this gateway should not be lightly closed by any passerby.
I. Introduction

During 2008, the mortgage foreclosure rate in the United States increased by 81%.

The ripple effect from the subprime residential mortgage crisis has been felt from the largest investment banks to the streets of every city or town. The fallout, however, was not limited to subprime residential mortgage providers and the individuals receiving subprime mortgages to buy or refinance their homes. In the wake of this crisis, the global economy has been reshaped leaving lawmakers and the courts with the task of restoring the residential lending market. Action is being taken at all levels and in some states – Massachusetts, for example – the judicial system has intervened to protect borrowers from losing their homes without a fair fight.

As foreclosure rates rise, the federal government and many states have acted to reduce the potential consequences that could stem from amplified foreclosure filings. Specifically, new legislation and recent judicial decisions may ease the burden on individuals who entered into subprime residential mortgages which were originated through predatory practices.

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lending practices or were “doomed to foreclosure” because of the terms of the loan documents.\(^3\) For example, the United States Congress passed the Mortgage Forgiveness Debt Relief Act of 2007.\(^4\) The Act allows a taxpayer to exclude from taxable income the income he or she is deemed to have received from forgiveness of mortgage debt on a principal residence resulting from a mortgage restructuring, as well as mortgage debt forgiven in connection with a foreclosure.\(^5\) In the first quarter of 2009, California had the third highest rate of foreclosures per total households.\(^6\) However the recently enacted California Foreclosure Prevention Act gives borrowers additional time to work out loan modifications and exempts mortgage loan servicers that have implemented a comprehensive loan modification program.\(^7\) The California Foreclosure Prevention Act requires an additional ninety day period beyond the period already provided by California foreclosure law that will allow all parties to pursue a loan modification.\(^8\)

\(^3\) Commonwealth v. Fremont Inv. & Loan, 897 N.E.2d 548, 554 (Mass. 2008) (noting that loans which contained certain characteristics were “‘doomed to foreclosure’ unless the borrower could refinance the loan at or near the end of the introductory rate period, and obtain in the process a new and low introductory rate.” (omission without ellipsis in original) (quoting Commonwealth v. Fremont Investment & Loan, 23 Mass. L. Rptr. 567, 571 (Mass. Super. Ct. 2008))).


\(^5\) Id. § 2 (attempting to encourage lenders and borrowers to restructure loans before foreclosure). The Mortgage Forgiveness Debt Relief Act also contains the following restrictions: (a) the amount of forgiven debt is limited to up to $2 million or $1 million for a married person filing a separate return; (b) the tax break only applied to mortgage debt discharged by a lender in 2007, 2008 and 2009; and (c) the loan must have been taken out to buy or build a primary residence. Id.

\(^6\) Louis Aguilar, Michigan Foreclosure Rate is Nation’s Sixth Highest, The Detroit News, Apr. 16, 2009, at 1. The states with the highest foreclosures per total households in the first quarter of 2009 were the following: (1) Nevada; (2) Arizona; (3) California; (4) Florida; (5) Illinois; and (6) Michigan. Press Release, RealtyTrac, Foreclosure Activity Increases 9 Percent in First Quarter (Apr. 16, 2009), http://www.realtytrac.com/ContentManagement/PressRelease.aspx?ItemID=6180.


\(^8\) Cal. Civil Code § 2923.52 (West 2009).
In *Commonwealth v. Fremont Investment & Loan*, the Massachusetts Supreme Judicial Court barred a lender, Fremont Investment and Loan (“Fremont”), from foreclosing on 2,500 subprime loans without first obtaining a court order. In this December 2008 decision, the court upheld a preliminary injunction against Fremont holding that certain types of variable rate interest mortgage loans with “teaser” interest rates are “presumptively” illegal under the Massachusetts Unfair and Deceptive Practices Act. The preliminary injunction restricted Fremont’s ability to foreclose on loans that contained a combination of the following four characteristics:

- An adjustable rate mortgage with a “teaser” interest rate period of three years or less;
- A teaser rate at least 3% lower than the fully indexed rate;
- A debt-to-income ratio of more than 50% indexed over the term of the loan; and
- A loan-to-value ratio of 100%, or a prepayment penalty that is either “substantial” or extends beyond the introductory rate period.

As a practical matter, requiring a court order to foreclose on certain types of loans should provide a lender with a powerful incentive to modify or rewrite a loan before initiating foreclosure proceedings. While it is too early to determine the implications of the *Fremont* decision, the court has sent a clear message to subprime mortgage lenders. The residential mortgage lending environment has changed and so too must

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11 *Id.* at 553, n.11 (“The ‘fully indexed rate’ refers to the interest rate that represents the London Interbank Offered Rate (LIBOR) rate at the time of the loan’s inception plus the additional rate specified in the loan documents . . . .”).
12 *Id.* at 554. The judge defined a “substantial prepayment penalty” as a penalty that was greater than the “conventional prepayment penalty” defined in section 2 of the Massachusetts Predatory Home Loan Practices Act. *Mass. Gen. Laws* ch. 183C, § 2 (2008). For a further explanation of a “conventional prepayment penalty,” see *infra* note 69 and accompanying text.
13 For an analysis of the four characteristics the Massachusetts Supreme Judicial Court used in its analysis to restrict Fremont’s ability to foreclose, see *infra* notes 69-79 and accompanying text.
residential lending practices. Nevertheless, with 3.1 million foreclosure filings in 2008, it remains clear that there is still a substantial amount of work and policy change needed to clean up the mess left in the wake of the subprime lending boom.\textsuperscript{14}

The thesis of this paper is that the \textit{Fremont} decision (and subsequent settlement) provides a reasonable solution to the current rise in foreclosures in Massachusetts. Part II reviews the many factors that contributed to the subprime mortgage crisis and follows the Fremont litigation over the three years leading up to the decision.\textsuperscript{15} Part III analyzes the \textit{Fremont} decision setting forth the Massachusetts Supreme Judicial Court’s holding that certain residential mortgage loans are “presumptively” illegal under the Massachusetts Unfair and Deceptive Practices Act.\textsuperscript{16} Part IV evaluates the practical effects of the \textit{Fremont} decision and its potential to change the landscape of the future residential mortgage model.\textsuperscript{17} Part V concludes that, although not ideal, judicial proceedings, such as the \textit{Fremont} decision, provide the best solution for working through many of these subprime loans because the court can determine the applicable “unfairness” standard to be applied.\textsuperscript{18}

II. Subprime Lending: The Calm Before the Storm

A. \textit{A Brief Overview of Subprime Lending}

The practice of subprime lending is not a concept that is new to this decade. Subprime lending – providing high interest loans to individuals who would be considered too risky for conventional loans\textsuperscript{19}

\begin{flushleft}
\textsuperscript{14} Christie, \textit{supra} note 1.
\textsuperscript{15} For a discussion on the factors that led to the \textit{Fremont} decision, see \textit{infra} notes 19-68 and accompanying text.
\textsuperscript{16} For an analysis of the \textit{Fremont} decision and the factors that were addressed by the court, see \textit{infra} notes 69-104 and accompanying text.
\textsuperscript{17} For rationales on whether the \textit{Fremont} decision will change the practice of marketing and providing subprime residential mortgages, see \textit{infra} notes 105-126 and accompanying text.
\textsuperscript{18} For a summary of the potential role of the judicial system in the foreclosure process, see \textit{infra} Section V.
\textsuperscript{19} John Atlas and Peter Dreier, \textit{The Conservative Origins of the Sub-Prime Mortgage Crisis}, The American Prospect, Dec. 18, 2008, \textit{available at} http://www.prospect.org/cs/articles?article=the\_conservative\_origins\_of\_the\_subprime\_mortgage\
– can be traced back as far as lending in general. Nevertheless, the initial groundwork of the current subprime lending market was laid in the early 1980s. In 1980, the federal government enacted new lending laws, which allowed lenders to charge high interest rates and fees, as well as provide loans with variable interest rates and balloon payments.\(^{20}\) Under the new lending laws, lenders had a greater incentive to extend loans to borrowers that would otherwise be denied credit. More importantly, these new laws legalized the practice of charging high rates and fees to borrowers.\(^{21}\)

Homeownership in the United States increased from 64% in 1994 to 69.2% in 2004.\(^{22}\) From 1997 to 2005, the value of residential real property increased by 124%.\(^{23}\) Fueling this increase in property values was the availability of credit to subprime mortgage borrowers. It was at this time that a specialized type of mortgage lender emerged as a leading player in the residential mortgage market. These lenders, which are not regulated as traditional banks,\(^ {24}\) marketed higher risk loan options, such as adjustable rate mortgages, interest only mortgages, and “stated income” loans.\(^ {25}\) These lenders were able to produce a high volume of these types of loans because the mortgages could be subsequently bundled and sold


\(^{23}\) Id. (explaining the housing demand fueled the rise in housing prices and consumer spending).

\(^{24}\) Id. at 7 (noting that traditional lenders held 60% of the mortgage market in the mid-1970s as compared to today where such lenders hold about 10%).

\(^{25}\) Id. Stated income loans are also called “no doc” or “liar” loans.
as securities in the secondary market.\textsuperscript{26}

The creation of a secondary market for subprime loans provided subprime mortgage lenders with an incentive to generate subprime loans in bulk, not loans that were necessarily going to be successful.\textsuperscript{27} Subprime mortgage lenders were rewarded for the number of mortgages generated, not the number of “good” mortgages generated. This led to lax lending standards.\textsuperscript{28} Profits were often based on the sheer volume of mortgages the lender could originate. Some commentators have noted that these mortgage lenders essentially became originating and servicing businesses.\textsuperscript{29} In order to entice borrowers to accept a new loan or refinance an existing loan, many mortgage lenders created products with special rates, such as adjustable rate loans and interest only loans.\textsuperscript{30} An adjustable rate mortgage loan is a loan that has an interest rate on the note that can be adjusted periodically based on a published index.\textsuperscript{31} Adjustable rate loans would contain low interest rates, many times as low as 4%, for an introductory period (two to three years), after which the interest rate increased significantly.

In 2007, global financial markets began to stumble. The housing bubble was beginning to burst. There was a rapid decrease in home values, which left many homeowners with mortgage debt higher than the value of their homes.\textsuperscript{32} As housing prices began to fall, borrowers had less ability

\begin{itemize}
  \item \textsuperscript{26} See Posting of Abraham Park to Graziado Business Report Blog, \textit{Why Did Subprime Loans Become Such a Big Deal}, http://gbr.pepperdine.edu/blog/index.php/2008/05/05/29 (May 5, 2008) (explaining that the government enabled agencies like Ginnie Mae, Fannie Mae, and Freddie Mac to buy mortgages in the secondary market which in turn provided the lenders with additional funds to sell more loans).
  \item \textsuperscript{27} It is important to note that there has been a secondary market for “conforming” loans for fifty or more years. It is only in the past ten to fifteen years that a secondary market has emerged for subprime loans.
  \item \textsuperscript{28} Vikas Bajaj, \textit{Lax Lending Standards Led to IndyMac’s Downfall}, \textit{N.Y. Times}, July 29, 2008, at A1 (describing lending practices of IndyMac, a mortgage company which was seized by the government on July 11, 2008). \textit{See also} Park, \textit{supra} note 26.
  \item \textsuperscript{29} Park, \textit{supra} note 26.
  \item \textsuperscript{30} An “interest only” loan is a loan in which the borrower is allowed to only pay interest on the loan. The option to pay interest only generally lasts for a specified period, usually 5 to 10 years.
  \item \textsuperscript{31} John P. Wiedemer, \textit{Real Estate Finance} 99-105 (8th ed. 2001)
  \item \textsuperscript{32} Bianco, \textit{supra} note 22 at 3.
\end{itemize}
to refinance their mortgage loans.\textsuperscript{33} This created a particular problem with adjustable rate loans and interest only loans. As home values began to drop, many borrowers were left with little chance to refinance because the value of their home was no longer worth the value of the loan. Given that many of these adjustable rate mortgages were originated between 2004 and 2006, the rate was primed to “adjust” at the impending end of the introductory term.\textsuperscript{34} The Massachusetts Supreme Judicial Court faced this particular situation in \textit{Fremont}. While this article only provides a very basic overview of the subprime lending environment over the past several years, a broader outline of subprime lending and securitization is better served by many of the scholarly publications that have originated in the past years.\textsuperscript{35}

**B. The Rise of Fremont**

Fremont, a California industrial bank, originated 14,578 loans to Massachusetts’s residents between January 2004 and March 2007.\textsuperscript{36} Roughly 50% to 60% of Fremont’s loans were considered subprime based on the fact that 64% of Fremont’s loans were adjustable rate mortgage loans and 38.4% were “stated income” loans.\textsuperscript{37} After originating the loans, Fremont subsequently sold these loans into the secondary market.\textsuperscript{38} As explained above, the secondary market for these residential mortgages acted to bundle and sell these mortgage loans as securities with the mortgage debt as collateral.\textsuperscript{39} Lenders, such as Fremont, could sell these securities on the secondary market. Under the terms of sale, the originating lender’s responsibility for problems with the loans was usually

\begin{itemize}
\item \textsuperscript{33} Id. at 10.
\item \textsuperscript{34} Id. at 15.
\item \textsuperscript{35} Id. at 1; see also Chomsisengphet & Pennington-Cross, \textit{supra} note 21, at 31; Park, \textit{supra} note 26.
\item \textsuperscript{36} Commonwealth v. Fremont Inv. & Loan, 897 N.E.2d 548, 551 (Mass. 2008).
\item \textsuperscript{37} Id. at 552 nn.6-7. The judge made this estimate based on the inference that all of the stated income loans were subprime adjustable rate mortgage loans, and a majority of the remaining adjustable rate mortgage loans were also subprime. A “stated income loan” is a loan in which the borrower provides no documentation of his or her income. Id. at n. 7.
\item \textsuperscript{38} Id. at 552.
\item \textsuperscript{39} For a more detailed description of the mortgage backed security market, see generally Bianco, \textit{supra} note 22.
\end{itemize}
very limited, giving these lenders the ability to replenish their funds in order to originate and fund more mortgage loans. Moreover, Fremont generally would not deal with the borrowers directly. Instead, mortgage brokers would find the borrowers, assist the borrowers in selecting one of Fremont’s mortgage products and submit the borrower’s loan application and credit report to Fremont for approval by Fremont’s underwriting department.

Mortgage lenders who sold and securitized these loans had a strong financial incentive to originate as many of these mortgages as possible. This was called the “originate-to-distribute” model. By shifting the risk of default of the mortgages to the secondary market, ensuring that each borrower qualified to pay the loan became less important. As long as housing prices continued to increase – as they had done for the past twenty years between 1986 and 2006 – this business was profitable for all parties involved. Moreover, the fees and returns for “risk-based” loan products were better than “conforming” loans, rewarding all stakeholders, including the originators, brokers, servicers, mortgage bankers, investment firms, and investors. It was a successful strategy so long as housing prices did not drop.

In order to generate additional residential mortgage borrowers, Fremont created subprime loan products structured to attract low-income

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40 Fremont, 897 N.E.2d at 552.

41 Id.

42 See Thomas Simpson, Massachusetts Supreme Court Puts the Brakes on Subprime Foreclosures by Invoking the State’s Unfair and Deceptive Practices Law, CLARK’S SECURED TRANSACTIONS MONTHLY, Dec. 2008, at 2 (explaining the process of selling mortgage loans to a third party that would package the loans into “mortgage-backed” securities and other forms of collateralized debt obligations).

43 Fremont General Corp., Annual Report (Form 10-K) 6 (2006), available at http://www.sec.gov/Archives/edgar/data/38984/0000950129-06-002726-index.idea.htm (supporting comment that Fremont did not share in the risk of loan default for the loans which they originated and distributed to the secondary mortgage market).

44 Christie, supra note 1.

45 Wiedemer, supra note 31, at 44, 78-86 (explaining that a “conforming loan” is a mortgage loan that conforms to the GSE guidelines for purchase by government sponsored enterprise (GSE)). The Federal Home Loan Mortgage Corporation (“FHLMC”) known as “Freddie Mac” is a GSE created in 1970 to expand the secondary market for mortgages in the United States. GSEs are only allowed to buy conforming loans.
borrowers.\textsuperscript{46} Fremont would offer adjustable rate mortgages, which featured a fixed interest rate for the first two or three years, then, after the introductory period, the interest rate would adjust every six months to a substantially higher variable rate for the remainder of the loan.\textsuperscript{47} In order to determine whether a borrower qualified for one of these loans, Fremont would require that the borrower have a debt-to-income ratio of 50\% or less. A borrower’s debt-to-income ratio is the percentage of a consumer’s monthly gross income that goes toward paying debts.\textsuperscript{48} Fremont, however, would calculate a borrower’s debt-to-income ratio on the introductory “teaser rate” mortgage payments, as opposed to the “fully indexed” interest rate of the loan resulting from the adjustment that takes place at the end of the “teaser rate” period.\textsuperscript{49} When the loan rate jumped to the fully indexed interest rate, the borrower’s debt-to-income ratio also increased.\textsuperscript{50} As a final feature, Fremont would offer subprime mortgages with no money down.\textsuperscript{51} Instead, Fremont financed the full value of the property resulting in a typical “loan-to-value ratio” of 100\% at the time the mortgage was created.\textsuperscript{52}

Borrowers were not always completely innocent parties in these situations. Some borrowers understood that they were taking significant risks that could have only been successful in a market with rising housing prices and the ability to refinance as needed.\textsuperscript{53} Also, as reported

\textsuperscript{46} Commonwealth v. Fremont Inv. & Loan, 897 N.E.2d 548, 552 (Mass. 2008).

\textsuperscript{47} Id. at 553, n.10 (explaining that the variable rate would be based on the six month London Interbank Offered Rate (“LIBOR”), a market interest rate, plus a fixed margin to reflect the risk of the subprime loan). These adjustable rate mortgages were generally for a period of thirty years. Id. at 552, n.10.

\textsuperscript{48} For example, if a borrower earned $2,000 per month and a mortgage payment of $500, taxes of $300 and insurance expenses of $200, the borrower’s debt-to-income ratio is 50\%.

\textsuperscript{49} Fremont, 897 N.E.2d at 552. Using the example from note 51, when the interest rate increased after the second or third year, so to would the borrower’s monthly mortgage payment which would negatively affect the borrower’s debt-to-income ratio.

\textsuperscript{50} Id.

\textsuperscript{51} Id.

\textsuperscript{52} Id. at 553. The loan-to-value ratio is calculated as a percentage of the first mortgage lien over the total appraised value of the property. For example, if a borrower receives $200,000 to purchase a house worth $250,000, the loan-to-value ratio is $200,000/$250,000 or 80\%.

\textsuperscript{53} Eric S. Rosengren, President & CEO, Fed. Res. Bank of Boston, Subprime
by BasePoint Analytics, as much as 70% of early payment defaults resulted from borrower’s fraudulently misrepresenting information on their loan applications. Nevertheless, in some cases subprime lenders appear to have chosen to ignore or perhaps overlook obvious borrower misrepresentations. Predatory lending appears to have been prevalent in the refinancing market. A cash-out refinancing is the process of taking out a new mortgage loan on the property in an amount that exceeds the existing balance on the current mortgage loan in order to refinance the original mortgage loan and receive additional cash. As a result, cash-out refinancing became a viable mechanism for homeowners to access cash based on the value of their homes. Slightly over 50% of subprime loan originations were related to cash-out refinancing. This allowed borrowers to access the value of their homes on the day of the refinancing. This cash could, in turn, be used to pay for home restorations, a car, a college education, and so on. All of these factors contributed to the stress and unpredictability of the residential lending market, a market that proved to be very unstable.

Unfortunately, instead of home values continuing to increase, the housing bubble burst. The economy began to take a turn for the worse and unemployment rates started to grow. As these events occurred many borrowers, who had borrowed with the assumptions that housing values would only rise and refinancing would be available before the end of the


55 Bianco, supra note 22 at 10 (George Mason University economics professor Tyler Cowen said: “There has been plenty of talk about predatory lending, but predatory borrowing may have been a bigger problem.”).

56 What is Predatory Lending, MORTGAGENEWSDAILY.COM, http://www.mortgagenewsdaily.com/mortgage_fraud/Predatory_Lending.asp (last visited Oct. 18, 2009) (examples of predatory lending in the refinancing market include using inflated and incorrect valuations for the refinancing, charging excessive fees, and providing unnecessary products or insurance).

57 Chomsisengphet & Pennington-Cross, supra note 21, at 38.

58 Id. (noting that cash-out refinancing was a much more attractive, and available, option when there were low and declining interest rates).
two to three year introductory rate period, began to default. When the Massachusetts Attorney General brought suit against Fremont in 2007, the value of the securities tied to subprime loans had dropped significantly and default was imminent for many borrowers.59

C. Warnings of Clouds in the Distance

Warnings of a possible price decline in the housing market were first provided in the late 1990s; however, many subprime lenders did not adjust their practices based on these warnings. Although many of these subprime loans were in compliance with banking-specific laws and regulations, state and federal regulatory guidance warned lenders operating in the subprime lending market that their practices could be considered unfair and deceptive.60 In January 2001, interagency federal guidance published jointly by the Office of the Comptroller of Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation (“FDIC”), and the Office of Thrift Supervision stated, “Loans to borrowers who do not demonstrate the capacity to repay the loan, as structured, from sources other than the collateral pledged are generally considered unsafe and unsound.”61

59 Commonwealth v. Fremont Inv. & Loan, 897 N.E.2d 548, 553 n.13 (Mass 2008). At the time the suit was initiated, Fremont indicated that it intended to foreclose on at least 20% of its loans.


61 Riccobono, supra note 60, at 11 (stating that subprime lending, when executed correctly, is a sound and profitable business, even though it is generally
Additionally, government agencies warned that subprime lenders were basing loans on the “foreclosure value of the collateral, rather than on the determination that the borrower has the capacity to make the scheduled payments under the terms of the loan . . . .” 62 Through 2006, Fremont continued to offer adjustable rate mortgages with “teaser” introductory interest rate periods. 63 In early 2007, the FDIC brought charges against Fremont for “unsafe and unsound” banking practices related to its subprime lending business. 64 These charges led Fremont to enter into a consent agreement with the FDIC on March 7, 2007, effectively providing that Fremont would “cease and desist” from originating adjustable rate mortgage products that the FDIC had deemed to be unsafe and unsound. 65

Fremont’s next assault came from the Massachusetts Attorney General. On July 10, 2007, Fremont entered into a letter agreement with the Massachusetts Attorney General providing that Fremont would give the Attorney General ninety days’ notice before foreclosing on any Massachusetts residential mortgage loan. 66 If the Attorney General objected to the foreclosure, Fremont would agree to negotiate in good faith to resolve the objection. In the event the parties did not resolve the objection, the Attorney General would be provided an additional fifteen days to decide whether to seek an injunction. 67

In theory, the letter agreement provided the opportunity for Fremont and the Attorney General to work out any potential issues before a foreclosure or judicial proceeding requesting an injunction. In practice, however, the agreement did not operate as either party expected. The Attorney General objected to every proposed foreclosure of a home

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63 *Fremont*, 897 N.E.2d at 551-52.
64 *Id.* at 553.
65 *Id.* (noting that in entering into the consent agreement, Fremont did not admit to any wrongdoing).
66 Simpson, *supra* at note 42, at 2 (providing background to Fremont’s dealings with the FDIC and the Massachusetts Attorney General).
67 *Fremont*, 897 N.E.2d at 553 (acknowledging that the negotiation period would provide sufficient time for Fremont and the Attorney General to possibly modify the loan).
that was owner-occupied as it was her understanding that Fremont would negotiate loan modifications and refinancing proposals for most of the loans. Concluding that the two sides would not be able to negotiate loan modifications, the Massachusetts Attorney General filed a motion for preliminary injunction prohibiting Fremont from foreclosing on owner-occupied properties without first obtaining court approval. Fremont subsequently terminated the letter agreement in December 2007, explaining that the Massachusetts Attorney General had “no intention of engaging in a meaningful review process on a borrower-by-borrower basis.”

III. A Unique Approach: Subprime Lending and Unfair or Deceptive Business Practices Law

A. Loans That Are “Doomed for Foreclosure”

Chapter 93A of the Massachusetts General Laws declares that, “unfair methods of competition and unfair or deceptive acts or practices in the conduct of any trade or commerce” are unlawful. The Attorney General may bring an action in the name of the Commonwealth against any person that he or she has reason to believe is using a method, act, or practice that is unfair or deceptive provided the proceedings are in the public interest. In Fremont, Massachusetts Attorney General, Martha Coakley, sued Fremont in the name of the Commonwealth, claiming that Fremont had “violated G. L. c. 93A in originating and servicing certain ‘subprime’ mortgage loans.”

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68 Simpson, supra at note 42, at 2 (explaining that the Massachusetts Attorney General expected Fremont would deliver proposals with “significant concessions for borrowers, only foreclosing on loans where there was no other option).

69 Fremont, 897 N.E.2d at 553. The Massachusetts Attorney General filed a motion for injunctive relief on October 4, 2007.

70 Id. (noting in the same letter that Fremont stated that it would continue to seek to avoid foreclosure and provide the Attorney General with loan files prior to foreclosure).

71 Mass. Gen. Laws ch. 93A, § 2 (2006) (allowing the attorney general to “make rules and regulations interpreting the provisions of subsection 2(a) of [Chapter 93A]”).

72 Id. § 4.

73 Fremont, 897 N.E.2d at 550-51 (outlining the purpose of the Attorney General’s
The trial judge determined that the Commonwealth was likely to prevail on the merits of its claim and, therefore, granted a preliminary injunction restricting Fremont’s ability to foreclose on loans with features that were “presumptively unfair.” In it’s finding, the trial court determined that loans were “presumptively unfair” if they contained (1) an adjustable rate mortgage with a “teaser” interest rate period of three years or less; (2) a teaser rate at least 3% lower than the fully indexed rate; (3) a debt-to-income ratio of more than 50% indexed over the term of the loan; and (4) a loan-to-value ratio of 100%, or a prepayment penalty that is either “substantial”74 or extends beyond the introductory rate period.75 Provided that the loan contained the four characteristics, the trial court determined that in originating these residential mortgage loans, the borrower would almost certainly not be able to make the mortgage payments, therefore leading to a default under the loan and subsequent foreclosure.76

The trial court judge went on to explain that loans that contained this package of four characteristics were “doomed to foreclosure.” The court noted:

Given the fluctuations in the housing market and the inherent uncertainties as to how that market will fluctuate over time . . . it is unfair for a lender to issue a home mortgage loan secured by the borrower’s principal dwelling that the lender reasonably expects will fall into default once the introductory period ends unless the fair market value of the home has increased at the close of the introductory period. To issue a home mortgage loan whose success relies on the hope that the fair market value of the home will increase during the introductory period is as unfair as issuing a home mortgage loan whose

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74 Id. at 554. Under section 2 of the Massachusetts Predatory Home Loan Practices Act, a “conventional prepayment penalty” is “any prepayment penalty or fee that may be collected or charged in a home loan, and that is authorized by law other than this chapter, provided the home loan (1) does not have an annual percentage rate that exceeds the conventional mortgage rate by more than 2 percentage points; and (2) does not permit any prepayment fees or penalties that exceed 2 per cent of the amount prepaid.” Mass. Gen. Laws ch. 183C, § 2 (2008).

75 Id.

76 Id. at 550.
success depends on the hope that the borrower’s income will increase during that same period.\textsuperscript{77}

Fremont appealed, and the Massachusetts Supreme Judicial Court granted the Commonwealth’s application for direct appellate review.\textsuperscript{78} The Massachusetts Supreme Judicial Court affirmed the lower court ruling granting the preliminary injunction against Fremont, essentially requiring the lender to obtain a court order to foreclose on any owner-occupied property.\textsuperscript{79}

It is notable that the injunction does not relieve borrowers of the obligation to repay their loans.\textsuperscript{80} The injunctive order requires Fremont to take the following steps before foreclosing on any property in Massachusetts:

- Provide advance notice to the Attorney General of its intent to foreclose on any of its home mortgage loans;
- As to loans that possess each of the four characteristics of unfair loans described above and that are secured by the borrower’s principal dwelling, Fremont is to work with the Attorney General to resolve any differences regarding the foreclosure, presumably through a restructure or work-out of the loan; and

\textsuperscript{77} Id. (omission in original) (quoting Commonwealth v. Fremont Inv. & Loan, 23 Mass. L. Rptr. 567, 574 (Mass. Super. Ct. 2008)) (finding a preliminary injunction would serve the public interest when taking into account the balance of harms in granting such injunction).

\textsuperscript{78} Id. at 551. The Fremont decision notes that the Supreme Judicial Court solicited amicus briefs shortly after granting direct appellate review and received amicus briefs filed on behalf of Fremont by New England Legal Foundation and Associated Industries of Massachusetts; the American Securitization Forum and the Securities Industry and Financial Markets Association; and the American Financial Services Association, the Consumer Mortgage Coalition, the Housing Policy Council of the Financial Services Roundtable, and the Mortgage Bankers Association; and on behalf of the Commonwealth by WilmerHale Legal Services Center of Harvard Law School; and National Consumer Law Center, Center for Responsible Lending, AARP, National Association of Consumer Advocates, and National Association of Consumer Bankruptcy Attorneys. Id. at n.4.

\textsuperscript{79} Id. at 562 (noting that the case is remanded to the Massachusetts Superior Court for further proceedings).

\textsuperscript{80} Simpson, supra note 42, at 3.
If the loan cannot be worked out, Fremont is required to obtain approval for foreclosure from the court.\textsuperscript{81}

B. Fremont’s Side of the Story

The Massachusetts Supreme Judicial Court rejected Fremont’s two main arguments in concluding that the Attorney General was likely to prevail on the merits of her Chapter 93A claim. First, the court determined that Fremont’s loans were not exempt from Chapter 93A because the loans were permitted under federal and Massachusetts laws at the time the loans were originated.\textsuperscript{82} Fremont argued that retroactively applying a new standard for whether a loan was “fair” at the time of its origination would represent “bad policy” because it could potentially cause lenders to be more hesitant to lend to subprime borrowers. This, in turn, would hurt Massachusetts’s consumers because fewer lenders would be willing to extend credit.\textsuperscript{83}

Fremont argued that “the loans were underwritten in the expectation, reasonable at the time, that housing prices would improve during the introductory loan term, and thus could be refinanced before the higher payments [began].”\textsuperscript{84} The court pointed out that Fremont had been warned by the Massachusetts Division of Consumer Affairs and Business Regulation that these loans were unfair to the borrower in that they were structured on the basis of unsupportable optimism about future economic conditions.\textsuperscript{85} In hindsight, it seems obvious that housing prices

\textsuperscript{81} Fremont, 897 N.E.2d at 555 (explaining that in no way did the injunction relieve borrowers of their obligation ultimately to prove that a particular loan was unfair and foreclosure should not be permitted).

\textsuperscript{82} Id. at 555-56 (arguing that, while the terms of its subprime loans may seem arguably “unfair,” they did not violate the applicable mortgage lending industry standards at the time they were originated).

\textsuperscript{83} Id. (summarizing Fremont’s argument regarding retroactively applying a new definition for “fairness”).

\textsuperscript{84} Id. at 558 (summarizing Fremont’s argument that borrowers would be able to refinance before the loan payments increased after the two to three year grace period).

\textsuperscript{85} Subprime Lending, supra note 60 (“[M]ost subprime loans have been originated during robust economic conditions and have not been tested by a downturn in the economy. Management must ensure that the institution has adequate financial operations strength to address these concerns effectively.”). \textit{See also}
could not continue to rise indefinitely. If housing prices did not continue to increase, many borrowers would not be able to refinance before the two to three year introductory period concluded.

Similarly, in an amicus brief, the New England Legal Foundation argued that retroactively applying the concepts of unfairness in consumer protection was inconsistent with the fundamental common law principle that conduct must be judged by the standards in place when it occurred and would impermissibly deprive businesses of certainty and predictability with respect to the conduct proscribed by Chapter 93A. Nevertheless, the court further noted that Fremont’s consent agreement with the FDIC on March 7, 2007, which ordered Fremont to “cease and desist” from making loans with the four troublesome characteristics, supported the Massachusetts Attorney General’s argument that Fremont violated established concepts of unfairness. Under Chapter 93A case law, in order to overturn the trial court’s decision, Fremont was required to demonstrate that the regulatory scheme at the time affirmatively permitted the practice that was alleged to be unfair. However, Fremont did not meet this burden as it was unable to prove that loans combining these four features were affirmatively permitted at the time of their origination.

Second, the Supreme Judicial Court determined that the trial judge properly applied the provisions of the Massachusetts Predatory Home Loan Practices Act to the Fremont loans even though the loans are not

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Credit Risk Management, supra note 60 (noting management for financial institutions should “actively assess a portfolio’s vulnerability to changes in consumers’ ability to pay and the potential for declines in home values”).


87 Fremont, 897 N.E.2d at 559 (“[T]he fact that the FDIC ordered Fremont to cease and desist from the use of almost precisely the loan features that are included in the judge’s list of presumptively unfair characteristics indicates that the FDIC considered that under established mortgage lending standards, the marketing of loans with these features constitute unsafe and unsound banking practice . . . .”).

88 Id. at 559-60 (detailing Chapter 93A case law on the issue of whether a Chapter 93A claim is barred because Fremont’s actions were permitted by law as it existed at the time of origination).

89 Id. at 561.

subject to the Act. The Massachusetts Predatory Home Loan Practices Act prohibits a lender from making a “high-cost” home mortgage loan unless the lender reasonably believes the borrower will be able to make the scheduled payment.\(^ {91}\) The applicable section of the Act states that the borrower is presumed to be able to repay the loan so long as his or her debt-to-income ratio, calculated based on the fully indexed rate associated with the adjustable rate mortgage loan does not exceed 50%.\(^ {92}\) The court agreed that Fremont’s mortgage loans were not high-cost mortgage loans as governed by the Massachusetts Predatory Home Loan Practices Act.\(^ {93}\) Nevertheless, the court determined that the conduct the Massachusetts Predatory Home Loan Practices Act prohibits is similar to the unfairness the judge found in Fremont’s lending practices.\(^ {94}\) Therefore, even though the plain language of the statute did not apply, the principles of fairness expressed in the statute supported the court’s finding that the loans were presumptively unfair and therefore illegal under Chapter 93A.\(^ {95}\)

Interestingly, although the court found that there was no evidence that Fremont encouraged borrowers to misstate their income to qualify for a loan, in October 2007, Morgan Stanley Mortgage Capital Holdings LLC accused Fremont of breaching agreements over residential mortgages.\(^ {96}\) In the suit, Morgan Stanley claimed that some of the Fremont loans misrepresented the income, assets, or employment of the borrower in the loan documents. Morgan Stanley went on to note

\(^ {91}\) Id. § 4; see also Fremont, 897 N.E.2d at 559.

\(^ {92}\) For a further explanation of a debt-to-income ratio, see supra note 49 and accompanying text.

\(^ {93}\) Fremont, 897 N.E.2d at 560 (noting that Fremont’s loans did not qualify as “high cost home mortgage loan” as defined by G.L. c. 183C, § 2, because a “high cost home mortgage loan” is a loan securing the borrower’s principal dwelling and that either exceeds by more than eight percentage points (for a first mortgage) the yield on Treasury securities with a comparable maturity period, or features total points and fees the greater of 5% of the total loan or $400).

\(^ {94}\) Id. The judge determined that Fremont should have recognized at the outset the borrower was not likely to be able to repay the loan.

\(^ {95}\) Simpson, supra note 42, at 4 (discussing that the banking industry will take strong exception to the reasoning used by the court).

that many of the loans were made without satisfying the requisite credit score standards.\textsuperscript{97} It remains a point of contention whether Fremont, and many subprime lenders in general, misrepresented vital loan information of subprime borrowers in originating many of these loans.

C. The Settlement: Commonwealth v. Fremont

The Massachusetts Attorney General and Fremont settled the Chapter 93A suit on April 17, 2009. As part of the settlement, Fremont agreed to pay as much as ten million dollars in damages.\textsuperscript{98} Additionally, Fremont agreed to submit to a permanent injunction barring the lender from foreclosing on Massachusetts properties without first notifying the state Attorney General’s office.\textsuperscript{99} In order to initiate or advance a foreclosure on a mortgage loan in Massachusetts that was deemed to be “presumptively unfair” by the Supreme Judicial Court, Fremont must give the Attorney General forty-five days advance written notice of the proposed foreclosure.\textsuperscript{100} This notice must identify the reasons why foreclosure is reasonable under the circumstances.\textsuperscript{101} In the fifteen days following the notice, the Attorney General has the right to object to the foreclosure. In the event the Attorney General objects, the Attorney General and Fremont must reasonably attempt to resolve their differences

\textsuperscript{97} Id. (arguing that Fremont did not attempt to obtain the proper credit history information for many borrowers).

\textsuperscript{98} Id. The article also notes that Fremont settled with the State of California insurance commissioner over claims of improper insurance transactions. Fremont agreed to pay the California insurance regulator $5 million in cash and to provide $4.1 million from the proceeds of sales of certain company-owned artwork. Id.

\textsuperscript{99} See id. Additionally, Fremont is barred from marketing or extending adjustable rate mortgage products to subprime borrowers in an unsafe and unsound manner.

\textsuperscript{100} Final Judgment by Consent, Commonwealth of Massachusetts v. Fremont Inv. & Loan and Fremont General Corporation, Civil Action No. 07-4373-BLS1 (Mass. Dist. Ct. June 9, 2009) (also providing that Fremont may not sell, transfer, or assign any mortgage loan originated by Fremont that is secured by any residential property in Massachusetts or the legal obligation to service any mortgage loan originated by Fremont that is secured by any residential property in Massachusetts, unless Fremont first gives the Attorney General notice of such assignment at least five (5) days before such assignment). See id.

\textsuperscript{101} Id.
regarding the foreclosure. If the differences are not resolved, Fremont may proceed with the foreclosure only with the prior approval of the Massachusetts Superior Court.\textsuperscript{102}

Nevertheless, the Fremont decision, arguably the first of its kind, may be remembered more for the subsequent effect of the ruling as opposed to the ruling itself. On May 7, 2009, the Commonwealth of Massachusetts and Goldman Sachs & Company (“Goldman”)\textsuperscript{103} entered into a settlement agreement regarding certain subprime mortgages originated in Massachusetts.\textsuperscript{104} The Massachusetts Attorney General commenced an investigation of Goldman’s practices of backing subprime mortgage lenders. For instance, Security and Exchange Commission filings show Fremont maintained a line of credit of at least $500 million with Goldman. In connection with the settlement agreement, Goldman agreed to resolve any potential claims stemming from the Massachusetts Attorney General’s investigation by providing loan restructuring valued at approximately fifty million dollars to Massachusetts subprime borrowers.\textsuperscript{105} Additionally, Goldman agreed to pay the Commonwealth of Massachusetts ten million dollars. Under the settlement agreement, Goldman agreed to write-down principal to allow approximately 700

\begin{flushleft}
\begin{enumerate}
\item Whether securitizers may have facilitated the origination of “unfair loans” under Massachusetts law;
\item Whether securitizers may failed to ascertain whether the loans purchased from originators complied with the originators’ stated underwriting guidelines;
\item Whether securitizers may failed to take sufficient steps to avoid placing problem loans in securitization pools; and
\item Whether securitizers may have been aware of allegedly unfair or problem loans.
\end{enumerate}
\end{flushleft}

\textsuperscript{102} Id. (explaining it will be the Superior Court’s determination whether the loan is (a) actually unfair and secured by the borrower’s primary residence that is both inhabited and inhabitable, (b) whether Fremont has taken reasonable steps to “work-out” the loan and avoid foreclosure, and (c) whether there is any fair or reasonable alternative to foreclosure).

\textsuperscript{103} The settlement agreement covered Goldman Sachs and Company on behalf of itself and its affiliates Goldman Sachs Mortgage Company and GS Mortgage Securities Corp.

\textsuperscript{104} Press Release, Office of the Attorney General of the Commonwealth of Massachusetts (May 11, 2009) (on file with author). The agreement stated that the Massachusetts Attorney General’s investigation concerned:

\begin{flushleft}
\begin{enumerate}
\item Whether securitizers may have facilitated the origination of “unfair loans” under Massachusetts law;
\item Whether securitizers may failed to ascertain whether the loans purchased from originators complied with the originators’ stated underwriting guidelines;
\item Whether securitizers may failed to take sufficient steps to avoid placing problem loans in securitization pools; and
\item Whether securitizers may have been aware of allegedly unfair or problem loans.
\end{enumerate}
\end{flushleft}

\textsuperscript{105} Id.
Massachusetts homeowners to refinance or sell their homes.\textsuperscript{106}

The Goldman settlement adds a new layer to this situation. While the Massachusetts Supreme Judicial Court determined that Fremont was at fault for originating loans that were “presumptively unfair,” the Goldman settlement extends past the originators to the underwriters of these subprime mortgage loans. Effectively, the Goldman settlement has indicated that securitizers may be held accountable for purchasing subprime loans from originators such as Fremont without ensuring that the loans that they were buying for securitization were sound. Extending accountability could very well lead to additional trouble for banks that backed subprime mortgage lenders.

IV. THE PRACTICAL EFFECTS AND RAMIFICATIONS OF \textit{Fremont}

As a legal matter, the \textit{Fremont} decision froze the foreclosure proceedings for 2,500 Fremont originated loans in Massachusetts. As a practical matter, \textit{Fremont} could potentially reshape the foreclosure process and open the door to additional unfair or deceptive business practices actions brought against other subprime mortgage providers in Massachusetts and in other states with similar legislation. In turn, subprime mortgage lenders may have an added incentive to modify or rewrite loans that contain the four troublesome characteristics because of the potential that the loans will be frozen in the foreclosure process.\textsuperscript{107}

A. \textit{The Issues Stemming from the Originate-to-Distribute Model}

In order to create a solution for handling the fallout from the subprime mortgage crisis, it is important to determine the relevant parties. While Fremont originated nearly 15,000 mortgage loans in Massachusetts between January 2004 and March 2007, the Chapter 93A suit involved only 2,500 subprime loans that Fremont continued to own

\textsuperscript{106} Id. (noting that Goldman agreed to reduce principal of first mortgages by up to 25-35\% and second mortgages by 50\% or more).

\textsuperscript{107} Commonwealth v. Fremont Inv. & Loan, 897 N.E.2d 548, 552 (Mass. 2008) (the “preliminary injunction granted . . . restricts, but does not remove, Fremont’s ability to foreclose on loans with features that [are] ‘presumptively unfair.’”).
or service. As of July 2007, Fremont owned and serviced approximately 290 loans in Massachusetts and serviced, but no longer owned, 2,200 other Massachusetts loans. Similar to other lenders that generated a large number of subprime mortgage loans in the early-to-middle part of the decade, Fremont no longer held or serviced many of the mortgages that it originated.

A frequently suggested solution to an impending mortgage default is to modify or rewrite the loan. In order to do this, the borrower must first determine the current holder and servicer of the loan. The growth of the subprime lending market was fueled by the availability of the secondary market. Financial institutions and mortgage brokers, such as Fremont, were less concerned with the financial condition of the borrower because the risk of default was outsourced to the secondary market. After many of these loans were generated and sold, the servicing of the mortgages were assigned to servicing companies, which collected the mortgage payments.

Generally, the servicer is the primary contact for borrowers who are behind in loan payments. Servicers, however, are bound by an agreement with the trustee bank which sets forth the responsibilities of the servicer and controls what a servicer can do to assist borrowers who are behind in their payments. The agreements governing the servicer’s actions often limit the servicer’s ability to modify existing loans in a mortgage pool. Therefore, at the outset, it is often difficult for borrowers to find a party with the authority to make substantive modifications to their mortgage. Further, in Massachusetts, eight out of the ten largest subprime loan originators are no longer lending. Fremont, for example, stopped

108 Id. (outlining the process for a subprime mortgage loan after Fremont originated the loan).
109 Id. at 552 n.6.
110 Park, supra note 26 (noting that the size of the mortgage market became bigger than the size of the mortgage originations).
111 Simpson, supra note 42, at 2.
112 Rosengren, supra note 53. Mr. Rosengren provides the following statistics:
lending in the subprime market when federal regulators contended that the company did not adequately ensure that borrowers would be able to repay their loans.¹¹³ Fremont then attempted to “rebrand” itself as a commercial real estate lender in late 2007. Nevertheless, Fremont’s past caught up with the company and it subsequently filed a voluntary petition under Chapter 11 of the U.S. Bankruptcy Code on June 18, 2008.

Therefore, the initial hurdle to a loan work-out is to find the loan holder and the servicer. Once an individual finds the servicer, the next obstacle is determining whether the servicer has the authority to negotiate substantive loan terms with the borrower. Even if the borrower finds the servicer, there is the chance, as in the Fremont case, that the loan holder has gone bankrupt and any legal work-out will be subject to the bankruptcy proceedings. In sum, attempting to obtain a loan modification could potentially bring about more questions than solutions. The answer to these troubled loans may rest in court proceedings and new legislation.

B. **Potential Outcomes for Court Ordered Work-Outs**

Before the Fremont case settled, there was speculation as to the potential damages should Fremont be unsuccessful in its defense.¹¹⁴

<table>
<thead>
<tr>
<th>Mortgage Provider</th>
<th># of Loans</th>
<th>% of Subprime Mortgages</th>
<th>Status</th>
</tr>
</thead>
<tbody>
<tr>
<td>Option One Mtg. Corp.</td>
<td>11,243</td>
<td>18.6%</td>
<td>Operating</td>
</tr>
<tr>
<td>New Century Financial Corp.</td>
<td>5,951</td>
<td>9.9%</td>
<td>Shutdown</td>
</tr>
<tr>
<td>Fremont Investment and Loan</td>
<td>5,550</td>
<td>9.2%</td>
<td>Shutdown</td>
</tr>
<tr>
<td>Argent Mtg. Co.</td>
<td>3,599</td>
<td>6.0%</td>
<td>Shutdown</td>
</tr>
<tr>
<td>Summit Mtg. Co.</td>
<td>3,067</td>
<td>5.1%</td>
<td>Shutdown</td>
</tr>
<tr>
<td>Mortgage Lender Net</td>
<td>2,798</td>
<td>4.6%</td>
<td>Shutdown</td>
</tr>
<tr>
<td>Long Beach Mtg. Co.</td>
<td>2,520</td>
<td>4.2%</td>
<td>Shutdown</td>
</tr>
<tr>
<td>WMC Mtg. Corp.</td>
<td>2,316</td>
<td>3.8%</td>
<td>Shutdown</td>
</tr>
<tr>
<td>Accredited Home Lenders</td>
<td>2,174</td>
<td>3.6%</td>
<td>Shutdown</td>
</tr>
<tr>
<td>First Franklin Financial</td>
<td>1,896</td>
<td>3.1%</td>
<td>Operating</td>
</tr>
</tbody>
</table>

Note: Mr. Rosengren used this list to show the top ten subprime lenders in terms of number of purchase mortgage originations in Massachusetts from 1993 to 2007.

¹¹³ Smythe, *supra*, note 96.
¹¹⁴ Simpson, *supra* note 42, at 4 (outlining the four possibilities discussed in this
While the issue of damages proved to be irrelevant to Fremont itself, it remains very relevant in terms of the other mortgage lenders who could be susceptible to a Chapter 93A claim in Massachusetts. Chapter 93A allows the Attorney General to “restore to any person that has suffered any ascertainable loss . . . any moneys or property, real or personal, that may have been acquired by means of such method, act, or practice.” The Attorney General may have a number of potential remedies for subprime mortgage loans that the court has determined to be “unfair and deceptive.”

1. Rescission of the Unfair Loan

Rescission is a remedy that eliminates the existing loan and restores the parties to their positions prior to entering into the contract. Where a subprime loan is involved, restoring the parties to their prior positions would seem unlikely given that Fremont did not alleviate the borrowers’ requirement to pay the loan. Moreover, as a matter of policy, allowing borrowers to rescind mortgage loans years after the loan has been in place would provide even more uncertainty in the residential lending market.

There are current laws that allow for rescission in the context of residential mortgage loans; however, these laws provide for only a three-day grace period after a loan has been supplied in order to shield borrowers from unscrupulous lenders.

2. Refunding Principal, Interest and Fees Paid by Borrower

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115 Mass. Gen. Laws ch. 93A, § 4 (2006) (noting that any person that the court finds has employed a method, act, or practice which he knew or should have known to be in violation of Chapter 93A could be required to pay the Commonwealth a civil penalty).
117 Fremont, 897 N.E.2d at 555 (Mass. 2008).
118 Truth in Lending Act, 15 U.S.C. § 1641(a)-(b) (2006). Provided the borrower provides notice to the lender within three days after the loan is put into effect, the Truth in Lending Act requires a lender to give up, within twenty days, its claim to the borrower’s property as collateral and to refund any fees paid by borrower.
The legal concept of restitution governs circumstances where the borrower receives a refund of principal, interest, and fees. Restitution serves to compensate the borrower for a sum of money paid related to the illegal act. Where a subprime mortgage loan is involved, if the court were to award restitution damages, the borrower would be reimbursed for the loan and all expenses related to the loan. The mortgage would be terminated and the borrower would no longer own the home. Essentially this would work to put the borrower and lender back in the place they were before the loan was originated.

Applying a pure restitution concept to this situation could have numerous drawbacks. First, similar to a foreclosure, it would take the homeowner out of his or her home. Second, although the borrower may be able to account for the amount paid to the mortgage broker and servicer, the fees and expenses would have been spread among many different companies. A court or similar authority would need to determine exactly which party would be liable for the amount of fees and expenses. Finally, it would be time inefficient and potentially counterproductive to reimburse the borrower for all principal, interest, and fees paid in connection with the loan. Alternatively, some states are taking a “restitution-like” approach, which acts to provide an incentive for loan restructuring.

The Texas Attorney General, Greg Abbott, initiated a $7.46 million restitution program against Countrywide Financial Corp. (“Countrywide”) that would make money available for eligible Countrywide residential mortgage customers in Texas.119 Similar to Fremont, the State of Texas brought an action against Countrywide alleging that it “encouraged homeowners to accept loans [that] they could not afford, failed to fully disclose risky loan terms to borrowers, and wrote loans for unqualified borrowers in an effort to increase market share.”120 Under the settlement agreement with Countrywide, eligible homeowners could modify the terms of their loans to make monthly mortgage payments more affordable. The potential modifications included interest rate freezes, interest rate reductions, loan term extensions, conversions


120 Id. (detailing the terms of the State of Texas’ law suit against Countrywide).
from variable to fixed rate loans, and principal reductions.\textsuperscript{121} The financial support for such modifications would be funded out of the restitution program.

3. Freezing Foreclosure and Allowing the Homeowner to Stay in the Home

Many large banks in the United States voluntarily instituted foreclosure freezes in late 2008 and early 2009. In February 2009, J.P. Morgan Chase & Co., Citigroup Inc. and Bank of America Corp. committed to weeks-long foreclosure moratoriums in anticipation of the government’s financial stability plan.\textsuperscript{122} Those moratoriums have started to come to an end as J.P. Morgan Chase & Co., Wells Fargo & Co., and Fannie Mae and Freddie Mac have all noted that they are increasing foreclosure activity as of April 15, 2009.\textsuperscript{123} These companies are now determining which troubled borrowers are candidates for government assistance and initiating the foreclosure process for those troubled borrowers not eligible for assistance. Freezing foreclosures is a temporary fix that does not solve the ultimate substantive problem: the loan will either need to be worked out or rewritten. As evidenced by Fremont, courts are also entering the picture by instituting foreclosure freezes;\textsuperscript{124} however, unless there is a comprehensive plan developed to aid borrowers who are dodging the foreclosure process due to a current freeze, it is only a matter of time before a solution is determined or the foreclosure begins.

4. Requiring Loan Work-outs with Substantial Modifications to the Mortgage Terms

Perhaps the most compelling solution would be legislatively

\textsuperscript{121} Id. (stating that eligible borrowers would not be charged late fees, loan modification fees, foreclosure fees, or pre-payment penalties).


\textsuperscript{123} Ruth Simon, Banks Ramp Up Foreclosure, \textit{Wall St. J.}, Apr. 16, 2009, at A1 (acknowledging that these companies have lifted internal moratoriums which temporarily halted foreclosures).

\textsuperscript{124} Commonwealth v. Fremont Inv. & Loan, 897 N.E.2d 548, 550-51 (Mass. 2008).
mandated or court ordered loan work-outs. As evidenced by the program instituted in Texas,\(^{125}\) individual borrowers who qualify could receive interest rate freezes, interest rate reductions, loan term extensions, conversions from variable to fixed rate loans, and principal reductions. The first issue that could arise with requiring individual loan work-outs is the substantial amount of time that it would take to work out these loans and the financial impact of these modified loans. A court cannot work through each subprime mortgage loan individually. Instead, court ordered initiatives similar to what has occurred in Texas and in the Fremont ruling in Massachusetts could be an effective conduit to working out troubled mortgage loans.

Legislatively mandated residential loan work-outs could be problematic outside of the bankruptcy context based on historic case law.\(^{126}\) In Louisville Joint Stock Land Bank v. Radford, the Court ruled that “the Fifth Amendment commands that, however great the nation’s need, private property shall not be thus taken even for a wholly public use without just compensation.”\(^{127}\) Legislatively mandated loan work-outs could be considered a “taking” of the lenders property. In Radford, the Court determined that if taking property of individual lenders in order to relieve the necessities of individual borrowers is in the public interest, action must be taken through a proceeding by eminent domain.\(^{128}\)

Work-outs mandated as the result of a judicial proceeding where there has been a finding of lender wrongdoing may provide a remedy. Due to the finding of lender wrongdoing the constitutional issues are avoided. The Fremont settlement, if executed effectively, would allow the Massachusetts Attorney General to review the foreclosure before the homeowner is forced to leave his or her home. Provided the Attorney General determines that the loan was “presumptively unfair,” the Attorney General could force the lender to negotiate new terms with the homeowner. In this scenario, the homeowner could keep his or her home. The loan would continue, as modified, allowing the lender to

\(^{125}\) Texas Restitution, supra note 119.


\(^{127}\) Id. at 601-02.

\(^{128}\) Id. at 602 (explaining that through taxation, the burden of the relief being provided in the public interest would be borne on the public).
realize some sort of value for a loan that seemed destined for foreclosure. The lender would bear the financial impact in the form of writing down principal or lowering interest rates. However, in the wake of the Goldman settlement, it is apparent that money is being made available to finance these concessions. In effect, the payments from Fremont and Goldman, while arguably a minimal amount when measured against the current rise in foreclosures, will begin to correct the problems of the housing market that has been ravaged by the very mortgage products Fremont created.

It is important to note the negative aspects of this solution. First, it will take a substantial amount of time to implement many of these loan work-outs. In order to fairly determine which loans should be modified, the Massachusetts Attorney General will need to review each individual loan. Second, the money that the Attorney General has secured from Fremont and Goldman will not be enough to help all affected borrowers. Furthermore, the Attorney General’s office will have to determine the parties who are entitled to the settlement amounts on a case-by-case basis. Finally, foreclosures are not going to stop. Every loan that is in default will not be worked out. Families will still lose their homes. The troubling aspect of many of these loans is the fact that the variety of terms allows courts wide latitude when determining whether the loan was “presumptively unfair.” Courts will face situations in which the homeowner has a loan containing three of the four troublesome characteristics and must decide if this is sufficient for the loan to be deemed unfair. The Fremont ruling and subsequent settlement does not provide a perfect solution.

V. The End of the Beginning

As the dust settles and the economy begins to stabilize, governments – on the local, state, and federal level – and courts must take leading roles working through the fallout from the boom in subprime lending in the early part of the decade. Judicial proceedings, such as Fremont, provide the best solution for working through many of these loans because the court can determine the applicable “unfairness” standard to be applied. As evidenced by the Goldman settlement, the Massachusetts Attorney General is not finished investigating the practices of subprime lenders as well as banks that supported subprime lenders.
The *Fremont* decision supplies the Attorney General with a structure for reviewing home loans that are part of a foreclosure proceeding. Although reviewing each mortgage loan on a case-by-case basis may be costly and time intensive, this review may be the only fair method in determining which individuals should qualify for a loan work-out and which foreclosures should proceed as planned. Other methods, such as foreclosure freezes and loan refunds, while beneficial for borrowers, would not effectively pinpoint the individuals who were wronged by these unfair and deceptive lending practices.

The landscape of the mortgage lending market is ever changing. The fallout has affected many lives and businesses. The wave from the housing bubble has come to an end and it is now time to repair the damage. Ideally, the subprime lending crash will compel borrowers to refrain from over-leveraging and lenders to take more care when determining borrowers’ financial stability. The *Fremont* decision will provide individuals working through these mortgage loans with a framework for determining which loans qualify for restructuring. Additionally, it may also prompt lenders and borrowers to begin restructuring negotiations before the foreclosure process is implemented, reducing stress on the court and the Massachusetts Attorney General’s Office. While time will only tell the effect of the *Fremont* decision, the Commonwealth is arguably moving in the right direction.
OF VICTIMS, VILLAINS AND FAIRY GODMOTHERS: REGNANT TALES OF PREDATORY LENDING

Carolyn Grose*

ABSTRACT

The subprime mortgage crisis has exposed a system of predatory and irresponsible lending on a scale we are only beginning to comprehend. Those initially harmed in this crisis — the canaries in the coal mine — were largely low-income people of color. As the crisis has unfolded, the potential solutions available to such borrowers seem to privilege one kind of legal story over all others: the story of the poor person as a victim in need of rescuing.

In order to win, therefore, lawyers who represent these clients often fall back on a default narrative about their clients as unwitting or irresponsible victims in high-stakes, crisis-driven stories that take place in the winner-take-all context of litigation. These narratives begin at the moment of crisis and not at any time before. In addition, these narratives do not take the long view of this crisis or its effects. As such, these stories reinforce the status quo by focusing attention on the victims’ bad choices and unscrupulous lenders, cabining the particular crisis as an unfortunate confluence of events rather than a part of the larger picture of a system that reinforces poverty.

But it does not have to be that way. Looking through the lens of narrative theory, my paper constructs counter-stories about those who find themselves faced with home foreclosure: stories that envision the individual clients’ broader context and their agency within that context; stories that imagine the clients’ ability to look and plan ahead. I perform this analysis by suggesting that these situations present lawyers with the opportunity to tell many different — competing, alternative, serial — but equally “good” stories. The choices about which of those stories to tell

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and how to tell them are complex and nuanced and depend on multiple variables that need to be weighed by both the lawyer and the client. The piece concludes by suggesting that a lawyering theory that is open to this multiplicity of stories — and does not privilege one among them — contributes to constructing lawyering models that empower all kinds of client narratives. This approach thus allows those who would otherwise assume victim roles in adversarial narratives to contribute in constructing narratives that do not necessarily involve them having to be rescued. Moreover, it helps lawyers recognize their power and responsibility to construct these stories collaboratively with their clients, and thus to move the law in a direction that recognizes the clients as something other than victims.
I. Introduction

The mortgage crisis has made sad stories of dispossession ubiquitous. Some of those faced with the loss of their homes have found lawyers to help them negotiate imminent foreclosures. These cases turn on a complex morass of laws dealing with lending practices. Perhaps as important, these cases also depend on the stories the lawyers tell about their clients. Some stories are more likely to get the attention of the public and lenders and result in settlements that may favor the borrower and save their homes. In the long run, these stories may fail to address the larger story that the mortgage crisis has revealed, which, left untold, promises to create even greater harm for the poor and dispossessed. This article discusses the power of narrative in predatory lending cases and the larger consequences of the stories lawyers tell in those cases.

Over the past two years, we have learned more than we thought we would ever need to know about subprime lending, securitization, ballooning interest rates, and bundling loans. Those of us who have listened to National Public Radio and read the newspaper can speak with some authority about the demise of mortgage-backed securities and foreclosure rates. We also know the difference between a legitimate subprime loan gone bad and a predatory loan. Thus, I begin with a


4 Early in what we now call the “subprime mortgage crisis,” we distinguished between predatory lending and “legitimate” subprime lending. As has become clear over the past several years, even “legitimate” subprime lending can result
familiar story.

Helen realized there was no way she could pay her new mortgage and manage her mounting credit card debt. She was afraid the bank was going to come and take her house and her credit cards. She heard on the radio and TV that there might be something she could do to get out of the loan. She called a lawyer and told him the story about how she came to refinance her house and that she needed help figuring out what to do next.

For many years, law review articles have discussed the relationship between narrative, story, and the law. I add my voice once again to this in disastrous consequences certainly for borrowers, and even, eventually, for lenders. As a result, what I refer to as a “predatory lending narrative” has actually been subsumed into the broader subprime lending narrative. See generally David Reiss, Subprime Standardization: How Rating Agencies Allow Predatory Lending to Flourish in the Secondary Mortgage Market, 33 Fla. St. U. L. Rev. 985 (2006); David Reiss & Baher Azmy, Modeling a Response to Predatory Lending: The New Jersey Home Ownership Security Act of 2002, 35 Rutgers L.J. 645 (2004).

“Helen” (not her real name) was my client when I was a supervisor in a general civil advocacy clinic from 2004 to 2005. While many details have been changed to maintain “Helen’s” anonymity, her basic situation and its resolution was as I describe it herein. The stories presented here should, therefore, be taken as true.

discussion by examining how the lawyer acts as a client’s representative to construct and tell a story. Specifically, I examine the process lawyers go through and the choices they make in determining what stories to tell and how to tell them.

The metaphor of the lawyer as constructor and teller of stories implies the possibility of a multiplicity of stories. This concept, which I call “narrative theory,” does not tell lawyers which stories to tell or how to tell them. Instead, lawyers make those decisions on their own, as they depend on a variety of factors, including the law, the facts, and the client’s goals.

Nonetheless, the current legal response to the mortgage crisis, as represented by the potential solutions available to people like Helen, tends to privilege one kind of story over all others: the story of the poor person as a victim in need of rescuing. Lawyers who represent the indigent often fall back on this default narrative in the high-stakes, crisis-driven, winner-take-all context of litigation. These narratives begin at the moment of crisis, and not at any time before. In addition, these

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8 Binny Miller and others have suggested that there is a difference between the two terms “narrative” and “story” – that “story” involves the “raw material” of life, while “narrative” is the construction of meaning from that raw material. Miller, supra note 6, at 1. In this piece, I refer both to narrative and to the act of storytelling.

9 See, e.g., Grose, Once Upon A Time, supra note 7, at 175 n.44 (and sources cited therein).

10 This kind of narrative does not exist exclusively in the predatory lending realm, but rather represents the dominant kind of “poor peoples” law. For example, the landlord/tenant case begins with the eviction notice and ends with the resolution of the action; the child welfare matter begins when the client’s children are taken from her, or the report is filed with the social service agency, and ends when the matter is resolved; the domestic violence case begins with
narratives do not take the long view of this crisis or its effects. As such, these stories reinforce the status quo, by focusing attention on the victims’ bad choices and unscrupulous lenders, cabining the particular crisis as an unfortunate confluence of events rather than as part of the larger picture of a system that reinforces poverty.

But it does not have to be that way. Narrative theory allows us to examine and deconstruct the stories that the media and lawyers are telling about the mortgage crisis. These stories, when told without reflection and intention, do little, if anything, to change the status quo. Narrative theory further shows lawyers how to tell different stories in a way that reveals the mortgage crisis as merely a symptom of a much larger systemic problem, one that lawyers can play a part in remedying. In the face of the biggest economic, housing, health care, and education crisis since the Great Depression, when low and middle-income people are under threat from all sides, anti-poverty lawyers must be more conscious than ever about the kinds of solutions they employ. Their stories must be clear, persuasive, and expressive of the context so that change can encompass this larger picture, this larger story.

Looking through the lens of narrative theory, my paper constructs counter-stories about those who find themselves faced with home foreclosure: stories that envision the individual clients’ broader context and their agency within that context; stories that imagine the clients’ ability to look and plan ahead. I perform this analysis by suggesting that Helen’s situation presents lawyers with the opportunity to tell many different – competing, alternative, serial – but equally “good” stories. The choices about which of those stories to tell and how to tell them are complex and nuanced; they depend on multiple variables that need to be weighed by both the lawyer and the client. To illustrate this point, I choose to tell two possible stories and examine the factors that go into such choices. These choices and the stories they result in teach us about the process of practicing law in a way that empowers clients and may provide a legal framework that makes room for the multiplicity of their stories.

In Part One, I tell Helen’s story against the backdrop of the client’s call to the police, or with her appearance in court and ends when the restraining order is issued. See generally Lucie White, Subordination, Rhetorical Survival Skills and Sunday Shoes: Notes on the Hearing of Mrs. G, 38 Buff. L. Rev. 1 (1990).
predatory lending laws. In Part Two, I explore the metaphor of the lawyer as storyteller by deconstructing both the elements of a story and the story the lawyer tells about Helen. In Part Three, I offer alternative constructions of Helen’s situation and suggest that lawyers can take an active role to make law conform to our clients’ lives rather than vice-versa.

The piece concludes by suggesting that a lawyering theory that is open to this multiplicity of stories – and does not privilege one over the others – contributes to constructing lawyering models that empower different client narratives. This approach allows those clients who would otherwise assume victim roles in adversarial narratives to contribute to constructing a narrative that does not involve them having to be “rescued.” Moreover, it helps lawyers recognize their responsibility to construct these stories collaboratively with their clients, and thus to move the law in a direction that recognizes them as something other than victims.

II. The Predatory Lending Story

Many of the subprime mortgage cases are being handled pro bono by lawyers who do not regularly practice in that area. Imagine that Helen is directed to such a lawyer and her situation appears to him to have many indicators of what could be a successful case:

Helen heard about the refinancing opportunity in a radio commercial, which promised not only a lower interest rate than she was currently paying but also $300 of free groceries and cash back to pay off credit card debts. She contacted the company and a man came out to her house and helped her fill out a mortgage application. She believed it was for a fixed rate mortgage but at the time of the closing, it had changed to an adjustable rate. Once the new rate kicked in, she was unable to make her payments. She has missed two payments and is now afraid that the bank is going to take her house. That is why she called the law office.

A. The Law

There are three categories of lenders in the market: those who make prime loans, those who make subprime loans, and those who engage in predatory lending. Lenders in the prime mortgage market provide mortgages to low risk borrowers with strong credit histories. Legitimate subprime lenders lend to borrowers who have experience shopping for credit, however do not have good enough credit to borrow from prime lenders. Predatory lenders, on the other hand, make mortgages available to inexperienced borrowers who are closed off from the prime and legitimate subprime loan markets due primarily to their poor credit rating.

12 This is by no means an exhaustive discussion of predatory lending or the subprime lending crisis. For such discussions, see generally Kurt Eggert, *Held up in Due Course: Predatory Lending, Securitization, and the Holder in Due Course Doctrine*, 35 Creighton L. Rev. 503 (2002); Kathleen Engel & Patricia McCoy, *A Tale of Three Markets: The Law and Economics of Predatory Lending*, 80 Tex. L. Rev. 1255 (2002). This recitation of the law is meant merely to provide a backdrop or framework for the story that follows. On its face, predatory lending is a contract dispute. Based on that assumption, basic contract defenses include fraud, mental incompetency, incapacity, infancy, duress, undue influence, and mistake. See E. Allan Farnsworth, *Contracts* § 4 (2d ed. 1990). Beyond these basic contracts defenses, which are usually too narrowly construed to permit relief, Congress passed the Home Ownership and Equity Protection Act of 1994 (HOEPA) as an amendment to the Truth in Lending Act statute. The Truth in Lending Act requires disclosures about the terms and cost of consumer credit. The Truth in Lending Act was amended to add the HOEPA. The HOEPA requires limitations on the amount of home loans, as well as substantial disclosure requirements. The Act also bans equity stripping and other abusive practices within mortgages. 15 U.S.C. § 1639.


14 Engel & McCoy, *supra* note 12, at 1258.

15 *Id.* Of course we have seen recently that even these “legitimate” lenders make some very bad loans that are costing the country. See Aubrey Cohen, *Subprime Mortgage ‘Rip-off’ Has Legitimate Roots*, Seattle Post Intelligencer, Nov. 20, 2008, at A1.

While at one time common discourse differentiated between legitimate subprime and predatory loans, due to the mortgage crisis in the last couple of years most, if not all, subprime loans have layers of “illegitimacy” and have contributed to the meltdown of the mortgage system.\(^1\) For purposes of this analysis, however, I focus specifically on predatory loans.

There is no exact definition of “predatory lending.”\(^2\) Rather, predatory loans can be recognized by how they are structured and whom they benefit and hurt.\(^3\) The most common and recognizable predatory mortgages are: loans structured in ways that result in seriously disproportionate net harm to borrowers; loans involving fraud or deceptive practices; loans that lack transparency yet are not actionable as fraud; loans that require borrowers to waive meaningful legal redress;\(^4\) loans with disproportionately high interest rates;\(^5\) loans given based on assets rather than income and whose primary purpose is foreclosure;\(^6\) and loans with adjustable interest rates that are not easy to predict.\(^7\)

Predatory lenders target low-income neighborhoods and potential borrowers or homeowners based on race and social status.\(^8\) They use marketing tools to deceive borrowers who are shut out from the legitimate mortgage markets to trick them into signing on to loans they are unable

\(^{17}\) See Reiss, Subprime Standardization, supra note 4, at 998. See also Reiss & Azmy, supra note 4, at 654-56.


\(^{20}\) Engel & McCoy, supra note 12, at 1260.


\(^{22}\) See id. at 543.

\(^{23}\) See id. at 543-44.

\(^{24}\) See Engel & McCoy, supra note 12, at 1282. Often, these lenders use Home Mortgage Disclosure Act (HMDA) data to identify areas of cities in which there is minimal or no lending activity by prime lenders. Id. at 1281.
Further, even the most legitimate mortgage loan is difficult to understand and predatory loans tend to be worse, written deliberately in dense legalese over multiple pages and copies.\textsuperscript{27} Agents and brokers secure the loans by telling the potential borrowers that if they do not sign the papers now they will miss out on the deal.\textsuperscript{28} Because the class of borrowers who are targeted by these lenders has little access to the legitimate prime and subprime markets, it is hard for these potential borrowers to shop around and judge for themselves whether the loan they are being offered is a good one or not.\textsuperscript{29} That is precisely the point. Predatory lenders purposely target low-income borrowers who do not know any better.\textsuperscript{30}

Federal and state laws can and have been used to combat some of these practices.\textsuperscript{31} The most common federal statutes used to combat predatory lending are: the Truth in Lending Act (TILA),\textsuperscript{32} which requires lenders to make certain disclosures to borrowers;\textsuperscript{33} the Real Estate Settlement Procedures Act (RESPA),\textsuperscript{34} which covers all federally related loans and requires that very particular procedures be followed at the time of the closing of the loan, and which prohibits fee-splitting among and kickbacks to agents and brokers;\textsuperscript{35} the Home Equity Protection Act

\textsuperscript{25} See id. at 1282.
\textsuperscript{26} Id.
\textsuperscript{27} Id.
\textsuperscript{28} Id. See also Davenport, supra note 21, at 557 n.54; McCoy, supra note 18, at 738-39.
\textsuperscript{29} Engel & McCoy, supra note 12, at 1257-58; See also Davenport, supra note 21, at 533; McCoy, supra note 18, at 731-32.
\textsuperscript{32} Id. This is not particularly effective against predatory lenders because even if the lenders technically make the required disclosures, they do so in convoluted and opaque ways, capitalizing on the borrower's lack of sophistication and inability to understand the terms of the loan. See Davenport, supra note 21, at 546-48.
\textsuperscript{34} Id. While there is no private right of action under RESPA for failing to make mandatory disclosures, such claims may be able to be incorporated into state consumer protection claims, which often cover RESPA violations. See, e.g., Jessica Fogel, State Consumer Protection Statutes: An Alternative Approach to Solving the Problem of Predatory Mortgage Lending, 28 Seattle U. L. Rev. 435, 436-37 (2005).
(HOEPA), which sets limits on the amount of home loans, and requires substantial disclosures by lenders;\(^{36}\) the Equal Credit Opportunity Act (ECOA),\(^{37}\) which prohibits discrimination in lending on the basis of race, public assistance, etc.;\(^{38}\) and the Fair Housing Act (FHA),\(^{39}\) which prohibits discrimination by the lender and can be used to make reverse redlining claims in these cases.\(^{40}\)

35 15 U.S.C. § 1639. The HOEPA requires limitations on the amount of home loans, as well as substantial disclosure requirements. The Act also bans equity stripping and other abusive practices within mortgages. See id.


37 Id. See also Federal Trade Commission, Facts for Consumers, http://www.ftc.gov/bcp/edu/pubs/consumer/credit/cre15.shtm (last visited October 23, 2009) (“When You Apply For Credit, Creditors May Not ... (1) Discourage you from applying or reject your application because of your race, color, religion, natural origin, sex, marital status, age, or because you receive public assistance. (2) Consider your race, sex, or national origin, although you may be asked to disclose this information if you want to. It helps federal agencies enforce anti-discrimination laws. A creditor may consider your immigration status and whether you have the right to stay in the country long enough to repay the debt. (3) Impose different terms or conditions, like a higher interest rate or higher fees, on a loan based on your race, color, religion, national origin, sex, marital status, age, or because you receive public assistance. (4) Ask if you are widowed or divorced. A creditor may only use the terms: married, unmarried, or separated. (5) Ask about your marital status if you are applying for a separate, unsecured account. A creditor may ask you to provide this information if you live in “community property” states: Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington, and Wisconsin. A creditor in any state may ask for this information if you apply for a joint account or one secured by property. (6) Ask for information about your spouse, except: if your spouse is applying with you; if your spouse will be allowed to use the account; if you are relying on your spouse’s income or on alimony or child support income from a former spouse; [or] if you reside in a community property state. (7) Ask about your plans for having or raising children, but they can ask questions about expenses related to your dependents. (8) Ask if you get alimony, child support, or separate maintenance payments, unless they tell you first that you do not have to provide this information if you aren’t relying on these payments to get credit. A creditor may ask if you have to pay alimony, child support, or separate maintenance payments.”).


39 Id. (In years past, there was a real estate term called “redlining” which referred to the practice of marking off areas that had a high minority population as a bad area to make loans, and that made it difficult if not next to impossible to obtain
In addition, most states have consumer protection statutes and other statutes that regulate the mortgage and lending industry, many of which can be used in predatory lending claims. And finally, common law claims of fraud and breach of contract can sometimes be used in predatory lending claims. Because there is no set definition of “predatory lending”, these federal and state remedies fall short of providing comprehensive relief for the victims and deterrence for the perpetrators of “predatory lending” practices. There appears to be a basic predatory lending story for the financing, but since the passage of the FHA the term reverse redlining refers to the practice of over-lending to minority populations). See also Hargraves v. Capital City Mortg. Corp., 140 F. Supp. 2d 7 (2000) (group of African-American borrowers alleged that mortgage company committed reverse redlining which constituted a violation of the FHA when they intentionally targeted plaintiffs for unfair and predatory loans on the basis of their race). See, e.g., Arkansas Home Loan Protection Act, Ark. Code Ann. § 23-53-101 to -106 (2003); Mortgage Lender and Broker Act of 1996, D.C. Code § 26-1112 (2001); District of Columbia Consumer Protection Procedures Act, D.C. Code §§ 28-3901-3913 (2001); Fair Lending Act, Fla. Stat. §§ 494.0078-.00797 (2002). See, e.g., Snapka v. Bell Road Kia, No. 1-CA-CV 07-003, 2007 WL 5463517, at *6 (Ariz. Ct. App. Div. 1, 2007); Melton v. Family First Mortg. Corp., 576 S.E.2d 365, 368 (N.C. Ct. App. 2003); Salley v. Option One Mortg. Corp. et al., 925 A.2d 115, 119 (Pa. 2007). See Fogel, supra note 34, at 435-36. Recognizing the shortcomings in these statutes, various scholars and practitioners have proposed either alternative legislation, or alternative readings of current legislation to better address the problem of predatory lending. For example, Frank Lopez suggests that the Fair Housing Act might be the best bet under current law. Frank Lopez, Using the Fair Housing Act to Combat Predatory Lending, 6 Geo. J. on Poverty L. & Pol’y 73, 73-108 (1999). Pat McCoy and Kathleen Engel propose a new cause of action for breach of duty of suitability (suitability for brokers or lenders to make loan to a person based on the data and expertise they have) to compensate victims of predatory lending. Engel & McCoy, supra note 12, at 1339. Cecil Hunt suggests various remedies but lands on economic hate crime as a remedy for punishing predatory lenders that target racial minorities. Cecil J. Hunt, In the Racial Crosshairs Reconsidering Racially Targeted Predatory Lending Under A New Theory of Economic Hate Crime, 35 U. Tol. L. Rev. 211, 211-315 (2003). See also Davenport, supra note 21, at 9; Engel and McCoy, supra note 12, at 8. And of course, Congress has proposed new legislation, in light of the subprime mortgage crisis, to prevent such loans in the future. Mortgage Reform and Anti-Predatory Lending Act, H.R. 3915, 110th Cong. (2007); Predatory...
borrower. It goes something like this: unscrupulous, devious, shady lenders target vulnerable members of the population who have no access to other lenders and trick them into signing on to loans they cannot afford so the lenders can steal their homes. Also, the borrowers themselves, i.e. the victims, are often complicit in some way, or at the very least, looking for that deal that seems too good to be true, even in the face of its obvious impossibility.

B. The Facts

Against this backdrop of the law, the lawyer will meet with Helen and briefly counsel her on the laws that might be able to help her. They lawyer then will gather more facts to flesh out her particular predatory lending story. Suppose Helen’s lawyer learns the following: Helen is a black woman suffering from diabetes and high blood pressure, dependent on social security and Medicare. Her husband, Samuel, is a black man struggling with alcoholism. They have been married for about thirty years. They are both in their early fifties. Helen stopped going to school when she was thirteen, reads at an eighth grade level, and certainly does not understand the technical language found in mortgage documents. Samuel completed high school but is functionally illiterate and never read any of the mortgage contracts. Helen runs the household, including managing the finances, however Samuel often squanders their funds on alcohol. Samuel has been an alcoholic throughout their entire marriage.

Helen and Samuel owned their house, which was in a very poor, predominantly African-American neighborhood. One of the things Helen really liked about the neighborhood was the local community radio station, which she listened to all the time. Several months before contacting the law office, she heard a particular advertisement. A company was offering deals for refinancing houses in her neighborhood. After hearing this commercial multiple times, Helen became intrigued by the possibility. Her primary interest in refinancing was to pay off various

Mortgage Lending Practices Reduction Act, H.R. 2061, 110th Cong. (introduced April 26, 2007); H.R. Con. Res. 391, 110th Cong. (introduced July 17, 2008) (recognizing the disparities that are associated with predatory lending abuses in minority communities and expressing the sense of the Congress that as new abuses continue to emerge, such laws should ensure that all those responsible for representing and protecting families have the authority to act to address these new problems).
outstanding credit card bills and lines of credit. She was also lured by
the offer in the ad that she would receive $300 in free groceries from the
mortgage lender.

Helen called the company to discuss the possibility of refinancing
her home. She told the broker she spoke to, Mr. Robinson, that she was
interested in applying for a fixed-rate mortgage. He came to Helen and
Samuel’s home and interviewed them, using the answers they gave to fill
out the loan application on the spot. The Good Faith Estimate that he
gave them at the time of the application confirmed that they had applied
for a loan at the fixed rate of 6.25 percent.

Samuel was visibly intoxicated during the interview, as well
as during all subsequent interactions with the broker. Helen told the
lawyer that he was routinely drinking seven or eight forty ounce bottles
of malt liquor (“forties”) every day and that the day of the application
was no different. In the course of filling out the loan application, Helen
specifically informed Mr. Robinson that Samuel would likely lose his job
soon, which in fact he did.

Several weeks after they had filled out the application, Mr.
Robinson called Helen and told her over the phone that because of
her poor credit rating, she was not eligible for the fixed-rate loan and
would have to take a variable rate loan. He told her that the monthly
payment would be approximately $1,000. When Helen balked at that,
Mr. Robinson offered to lower the amount to $900 per month. He told
her she would never find such a good deal for her house and that, if she
did not jump on it now, it would disappear. She eventually agreed to
the $900 a month, knowing it would be a real struggle to make those
payments.

Helen never received anything in writing rejecting her application
for the fixed rate loan, nor did she ever fill out another application for an
adjustable rate loan.

Helen knew when she agreed to the loans that she and Samuel
would not be able to afford the loan at the new adjustable rate. However,
she knew that she had to refinance in order to cover her credit card debts
and other lines of consumer credit. She asked Mr. Robinson to confirm that
the loan amount would be enough to pay off these debts. Mr. Robinson
promised it would—she was to receive $15,000 in cash from the transaction.
At Mr. Robinson’s instruction, Helen called the credit card companies and
told them she was borrowing money from her sister to pay off her debts. 

At the closing, Samuel was once again visibly intoxicated. In fact, he was holding and drinking from a “forty” throughout the entire process. The copies of the loan Helen received at the closing were unsigned and the closing documents were dated three days earlier than the date of the actual closing. In addition, Helen was not provided with copies of various documents that she requested, including signed copies of the closing documents. She never received either the $15,000 in cash or the $300 in free groceries. She believed that her old mortgage had been paid off and that she now had a new one at the new adjustable rate because her monthly payments had gone up to the $900.

By the time she contacted the law office, she was two months behind in her mortgage, unable to afford the $900 per month, and her credit card bills were higher than ever.

C. The Lawsuit

The transaction between Helen and Mr. Robinson has all the elements of a good juicy predatory lending story: big bad subprime mortgage company targets poor black neighborhood, enticing clients with free groceries and promises to pay off credit card debt. This particular client was not only poor and black, she was also disabled and barely educated. Her husband was an alcoholic who was drunk throughout the entire process and could not read. The slick broker who came to her house played bait-and-switch with the terms of the loan and then turned up the heat when she started to balk, all along banking on getting her house out of the deal.

In this situation, the lawyer would draft a complaint against the original lender and mortgage broker based on the tools available to him: parts of the Truth in Lending Act (TILA), provisions of the state Consumer Protection Procedures Act, provisions of the Real Estate Settlement Procedures Act (RESPA), and common law fraud and contract claims. It is likely that, after months of discovery and motion practice, the case would probably settle, with the defendants agreeing to rescind the loan and forgive the two months of nonpayment. Helen’s mortgage would go back to being what it was before she contacted the

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company. Thus, it would be as if the whole thing never happened.

III. LOOKING AT THE STORY MORE CAREFULLY

The lawyer chose to tell Helen’s story because he understood it to be the story the law required him to tell in order to protect Helen’s home from foreclosure. Indeed, the various laws against predatory lending do seem to imagine stories just like Helen’s: situations where poor people have lost out either to the system, or to wealthy individuals. The solutions offered by these laws are solutions to high stakes problems. They tend to kick in only at the moment of crisis and not at any time before.46 Further, they tend to address only the immediate crisis and not its underlying causes. In order to benefit from these policies, therefore, plaintiffs need to assume the posture of victim in this high stakes, winner-take-all, reactive system. The stories these plaintiffs tell are therefore victim stories.

How the lawyer chooses to frame the facts of the case is significant, but it is not an inevitable framing. Lawyers choose what stories to tell and how to tell them.47 The fact that a lawyer may have good reasons for a choice does not negate its essential character as a choice. When a lawyer chooses one particular story, he implicitly chooses not to tell other stories.

Lawyers have been reading and writing about the relationship between narrative, story, and the law for many years.48 I would like to examine more closely this idea that lawyers construct and tell stories when they represent clients. Specifically, what is the process that lawyers go through and the choices they make in determining what stories to tell and how to tell them?

My analysis of this process involves three lines of inquiry. First,

45 I suggest that predatory lending is not the only issue in these situations. It is beyond the scope of this article to explore more fully, but many of the laws that “protect” poor people are structured this way: Their homes are going to be foreclosed, their children are going to be taken away, and their medical care is going to deplete their assets. See, e.g., Juliet M. Brodie, Post-Welfare Lawyering: Clinical Legal Education and a New Poverty Law Agenda, 20 Wash. U. J.L. & Pol’y 201 (2006); White, supra note 10. Another wonderful example of this is bankruptcy. See Elizabeth Warren, What is a Women’s Issue? Bankruptcy, Commercial Law, and Other Gender-Neutral Topics, 25 Harv. Women’s L.J. 19, 47-48 (2002).

46 Grose, A Persistent Critique, supra note 6, at 330-32.

47 See generally sources cited, supra note 6.
what are the components of a story? Second, what choices can and does a lawyer make about the story he tells? Third, how does he make those choices? In considering each of these questions in turn, I construct a theory of lawyering based on storytelling that can help us to understand how lawyers practice our craft, and also help us to engage in that practice with intentionality and awareness of the consequences of our choices.49

A. What Is a Story

Thinking about the practice of law as a practice of storytelling gives us the opportunity to look behind, between, over, and under the black letter rules that comprise “the law.”50 In those interstices, we find facts, language, structure, and ideas that go well beyond the holding of an opinion or the mandate of a statute.51 By treating law as narrative, we discover not only “how law is found but how it is made.”52

Cultural psychologist Jerome Bruner describes the act of storytelling as so instinctive, so intuitive, as to render an explanation of how we do it close to impossible. “We stumble when we try to explain, to ourselves or to some dubious other, what makes something a story rather than, say, an argument or a recipe.”53 And yet, if lawyers are


49 Amsterdam & Bruner, supra note 6, at 110.

50 Brooks & Gewirtz, supra note 48, at 3.

51 Id.

52 Jerome Bruner, Making Stories: Law, Literature, Life, 3-4 (Harvard University Press 2003). See also Schoppele, supra note 6, at 2088 (“gifted practitioners know without reflection how to make accounts into legal narratives the way native speakers of a language know how to express thoughts in grammatical sentences. But that does not mean that those who can do it know how to describe systematically what they have done.”).
to be effective legal storytellers – the kind who explain not only how law is found, but also how it is made – they must be able to overcome this asymmetry between doing and understanding what they do.\textsuperscript{54} They must be able to describe what goes in to the making of a story.

Starting with the basics, what is a story? Anthony Amsterdam and Jerome Bruner provided a great service to the world of legal scholarship with their book \textit{Minding the Law} in which they translated literary theory and rhetoric into terms that can be understood by the contemporary legal (as opposed to literary) scholar.\textsuperscript{55} As described therein (and as we all know instinctively and intuitively), stories are comprised of:

- A “steady state” – that is, a state “grounded in the legitimate ordinariness of things.”\textsuperscript{56}
- The “trouble” – that is, something that happened to disrupt the “legitimate ordinariness.”\textsuperscript{57}
- Efforts at redress, to cope or come to terms with the disruption.
- Outcome/resolution
- Coda or moral – a “retrospective evaluation of what it all might mean” – which returns the audience from the “there and then of the narrative to the here and now of the telling.”\textsuperscript{58}

\begin{itemize}
\item \textsuperscript{53} \textit{Bruner, supra note 52, at 4.}
\item \textsuperscript{55} \textit{Amsterdam & Bruner, supra note 6, at 113; \textit{See generally Bellow & Minow, supra note 48; Brooks & Gewirtz, supra note 48; Alfieri, supra note 6; Cover, supra note 54; Cunningham, supra note 54; Farber & Sherry, supra note 6; Grose, \textit{Benetton, supra note 6}; Jacobs, supra note 48; Miller, \textit{Teaching Case, supra note 54}; Miller, \textit{Their Lives, supra note 54}.}
\item \textsuperscript{56} \textit{Amsterdam & Bruner, supra note 6, at 113.}
\item \textsuperscript{57} \textit{Bruner, supra note 52, at 20.}
Of Victims, Villains and Fairy Godmothers: 
Regnant Tales of Predatory Lending

Taken together, these five elements make up what we call “the plot” of the story,\(^\text{59}\) i.e. the “what happened and why.” Plots usually fit into particular “genres” —“mental models representing possible ways in which events in the human world can go.”\(^\text{60}\) In other words, the story is recognizable to the reader or listener almost from the outset, causing him or her to register it as a comedy, tragedy, or drama, etc.\(^\text{61}\) These are established or stock scripts that we recognize and expect to resolve in certain ways.\(^\text{62}\)

The characters as free agents with minds of their own,\(^\text{63}\) make the plot move by engaging in the “what happened and why” of the story.\(^\text{64}\) Theodore Leitch describes characters as representatives of different identities, which, like plots, tend to register with readers or listeners as familiar, each one expected to embody one or more general truths.\(^\text{65}\) Thus, in every story, we expect to encounter and to recognize heroes, villains, lovers, enemies, good guys, bad guys, clowns, tragic figures, protagonists, antagonists, etc.

The plot and the characters make up what I call the “what” of the story – something happened to someone and the story is about how to fix it. In addition to these substantive components, there is what I call the “how” of the story. These are the technical pieces that literally make up the story: timing, framing, pace, language, when the story begins, when it ends, what gets described fully, what gets left out, setting, organization, and structure.\(^\text{66}\) As much as the plot or the characters, these elements make the story what it is, delivering it to the reader or listener in a form that he or she recognizes and responds to.

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\(^{58}\) See Leitch, supra note 54 (The plot consists of action and telos. It is a trope for human experience; something more than just an intelligible sequence of events); see also Peter Brooks, Reading for the Plot: Design and Intention in Narrative (Harvard University Press 1992).

\(^{59}\) Amsterdam & Bruner, supra note 6, at 133 (establishing that genres are tools of narrative problem-solving that can shape human encounters and institutional arrangements).

\(^{60}\) See id.

\(^{61}\) See id.; see generally Lopez, supra note 48.

\(^{62}\) See Amsterdam & Bruner, supra note 6; see also Leitch, supra note 54.

\(^{63}\) See generally Leitch, supra note 54.

\(^{64}\) See id.

\(^{65}\) See Amsterdam and Bruner, supra note 6 at 113; see also Scheppele, supra note 6, at 2094-97.
B. **How Lawyers Tell Stories**

Narrative theory, however, requires exploration beyond this essential deconstruction of a story. Each one of those elements – character, plot, genre, timing, framing, rendering of detail, pacing, etc. – represents one, if not more than one, choice about the kind of story to tell and how to tell it. In order to know how to tell a story, lawyers need to understand the choices they make and why they make them.

Lawyers are particular kinds of storytellers, influenced by variables unique to their role as tellers of their clients’ stories. In that role, as makers of legal arguments, we decide what story to tell and how to tell it “guided by some vision of what matters.” Put another way, in order to figure out what story to tell and how to tell it, the lawyer must weigh three substantive factors, the same factors that make up the theory of the case: the law, the facts, and the client’s goals. In addition, the lawyer must consider contextual factors, e.g. the audience, the forum, the availability of resources, the personality of the client, and the potential supporting or detracting characters in the story. The lawyer must also take into consideration particular cultural norms and values in deciding among different stories and ways of telling them. And finally, the lawyer must consider factors personal to him, such as whether he is comfortable in a courtroom, whether he can pull off a humorous narrative, whether he does better in a more formal or less formal setting, and whether the client’s

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68 Amsterdam & Bruner, *supra* note 6, at 7.
69 Binny Miller has written extensively about the construction of case theory, which is the incorporation of law and facts and client goals into a story that can be used to drive a case or an organizing campaign. See Miller, *Their Lives*, supra note 54, at 485-90.
70 At a more subtle level, though, lawyers make choices based on other things as well. Each of these elements of narrative themselves is a portal into cultural and personal norms and values. In order to understand what is behind these stories, we can ask: what norms does the script embody, what vicissitudes derail the script, what consequences follow the derailment? See Amsterdam & Bruner, *supra* note 6, at 122.
situation raises personal moral or ethical concerns, among other issues.\textsuperscript{72}

When a lawyer drafts a statement of facts, for example, she does not simply record the known universe of “relevant” facts in an interesting and persuasive way. Indeed, there is no such thing as an absolutely neutral description of the facts.\textsuperscript{73} Lawyers repeatedly engage in fact-gathering – at initial client interviews, after doing legal research, in anticipation of the other side’s argument – and then they pick and choose from available facts to present a picture of what happened\textsuperscript{74} that most accurately reflects their sense of what matters. In addition, the other lawyers involved do exactly the same thing, with exactly the same pool of facts; however, they emphasize different details, draw different inferences, which results in quite a different picture.\textsuperscript{75}

This also goes for the story’s “how.” The law might define what is relevant, but it cannot define “how the relevant facts, in a particular case, are to be expressed.”\textsuperscript{76} It is up to the lawyer to figure out what words to use and with what emphasis. A lawyer’s statement of facts thus “reflects – by its inclusions and exclusions, the emphasis of its sentence construction and the structures of its argumentation – choices.”\textsuperscript{77} Lawyers make choices about the other technical elements of a story as well: when the story should begin and when it should end, how quickly or slowly the action should move, how fleshed out each character should be, etc. Kim Lane Scheppele provides wonderful examples of choices judges make in the “how” of their stories (in essence, appellate opinions are stories) both about word choice (“lightly choke” v. “heavy caress”)\textsuperscript{78} and framing (beginning with the defendant’s childhood v. beginning with the night of the crime).\textsuperscript{79}

Thus, stories are not “recipes for stringing together a set of ‘hard facts.’”\textsuperscript{80} Rather storytellers construct the facts that comprise the stories\textsuperscript{81}

\textsuperscript{71} See id; see also Grose, A Persistent Critique, supra note 6, at 363-67.
\textsuperscript{72} See Scheppele, supra note 6, at 2089-2091 (discussing ‘point of viewlessness’).
\textsuperscript{73} See Amsterdam & Bruner, supra note 6, at 110, 122-124.
\textsuperscript{74} Id.; see also Lopez, supra note 48, at 31.
\textsuperscript{75} Bernard Jackson, Narrative Theories and Legal Discourse, in Narrative in Culture: The Uses of Storytelling in the Sciences, Philosophy, and Literature 27 (1994).
\textsuperscript{76} Id.
\textsuperscript{77} Scheppele, supra note 6, at 2086.
\textsuperscript{78} See id. at 2096.
\textsuperscript{79} Amsterdam & Bruner, supra note 6, at 111.
\textsuperscript{80} See id. at 116-17 (Endogenous theory of narrative – that narrative constructs a
by sorting through what is out there and figuring out both what to say and how to say it, based on the storyteller’s own perspective about “what matters.” Narrative is not a purely logical argument because there is not one right solution. A set of events can be organized into alternative narratives and the choice among them depends on perspective, circumstances, and interpretive frameworks. These choices are governed by what lawyers care about. Thus, the “fabric of narrative reflects the shape of [their] concerns.”

For lawyers, then, figuring out “what matters” is a complex and nuanced process. When they choose what story to tell and how to tell it, lawyers must work hard and with awareness to reconcile and balance these various facets of “what matters.”

C. Deconstructing Helen’s Story

What lawyers must appreciate is that in choosing to tell a particular story in a certain way they are shaping future stories. If the story presented is persuasive, then other stories will be shaped to fit that “winning” story. This process reifies what the legal system recognizes as actionable harms, thus, in essence, making law. Such reification may prevent a deeper look at the problem we are trying to solve, which can have significant consequences for those affected by that underlying problem.

world “not just according to how the world is, but according to its own categories.” Endogenous theories can be called constructivism – the world is constructed by mental activity, not found out there by the senses. Plight-modeling theory of narrative – narrative form translates knowing into telling. Legal narratives tend to conform – narratives model characteristic plights of particular groups. Cultures convert plights and aspirations into narrative forms that represent both the expected steady state and the expected trouble).

81 Cf. Amsterdam & Bruner, supra note 6, at 110. There is a rich body of scholarship on assumptions and lawyer bias affecting the shape of their concerns. See, e.g., Grose, A Persistent Critique, supra note 6 (and sources cited therein).

82 Amsterdam & Bruner, supra note 6, at 124.

83 The client may play a significant role or a minor role in helping to craft the story the lawyer tells on her behalf, depending on the client’s relationship with the lawyer and the lawyer’s practicing style. See, e.g., Grose, Once Upon A Time, supra note 7; Gerald Lopez, Rebellious Lawyering: One Chicano’s Vision of Progressive Law Practice (Westview Press 1992); Lucie White, Collaborative Lawyering in the Field? On Mapping the Paths from Rhetoric to Practice, 1 Clin. L. Rev. 157 (1994); Ascanio Piomelli, Appreciating Collaborative Lawyering, 6 Clin. L. Rev. 427 (2000).
The winning “predatory lending” story, which the lawyer told about Helen, in its most caricatured, boils down to this:

Once upon a time, there was a poor disabled black woman who lived in a house in a bad part of town, with her poor alcoholic black husband. Along came a slick mortgage broker who offered her a great deal on her house and promised to help her pay off all her debts so she could live happily ever after. She accepted his offer, even though she knew in her heart that it was too good to be true. Of course, it was too good to be true. The slick mortgage broker took her money and got her to sign the papers and then he disappeared. The poor disabled black woman never got the money to pay off her debts and ended up even poorer than she was before. Now, she and her husband need the government to step in and undo the deal so she can go back to being only as poor as she was before, and live happily ever after like that.

Helen’s “steady state” was living beyond her means, buried in credit card debt, in a house in a bad part of town. The “trouble” comes along in the shape of the mortgage broker conning her into a refinance deal she cannot afford. The resolution of the story returns Helen to her original steady state – “only as poor as she was before.”

We recognize a number of characters in this story, and they help us figure out what kind of story it is. The most prominent are the victims, Helen and Samuel, identifiable by their poverty, their lack of education, their lack of ability (both physical and mental) and their desire to do better for themselves. They represent a certain kind of victim – not the totally innocent one like Cinderella, but rather the one who wants to better herself a bit sneakily and ends up getting into trouble, like the husband and wife who have three wishes and end up turning each others’ noses into sausages, only to have to use their final wishes to turn them back into noses.

We also recognize the villain in the story – the mortgage broker, identifiable by his slickness, his insistence, his persistence, and of course, the fact that he cheats and lies and makes off with the victims’ hard-earned house. However, he is not pure evil like the Wicked Witch of

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84 See generally, Charles Perrault, Fairy Tales (University Press 1903) (This version introduces the most widely accepted Cinderella character, including her glass slipper and fairy godmother).

85 See generally, Gabriel Djurklou, The Sausage in Fairy Tales from the Swedish 27-32 (J. B. Lippincott Company 1901).
the West, but rather manipulative and clever, playing on the victims’ own weaknesses. And we recognize the fairy godmother in the story, in the form of the Law (as the “magic wand”) and the lawyer (who wields the wand), identifiable by her power to swoop down and undo the deal the foolish victims got themselves into. With a wave of the “magic wand” (the laws against predatory lending), the lawyer removes the sausages from Helen’s and Samuel’s noses, and they are left with no more wishes, but with their noses back to normal.

We learn through these characters that this story is not a fairy tale, but rather a morality tale – a “be careful what you wish for” story. Much like the sausage story, this one warns Helen and Samuel, and through them, us, not to try to get more than we are entitled to through our own hard work and honest means, and to be content with our lot as is. Otherwise, we will end up losing our houses or with sausages for noses.³⁸

Written literally in the language of predator and prey, the story is framed tightly around the loan itself. We learn very little about Helen and Samuel, other than that they are victims of the predatory lending scheme. They have been boiled down to the caricatures of the poor, black, disabled, alcoholic victims. Thus, we learn very little about the plots of their lives beyond that scheme. The story provides historical background only to flesh out Helen and Samuel’s roles as victims and Mr. Robinson’s role as villain; and only those details necessary to make a compelling argument that the fairy godmother government should come in to right the wrongs they have suffered. In the complaint, Helen’s lawyer tells the very simple story about the predatory loan and its effect on the plaintiffs.

Indeed, Helen’s lawsuit was successful. Faced with the threat of the fairy godmother swooping down and waving her magic wand, the defendants agreed to settle the case and the plaintiff was returned to her pre-trouble steady state.

³⁸ This story is consistent with the stories we’ve heard in the press about these predatory loans and their victims. See NPR Morning Edition: Foreclosures Hit Rural America, But Quietly (NPR radio broadcast Oct. 7, 2008); NPR Tell Me More: Black Households Hit Hard by Mortgage Crisis (NPR radio broadcast Jan. 15, 2008); Joshua Michael Stolly, Subprime Lending: Ohioans Fall Prey to Predatory Lending at Record Levels, What Next?, 34 OHIO N.U. L. REV. 289 (2008).
IV. Other Stories

Helen’s lawyer told her story as an adversarial story about victims and perpetrators in the form of a complaint in the particularized context of a lawsuit. In the complaint, he identified Helen’s situation as a mortgage crisis and the legal remedies available to ameliorate that crisis. Those remedies, i.e. the various laws against predatory lending practices, in turn dictated the kind of story the lawyer told and the way he told it. These remedies allowed the lawyer to determine “what matters” in Helen’s case.

Helen’s lawyer understood that Helen wanted to avoid foreclosure; he appropriately researched the law of predatory lending and gathered the facts in light of the law he found. Helen was behind in her mortgage payments and told the lawyer that she needed help saving her house. Helen herself understood the litigation route to be her only remedy. Her lawyer therefore told the story he needed to tell in order to get the remedy the law provided. Further, he framed the story to conform to the legal requirements of a particular context— the landscape of predatory lending law.

The fact that this story did not completely or adequately describe Helen and Samuel’s lives, or that it played on ugly racial and class stereotypes, should have given the lawyer pause. He liked Helen a lot based on their few meetings, but he felt that the legal remedies available to Helen defined the story he had to tell. It was a story about a crisis with high stakes that required intervention in order to salvage the victim’s house.

A. The Realm of Possibilities

But what about Helen’s underlying goals of getting cash and paying off her debt, the very reasons Helen looked into the loan to begin with? Has this solution really improved Helen’s lot in life? The immediate crisis was averted, but how can she be sure another similar crisis will not happen at some point in the near future?

The basic premise that lawyers choose what stories to tell and how to tell them is not just about facts or framing or language; it is also about the law itself. The law is not just there, waiting for us to come along and plug our clients’ lives into it or the other way around (plug it in to our clients’ lives). The process lawyers go through to make choices
about what story to tell and how to tell it is, in fact, what constructs the law.\textsuperscript{88} Lawyers make the law by telling stories about their clients’ lives.\textsuperscript{89}

This is the most powerful part of the storytelling metaphor – by being sensitive to narrative, we begin to see the law differently: “it ceases to be limited, settled and formal and, instead, becomes fluid, contested and even contradicted.”\textsuperscript{90} In addition, when lawyers see themselves as storytellers about, \textit{inter alia} the law, they begin to understand that the law is not objectively created and applied, but rather that it is subjective and constructed \textit{by them}.\textsuperscript{91}

As storytellers about the law, lawyers are powerful actors in the legal system who can and must make choices about the kind of stories to tell and therefore the kind of law to make. As such, they “participate in the ongoing process of re-creating the law. Bearing legal narrative in mind, we can understand law not as restriction and control but rather as a realm of possibilities.”\textsuperscript{92}

What is the realm of possibilities in Helen’s case? What other stories could the lawyer have told?

Helen’s lawyer could have told another kind of “victim” story: one that played less on racial and economic stereotypes, one that defined the defendants more broadly and sought greater remedies, or one that developed the client’s character as more of a change agent than a helpless victim.

The lawyer could also have widened his frame a bit in telling the story so that the fact-finder learned more about Helen and Samuel. He could have provided more historical background of the subprime lending crisis to place this particular loan in a social, political, and economic context. He could have described the villains more broadly to include not only the slick mortgage broker, who was, after all, just a minnow in

\begin{itemize}
\item \textsuperscript{87} See generally, Grose, Benetton, supra note 6; Grose, \textit{A Persistent Critique}, supra note 6.
\item \textsuperscript{88} See Robert Weisberg, \textit{Proclaiming Trials as Narratives: Premises and Pretenses, in Law’s Stories: Narrative and Rhetoric in the Law}, supra note 48, at 62 (“[T]elling a legal narrative . . . motivate[s] us to be the artificers of our own law.”). See also generally Brooks & Gewirtz, \textit{supra} note 48.
\item \textsuperscript{90} Id. See also Grose, \textit{A Persistent Critique}, supra note 6, at 331-32.
\item \textsuperscript{91} Papke, \textit{Preface to Narrative and the Legal Discourse: A Reader in Storytelling and the Law}, \textit{supra} note 89, at 1, 5.
\end{itemize}
the subprime lending war, but also the various lending institutions that made this loan and others like it possible. He could even have told a story that named the FDIC and other federal oversight agencies as the bad guys.

In all of these stories, the essential plot structure and characters remain consistent – Helen and Samuel are the victims, living in their house above their means, who are conned by some bad guys into a loan they cannot afford, and the Fairy Godmother (in the form of the law and the lawyer) swoops down and gets them back to their pre-trouble steady-state, maybe with a little extra cash, so they end up a bit better off than when they started.

The genre of these stories also remains essentially the same: they are good-guy/bad-guy stories with varying degrees of blame placed on the victim relative to the villain. They are stories that take place in and around a crisis that needs to be resolved. Their morals are also the same: if you are living beyond your means and get into a situation that seems too good to be true, it probably is, and you are going to need help getting out of it. Not quite the sausage story, but certainly not the innocent Cinderella story either.

Finally, these stories all take place against the same essential backdrop and in the same context: the laws against predatory lending and the specter of a lawsuit define the stories’ plot, characters, and structure. The stories are still written in the language of predator and prey; there are still good guys and bad guys; they are still framed tightly around the loan and the only background facts that are given are those that explain the characters’ behavior or the applicability of the law to the situation. The essential narrative structure – steady state, trouble, resolution, moral – is consistent among all of these stories, as well as the story Helen’s lawyer told initially.

B. Another Kind of Story

What if we changed the narrative structure of Helen’s situation by fiddling with her steady state and the trouble that disrupted it and the

92 Cf. Elliot G. Hicks, Shooting Ourselves in the Foot in the Drug War, 1999 W. Va. Law. 4, 4 (1999) (explaining that mandatory minimum sentencing laws for drug-related violations result in “little minnows going to prison, while the big fish continue to swim in a sea of crime.”); Andrew N. Sacher, Inequities of the Drug War: Legislative Discrimination on the Cocaine Battlefield, 19 Cardozo L. Rev. 1149, 1190 (1997) (explaining the disparity between small-time drug dealers who are aggressively prosecuted and replaced and the drug kingpins, whose power is enhanced by this legal regime).
resolution she sought? Would that not affect the rest of the story’s plot – the resolution itself and the moral of the story? Would it not change who the characters were? Might it alter the story’s genre? And what about the story’s structure – how it is framed, organized, where it begins, and where it ends?

Imagine the following scenario:

Helen realized there was no way she could pay her new mortgage and manage her mounting credit card debt. She was afraid the bank was going to come and take her house and her credit cards. She heard on the radio and TV that there might be something she could do to get out of the loan. So she called a lawyer and told him the story about how she came to refinance her house and that now she needed help figuring out what to do next.

The lawyer sat down with Helen who told him that she and her husband Samuel owned their home and had been employed for many years, but they recently had been having a hard time making ends meet. Gradually, Helen, who had always run most aspects of the household, began putting things on credit cards and installment plans. Initially, she made the payments every month, however, lately, she had started to miss payments or was not able to make them fully. Thus, the balances began adding up.

When she realized she was paying back more in interest than she had spent on any particular thing, she decided to try to refinance her house, lured by the infamous commercial on the radio. Because the new monthly payments turned out to be more than her original mortgage, Helen was now two months behind in paying the mortgage.

Helen became overwhelmed by the burden of juggling all the different accounts and was scared by the phone calls and threatening letters she had started to receive. She wished there were something she could do to prevent the debt from continuing to escalate.

The lawyer felt compelled by Helen and her story and wanted to help her. He asked her to bring him all of the documents associated with the refinancing and all of her credit card statements, her installment plan receipts, her bank statements, her pay stubs, Samuel’s pay stubs, and anything else that might have anything to do with their finances.
Helen asked if she should bring her grocery receipts and the like, and the lawyer said absolutely – anything she had that could help him get a complete picture of their financial situation. They made an appointment to meet again once Helen had gathered all of this material.

In the meantime, the lawyer did some research into consumer protection, contract law, and banking and real estate law. He did not find a particular case or statute that would completely solve Helen’s problem, but he believed he could cobble something together with what he found. However, before doing so, he wanted to learn more about Helen and her life and have a better understanding of her goals.

At the next appointment, the lawyer explained to Helen that he was unsure exactly how he could use the law to help her, but that they would figure out a way to ease her financial burden. He suggested that they go through her bills and financial documents together in order to develop a fiscal plan. In addition, inquired about more details of Helen’s life in an effort to better understand how to help her.

Luckily, Helen had kept meticulous records of what she and Samuel spent, what they made, and what they owed. Over the next several hours and two subsequent meetings where Helen brought documents she either had not yet received or had since discovered, they pored through these records, while Helen narrated them, filling in gaps when prompted by her lawyer’s questions or her own sense that further explanation might be needed. Here is the story that emerged.

Helen and Samuel had known each other their whole lives. Growing up, because Samuel was a couple of years older than Helen, he never much gave her the time of day. It was his younger sister Jeannie with whom Helen used to spend every waking moment. But once Helen became a teenager, Samuel started to notice her, and the two began dating. Samuel joined the service on his twenty first birthday, and he was immediately deployed to Vietnam. Two years later he came home, and they got married.

Until about three years ago, Samuel worked regularly as a carpenter and continued to be active in the army reserves. Helen had always loved kids and had worked with them for as long as she could remember. She left school after eighth grade so she could help her mother take care of her eight younger siblings, and she started getting jobs as a paid nanny for other people or as a helper in day care centers. She and Samuel
tried for many years to have children but never succeeded. Not having children of her own has been one of Helen’s biggest disappointments.

With both of them working steadily, plus Samuel’s veteran’s pay, Helen and Samuel managed to get by pretty well. About ten years ago, they decided they had enough money saved to buy the house they had been living in as renters for almost their entire marriage. They even got a pretty decent fixed rate mortgage.

Things got difficult over the last three years. Helen, who had always struggled with her weight and had a history of obesity and diabetes in her family, had grown increasingly infirm, and she finally had to confront the reality that she could no longer get around well enough to work with kids or really do anything much on her own outside the house. She started to get social security disability benefits, which helped, but did not fully replace the income she was making before.

Samuel was also having trouble making money. According to Helen, Samuel was never the same after he got back from the war. She said something seemed broken inside of him, which is why she thinks he began to drink. However, Helen did not care that much because he never got violent and the beer took the edge off and made it possible for him to be in the world with her. But, his drinking got worse and began getting in the way of his work; he could not seem to hold down jobs for very long. There were long stretches when his only income was his army benefits, and those did not replace his carpentry earnings.

Thus, Helen turned to credit cards and installment plans and then to refinancing their house. This is how they got to where they are now.

As he gathered this information from Helen, her lawyer began imagining the role he could play in helping Helen resolve, at the very least, her financial struggles. They punched numbers into the calculator to get a sense of what Helen and Samuel could count on for income, and what they absolutely needed to spend every month. The lawyer came to understand that for a homebound woman not to have access to television, for example, was an unreasonable sacrifice, so cutting out cable was not an option. And Helen came to understand, for example, that monthly trips to Atlantic City were not possible, but that once she got some of her debt paid off, they could start going every 6-8 weeks. Helen and her lawyer developed both a short-term and a long-term budget that would allow her and Samuel to live but also to continue to pay down their debts so
they could avoid having to declare bankruptcy or another credit crunch.

Because the threat of foreclosure was imminent, the lawyer began working on a strategy to protect their mortgage. On the advice of a local nonprofit agency that acted as both a watchdog of banks and mortgage brokers and a counselor for low-income clients in mortgage crisis, the lawyer bypassed the mortgage broker and initial lender, and instead focused on tracking down the current holder of Helen’s mortgage using Helen’s monthly mortgage statements as a kind of trail map.

Once the lawyer found the current lender, he proposed a simple solution to the mortgage crisis: “rescind the loan, refinance at a fixed rate with monthly payments that Helen could afford, and avoid the financial and logistical costs of foreclosure, and having a bad loan on your books.” The lender countered by offering a probationary six month loan at the lower rate, during which time Helen had to make all her payments on time and in full. If Helen could meet these requirements, the lender would convert the loan to a thirty year loan at the fixed rate. The lawyer agreed, provided that the lender would waive the two months of nonpayment. The lender agreed, and thus foreclosure was averted.

Helen’s lawyer did not stop there. He then negotiated with the individual credit card companies, varying his approach depending on the size and nature of the debt, and on the personality of the particular employee whom he was dealing with. He was able to convince some of Helen’s creditors to discharge her debts completely, however, for the most part he was able to negotiate to have them consolidated and reduced through interest-free, low monthly payment plans over the next six to twelve months.

After two months, Helen’s lawyer had resolved all of her debts – either discharged or packaged into a payment plan. As a result, Helen was no longer receiving threatening letters, she had a mortgage she could manage, and she was in control of her finances.

C. Deconstructing This Story

This story about Helen and Samuel is very different from the predatory lending story, both substantively and technically.

First, the plot: Helen’s “steady state” is simply living her life, struggling to make ends meet on limited resources and mounting expenses. The “trouble” is Samuel’s increased inability to work steadily and Helen’s
increased infirmity, resulting in rising credit card and consumer debt and a mortgage they could not afford. The resolution, rather than to return Helen to her pre-trouble steady state, was a new steady state where Helen was financially stable and had a long-term plan to maintain this stability.

In this story, the “steady state” and the “trouble” are subtle and slow-moving, almost intertwined. There is no clear moment when things shift from “okay” to “not-okay” – the crisis was slow in developing and slow to resolve. The story is not over when Helen goes to the law office. In fact, part of the plot of the story is the relationship between Helen and her lawyer – together they identified and worked toward the transformation that resolved the trouble.

The main character is still Helen, but she is not the victim that she was in the predatory lending story. Rather, she is an empowered black woman who is struggling in the face of life’s challenges – the challenge of poverty, the challenge of disappointment, the challenge of devastation caused by war, the challenge of a loved one’s alcoholism, the challenge of poor health. We recognize in this protagonist not the wife whose nose turns into a sausage, but rather someone closer to Willie Loman or George Bailey – characters who work hard, may have made some poor choices, but who are not trying to deceive anyone or attain anything they do not deserve.

There is no villain in this story, nor is there a fairy godmother who swoops down to fix the mess that Helen got herself into. The lawyer, a main character in the story, is not the traditional litigator of predatory lending cases whose goal is to defeat the bad guys, even though, here there are no bad guys. Rather, the lawyer is Helen’s guide, her advisor, and her counselor, negotiating with her creditors (negotiations which could have ended up in litigation), but also helping Helen put together a financial plan that she and Samuel could live with.

93 See Arthur Miller, Death of a Salesman (1949).
94 See It’s a Wonderful Life (Liberty Films 1946).
96 In addition to the various proposals and current legislation aimed to remedy the plight of victims of predatory lending, various scholars and policymakers are calling for new and different approaches, focused on things like financial education. Surveys have shown that low-income consumers do less comparison shopping and know less about personal financial issues than those consumers in higher income brackets. Because the market itself—and particularly the loan market—is so opaque, folks who do not have market or financial savvy are at a
The moral of this story is more complicated than that of the predatory lending story, perhaps because it is more nuanced, less caricatured. The story derives from the facts of Helen and Samuel’s reality – their history, their struggles, their worries, and their desires. In addition, the plot is driven by Helen’s vision of a future with greater economic stability and less financial stress. The story boils down to the protagonist and her husband getting their affairs in order and taking a strong disadvantage, and more likely to fall prey to the high interest, high stakes loans. A solution to this would be to offer educational opportunities targeted at low-income communities to give families and individuals in those communities more information that they can use to shop around and recognize predatory or other bad loans. See, e.g., Matt Fellowes, Making Markets an Asset for the Poor, 1 HARV. L. & POL’Y REV. 433, 453-55 (2007). Many states offer general financial literacy courses in high school and beyond. See id.; see also Laurie A. Burlingame, A Pro-Consumer Approach to Predatory Lending: Enhanced Protection Through Federal Legislation and New Approaches to Education, 60 CONSUMER FIN. L.Q. REP. 460, 484-85 (2006) (describing, “harnessing the power of the online environment” both to provide information to would-be borrowers and to keep would-be lenders accountable (and thereby less unscrupulous?). In addition, state and local initiatives are springing up to provide more appropriate financial services to low-income people. For example, the city of San Francisco has formed a partnership with 20 banks and credit unions whereby the financial institutions are working together to design banking products that will more effectively meet the needs of low-income consumers, thus reducing the lure of high-priced, often predatory alternatives. See Fellowes, supra, at 447-48. Michael Barr and Rebecca Blank propose that government and financial institutions develop a range of financial service products specifically designed to help low and middle-income households meet their financial needs of receiving income and paying bills. See Michael S. Barr, Financial Services, Saving and Borrowing Among Low-and Moderate-Income Households: Evidence from the Detroit Area Household Financial Services Survey, in INSUFFICIENT FUNDS: SAVINGS, ASSETS, CREDIT AND BANKING AMONG LOW-INCOME HOUSEHOLDS 66 (Michael S. Barr & Rebecca Blank, eds., April 2009). Rather than traditional bank accounts, which usually have overdraft and other hidden or back-end fees, they propose accounts and services that are more realistic and responsive to the actual needs of low-income persons. See Barr, supra, at 30-31. In addition, Jeanne Charn has done a number of projects describing alternative kinds of legal services that could be provided to help clients either stay in their at-risk homes, or move out and into more stable financial situations. See, e.g., Jeanne Charn, Preventing Foreclosure: Thinking Locally, Investing in Enforcement, Playing for Outcomes, (March 2006) (draft on file with the author).
realistic look at what they can and cannot afford and preparing to do what it takes to keep their finances in order. As a reward for that hard work and pragmatism, their burden is lightened – some of their debts are discharged, some are reduced, and some are stretched out. Just as there are no good guys and bad guys, there are no winners and losers. Helen and Samuel tighten their belts a bit and their creditors agree to accept fifty cents on the dollar. Everyone lives happily ever after.

This story is also different because it is not written down anywhere (except here). It is a story that Helen and the lawyer spun together over the course of their relationship. Pieces of it were uncovered in the initial client interview and then in the subsequent fact-gathering. Other parts evolved as the lawyer worked with Helen to develop a plan for discharging or consolidating the debts. And still others emerged as they constructed a budget and planned for the months and years to come. As such, it is a fluid story, one that is flexible and changing.98

Finally, this story is not a case.99 It does not take place against the backdrop of litigation or a judge’s ruling. Thus, the role of the law is very different from what it was in the predatory lending story where Helen’s lawyer worked hard to fit the facts into what he understood the law to require.100 In this second story, the

97 See Grose, Once Upon A Time, supra note 7, at 181.
98 As a relatively recent crossover from the world of litigation to the world of “legal planning” and transactional work, I was curious about whether this term was used in the latter context. I ran a query on the law clinic listserv and the transactional/business clinic listserv and discovered that no, it is not, except by crossovers like me. In the non-litigation context client work is described as “matters,” “files,” “projects,” etc. When pushed to explain the differences between those kinds of terms and the term “case,” non-litigation lawyers described a “case” as more narrow, driven by the context and rhythm of the courtroom, and with a definite beginning and end. The other terms represented more open-ended and self-defined kinds of lawyering work for clients.
99 I am reminded here of the famous scene in “Anatomy of a Murder” where Jimmy Stewart, as the defense attorney, coaches his client to come up with a story that would fit into a murder defense:

“Defense Attorney (DA): There are four ways I can defend murder. Number one, it wasn’t murder . . . Number two, you didn’t do it. Number three, you were legally justified . . . Number four, the killing was excusable.

Defendant (D): Where do I fit in to this rosy picture?
DA: I’ll tell you where you don’t fit – you don’t fit in to any of the first three.

...
law took a back seat to the facts and lived context of Helen’s life.101

In the second story, rather than striving to fit the facts into a predetermined substantive and technical context, the lawyer gathered Helen’s facts first. He heard her story, pored through her documents, consulted with her about her concerns, and then he found the legal means and methods that could interact with those facts to achieve Helen’s goals. Also, the law itself was no magic wand. Sure the lawyer conducted legal research and came up with some consumer protection

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**D:** What are you telling me to do?

**DA:** I’m not telling you to do anything. I just want you to understand the letter of the law.

**D:** Go on.

**DA:** Go on with what?

**D:** Whatever it is you’re getting at.

**DA:** You know, you’re very bright Lieutenant. Now let’s see how really bright you could be.

**D:** Well I’m working at it.

**DA:** All right now because your wife was raped you’ll have a favorable atmosphere in the courtroom . . . What you need is a legal peg so the jury can hang their sympathy in your behalf. You follow me?

**D:** Uh huh.

**DA:** What’s your legal excuse Lieutenant? What’s your legal excuse for killing Barney Quill?

**D:** Not justification?

**DA:** Not justification.

**D:** Excuse, just excuse. What excuses are there?

**DA:** How should I know? You’re the one who plugged Quill.

**D:** I must have been mad.

**DA:** How’s that?

**D:** I said I must have been mad.

**DA:** No, bad temper’s not an excuse.

**D:** I mean I must have been crazy. Am I getting warmer?

**DA:** Okay see you around.

**D:** Am I getting warmer?

**DA:** I’ll tell you that after I talk to your wife. In the meantime, see if you can remember just how crazy you were.”

**Anatomy of a Murder** (Columbia Pictures 1959).

100 See Brooks & Gewirtz, supra note 48, at 31; see also generally Grose, A Persistent Critique, supra note 6; Peggy C. Davis, Law and Lawyerin: Legal Studies with an Interactive Focus, 37 N.Y.L. Sch. L. Rev. 185, 186-87 (1992); Gerald P. Lopez, Reconceiving Civil Rights Practice: Seven Weeks in the Life of a Rebellious Collaboration, 77 Geo. L. J. 1603 (1989).
and other regulatory tools to use as leverage with creditors, but what really resolved Helen’s “trouble” was the lawyering he did, i.e. fact-gathering, investigation, client counseling, negotiation, contract-drafting, letter-writing. Unbundled from the law, these legal skills helped Helen, Samuel, and the rest of the characters live happily ever after.  

D. Imagining That Everything is Relevant

In telling these two stories, I suggest that lawyers, in representing their clients, could do more to imagine the universe of problems and solutions before settling on one story. People tend to define problems by what solutions might be available. Put another way, we recognize the “trouble” in part by understanding its possible resolution. That is what happened in the first story: Helen’s lawyer constructed her story to fit in to the lawyer’s understanding of how it could be resolved, based on the currently existing predatory lending laws.

The second story, however, developed in a different way. Neither the lawyer nor Helen knew the solution, and the lawyer indicated as much to Helen at their second meeting. But he did not say, “Therefore, I can’t help you;” or, “I can help you with the juicy predatory lending

101 When I presented an earlier version of this piece, and indeed, in the case rounds discussions of the actual client’s situation, some form of this question was raised: Is this really legal work, helping clients figure out budgets and consolidate credit card balances? A discussion of the difference between law and social work, let alone the problems with multi-disciplinary practice, is beyond the scope of this piece. However, Nathalie Martin at the University of New Mexico School of Law has done some work on training law students to be proficient in financial terms so that they may provide a form of financial counseling to their clients. See generally Nathalie Martin, Poverty, Culture and the Bankruptcy Code: Narratives from the Money Law Clinic, 12 Clinical L. Rev. 203 (2005). Her website is also a wonderful resource. See University of New Mexico School of Law, Financial Literary Class, http://lawschool.unm.edu/finlit/class.php (last visited January 18, 2009); see also Jeanne Charn & Rebecca Sandefur, Learning from Service: Using Service-Embedded Research to Improve the Practice and Target of Legal Assistance (2005) (presenting the research design and preliminary results from a study on the impact of a foreclosure prevention project on clients’ foreclosure outcomes) (draft on file with author); infra note 102 (discussing lawyering for poor people as opposed to wealthy people).

case, but not with the other problems because they’re not really legal problems.” Instead, he told her he was unsure exactly what legal remedies might be available, but that he was interested in working with her to figure it out. The “trouble” was defined simply as what it was — a stack of cancelled checks and credit card bills and nasty letters from creditors. It was only one piece of Helen’s life, not her whole life and not what defined her. Thus, the solution emerged from that stack of papers, slowly, piece by piece, until the client’s trouble had been resolved.

These two stories reveal that context can change everything. It can change the plot and characters of the story, the genre and moral of the story, how the story is framed, when it begins and when it ends, and it can change the role of the law and the role of the lawyer in constructing the story. Helen’s lawyer in the second story, because he was open to different plots, characters, genres, and morals, was able to free himself from a particular role and a particular relationship with the law, and thus construct a different kind of story.104

Lawyers are not the only ones who need to be freed up in this way. Why, do we imagine, did Helen in the first story not insist that the lawyer deal with her credit card debt as well as her mortgage crisis? I suggest it is because she did not believe that she had a story to tell to a lawyer, let alone one that would entitle her to any legal relief. In Helen’s world, folks go to lawyers armed with their crisis stories: the child welfare worker has taken their kids, they have received an eviction notice, and their husbands have beaten them up. In her mind, no less than in the mind of the lawyer, laws that work for poor people do so only at the moment of crisis, when they are the most vulnerable, the most desperate, and the most in need of that fairy godmother.105

As a result, the stories available to clients like Helen are exactly like the first story her lawyer told: the story about the victim who needs to be rescued, even though, behind that story, there are a multitude

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103 See Davis, supra note 100, at 186-87; Grose, A Persistent Critique, supra note 6, at 332; see also Grose, Once Upon A Time, supra note 7, at 189.

104 As Claudia Angelos remarked at the Clinical Legal Theory Workshop where I presented an earlier version of this piece, this really is an issue for lawyers for poor people. Lawyers for rich people (and certainly for corporations) do this kind of preventative or planning work all the time. Why do we frame it differently for poor people? See Claudia Angelos, Remarks at the New York Law School Clinical Legal Theory Workshop (Oct. 16, 2008).
of others that could be told that may result in a better long-term and empowering solution for the client. Because of what Helen and the first lawyer believed about the role of the law in the lives of poor people, the stories with the better results do not end up getting told.

This article began with the proposition that lawyers are not only storytellers but also active participants in the construction of stories, by choosing what story to tell and how to tell them. What the two stories have illustrated, however, is that lawyers must act with greater awareness and intentionality about the choices they make when constructing and telling their client’s stories.

In particular, lawyers need to recognize their power in relation to the law, but remember that it is only one element, amongst many, in the stories we hear, construct, and tell. Lawyers must have the confidence to wrestle with the law to make it fit their clients’ lived realities, rather than funneling our clients’ lived realities into what they understand the law to require. When the law defines the story, the point is missed. In order to determine the circumstances in which predatory lenders find their prey, lawyers must be open to hearing and telling different stories in different ways.

A concrete way to do this would be to begin with the proposition that everything the client tells the lawyer is “relevant,” that every trouble the client has will be resolved (because we know all stories have to end somehow), and that lawyers have the skills to figure out how to get there.

105 See Grose, Once Upon A Time, supra note 7, at 189.
106 I am reminded here of Lucie White’s description in “Notes on the Hearing of Mrs. G” of the process the lawyer went through in “choosing” which story to tell at the hearing – the “estoppel” story or the “life necessities” story. See Lucie White, supra note 10, at 27. That piece was the first to articulate the theory of collaborative lawyering or critical lawyering theory that the client is actually an expert in her own life, and should be seen as such by the lawyer.
107 Davis, supra note 100, at 188.
Of Victims, Villains and Fairy Godmothers: Regnant Tales of Predatory Lending

IV. Other Stories

I, too, made choices about what stories to tell and how to tell them. I made those choices with the particular intent to demonstrate the stark differences between the two stories and what those differences tell us about lawyers ability to craft such stories.

The first story was one framed by the litigation. As such, it was adversarial and crisis-driven, with very high stakes. There were clear winners and losers, good guys and bad guys. The second story, on the other hand, was one framed by the relationship between the lawyer and the client. It was more slow-moving and fluid. The characters were more nuanced and the story evolved in such a way as to make real change and progress seem possible.

The lawyer in the first story was written to seem less reflective about and hamstrung by his understanding of the law. He represented the default reaction that lawyers should not have when working with their clients to construct stories about the intersection between the clients' lives and the law. The lawyer in the second story, on the other hand, was written to seem more reflective, more collaborative, and more holistic in his approach to working with the client to solve her troubles. He represented the reactions lawyers should have when working to construct stories with their clients that both accurately reflect their clients' lives and succeed in achieving their goals.

Let me be clear: it is not that high-stakes litigation based storytelling is bad and that lawyers who tell such stories are unreflective and unholistic. Nor is it that the kind of storytelling that took place in the second story is good and the lawyers who tell those stories are necessarily reflective and holistic.

On the contrary, all lawyers and all lawyering have the potential to be both reflective and holistic (and unreflective and unholistic). None of these stories should necessarily, automatically, and unreflectively be privileged as the default story to tell. Lawyers should view everything their clients tell them as relevant – not only the facts, but also the client’s goals and desires as well. Lawyers, as the constructors of their client’s stories, must understand the law and how to use it to meet such goals and desires.

These two stories are both equally possible. They are, perhaps, serial, not alternate stories.110 If lawyers can come up with long-term, empowering solutions to their client’s problems, new clients will go to them seeking such solutions. If lawyers start telling these stories and continue to tell them, others will start hearing them too. That is how the law changes.

Ultimately, this article discusses the use of the narrative framework as a way to expose lawyering techniques. The lens of narrative theory is a variable lens: it can widen when necessary to better understand and achieve the client’s goals, and it can contract when a narrower view better presents the client’s stories. Likewise, the skills lawyers employ are variable skills – when necessary they can be used to bully, to persuade, to smooth over, to rough up, but most importantly, to better understand and achieve our clients’ goals.

A lawyer who is open to narrative can acknowledge the complexity of the problem presented and incorporate the context in which the problem arises. Lawyers should seek to hear and understand their clients’ stories, with an eye toward collaboratively constructing new stories that address their clients’ goals and concerns. This approach to solving problems recognizes the agency of the client, yet makes room for the reality that agency might mean very different things to different people. Thus, lawyers who are open to narrative allow Helen and Samuel – the individuals at the center of these problems – to determine what story to tell, when to tell it, and what role they want to play in its construction.

109 And in fact, that is what they were. In “real life,” the student lawyers who represented “Helen” told her predatory lending first, and then, the following year, a team of students worked with her to get her credit and debt situation in shape to avoid bankruptcy or another housing crisis.
CAUSES OF THE SUBPRIME FORECLOSURE CRISIS AND THE AVAILABILITY OF CLASS ACTION RESPONSES

Gary Klein & Shennan Kavanagh*

The pervasiveness of toxic subprime refinance mortgage loans is destroying entire communities. Record numbers of foreclosures are being driven by astronomical default rates on subprime loans, rates that exceed twenty percent on some portfolios. More problems are anticipated in

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1 See Faten Sabry & Thomas Schopflocher, The Subprime Meltdown: A Primer (2007), available at http://www.nera.com/publication.asp?p_ID=3209 (noting subprime loans are high interest loans made to borrowers who are perceived to present higher risk of default). Between 1995 and 2005 the percentage of subprime mortgage refinance loans increased from five percent to twenty percent of all mortgages made. Id. As of 2007, there is approximately $1.3 trillion in subprime mortgage loans outstanding. Id.

2 Refinance loans are distinct from purchase-money loans in that the borrower already owns the home that will be security for the loan. Federal law recognizes this distinction and provides cancellation rights to homeowners who obtain refinance loans. 15 U.S.C. § 1635 (2006). As discussed below, these rights have proven insufficient to prevent a crisis grounded in predatory lending practices.


4 According to the Federal Reserve Board, more than twenty percent of all subprime loans are seriously delinquent, as are one in ten securitized near-prime loans. Ben S. Bernanke, Chairman, Bd. of Governors of the Fed. Reserve Sys., Housing, Mortgage Markets, and Foreclosures, Speech at the Federal Reserve System Conference on Housing and Mortgage Markets (Dec. 4, 2008) (transcript available at http://www.federalreserve.gov/newsevents/speech/bernanke20081204a.htm). See also, e.g., Dan Immergluck, Foreclosed: High-Risk Lending, Deregulation, and the Undermining of America’s Mortgage Market 30 (Cornell University Press 2009). See also Vikas Bajaj &
the future as the bill comes due on certain forms of gimmicky products that defer interest by negative amortization, leading to significant payment increases two or three years into the loan term. These increases are virtually guaranteed to generate monthly obligations that are beyond many borrowers’ ability to pay.\(^5\)

Foreclosures are not just a catastrophe for individual homeowners; they also reduce tax rolls, lead to neighborhood deterioration due to property abandonment and vandalism, and generate a cycle of declining property values.\(^6\) Indeed, many point to the poor credit quality of subprime loan portfolios as a leading cause of the nation’s current economic problems.\(^7\)

Loan-by-loan solutions, whether by individual litigation or negotiated loan restructuring arrangements, are costly and inefficient.

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\(^5\) As of December 2008, twenty-eight percent of Payment Option Arm (“POA”) Loans were delinquent or in foreclosure, according to LPS Applied Analytics, a data firm that analyzes mortgage performance. Ruth Simon, *Option Arms See Rising Defaults*, WALL ST. J., Jan. 30, 2009, at A1. Nearly sixty-one percent of POAs originated in 2007 will eventually default, according to a recent analysis by Goldman Sachs. *Id.* Goldman further estimates that more than half of all POAs originated in any year will default. *Id.* See also John Leland, *Loans that Looked Easy Pose Threat to Recovery*, N.Y. TIMES, Aug. 27, 2009, at A12.

\(^6\) The City of Cleveland unsuccessfully pursued a lawsuit against a variety of subprime mortgage lenders in which the core claim was that lending practices constituted a public nuisance because of the resulting foreclosures and neighborhood deterioration. See City of Cleveland v. Ameriquest Mortgage Sec., Inc., 621 F. Supp. 2d 513, 516 (N.D. Ohio, 2009).

\(^7\) E.g., Immergluck, *supra* note 4, at 3; Kurt Eggert, *The Great Collapse: How Securitization Caused the Great Subprime Meltdown*, 41 CONN. L. REV. 1257, 1260-61 (May 2009). The national economic downturn reinforces the foreclosure problem as joblessness and underemployment lead to new rounds of defaults. Because many subprime borrowers have loans that require an extraordinary portion of their income, even small economic changes like loss of overtime income, divorce, or wage concessions can lead to default or foreclosure. See Elizabeth Warren & Amelia Warren Tyagi, *The Two Income Trap: Why Middle Class Mothers and Fathers are Going Broke* 136-37 (2003).
Affected homeowners have inadequate funds to cover the costs of private counsel, and relatively few cases have sufficient damage potential to justify contingent fee arrangements. Despite the heroic work of legal services lawyers and housing counseling agencies, legal and counseling resources are inadequate to the problem.9

This article, written by lawyers experienced in consumer protection and class actions, will describe some of the systemic problems that led so many homeowners into unaffordable subprime loans. For each contributing factor, the authors discuss recent and current class litigation generated to create aggregate remedies. Some of that litigation has been successful, some less so. The article will conclude with a discussion of the role of class litigation in the current policy debate. The authors describe the value of case resolutions that include effective loan modification relief as a class remedy and how such resolutions may address homeowner needs more effectively than cash.

A. The Illusion of “Risk Based” Pricing

“Risk-based” mortgage pricing is a frequently overlooked contributing factor to both the explosion of subprime lending abuses and to foreclosures. The proponents of risk-based pricing have asserted that a closer tie between credit risk and mortgage prices leads to more borrowing opportunities for borrowers with fewer resources or with checkered credit


9 Few lawyers have the background to fully understand, let alone litigate, under complex and often technical consumer protection laws. The National Consumer Law Center, an advocacy organization, publishes a helpful series on virtually every aspect of consumer law. Several of the manuals in the series are directly relevant to the issues discussed in this article. See generally JOHN RAO et al., Nat’l Consumer L. Ctr., Foreclosures (2d ed. 2007) [hereinafter Rao et al., Foreclosures]; ELIZABETH RENUART et al., Nat’l Consumer L. Ctr., Truth in Lending (6th ed. 2007) [hereinafter Renuart et al., Truth in Lending]; ELIZABETH RENUART et al., Nat’l Consumer L. Ctr., Cost of Credit (4th ed. 2009) [hereinafter Renuart et al., Cost of Credit].
profiles. Risk-based pricing has thus been closely linked with policies favoring expansion of homeownership.

Another argument in favor of risk-based pricing is that it protects responsible borrowers with good credit scores from paying an interest rate premium justified by the expectation of higher default rates associated with loans to more risky borrowers. Certainly this is appealing, conceptually, because it implies that the mortgage industry can serve low-income borrowers’ needs and assign the extra cost of doing so where it belongs – on those who generate additional risk.

In practice, however, risk-based pricing is a disaster for those at the bottom of the economic ladder. There are three reasons for this result. First and most obviously, charging higher interest rates to people with fewer resources leads to a self-fulfilling prophecy. When those facing economic pressures need more of their limited economic resources to service their mortgage debt, the default risk goes up.

Higher rate loans are, de facto, more expensive and, therefore, harder for vulnerable homeowners to manage.

Second, the idea that a lender can effectively assign risk based on credit factors is chimerical. In more than one study, credit reports have been found to be replete with errors. A borrower whose profile

12 White, supra note 10, at 504.
13 The problem is exacerbated because these same borrowers are also likely to be charged higher rates for car loans, credit cards, student loans, and, according to some studies, even for groceries. See Warren & Tyagi, supra note 7, at 136-37.
14 Anne Kim, Taken for a Ride: Subprime Lenders, Automobility, and the Working Poor 9 (Progressive Policy Institute 2002), available at www.ppionline.org/documents/Automobility_1102.pdf (Table 2: Impact of Subprime Interest Rates shows a five year loan with a principal balance of $10,000).
16 Consumer Fed’n of Am., supra note 10 at 6-7; Robert B. Avery et al., An Overview of Consumer Data and Credit Reporting 50 (2003).
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includes a poor credit score may have been a victim of identity theft or simple error. Further, even if credit reports were solely based on accurate information, people can have low credit scores for entirely benign reasons that are unconnected to future risk. A borrower whose low credit rating reflects a temporary period of unemployment due to a now-resolved family health need, for example, can have the same poor credit score as someone whose problems arose from an unresolved gambling addiction. Yet, in risk-based pricing models, both would receive the same subprime interest rate.

Third, and most problematic, unscrupulous lenders have seized on popular perceptions of risk-based pricing to manipulate some borrowers into accepting more profitable higher rate loans. Loan officers and mortgage brokers have long been incentivized to mark-up borrowers’ interest rates. A popular way of getting a borrower to accept a marked-up rate is to tell that borrower that her credit score was lower than anticipated, whether that information is true or not, or that some other perceived blemish mandates a mark-up. Often this occurs at the closing table, to justify a rate higher than originally promised. At the end of the day, there is little evidence that prices on subprime loans accurately reflect their risk.

The psychology that allows the latter abuse is grounded in the perceptions that lenders’ pricing models are effectively objective and that credit scores do not lie. The reality, however, is not only that credit scores do not accurately reflect risk, but also that loan officers and mortgage brokers have lied and have done so often.

Yet, a class action response to this problem has been elusive. Because credit scores are ordered from third party credit reporting agencies, it is difficult to pin inaccuracies on the lending community unless the inaccuracies originated with information reported by that


18 See White, supra note 10, at 506.

lender. Moreover, the misuse of credit scores, including misrepresentation to consumers about their impact on borrowing options, tends to be an individual issue that is not susceptible to class treatment. There may be a different result when mortgage lenders override credit scores with their own, generally proprietary, mortgage scoring systems. When those systems include consistent errors, class litigation may be possible.

More tangentially, many class action cases under the Fair Credit Reporting Act challenge systemic problems in credit reporting. One recent set of such cases, for example, challenged the way in which debt discharged in bankruptcy is reported. Other cases have challenged reporting of bankruptcies in the record of non-debtor cosigners, improper use of credit reports in insurance pricing, and failure to disclose complete information to requesting consumers about their own

20 Furnishers of information to credit reporting agencies are generally protected from liability except in limited circumstances. See generally Wu & DeArmond, supra note 17, at § 6.10. The creditor does, however, have a duty to reinvestigate based on request by the consumer and can be held liable for failure to reinvestigate. 15 U.S.C. § 1681s-2(b) (2006). See also Nelson v. Chase Manhattan Mortgage, 282 F.3d 1057, 1059-60 (9th Cir. 2009) (finding private right of action for failure to reinvestigate).

21 See Ori v. Fifth Third Bank, 603 F. Supp. 2d 1171, 1173 (E.D. Wis. 2009). The consumer’s obligation to request reinvestigation described in the previous footnote makes class treatment difficult. Id. at 1174.


A handful of other cases have challenged negligent conduct leading to increased risk of identity theft. These cases, when successful, should have the effect of improving the credit reporting and credit scoring system. This should, in turn, help alleviate the unfairness inherent in a risk-based price that is grounded in a fundamental mis-assessment of risk.

B. Excessive Origination Costs and Fees

Although a lender’s main profit center is the resale of mortgages to investors on the secondary market, and has been so for many years, those profits are now enhanced by virtually unfettered access to fee-based origination income. This income takes many forms. Lenders typically charge application fees, underwriting fees, processing fees, origination points, and a host of other mystifying and often unexplained settlement charges. These fees are typically financed from the proceeds of the loan and add to a borrower’s loan costs. Additionally, the fees are often duplicative such that many borrowers pay application fees to both lenders and brokers. In other cases, fees are charged for work that is not actually performed. Moreover, fees can be in amounts that bear no relation to


29 The Truth in Lending Act and its implementing regulations contain a basic definition of finance charge such that it includes fees that add to the cost of credit. 15 U.S.C. § 1605 (1995); 12 C.F.R. § 226.4 (2009). Unfortunately, many consumers still look only at the interest rate without recognizing these additional credit costs.

30 E.g., Jenkins v. Mercantile Mortgage Co., 231 F. Supp. 2d 737, 749-50 (N.D. Ill. 2002) (charges for which no benefit was provided may violate state unfair trade practice law).
the value of the service provided.\textsuperscript{31}

Origination points are often the largest single source of fee-based income. These points are calculated as a percentage of the loan balance, and one to five origination points are common in subprime transactions.\textsuperscript{32} These amounts come off the top of the borrower’s loan. For example, a subprime borrower with a loan of $200,000 paying three “origination points” really receives only $194,000 in loan proceeds but pays interest for the life of the loan on the full $200,000. Not only does the borrower never have real use of $6,000, but, to add insult to injury, she pays interest for use of that amount. Other loan fees financed in the transaction have the same effect.\textsuperscript{33}

When charged, the effect of such points on a borrower’s effective rate can be profound. If the borrower finances the additional $6,000 in points over thirty years at eight percent interest, the total carrying costs for money that the borrower never really received is nearly $16,000. Even more perniciously, if the loan is paid back early by refinancing, the points (and other prepaid finance charges) act as a \textit{de facto} prepayment penalty.\textsuperscript{34} The borrower must repay the fees in full from the proceeds of the refinancing as, unlike interest, prepaid finance charges come due in full as of the date the loan is closed. The new refinance loan thus effectively capitalizes these finance charges and the borrower is obligated to pay additional fees and interest to repay sums that she never actually received.

Another common problem involves payment of points to receive a purported rate buy down or discount. Some lenders charge discount points that do not provide a real discount – thus charging borrowers but providing nothing in return.\textsuperscript{35} Other lenders load the dice by providing

\textsuperscript{31} See \textsc{Renuart et al.}, \textsc{Cost of Credit}, supra note 9, § 12.2.1.7 (discussing excessive, unearned and duplicative fees).

\textsuperscript{32} One point represents one percent of the loan amount. \textit{E.g.}, \textsc{Black’s Law Dictionary} 1275 (9th ed. 2009).

\textsuperscript{33} The interest rate can thus effectively mislead borrowers about the real cost of borrowing. See \textsc{Renuart et al.}, \textsc{Truth in Lending}, supra note 9, § 3.2.3.

\textsuperscript{34} \textit{Id.} § 3.8.3; \textsc{Renuart et al.}, \textsc{Cost of Credit}, supra note 9, §§ 6.3, 7.2.2.

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discounts that are not a fair exchange for the number of points charged.

Consumers are rarely able to do the necessary calculations to evaluate the costs and fees on their loans. They are misled by the idea that they are receiving a “discount” without understanding what they pay for that perceived privilege. The benefit of the discount, if any, can only be achieved by staying in the loan long enough that lower monthly payments attributable to the lower rate exceed the amount paid in points. Because consumers do not understand this trade-off and can rarely calculate the latter crossover point, many have paid thousands (or tens of thousands) in discount points with little or no benefit in return. In the boom years of refinancing, consumers rarely kept the loan long enough to receive sufficient benefit. And lenders exacerbated the problem by touting the chimerical benefits of early refinancing, which often imposed a new set of points and fees.

Similar problems arose with prepayment penalties. For many years borrowers agreed to loans with prepayment penalty provisions without receiving any benefit in return. When lenders marketed aggressively to borrowers during the period of the penalty, borrowers often failed to understand the prepayment penalty as a hidden cost of refinancing. Undoubtedly, some lenders do provide lower rates to borrowers whose loans include prepayment penalties and offer consumers a meaningful choice between the higher rate and the penalty provision. But again,

36 Lenders are not required to inform consumers of the amount of the rate discount they are paying for. Unsophisticated consumers are unlikely to ask.

37 One financial reporter illustrates the complications of calculating the benefits associated with payment of discount points. Among other things, the calculations are complicated and require the homeowner to make an assumption about how long he or she is likely to stay in the home—an issue that depends on life events and planning that is far beyond the average homeowner’s capacity to control. Terri Ewing, Discount Point, Mortgage Insider, Aug. 1, 2008, http://themortgageinsider.net/glossary/discount-points.html.

38 Besta v. Beneficial Loan Co. of Iowa, 855 F.2d 532, 534 (8th Cir. 1988); In re Milbourne, 108 B.R. 522, 528-529 (Bankr. E.D. Pa. 1989); Renuart et al., Cost of Credit, supra note 9, § 6.3.2.


40 Michael LaCour-Little & Cynthia Holmes, Prepayment Penalties in Residential
even when the rate discount associated with the penalty is disclosed, it is virtually impossible for a consumer to calculate the necessary trade-offs.

Notably, though, improper fees have been challenged in a variety of class action cases. Theories have included unfair trade practice laws, unconscionability, and the anti-kickback provision of the Real Estate Settlement Procedures Act Amendments of 1975 ("RESPA"). Many such cases have led to successful settlements or judgments with commensurate refunds to homeowners.

Finally, consumers have sued lenders who generate profit centers by creating businesses or joint ventures that capture settlement charges in loans they make. These lenders pay themselves or a related company for settlement services at marked-up rates. Additionally, lenders have

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41 Renuart et al., Cost of Credit, *supra* note 9, § 12.5.3.6 (2009). See also Cohen v. JP Morgan Chase & Co., 498 F.3d 111, 126-27 (2d Cir. 2007) (reversing dismissal of UDAP claim; charging of illegal fee may constitute deception even if it was disclosed); McKell v. Wash. Mut., Inc., 49 Cal. Rptr. 3d 227, 234, 240-41 (Cal. Ct. App. 2006) (finding that lender may commit an unfair and deceptive act by leading borrowers to believe that it is merely passing through third-party charges when in fact it is charging significantly more than its costs).

42 United Companies Lending Corp. v. Sargeant, 20 F. Supp. 2d 192, 206-207 (D. Mass. 1998) (considering defendant borrower’s counterclaim that points charged by plaintiff lender were unconscionable).

43 12 U.S.C. § 2607 (2006). See also Kruse v. Wells Fargo Home Mortgage Inc., 383 F.3d 49, 62 (2d Cir. 2004) (holding that plaintiffs stated a cause of action under RESPA by alleging defendants marked-up third parties’ fees without providing additional services); Sosa v. Chase Manhattan Mortgage Corp., 348 F.3d 979, 981, 983 (11th Cir. 2003) (finding that a lender may violate RESPA by marking-up the charges of another service provider); Boulware v. Crossland Mortgage Corp., 291 F.3d 261, 265 (4th Cir. 2002) (stating that overcharges only violate RESPA when kicked back to a third party).


attempted to capture their own business for appraisals, title services, flood insurance, and even loan closings.

C. Incomprehensible Disclosures

In the last twenty years, regulation of subprime lending has largely been through disclosures of loan terms to consumers. The working legislative and regulatory assumption has been that if a consumer is told about various loan features, even if predatory, the consumer has sufficient information to make an informed choice.

One problem with a disclosure approach to consumer protection in mortgage lending is the sheer amount of paperwork associated with a given loan. Most loans involve hundreds of pages of documents at the closing table. For some, finding the most relevant disclosures is like locating a needle in a haystack.

A second problem is that mortgage loans are increasingly complicated. Variable rate loans typically contain references to obscure

47 See, e.g., Countrywide, 601 F. Supp. 2d at 1207.
48 Macheda, 631 F. Supp. 2d at 188.
interest rate matrices that are both unavailable and incomprehensible to the average consumer. The problem is exacerbated by gimmicky loan features that are designed to obscure the real cost of the loan, sometimes by overshadowing the true price of the loan with an initial rate that will only be in effect for a matter of days. Similarly, deregulation has led to ineffectiveness of TILA in conveying relevant information in a complex refinancing transaction and concluding, “[s]o much for the Truth in Lending Act as a protection for borrowers”). See also Bd. of Governors of the Fed. Reserve Sys. & Dep’t Of Hous. and Urban Dev., Joint Report to the Congress Concerning Reform to the Truth In Lending Act and the Real Estate Settlement Procedures Act 9, 17, 62 (1998), available at http://www.federalreserve.gov/boarddocs/RptCongress/tila.pdf (noting consumers’ difficulty in understanding mortgage terms with or without disclosure).

53 One loan recently reviewed by our office generates a variable rate based on the following index: “[T]he weighted average of the interest rates in effect as of the last day of each calendar month on the deposit accounts of the federally insured depository institution subsidiaries (‘Subsidiaries’) of Golden West Financial Corporation (‘GDW’), as made available by GDW. Included in the deposit accounts for purposes of the Index calculation are all of the items and adjustments that GDW uses to calculate the line item currently called ‘costs of deposits’ that appears in its quarterly and annual reports to shareholders as well as in other financial reports publicly distributed by GDW. The Index does not include deposit accounts owned by GDW or its Subsidiaries or other affiliates. The calculation of the Index includes adjustments for the effects of financial instruments related to the deposit accounts and other adjustments determined by GDW in its sole discretion as appropriate to accurately reflect the weighted average of interest rates on the deposit accounts. If an index is substituted as described in Section 2(F) of this Note, the alternative index will become the index. The most recent Index figure available on each Interest Change Date is called the ‘Current Index.’” First Amended Class Action Complaint at 7, Bettinelli et al. v. Wells Fargo Home Mortgage, Inc., No. 09-11079-MLW (D. Mass. June 24, 2009) [hereinafter Bettinelli Complaint]. The loan was made to borrowers with a high school-level education who could never have understood this index even if it were publicly available.

54 Another loan recently reviewed, also given to a borrower with a high school education, had a low fixed teaser rate in effect for just sixty days followed by the following provision for biannual payment changes: “At least 30 days before each Payment Change Date, the Note Holder will calculate the amount of the monthly payment that would be sufficient to repay the unpaid Principal that I am expected to owe at the Payment Change Date in full on the maturity date in substantially equal payments at the interest rate effective during the month preceding the Payment Change Date. The result of this calculation is called the
increasingly complex loan provisions, including confusing prepayment penalty terms, complex provisions for negative amortization and payment changes, holdbacks from loan proceeds, and mysterious fees and costs. Thus, as loans themselves become more complex, disclosures become increasingly inadequate.

Equally important is that loan officers and mortgage brokers have strong incentives to close loans in order to earn out-sized commissions. Their interactions with consumers are often designed to override disclosed information. Finally, the disclosure regime is poorly equipped to deal with the educational level of many American consumers. Many recent studies show that consumers rarely understand complex disclosures of

‘Full Payment.’ Unless Section 3(F) or 3(G) apply, the amount of my new monthly payment effective on a Payment Change Date, will not increase by more than 7.500% of my prior monthly payment. This 7.500% limitation is called the ‘Payment Cap.’ This Payment Cap applies only to the Principal and interest payment and does not apply to any escrow payments Lender may require under the Security Instrument. The Note Holder will apply the Payment Cap by taking the amount of my Minimum Payment due the month preceding the Payment Change Date and multiplying it by the number 1.075. The result of this calculation is called the ‘Limited Payment.’ Unless Section 3(F) or 3(G) below requires me to pay a different amount, my new Minimum Payment will be the lesser of the Limited Payment and the Full Payment.” Amended Class Action Complaint at 8, Hart v. Bank of Am. Home Loans, Inc., No. 09-11096-RWZ (D. Mass. July 13, 2009) [hereinafter Hart Complaint]. Importantly, the loan included complicated provisions making it virtually certain that the loan principal would increase over time triggering significant and unaffordable payment changes to amortize the balance. See generally id.

55 See Renuart et al., The Cost of Credit, supra note 9, § 5.8.
56 Id. § 4.3.1.2.
59 See infra Part E (discussion of compensation as incentives to fraud).
loan terms.\textsuperscript{60}

Despite these weaknesses in disclosure laws as consumer protection, failure to make disclosures does in some cases\textsuperscript{61} provide consumers with remedies,\textsuperscript{62} often on a strict liability basis.\textsuperscript{63} Individual truth-in-lending rescission cases for failure to make material disclosures, for example, can be an effective tool to prevent a foreclosure.\textsuperscript{64} Unfortunately, several courts have recently ruled that such disclosure failures cannot give rise to a class remedy for rescission.\textsuperscript{65} In these jurisdictions, only damage remedies are available to a class.\textsuperscript{66}

Perhaps more promising, though, is that non-disclosure can lead to state unfair trade practice remedies.\textsuperscript{67} The absence of a disclosure of a material term can be actionable for a class. The Fair Debt Collection Practices Act also requires certain disclosures in circumstances that involve servicing abuses.\textsuperscript{68} That statute specifically authorizes class claims but

\textsuperscript{60} See supra note 52.

\textsuperscript{61} Unfortunately, one area in which there has been no private right of action is for violations of the Real Estate Settlement Procedures Act requirement for early disclosure of estimated loan costs. See 12 U.S.C. § 2604(c) (2006); 24 C.F.R. § 3500.7 (2008). See also Collins v. FMHA-USDA, 105 F.3d 1366, 1368 (11th Cir. 1997). It appears that some lenders, absent potential liability and/or meaningful regulatory concerns simply dispensed with these disclosures. Note too that the regime for such disclosures will change, by amendments effective on January 1, 2010. 73 Fed. Reg. 68239 (Nov. 17, 2008) (to be codified at 24 C.F.R. § 3500.2).


\textsuperscript{63} Id. See generally Renuart et al., Truth in Lending, supra note 9, §§ 8.1-8.11.2.


\textsuperscript{65} See, e.g., Andrews v. Chevy Chase Bank, FSB, 474 F. Supp. 2d 1006, 1008 (E.D. Wis. 2007); McKenna et al. v. First Horizon Home Loan Corp., 475 F.3d 418, 422 (1st Cir. 2007).

\textsuperscript{66} 15 U.S.C. § 1640(a)(2)(B). See, e.g., Williams v. Chartwell Fin. Servs., 204 F.3d 748, 760 (7th Cir. 2000) (describing importance of TILA’s class action remedy). It is also possible that there can be a continue class claim under the TILA for consumers who have actually rescinded. See, e.g., Andrews, 474 F. Supp. 2d at 1008-1010 (decision appears to leave this possibility open).

\textsuperscript{67} For example, some courts have found that failure to make the early disclosures properly may violate state unfair trade practice laws. See, e.g., Chow v. Aegis Mortgage Corp., 286 F. Supp. 2d 956, 963 (N.D. Ill. 2003).

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caps damages at a fairly low level.\textsuperscript{69}

D. \textit{Variable Rate Loan Structures Designed for Failure}

At one time, subprime lending provided unprecedented wealth to various elements of the American financial services industry.\textsuperscript{70} As discussed elsewhere in this article, mortgage originators skimmed fees from their customer’s home equity.\textsuperscript{71} Lenders, in turn, sold mortgages virtually overnight for more than their face amounts to investors on Wall Street.\textsuperscript{72} And Wall Street reaped fee income for underwriting, packaging, marketing, and selling the securities, often to each other (or at least each other’s investors).\textsuperscript{73}

In order to sustain the boom, all of these market players needed to find new and creative ways to sustain the source of their wealth – origination volume. That is, sufficient numbers of new mortgages had to be originated each day to feed the hunger for fee income and profits in the secondary market. By late 2005, credit quality had reached bottom.\textsuperscript{74} It could not be reduced any further to create additional markets among previously underserved populations. The only alternative was for Wall Street to create ever more gimmick-laden products in order to convince

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\textsuperscript{69} 15 U.S.C. § 1692k(2)(B).
\textsuperscript{70} See, \textit{e.g.}, \textsc{Paul Muolo} & \textsc{Mathew Padilla}, \textit{Chain of Blame: How Wall Street Caused the Mortgage and Credit Crisis} 6 (John Wiley \& Sons, Inc. 2008). \textit{See also} \textsc{Charles R. Morris}, \textit{The Two Trillion Dollar Meltdown: Easy Money, High Rollers, and the Great Credit Crash} 69 (Public Affairs 2008).
\textsuperscript{71} See \textsuperscript{supra} Part B (discussing the use of “origination points” by lenders that result in a decrease of the loan’s value for the borrower).
\textsuperscript{72} See \textit{infra} Part I (explaining how the sale of loans on the secondary market allows lenders to utilize that capital to immediately originate new loans).
\textsuperscript{74} See \textsc{Immergluck}, \textsuperscript{supra} note 4, at 130.
\end{flushleft}
homeowners to refinance, often with limited or dubious benefits. The goal with most of these new product types was to allow homeowners to believe that they could get more for less. Making use of tactics first implemented in the credit card industry, lenders increasingly offered products with temporary fixed, “teaser” rates, designed to keep initial payments at artificially low-levels. These teaser rate products allowed originators to focus borrowers on temporarily affordable, low monthly payments and to distract them from the virtually guaranteed higher long-term monthly payments anticipated for the duration of the loan.

These products were offered in various permutations. Some involved teaser rates for time periods as limited as thirty days with correspondingly higher rates thereafter. Most commonly, the loans had fixed interest periods of two years, followed by higher rates and higher payments in effect for twenty-eight years. These products were commonly known as 2/28 ARMS, representing two years of fixed payments, followed by twenty-eight years of payments floating at a higher, fully indexed rate.

Most purveyors of such loans deliberately used the temporarily low interest rates as a selling point. “I can get you a loan at three percent fixed” was a nice sales line that conveniently omitted that the variable rate for the other twenty-eight years of the loan was likely to exceed ten percent and vary unpredictably with interest rates. For those borrowers who saw through the deception, the loan originator had a different easy answer: “we’ll help you refinance before the payment goes up.” Not only did the promise of refinance entice many borrowers to take a loan they

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77 See Hart Complaint, supra note 54, at 4.
could not really afford, but it also kept the borrower on the hook for the next expensive, equity stripping product. When the housing bubble burst, it was the homeowner left holding the bag for higher monthly payments.

Another gimmicky product was the Payment Option ARM loan (“POA”). The hallmark of a POA mortgage is a limited time period during which the minimum payment is fixed – typically one to three years. During this period, if the initial rate was a teaser (or if the interest rate otherwise goes up), negative amortization results. This leads to a steady increase in the principal owed on the loan.

In a POA loan a borrower has, in theory, a choice of three payments: a minimum payment based on an initial, low teaser interest rate; an interest only payment that covers the actual interest accruing; and a fully amortizing payment. In practice, because the loans are sold to borrowers of limited means, three-quarters of all borrowers pay only the minimum payment, thus generating further negative amortization.

POAs have been aggressively pressed on unsophisticated borrowers as a way to borrow more money with temporarily and artificially low monthly payments. Nearly $750 billion in these loans were issued

79 After all, loan brokers were ostensibly looking after the best interests of their customers.
between 2004 and 2007.\textsuperscript{84} Unsurprisingly, POAs are a substantial cause of defaults and foreclosures across the country.\textsuperscript{85} As of December 2008, twenty-eight percent of option ARMs were delinquent or in foreclosure.\textsuperscript{86} Nearly sixty-one percent of option ARMs originated in 2007 will eventually default, according to a recent analysis by Goldman Sachs.\textsuperscript{87}

Given the low initial teaser rates in POA loans – rates below the long-term margin and index rate that are contractually applicable to the loan – negative amortization occurs whenever minimum payments are made after the initial fixed rate period. This is by design in order to render payments ultimately unaffordable and to force prepayments, refinancings (with new sets of points and fees), and, more commonly now, expensive loan modification agreements with obligations to pay interest on top of interest.

Once POA principal caps are reached (typically at 110\% to 125\% of the principal), the borrower must pay an amount sufficient to pay off the loan in the remaining time of the loan term. This means that if the original loan term was thirty years and the remaining term is now twenty-five years, the aggregate principal will be amortized over the remaining twenty-five years of the loan. The combination of negative amortization and low teaser rates results in significant payment shock – often a doubling or tripling of the borrower’s payment obligations thirty to sixty months after loan consummation – generally with limited contractual notice of payment changes. Thus, POA loans are complex and involve concepts that are unfamiliar and confusing to most, even fairly sophisticated homeowners.\textsuperscript{88} Lenders make these loans knowing

\begin{itemize}
  \item \textsuperscript{84} Ruth Simon, \emph{Option ARMs See Rising Defaults – Woes Mount in $750 Billion Home-Loan Market; Analysts’ Dim Views}, WALL ST. J., Jan. 30, 2009, at C1.
  \item \textsuperscript{85} \textit{Id.} See also Susan E. Barnes et al., \emph{Standard & Poor’s Weighs in on the U.S. Subprime Mortgage Market}, STANDARD & POOR’S, Apr. 5, 2007, at 12, \textit{available at} www2.standardandpoors.com/spf/pdf/media/TranscriptSubprime_040507_.pdf (increase in early payment defaults within four months of origination).
  \item \textsuperscript{86} Simon, supra note 84, at C1.
  \item \textsuperscript{87} \textit{Id.} (Goldman further estimates that more than half of all option ARMs outstanding will default).
  \item \textsuperscript{88} See, e.g., Press Release, Consumer Fed’n of Am., Lower-Income and Minority Consumers Most Likely to Prefer and Underestimate Risks of Adjustable Rate Mortgages 5 (July 26, 2004), \textit{available at} http://www.consumerfed.org/elements/www.consumerfed.org/file/housing/072604_ARM_Survey_Release.pdf (consumers cannot calculate the increase in the payment in an adjustable}
that borrowers cannot afford the fully indexed rate or the anticipated fully amortizing payments.89

The problems with loan gimmicks are exacerbated by incomprehensible explanations of the basis on which rates would change. In one such loan, the interest rate is described as being based on a margin and an index: “The margin is 3.5% added to the ‘Index.’”90 The “Index” described in the note is the “‘Twelve Month Average’ of the annual yields on actively traded United States Treasury Securities adjusted to a constant maturity of one year as published by the Federal Reserve Board in the Federal Reserve Statistical Release entitled ‘Selected Interest Rates (H.15).’”91

The note goes on to state that “[t]he Twelve Month Average is determined by adding together the Monthly Yields for the most recently available twelve months and dividing by 12. The most recent Index figure available as of the date 15 days before each Interest Rate Change Date is called the ‘Current Index.’”92 Plainly, a sophisticated lender could calculate the likely long-term rate by reading the loan note, while unsophisticated borrowers could not even read to the end of the first subclause, let alone find or predict the trend in the relevant index.

Several class actions are pending on Payment Option Arm issues.93

rate mortgage and minimize the interest rate risk by understating the increase in the payment).

89 See, e.g., Subprime Mortgage Market Turmoil: Causes and Consequences: Hearings Before the S. Comm. On Banking, Hous., & Urban Affairs, 110th Cong. 3 (2007). See also Steven Sloan & Joe Adler, How Freddie Cutback in Hybrids May Reverberate, Am. Banker, Feb. 28, 2007, at 1 (quoting Wright Andrews, a lobbyist for nonbank lending institutions, as saying that most subprime borrowers cannot afford the fully indexed rate and that requiring underwriting to the fully indexed rate would prevent adjustable rate mortgages from being made).


91 Id.

92 Id.

In addition, there are class cases alleging that some lenders used “bait and switch practices” by promising fixed rates and then converting to variable at closing. Finally, several class and individual cases have challenged loan disclosures in connection with complicated variable rate structures.

E. Loan Officer Compensation Structures As Incentives for Fraud

Lenders market and originate subprime loans through retail, wholesale, and correspondent lending channels. Many lenders primarily used mortgage brokers in the wholesale channel to transact subprime loans. But, lenders also maintained retail offices using loan officers to market and sell loans through aggressive and relentless telemarketing and other sales campaigns. Loan officers have described their offices


96 See Realestateabc.com, Types of Mortgage Lenders, http://www.realestateabc.com/loanguide/typesof.htm (last visited Oct. 4, 2009). See also, Santoro v. CTC Foreclosure Serv. Corp., 12 F. Appx. 476, 479 (9th Cir. 2001) (noting that retail loans are those that lenders make available directly to consumers, consumers would contact a loan broker to obtain a loan through a lender’s wholesale channel).

97 Realestateabc.com, supra note 96.

98 E.g., In re First Alliance Mortgage Co., 471 F.3d 977, 984-85, 991-92 (9th Cir. 2006) (describing a lender’s retail marketing strategy, which used loan officers to target individuals who had built up substantial equity in their homes and make a standardized sales presentation to persuade borrowers to take out loans with high interest rates and hidden high origination fees or “points” and other “junk” fees, of which the borrowers were largely unaware); Wong v. HSBC Mortgage Corp., No. C-07-2446 MMC, 2008 WL 753889, at *6-7 (N.D. Cal. Mar. 19, 2008) (citing loan officers’ testimony that their primary job duty was to sell as many loans as possible).
as “boiler rooms,”99 where they would “work the phones hour after hour . . . trying to turn cold calls into lucrative ‘subprime’ mortgages.”100 As one news article reported, “[loan officers] described 10- and 12-hour days punctuated by ‘power hours’ – nonstop cold-calling sessions to lists of prospects burdened with credit card bills; the goal was to persuade these people to roll their debts into new mortgages on their homes.”101 Lenders provided their loan officers with scripts designed to convince unwitting borrowers to take unaffordable and unfavorable loans, and to avoid borrowers’ questions and concerns.102 This marketing strategy targeted financially struggling homeowners in immediate need of capital and those with equity in their homes.103 While lenders trained their loan officers how to sell the most loans possible, they failed to provide loan officers any meaningful training on mortgage lending laws and regulations.104

Loan officer compensation in the subprime boom was volume based – the more loans originated, the higher the loan officer’s commission.105


100 Hudson & Reckard, supra note 99, at A1.

101 Id.


104 See In re First Alliance Mortgage Co., 471 F.3d 977, 985 (9th Cir. 2006) (“First Alliance trained its loan officers to follow a manual and script known as the ‘Track,’ which was to be memorized verbatim by sales personnel and executed as taught. The Track manual did not instruct loan officers to offer a specific lie to borrowers, but the elaborate and detailed sales presentation prescribed by the manual was unquestionably designed to obfuscate points, fees, interest rate, and the true principal amount of the loan. First Alliance’s loan officers were taught to present the state and federal disclosure documents in a misleading manner.”). See, e.g., REPORT OF THE MORTGAGE SUMMIT WORKING GROUPS 12 (2007), available at http://www.mass.gov/Eoca/docs/dob/Mortgage_Summit_Final_20070409.pdf (noting that in Massachusetts there was no testing or education requirements for loan officers to ensure they were fully informed on all of the obligations in Massachusetts).

105 CENTER FOR RESPONSIBLE LENDING, CLR POLICY BRIEF: NEGLECT AND INACTION: AN ANALYSIS OF FEDERAL BANKING REGULATORS’ FAILURE TO
Furthermore, lenders provided additional incentives to increase loan volume by rewarding successful loan officers with extravagant gifts such as vacations, cars, and sports tickets. Lenders themselves obtained a significant percentage of their revenue from loan origination points. Because management level employees received commissions based in part on revenue earned by their subordinates, they trained loan officers to convince homeowners to borrow more often in ever larger amounts.

These high-pressure sales environments and incentives encouraged massive underwriting fraud. Loan officers manipulated loan applications to qualify otherwise ineligible borrowers with poor credit histories for...
loans to meet and exceed their quotas. These manipulations included forging signatures on loan documents, cutting and pasting portions of borrowers’ W-2 forms to substitute income information, and otherwise mischaracterizing and misreporting income and assets.

Moreover, loan officers typically took a borrower’s loan application over the telephone, and the borrower would not see a copy of the application until the closing. Retail offices used closing agents to meet with borrowers and complete the necessary paperwork to transact the loan. Lenders paid these closing agents a flat fee for every loan, regardless of the amount or quality of work the closing agent did. These fees are generally regulated and capped on a state-by-state basis. Therefore, closing agents’ compensation depended on the number of loans they closed. Borrower complaints of hurried or rushed closings, often in inappropriate places like parking lots and bars, became commonplace.

Recently, there have been a number of class actions challenging loan officers’ sales and marketing tactics, claiming that the loan officers participated in a common scheme to place borrowers into bad loans.


111 See The American Dream Shattered, supra note 76, at 12-13, 15, 18. See also Sheldon et al., Unfair and Deceptive Acts and Practices, supra note 110, §§ 6.3.4.1, 6.3.4.2.

112 See, e.g., Wells Fargo Home Mortgage, https://www.wellsfargo.com/mortgage/apply/expect (last visited Oct. 8, 2009) (“Applying over the phone allows you to give your information directly to a mortgage consultant. This person will walk you through the application and complete it for you based on your answers.”).


115 The American Dream Shattered, supra note 76, at 8.

116 Id.

117 In re Ameriquest Litigation Complaint, supra note 94, ¶¶ 106-15; In re First Alliance Mortgage Co. 471 F.3d 977, 983 (9th Cir. 2006); In re Countrywide Fin. Corp. Mortgage Mktg. & Sales Pracs. Litig. (Countrywide), 601 F. Supp.
To show that a common scheme existed, the plaintiffs pointed to scripts provided by the lender for loan officers to use to overcome borrowers’ objections to unwanted loans. These cases also assert that loan officers’ compensation structure incentivizes them to act against the borrowers’ best interest.

Establishing a common practice is essential in a class action. Class action lawsuits against loan officers for misrepresenting the terms of the loans they sold may be difficult to maintain because of the necessity to show borrowers’ relied upon the misrepresentations in a common way. However, where a misrepresentation is made in a uniform way and the members of the putative class had damages that they would not have incurred but for the misrepresentation, reliance can sometimes be inferred and a misrepresentation class certified.

F. Wholesale Marketing Abuses

The subprime lending market expanded rapidly from the 1990s through 2007, fueled by loosened underwriting standards and the

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118 E.g., In re Ameriquest Litigation Complaint, supra note 94, ¶¶ 109-10.
119 E.g., id. ¶¶ 116-17.
121 E.g., Sandwich Chef of Tex., Inc. v. Reliance Nat’l Indem. Ins. Co., 319 F.3d 205, 211 (5th Cir. 2003) (“Fraud actions that require proof of individual reliance cannot be certified as Fed. R. Civ. P. 23(b)(3) class actions because individual, rather than common, issues will predominate.”).
123 Press Release, Fed. Trade Comm’n, FTC Testifies on Enforcement and Education Initiatives to Combat Abusive Lending Practices (Mar. 16, 1998), available at http://www2.ftc.gov/opa/1998/03/subprime.shtm (“Subprime lending refers to the extension of high interest rates or higher fee loans to higher risk borrowers. This segment of the lending industry has grown substantially since the early 1990s. In 1997 alone, subprime lenders originated over $125 billion in home equity loans. In addition to an expansion in the number of loans, the Commission’s testimony notes that the composition of the industry is changing. One of the most dramatic changes has been the growth in subprime mortgage lending by large corporations that operate nationwide.”); Press
appetite of the secondary market, and with a primary goal of closing as many loans as possible. Opportunistic lenders expanded their presence beyond retail offices and set up national broker networks for wholesale marketing. Brokers then saturated low-income and minority communities where credit was previously less available. A 2006 Mortgage Bankers Association Study estimated that broker-originated loans constituted fifty percent of the overall market and seventy percent of the subprime market.

Broker-originated loans exposed borrowers to substantial closing costs such as additional brokers’ fees. Brokers receive commissions based on the number of loans they close, the principal balance of the loan, and the interest rate on the loan. To close more loans, similar to abuses by retail offices, brokers routinely manipulated underwriting information to

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125 See supra Part E (discussing high pressure sales tactics and compensation incentives that rewards a high volume lending).

126 See infra Part G (discussing discrimination in the mortgage industry).


qualify otherwise ineligible borrowers. This practice was rampant in wholesale subprime lending. Lenders no longer required a borrower to complete her own loan application. Rather, brokers completed applications on borrowers’ behalf, usually by taking limited information from the borrower through a telephone call or by email. While a borrower met directly with a broker instead of a closing agent, she often did not receive the completed loan application from the broker until the day of the closing, and thus never had an opportunity to verify the accuracy of the information before the lender qualified her for the loan.

Lenders also created loan products that allowed for “no income verification,” “no doc,” or “stated income” that did not require borrowers to submit supporting documentation to verify the income stated on their loan applications. Additionally, brokers routinely inflated borrowers’ income to qualify them for loans that were otherwise impossible to repay on the borrowers’ true salaries.

Another way brokers were able to close more loans was through “bait and switch” tactics – inducing a borrower into taking a loan by promising certain terms, then pressuring the borrower into a loan with worse terms at the closing. Often, a broker would initially promise

129 Kimberly Blanton, \textit{AG Charges Mortgage Broker With Fraud}, Boston Globe, Mar. 8, 2008, at F1 (discussing Massachusetts Attorney General’s complaint against a brokerage firm, in which the Attorney General alleged the firm “engaged in a widespread practice of submitting false information about bank accounts and incomes that ‘it knew or should have known were inflated’”). \textit{See also} Hardy v. Indymac Federal Bank, No. CV F 09-935 LJO SMS, 2009 WL 2985446, at *4 (E.D. Cal. Sept. 15, 2009) (upholding fraud claim, in part, because the plaintiff alleged falsification of income); Ware v. Indymac Bank, 534 F. Supp. 2d 835, 842 (N.D. Ill. 2008) (refusing to dismiss UDAP claim based on broker’s and lender’s falsification of loan application); Vincent v. Ameriquest Mortgage Co. (\textit{In re Vincent}), 381 B.R. 564, 574 (Bankr. D. Mass. 2008).
130 \textit{See} Hardy, 2009 WL 2985446, at *4; Ware, 534 F. Supp. 2d at 842; Vincent, 381 B.R. at 574; Blanton, \textit{supra} note 129.
131 \textit{See} The American Dream Shattered, \textit{supra} note 76, at 7, 12.
132 Moreover, brokers frequently rushed unrepresented borrowers through the closing process, which involves reviewing and signing voluminous documents, so that most borrowers never had the opportunity to carefully review documents pertaining to the fees and costs of their loans. \textit{See id.} at 18-19.
133 \textit{Id.} at 6-7, 16-17.
134 Hardy, 2009 WL 2985446, at *4; Patetta v. Wells Fargo Bank, N.A., No.
an interest rate that was lower than the interest rate on the final loan
documents. Or, a broker would promise the borrower a fixed interest
rate, but ultimately give the borrower a variable rate. Other empty
promises included that the loan would lower a borrower’s monthly
payment, the loan would not contain a prepayment penalty, or the loan
would not require the payment of certain fees and costs. Even if the
borrower became aware of the change in terms at the loan closing, which
she often did not, she unwillingly accepted the less-favorable loan
because she did not understand that she could walk away from it. In
fact, many borrowers did not question what brokers told them about
their loans and options because they believed that the broker’s role was to
act in their best interests – to find the borrower a loan on the best terms
possible.

Some brokers received compensation in the form of “broker” or
“origination” points. Because broker points are based on a percentage of
the loan amount, loans with higher principal balances increased brokers’
overall commissions. Lenders hid these broker fees from borrowers
by rolling them into the principal amount of the loan so that borrowers
financed them. Financing these fees increases the Annual Percentage Rate
(“APR”) on the borrower’s loan, which makes the loan more expensive
to the borrower for its entire term.

Lenders also cavalierly extended large amounts of credit offering

bait and switch based on receiving a loan with an adjustable rate when promised
a fixed rate); In re Ameriquest Litigation Complaint, supra note 94, ¶¶ 3-4, 93-
97 (alleging a variety of bait and switch practices); but see Chiles v. Ameriquest
he misrepresented his own income to qualify for a refinance).

135 In re Ameriquest Litigation Complaint, supra note 94, ¶¶ 8, 93-97.
136 See Sheldon et al., UNFAIR AND DECEPTIVE ACTS AND PRACTICES, supra note
110, § 6.2.1, at 329.
137 See id.
138 Id.
139 Brokers sometimes receive loan origination points, or “broker’s points,” which
are based on a percentage of the loan amount. See supra Part B (discussing how
origination points are paid).
140 Id.
141 The Annual Percentage Rate is the effective interest rate on a loan, including all
financed fees and interest. See Truth in Lending Act § 107, 15 U.S.C. § 1606
“cash out” and encouraging borrowers to consolidate non-mortgage debts, such as credit card debts, car loans, student loans, and/or medical debt into their mortgage loans. Jumbo loans – loans that exceeded the industry standard for limits on principal amounts – became commonplace as lenders encouraged more borrowing and loosened down-payment requirements. Such reckless lending coupled with the housing market crash left borrowers saddled with hundreds of thousands, sometimes over a million dollars, in mortgage debt. According to the 2009 U.S. Census Report, total U.S. mortgage debt increased from $205.5 billion in 1990 to $1,061.5 billion in 2006. Brokers, on the other hand, profited handsomely from their percentage-based commissions on these loans.

Lenders also compensated brokers by allowing them to mark up interest rates with yield spread premiums. The yield spread is the difference between the par rate (the lowest interest rate for which a borrower could qualify) and the marked-up interest rate, expressed as a percentage. Thus, the dollar amount brokers received as a premium correlated with the size of the mark-up on the interest rate. The higher interest rate would remain in effect for the entire term of the loan and could continue long after the lender recouped the broker’s compensation through the borrower’s higher interest payments.

Not privy to lenders internal underwriting standards, borrowers did not know the lowest

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146 Id.

147 Id.
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interest rate for which they could qualify independent of brokers’ representations. They, therefore, had no basis with which to challenge the mark-up on their interest rate.

In a series of class actions brought by borrowers against mortgage lenders and brokers in the early 1990s, borrowers challenged brokers’ charging of YSPs on the ground that they constituted referral, or “kickback”, fees prohibited by the Real Estate Settlement Procedures Act (“RESPA”). The two primary issues courts initially faced were whether the fee was for actual and legitimate services performed by the broker and, if so, whether the amount of the fee was reasonable. Unfortunately, the majority of courts found that these issues are not suitable for class-wide treatment, claiming they require individual factual determinations as to whether YSPs bore any reasonable relationship to the value of the services brokers provided. Ultimately, the United States Department of Housing and Urban Development (“HUD”) effectively eliminated the potential to raise these issues in a class action in its October 18, 2001 policy statement, which stated that it is necessary to look at each mortgage loan transaction individually to determine whether excessive fees constitute a RESPA violation.

Many individual brokers and brokerage firms have long since exited the market, generally escaping accountability. Although brokers

148 Id.
149 Glover v. Standard Fed. Bank, 283 F.3d 953, 966 (8th Cir. 2002) (overturning the district court’s class certification order, finding that the determination of whether a broker’s fee was commensurate with the work the broker performed had to be done on a loan-by-loan basis). See also Heimmermann v. First Union Mortgage Corp., 305 F.3d 1257, 1264 (11th Cir. 2002); Schuetz v. Banc One Mortgage Corp., 292 F.3d 1004, 1015 (9th Cir. 2002).
are regulated under state law,\textsuperscript{154} they are difficult to hold accountable for their illegal acts because many go out of business or are not solvent enough to sue.\textsuperscript{155} But lenders are liable for the conduct of their brokers under a variety of legal theories, such as agency,\textsuperscript{156} direct participation,\textsuperscript{157} aiding and abetting,\textsuperscript{158} joint venture,\textsuperscript{159} and conspiracy.\textsuperscript{160} In addition, if the lender obtained a benefit from the broker’s fraudulent act or the lender induced the broker to breach its fiduciary duty to the borrower, the lender could be held liable for those acts.\textsuperscript{161}

G. \textit{Discrimination Against Minority Homeowners}

Despite the Equal Credit Opportunity Act (“ECOA”), enacted to ameliorate discrimination in credit transactions,\textsuperscript{162} credit discrimination

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\textsuperscript{156} See Whitley v. Taylor Bean & Whitaker Mortgage Corp., 607 F. Supp. 2d 885, 895-96 (N.D. Ill. 2009) (denying motion to dismiss claim that broker was lender’s agent where plaintiff alleged that broker used lender’s credit granting policies, rate sheets, product sheets, loan pricing software, closing documents, and training materials to process borrowers loans, and broker and lender shared YSPs).

\textsuperscript{157} See Miller v. Countrywide Bank, N.A., 571 F. Supp. 2d 251, 260 (D. Mass. 2008) (denying motion to dismiss, finding that a lender’s liability flows directly from its own participation in the transactions as the “creditor” which set the markup policy at issue).

\textsuperscript{158} See \textit{In re} First Alliance Mortgage Co., 471 F.3d 977, 992-93 (9th Cir. 2006).


\textsuperscript{160} Sheldon et al., \textit{Unfair and Deceptive Acts and Practices}, supra note 110, § 11.5.3.3, at 644.

\textsuperscript{161} \textit{Id.} § 11.5.3.4.

remains a widespread problem in America’s mortgage lending industry.\textsuperscript{163} Racial redlining was a prevalent form of mortgage lending discrimination practice from the 1930s to the 1990s which was ameliorated largely by aggressive fair housing advocacy for home purchase mortgages.\textsuperscript{164} Reverse redlining – the practice of targeting minority communities


\textsuperscript{163} See William C. Apgar & Allegra Calder, Joint Ctr. for Hous. Studies at Harvard U., \textit{The Dual Mortgage Market: The Persistence of Discrimination in Mortgage Lending}, in \textit{The Geography of Opportunity: Race and Housing Choice in Metropolitan America} (Xavier de Souza Briggs ed., Brookings Inst. Press, 2005), available at http://www.jchs.harvard.edu/publications/finance/w05-11.pdf (finding that mortgage lending discrimination today is subtle but pervasive, with minority consumers continuing to have less-than-equal access to loans at the best price and on the best terms that their credit history, income, and other individual financial considerations merit more than three decades after the enactment of national fair lending legislation); Ass’n of Cmty. Orgs. for Reform Now (ACORN), \textit{The High Cost of Credit: Disparities in High-priced Refinanced Loans to Minority Homeowners in 125 American Cities} 1 (2005), available at http://www.acorn.org/index.php?id=9755 (follow link at bottom of page to download .doc format) (finding that, nationally, black home purchasers were 2.7 times more likely and Hispanics were 1.4 times more likely than white borrowers to be issued a problematic, subprime loan); Robert B. Avery, Kenneth P. Brevoort & Glenn B. Canner, \textit{Higher-Priced Home Lending and the 2005 HMDA Data}, in \textit{Federal Reserve Bulletin} A124, A159 (2006), available at http://www.federalreserve.gov/pubs/bulletin/2006/hmda/bull06hmda.pdf (revealing that, according to HMDA data from both 2004 and 2005, “Blacks and Hispanic whites were more likely . . . to have received higher-priced loans than non-Hispanic whites . . . [which has] increased concern about the fairness of the lending process”); \textit{California Reinvestment Coal., et al., Paying More for the American Dream: A Multi-State Analysis of Higher Cost Home Purchase Lending} 1 (2007), available at http://www.nedap.org/resources/documents/2007_Report-2005_HMDA.pdf.

\textsuperscript{164} Alys Cohen et al., Nat’l Consumer L. Ctr., \textit{Credit Discrimination} § 7.1, at 155 (5th ed. 2009) [hereinafter COHEN et al., \textit{Credit Discrimination}].
and steering them into bad loans – emerged with the subprime lending boom.\footnote{165}

Deregulation allowed lenders to aggressively market unconventional mortgage loan products to borrowers with tarnished credit histories in the subprime market.\footnote{166} Loan origination volume contributed greatly to lenders’ profitability.\footnote{167} To maximize volume, mortgage lenders increasingly used brokers, which allowed them to market and process their loans nationally while maintaining a limited number of retail offices.\footnote{168} Prior to the economic downturn,\footnote{169} the wholesale market\footnote{170} was an immeasurably profitable channel for loan origination, and for brokers, lenders and the secondary market.\footnote{171}

Mortgage lenders controlled borrowers’ access to their loan products by choosing in which communities to place their retail, or brick-and-mortar offices, and in which communities to use mortgage brokers.\footnote{172}

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\item \footnote{165} See, e.g., \textit{id}. (listing a number of cases challenging reverse redlining practices between the years 2000 to 2008).
\item \footnote{166} \textit{E.g.}, Depository Institutions Deregulatory and Monetary Control Act of 1980, 12 U.S.C. § 1735f-7a(a)(1) (1981) (eliminating state rate and fee caps on residential real property).
\item \footnote{167} \textit{Sheldon et al., Unfair and Deceptive Acts and Practices, supra note 110, § 6.3.4.1, at 334.}
\item \footnote{168} \textit{See supra Parts E and F.} Lenders used wholesale brokers to solicit mortgages and who used high pressure tactics and targeted minority borrowers.
\item \footnote{170} \textit{See supra Part F.} Brokers earned fees on top of the loan costs. More, since they were paid based on volume, many brokers downplayed or avoided altogether concerns of prospective borrowers and, since the brokers themselves frequently filled out the applications, they often altered the applicants’ information in order to sign them to loans they otherwise would not have been able to obtain.
\item \footnote{171} \textit{Id.}
\item \footnote{172} In 2003, the National Community Reinvestment Coalition (“NCRC”) released a report on credit discrimination. \textit{See Nat’l Cmty. Reinvestment Coal., The Broken System: Discrimination and Unequal Access to Affordable Loans by Race and Age 5} (2003), \url{available at http://www.omm.com/omm_}\
\end{itemize}
Mortgage lenders rarely placed their retail operations in predominately minority neighborhoods. Instead, mortgage lenders overwhelmingly used brokers to market and process their loans in these communities. As a result, minority borrowers did not have ready access to retail prime loans.

Mortgage brokers infiltrated minority communities. Minority homeowners often say they met a mortgage broker on the street in their neighborhood. A former Wells Fargo loan officer, and current whistleblower, submitted a declaration in support of a racial redlining case brought by the City of Baltimore. Among other things, the

distribution/newsletters/client_alert_financial_services/pdf/ncrcdiscrimstudy.pdf (indicating that consumers living in areas with more minority residents are more likely to have mortgages with interest rates higher than the “prevailing and competitive” rates, often because of discrimination in lending). See also Remarks of Martin J. Gruenberg, Vice Chairman, FDIC, Inter-American Development Bank, October 18, 2006, http://www.fdic.gov/new/speeches/archives/2006/chairman/spsep1906.html (“[P]revious studies have also suggested higher-priced, subprime lenders are more active in lower income, urban areas and that minority access to credit is dominated by higher cost lenders.”); CENTER FOR RESPONSIBLE LENDING, UNFAIR LENDING: THE EFFECT OF RACE AND ETHNICITY ON THE PRICE OF SUBPRIME MORTGAGES 16 (2006), http://www.responsiblelending.org/mortgage-lending/research-analysis/unfair-lending-the-effect-of-race-and-ethnicity-on-the-price-of-subprime-mortgages.html (compared to their otherwise similarly-situated white counterparts, blacks were thirty-one to thirty-four percent more likely to receive higher rate fixed-rate loans and six to fifteen percent more likely to receive adjustable-rate loans).

E.g., JONATHAN BROWN, RACIAL REDLINING: A STUDY OF RACIAL DISCRIMINATION BY BANKERS AND MORTGAGE COMPANIES IN THE UNITED STATES § I(C)(1) (1993), available at http://public-gis.org/reports/red1.html#C (reporting that “[t]he 62 worst case lending patterns identified in this report demonstrate that the 49 major mortgage lenders responsible for these patterns have excluded minority neighborhoods from their effective lending territories or substantially undeserved such neighborhoods”).


175 Because there is no broker involved in a direct lender, or retail, transaction, the borrower is not required to pay any brokers’ related fees and costs.

whistleblower revealed that Wells Fargo targeted African Americans through special events in African American communities called “wealth building” seminars and targeted African American churches. Wells Fargo steered minority borrowers with prime credit into subprime loan products, and it did so by incentivizing its loan officers to originate the highest volume of subprime loans possible.

Lenders also gave their brokers and loan officers discretion to mark up loans, which was then used to mark up loans made to minority borrowers more than those made to whites. Based on a number of objective credit criteria, lenders set par (i.e., no points) interest rates for its various loan products. Lenders gave their brokers and loan officers’ discretion to increase a borrowers’ par rate in return for increased compensation. In some cases, brokers and loan officers received tens of thousands of dollars for closing just a single mortgage loan.

Under HMDA, lenders are required to report to HUD the number of high cost loans they originated, both by race and by year. Data in the past ten years show that a statistically significant percentage of minority borrowers, primarily African Americans and Hispanics, consistently received more high cost loans than white borrowers.

177 Id.
178 Id.
179 Id.
181 E.g., Jacobson Affidavit, supra note 176, ¶ 6.
183 HMDA data for 2006 revealed that black and Hispanic borrowers are more likely to obtain higher-priced loans than are white borrowers. The data indicated that black homeowners who received subprime mortgage loans were much more likely to be issued a higher-rate loan than white borrowers with the same qualifications. Federal Financial Institutions Examination Council, Home Mortgage Disclosure Act, http://www.ffiec.gov/hmda (last visited Oct.
While the HMDA data raises an eyebrow, it does not explain the reasons why minority borrowers received more high cost loans than white borrowers.\footnote{3, 2009) same data for 2005, available at http://www.federalreserve.gov/pubs/bulletin/2006/hmda/bull06hmda.pdf (last visited Oct. 3, 2009). See also supra note 163 (both 2004 and 2005 HMDA data revealed that “Blacks and minority borrowers were more likely . . . to have received higher-priced loans than non-Hispanic whites . . . [which has] increased concern about the fairness of the lending process.”). African Americans were 3.3 times more likely and Hispanics were three times more likely than similarly-situated whites to be issued a high-cost, subprime loan. ACORN Fair Housing, The High Cost of Credit: Disparities in High-priced Refinanced Loans to Minority Homeowners in 125 American Cities 11-13 (2005), available at http://www.74.125.93.132/search?q=cachekknatal6_XFcJ:www.acorn.org/fileadmin/Affordable_Housing/hmda/High_Cost_of_Credit_Report.doc+%22acorn+fair+housing%22+and+%22high+cost+of+credit%22&cd=3hl=en&ct=clnk&gcl=us.} To understand whether this discrepancy occurred because of credit discrimination, further analysis of the relevant data is necessary.\footnote{185 Id.} Statistical experts have performed regression analyses on loan level account data, by which they removed all objective credit factors and determined discrepancy results based on purely subjective criteria.\footnote{186 See Cohen et al., Credit Discrimination, supra note 164, § 4.4.5.4, at 91.} Several academic and empirical expert studies discussing the results of regression analyses find that minority borrowers, after controlling for objective credit risk factors, received higher cost loans than whites.\footnote{187 See supra notes 163, 172, and 186.} The nature of this kind of credit discrimination is subtle and, as a result, there historically has been little remedial action under ECOA or similar statutes. However, as research and publicity bring this problem to light, public and private litigants are taking action.

In a recent effort to combat credit discrimination, private attorneys, Attorneys General, and civil rights organizations have sued mortgage lenders under ECOA, FHA, and state statutes, in their various representative capacities. Courts across the country adjudicating these
cases have upheld plaintiffs’ disparate impact theories in a series of cases brought by private attorneys. That is, without alleging that lenders have intentionally discriminated against minority borrowers, these actions have challenged lenders’ pricing policies, which statistical data shows result in minority borrowers receiving higher cost mortgage loans than white borrowers with the same credit qualifications. These price disparities cannot be explained by any factor other than race. These lawsuits seek, among other goals, to stop mortgage lenders from maintaining loan-pricing policies that cause discrimination and to provide restitution to minorities for the disparities in the costs of their mortgage loans.

Attorneys General in several states have also launched investigations and brought enforcement actions to address the discriminatory effect of lenders’ pricing practices. Government investigations have found that credit discrimination is taking place in a new area – loan modifications. The National Association for the Advancement of Colored People is pursuing a lawsuit against fifteen of the country’s largest mortgage lenders, alleging claims under the FHA, ECOA, and the Civil Rights Act with regard to the lenders’ practices towards African Americans.

188 See Sheldon et al., Unfair and Deceptive Acts and Practices, supra note 110 (listing cases).
189 Id.
190 Id.
191 Id.
193 Eric Holder, Attorney General, Remarks as Prepared for Delivery at the Foreclosure Rescue Scams and Loan Modification Fraud Press Conference (Apr. 6, 2009), available at http://www.usdoj.gov/ag/speeches/2009/ag-speech-090406.html (“Already, we are hearing increasing concerns that not all distressed borrowers are receiving the same opportunities for loan modifications. We are also hearing that the terms and fees for such modifications are not being made available on a non-discriminatory basis.”).
194 The lender defendants in the NAACP lawsuit are Accredited Home Lenders,
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Due to the seriousness and pervasiveness of credit discrimination, these lawsuits are the most effective means for remedying past discrimination and preventing future discriminatory conduct.

H. Loan Servicing Abuses

In today’s mortgage lending marketplace, subprime loans are often serviced, under contract with an investor, by a servicing company with no connection to the originating lender. In these instances, servicers collect payments and handle customer service to homeowners on their mortgage loans but do not bear the risk of default. Consumer advocates believe that a resulting indifference to risk of nonpayment permits servicers to engage in a variety of profitable but predatory practices.

Predatory servicing problems often go hand in hand with predatory lending. Servicing subprime loans can be highly profitable when default and foreclosure rates are high. Late payments charges, for example, are a profitable source of fee-based income for servicers because, by contract,


195 As described elsewhere in this article, most mortgages are transferred on the secondary market. The servicing rights are then sold separately, typically pursuant to “Pooling and Servicing Agreements.” See Nat’l Consumer L. Ctr., Finding Pooling And Servicing Agreements (“PSAs”) For Securitized Mortgage Loans passim (2002), available at http://www.consumerlaw.org/fprc/content/Pooling.pdf. See also In re Nosek, 406 B.R. 434, 438-40 (Bankr. D. Mass. 2009).


the servicer is allowed to retain them. Deregulation in the form of federal preemption of state laws has allowed the size of late payments to become unmoored from any connection to the real harm associated with short-term delinquency. 199 Several subprime servicers have been accused of deliberately posting payments to borrowers’ accounts long after they are received in order to generate late fees despite timely payments. 200

Because a delinquent loan generates a new late fee each month, delinquencies can generate a steady stream of income from large monthly late payment charges. In some cases, an inference can be raised that servicers deliberately generate chronic delinquencies and then refuse to work with borrowers to resolve them. 201 Ironically, due to late fee and other default and delinquency charges described below, this can be good for the servicer’s bottom line.

Other servicing problems are equally endemic. Many servicers profit from relationships with insurance companies. These servicers will receive commissions (kickbacks) from those insurers for placing expensive hazard insurance policies with those insurance companies to cover the property secured by the mortgage. 202 In order to do so, servicers will

199 Most loans allow late fees that are a percentage of the late payment. A three percent late payment fee on a monthly mortgage payment of $2500 is $75. This amount is significant to a homeowner already struggling to make timely monthly payments. But see, Manuel Adelino, Kristopher Gerardi & Paul Willen, Federal Reserve Bank of Boston, Why Don’t Lenders Renegotiate More Home Mortgages? 25-26 (2009), available at http://www.bos.frb.org/economic/ppdp/2009/ppdp0904.pdf (concluding that re-default risk rather than servicer profits prevents loss mitigation).


sometimes ignore or misplace the borrower’s proof of an existing policy. In other instances, proof of insurance is never transferred when servicing is passed from one entity to another, and little or no inquiry is made of the homeowner. Servicer arranged hazard insurance policies, known as “force placed insurance,” are far more expensive than similar policies borrowers could obtain themselves. Placement of such a policy, particularly when unnecessary because it is on top of a cheaper, existing policy, can cause payments to swell and lead to delinquencies and default. Similar issues arise for servicer arranged property inspections, some of which are billed to consumers even when no inspection is performed.

Additionally, some servicers generate fees for routine customer service work. Such fees include charges for providing pay-off information to customers, handling telephone payments, and other similar routine matters. Some advocates question whether fees for such work are permitted by contract, particularly in situations where the work is not performed.

Many consumers experience frustration when attempting to resolve disputes with their loan servicers. Some subprime servicers keep costs low by cutting customer service staff or by transferring call centers to far-flung jurisdictions. Call center employees often do not have full access to customer records, including back-up documentation for fees and, therefore, cannot resolve disputes. Some lawsuits have alleged that


205 Curry Complaint, supra note 202, ¶ 18; Ocwen Complaint, supra note 201, ¶¶ 16-18.

206 Rao et al., Foreclosures, supra note 9, § 7.7, at 186 (breach of contract for unauthorized fees is a common claim raised by advocates).

the lack of customer service is deliberate because failed dispute resolutions further increase fees.\textsuperscript{208}

Foreclosures can also be profitable to servicers. In addition to generating delinquency-related charges,\textsuperscript{209} some servicers have set up property management companies that profit from managing real estate after foreclosure. Mortgage holders and investors pay the servicers for managing and sometimes for reselling foreclosed homes.

Problems also arise because servicing frequently gets transferred from one entity to another. Although the RESPA has a provision for notice of transfers of servicing,\textsuperscript{210} these notices are easily lost or overlooked by consumers. In other instances, proper notice is never sent.\textsuperscript{211} In these instances consumers can make payments to the wrong entity, resulting in confusion, lost payments, and default.

Federal preemption of state laws has made it difficult for states to regulate on issues like appropriate late fees or pay-off statement fees.\textsuperscript{212} Servicers have frequently argued that substantive state limits on the amounts they can charge are invalid. They have also argued, with less success, that even state contract law is preempted.\textsuperscript{213} There is significant difference of opinion about the scope of federal preemption of state unfair trade practice laws.\textsuperscript{214}

\textsuperscript{208} See, e.g., Ocwen Complaint, \textit{supra} note 201, ¶¶ 18-19, 23-24 (alleging the failed dispute resolution experience of Plaintiff Cyd Bowman); Goodman, \textit{supra} note 198, at A1.

\textsuperscript{209} See Curry Complaint, \textit{supra} note 202, at ¶ 17; Ocwen Complaint, \textit{supra} note 201, ¶ 18; Katherine Porter, \textit{Misbehavior and Mistake in Bankruptcy Mortgage Claims}, 87 Tex. L. Rev. 121, 140-44 (2009).


\textsuperscript{211} Curry Complaint, \textit{supra} note 202, ¶ 4; Ocwen Complaint, \textit{supra} note 201, ¶ 19.


\textsuperscript{213} \textit{See In re} Ocwen Mortgage Loan Servicing, LLC Mortgage Servicing Litig., 491 F.3d 638, 643-46 (7th Cir. 2007); Gibson v. World Sav. and Loan Ass’n, 128 Cal. Rptr. 2d 19, 25-31 (Cal. Ct. App. 2002).

Nevertheless, there has been substantial public and private action to reign in servicing abuses. The Federal Trade Commission ("FTC") has reached a settlement, for example, with EMC Mortgage Corp., formerly a division of Bear Stearns. That settlement provides for damages to affected consumers and injunctive relief to borrowers to prevent further abuses. In another case, against the servicer Fairbanks Capital Corp., a settlement was reached that addressed both class action claims and those brought by the FTC. That settlement resulted in recovery of approximately $55 million for consumers in 2003.

More than twenty class actions against the subprime servicer Ocwen Mortgage have been consolidated in a single multi-district litigation proceeding in the Northern District of Illinois. The complaint in that matter asserts a panoply of claims grounded in breach of contract and the unfair trade practice law of various states. The underlying legal problems include allegations of improper charges for force-placed aspects of a regulated area are, by necessity, complex and detailed, does not imply that Congress intended to occupy the entire field to the exclusion of state law”), with Boursiquot v. Citibank F.S.B., 323 F. Supp. 2d 350, 356 (D. Conn. 2004) (preemption found where statute had “a direct bearing on the lending operations of federal savings associations”) and Chaires v. Chevy Chase Bank, F.S.B., 748 A.2d 34, 46-47 (Md. Ct. App. 2000) (claim that bank charged fees in excess of those allowed by state statute was not actionable, because state law required insurance as loan collateral and was therefore preempted).


Ocwen Complaint, supra note 201, ¶¶ 2, 5-8. A similar case, also in the Northern District of Illinois, is pending against Litton Loan Servicing. See Complaint Class Action Matters Common to Multiple Claims ¶ 1-5, Gburek et al. v. Litton Loan Servicing LP, No. 1:08-cv-03188 (N.D. Ill. June 3, 2008). Some predatory lending cases also include predatory servicing claims, which occur when lenders service their own loans. See Borrowers’ Consolidated Class Action Complaint ¶ 1-14, In re Ameriquest Mortgage Co., Mortgage Lending Pracs. Litig., No. 1:05-cv-07097 (N.D. Ill. Dec. 6, 2006).

insurance, late fees, “recoverable breach fees,” and foreclosure related fees and costs. The complaint also alleges that Ocwen charges bankruptcy fees that are impermissible under federal bankruptcy law and/or that are never approved by a bankruptcy court.

Class actions on late posting of payments have had mixed success. Surprisingly, claims that servicers charge impermissible or excessive fees for payoff statements have been largely unsuccessful because such fees typically have no grounding in any contractual obligation by the borrowers. Improper force-placed insurance cases have been more successful. Other cases have challenged inspection fees, collection of prepayment penalties that are not owed, telephone payment fees, failure to provide notice of change of servicing, and foreclosure-related servicing fees.

There is also litigation challenging the perceived failure of some servicers to offer legitimate loan modification relief to struggling homeowners, including options mandated by receipt of government bailout monies. Another area of class action activity is breach of

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219 Ocwen Complaint, supra note 201, ¶¶ 5-7.
220 Id. ¶ 9.
222 See, e.g., Vician v. Wells Fargo Home Mortgage, 2006 WL 694740, at *3-6 (N.D. Ind. Mar. 16, 2006) (plaintiffs’ allegations of force-placing held to support an actionable claim under RESPA, TILA, the Illinois Consumer Fraud Act, and state contract law).
223 See, e.g., Scott v. Fairbanks Capital Corp., 284 F. Supp. 2d 880, 894-95 (S.D. Ohio 2003) (plaintiffs claims of padded inspection fees held to be adequate under state law and the FDCPA); In re Jones, 366 B.R. 584, 604 (Bankr. E.D. La. 2007) (lender ordered to return to mortgagee excess funds collected in part on the basis of inflated inspection fees); In re Parrish, 326 B.R. 708, 721 (Bankr. N.D. Ohio 2005) (lender should be able to document the inspection fees it charges).
224 See, e.g., Sandlin, 919 F. Supp. at 1569 (finding a cause of action where plaintiff alleged the improper collection of prepayment fees).
226 See, e.g., In re Jones, 366 B.R. at 590 (court reduced charges incurred by mortgagee to reflect foreclosure costs).
227 Porter, supra note 209, at 179.
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contractual agreements for loan workouts. Servicers have agreed to forebear in foreclosure, but have gone forward with foreclosure sales despite the agreement. Other cases challenge failure to properly modify payment records to make them consistent with loan modifications.

I. The Secondary Market and Its Facilitation of Lending Abuses

In response to the collapse of the housing market during the Great Depression, Congress passed three acts intended to stabilize the housing industry: the Federal Home Loan Bank Act of 1932, the Home Owners’ Loan Act of 1933, and the National Housing Act of 1934. This legislation provided, for the first time, direct federal government involvement in the mortgage market. Among other purposes, the National Housing Act, through the creation of the Federal Housing Administration, was designed to free up capital for lenders to extend more mortgage loans by enabling them to sell their loans to investors.


229 Pestana Complaint, supra note 228, ¶¶ 13-14.

230 Larffarello, No. SUCV2006-04962-BLS2 at ¶¶1, 14-26, 31-48, 54-58, 71-77.


233 Immergluck, supra note 4, at 27-29.


235 12 U.S.C. § 1719(d) (2006) (“To provide a greater degree of liquidity to the
Rather than holding loans and having to wait for full repayment until the end of the loan term, the ability to sell loans on the secondary market allowed lenders to obtain repayment immediately and use the returned capital to originate more loans. Congress amended the National Housing Act over the years and created three hybrid governmental-corporate entities, commonly known as Ginnie Mae, Fannie Mae, and Freddie Mac. These entities became a vehicle for purchasing loans and converting them into securities, known as mortgage-backed securities, for resale to investors.

These rational policy choices were turned on their head as big investment banks set up a private secondary market for subprime and other non-conforming loans. Investors’ demand for mortgage-backed securities skyrocketed in the mid-2000s. According to Ginnie Mae, the cumulative total of the dollar amount of mortgage-backed securities increased exponentially from about $5 billion in 1975 to approximately $2,660 billion in 2007.

mortgage investment market and an additional means of financing its operations . . . the corporation is authorized to set aside any mortgages held by it . . . and, upon approval of the Secretary of the Treasury, to issue and sell securities based upon the mortgages so set aside.”


See U.S. Securities Exchange Commission, Mortgage-Backed Securities (June 25, 2007), http://www.sec.gov/answers/mortgagesecurities.htm (“Mortgage-backed securities (‘MBS’) are debt obligations that represent claims to the cash flows from pools of mortgage loans, most commonly on residential property. Mortgage loans are purchased from banks, mortgage companies, and other originators and then assembled into pools by a governmental, quasi-governmental, or private entity. The entity then issues securities that represent claims on the principal and interest payments made by borrowers on the loans in the pool, a process known as securitization.”).


For an entertaining description of the origins of the secondary market for non-conforming mortgages, see Michael Lewis, LIAR’S POKER: RISING THROUGH THE WRECKAGE ON WALL STREET (Penguin 1990).

Securitization freed up capital for lenders to originate more loans.\textsuperscript{242} With high demand from investors, lenders had an easy opportunity to sell their loans.\textsuperscript{243} Lenders became mere pass-through agents – originating loans and flipping them to investors – while making enormous profits on origination-related fees and shifting the risk of default onto investors.\textsuperscript{244} All of these factors, coupled with a deregulated market,\textsuperscript{245} incentivized lenders to aggressively market and originate large volumes of high-cost loans.\textsuperscript{246}

For borrowers, the expansion of the secondary market meant exposure to relentless predatory lenders and an increased risk of foreclosure from falling prey to bad loans. Lenders targeted unsophisticated borrowers with subprime credit with promises of lower interest rates, lower monthly payments, or cash out if they refinanced their loans.\textsuperscript{247} Lenders used inflated appraisals to convince borrowers they had plenty of equity to borrow against.\textsuperscript{248} When the housing bubble burst and home values sank, borrowers were left with costly loans and owing tens and hundreds of thousands of dollars more on their homes than their homes were worth,

\begin{footnotesize}
\begin{enumerate}
\item See supra note 238.
\item In re Countrywide Fin. Corp. Sec. Litig., 588 F. Supp. 2d 1132, 1151 (C.D. Cal. 2008).
\item See In re 2007 Novastar Fin. Inc., Sec. Litig., 579 F.3d 878, 880 (8th Cir. 2009) (explaining that a subprime lender can “raise[] additional capital by bundling groups of loans into mortgage-backed securities and selling the rights to the income generated by these securities”); IMMERGLUCK, supra note 4, at 41.
\item The American Dream Shattered, supra note 76, at 1.
\item See, e.g., Spears v. Wash. Mut., Inc., No. C-08-00868 (RMW), 2009 WL 2761331, at *1 (N.D. Cal. Aug. 30, 2009) (plaintiffs in class action alleged that Washington Mutual Bank and others engaged in a scheme to inflate the appraised values of homes receiving loans in order to sell the aggregated security interests in the financial markets at inflated prices); Watkins v. Wells Fargo Home Mortgage, 631 F. Supp. 2d 776, 787 (S.D.W. Va. 2008) (decision regarding a motion to amend a complaint in a class action in which plaintiffs allege they were induced into larger loans because of lenders’ inflated appraisals).
\end{enumerate}
\end{footnotesize}
making it impossible to obtain a new loan or sell their home when their mortgage loans became unaffordable.\footnote{See Mortgage Lending Reform: A Comprehensive Review of the Am. Mortgage Sys.: Hearings Before the Subcomm. on Fin. Institutions and Consumer Credit of the H. Comm. on Fin. Servs., 111th Cong. 2 (2009) (statement of David Berenbaum, Executive Vice President, Nat’l Comty. Reinvestment Coal) (with the decrease in available credit, housing prices have plummeted and homeowners lost an estimated $3.3 trillion in equity in 2008); David Streitfeld, \textit{Home Prices in January Fell by a Record Amount}, N.Y. Times, Apr. 1, 2009, at B3.}

Moreover, as borrowers defaulted on their high cost loans with alarming frequency, they were often unable to turn back to their original lenders (who long since sold the loans on the secondary market) to evaluate forbearance of loan modification options.\footnote{See Kurt Eggert, \textit{Comment on Michael A. Stegman et al.’s “Preventive Servicing Is Good for Business and Affordable Homeownership Policy”: What Prevents Loan Modifications?}, 18 \textit{Hous. Pol’y Debate} 279, 285-87 (2007) (noting “several barriers to effective preventive servicing and its attendant loan modifications”); \textit{Foreclosure Prevention and Intervention: The Importance of Loss Mitigation Strategies in Keeping Families in Their Homes: Hearing Before the H. Subcomm. on Hous. and Cmty. Opportunity}, 110th Cong. 4 (2007) (written testimony of Tara Twomey, Of Counsel, National Consumer Law Center)[hereinafter Testimony of Twomey].} For example, to cope with the vast pools of securitized loans the real estate finance industry created the Mortgage Electronic Registration System (“MERS”), an automated system that registers and processes chain of title documents, such as mortgages and assignments, for lenders.\footnote{By 2007, more than fifty million mortgages were registered with MERS. Press Release, Mortgage Elec. Registration Sys. (“MERS”), 50 Millionth Loan Registered on the MERS® System (May 24, 2007), \textit{available at} http://www.mersinc.org/newsroom/press_details.aspx?id=194.} MERS was intended to make it cheaper and faster for lenders to buy and sell loans without all the extra paperwork and fees they would have incurred had they done it by the traditional method\footnote{Id. through local registries of deeds. The idea was that while a mortgage was packaged, securitized, sold, and resold, the ownership interests would be electronically tracked by MERS. However, while MERS may have saved the real estate industry over a billion dollars,\footnote{Id. it has been nothing but a disservice to homeowners. Often, MERS remains listed as the holder of these loans rather than investors. MERS, therefore, frequently brings foreclosure actions against borrowers, who usually have}
never heard of MERS and who have no way of contacting it. Several pending lawsuits across the country are challenging the ability of MERS to foreclose in the name of the actual mortgage holder.\(^{253}\)

Moreover, borrowers’ loan servicers are unable to modify loans without investor authorization. Unfortunately, some subprime lenders went out of business for various reasons and were unable to repurchase problem loans.\(^{254}\) In some cases, investors have been shielded from liability for the origination-related conduct of the lenders from whom they purchased loans.\(^{255}\) However, there are theories under which investors have been sued for their role in the transaction.\(^{256}\) For example, in the landmark case *In re First Alliance Mortgage Co.*, 298 B.R. 652 (C.D. Cal. 2003), the jury found Lehman Brothers, Inc. liable for First Alliance’s mortgage fraud under an aiding and abetting theory.\(^{257}\)

### J. The Absence of Bankruptcy As a Backstop

Bankruptcy law is intended to give insolvent debtors a fresh start.\(^{258}\) Filing for bankruptcy is often a last resort for financially struggling homeowners to avoid foreclosure.\(^{259}\) Today, with the country in the midst

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\(^{254}\) See The Mortgage Lender Implode-O-Meter, http://ml-implode.com (noting that “[s]ince late 2006, 362 major U.S. lending institutions have ‘imploded’”).


\(^{256}\) E.g., Plascencia v. Lending 1st Mortgage, 583 F. Supp. 2d 1090, 1099-1100 (N.D. Cal. 2008) (refusing to dismiss fraud claim against entity that purchased and then securitized option ARMs; it did not make misrepresentations to consumers, but complaint sufficiently alleged that it substantially assisted lender’s misrepresentations).

\(^{257}\) *In re First Alliance Mortgage*, 298 B.R. at 668-70.


\(^{259}\) See 11 U.S.C. § 362(a)(1) (2009) (a filed bankruptcy petition operates as an automatic stay, applicable to all entities, of “the commencement or continuation . . . of a judicial, administrative, or other action or proceeding against the
of an unprecedented foreclosure crisis, the integrity of the bankruptcy system is essential. Nevertheless, bankruptcy is not a feasible option for many homeowners. Even if a homeowner is able to stop a foreclosure sale by filing for bankruptcy, only about one third of debtors successfully emerge from bankruptcy able to keep their homes. Economic realities, unaddressed in recent Bankruptcy Code legislation, play a part. Creditor abuses of the bankruptcy system also prevent debtors from successfully completing their bankruptcies.

Debtors who file a Chapter 13 bankruptcy – a debt repayment plan that includes their mortgage – must be able to afford their entire monthly mortgage payments together with a portion of their arrears, required trustees’ fees, plus a percentage of their unsecured debts. Today, homeowners in foreclosure are in far more dire financial straits than merely being unable to pay their credit card bills. Thus, bankruptcy often does not help homeowners with limited means. Mortgage payments alone are too high for homeowners to afford, irrespective of any required payments on unsecured debts. Borrowers’ debt-to-income ratios exceed fifty percent. Mortgage loan affordability is only possible if the loan

260 See Bernanke, supra note 4.
261 Bankruptcy Site: Statistics, http://www.bankruptcylawinformation.com/index.cfm?event=dspStats (last visited Nov. 29, 2009) (“Nationally, only one third of all [C]hapter 13 filings reach a successful discharge. That is, only one third of [C]hapter 13 cases reach the end of the repayment plan. The other two thirds . . . are either dismissed or converted to a [C]hapter 7 bankruptcy.”).
262 Id.
264 Id. at §§ 1322(a)(2), 1325.
266 See supra Part D.
267 A debt-to-income ratio is the relationship between monthly income and minimum monthly debt payments; frequently used by financial institutions as
is modified based on a borrower’s ability to pay. But lenders are not legally required to modify loans – leaving borrowers with no enforceable options. Congress ignored this reality when the Senate struck down the House-passed (by a vote of 234-191) Bankruptcy Bill – HR 1106, which would have allowed bankruptcy judges to modify mortgages on primary home loans.

Congress also failed to recognize the extent of borrowers’ financial distress at the height of the subprime lending market when it passed the Bankruptcy Abuse Prevention and Consumer Protection Act (“BAPCPA”). BAPCPA, enacted in 2005, was designed, in part, to make it more difficult for individuals to file Chapter 7 bankruptcy. Among other obstacles, BAPCPA imposed several new prerequisites to filing bankruptcy on debtors, such as credit counseling and satisfaction of a “means test.” These new administrative hurdles have sometimes an indicator of a borrower’s ability to take on additional debt.

268 See, In re Nowlin, 576 F.3d 258 (5th Cir. 2009).


272 Opening Statement of Sen. Chuck Grassley at the Bankruptcy Reform Hearing (Feb. 10, 2005), available at http://grassley.senate.gov/news/Article.cfm?customel_dataPageID_1502=9716 (“Most people think it should be more difficult for people to file for bankruptcy. Americans have had enough; they are tired of paying for high rollers who game the current system and its loopholes to get out of paying their fair share. This legislation eliminates some of the opportunities for abuse that exist under the current system. Our current system allows wealthy people to continue to abuse the system at the expense of everyone else. People with good incomes can run up massive debts and then use bankruptcy to get out of honoring them.”).

273 Section 109(h) provides that a debtor will no longer be eligible to file under
prevented debtors from being able to file bankruptcy in time to stop a foreclosure. 274

Lenders abuse the bankruptcy system by charging hidden, illegal bankruptcy and mortgage related fees and by failing to account pre and post-petition payments properly. 275 These abuses prevent debtors from completing their bankruptcies and obtaining a fresh start. Lenders hide fee overcharges by placing the improper fees on borrowers’ accounts but waiting to collect them after the bankruptcy is discharged – when the debtor is no longer under the bankruptcy court’s protection. 276 They improperly apply debtors’ funds to questionable fee balances rather than either Chapters 7 or 13 unless within 180 days prior to filing the debtor received an “individual or group briefing” from a nonprofit budget and credit counseling agency approved by the United States trustee or bankruptcy administrator. 11 U.S.C. § 109(h) (1978).

274 In re Sosa, 336 B.R. 113, 114 (Bankr. W.D. Tex. 2005) (calling the legislation’s adoption in its title of the words “consumer protection” the “grossest of misnomers.”); U.S. Gov’t. Accountability Office, GAO-07-203, Bankruptcy Reform: Value of Credit Counseling Requirement Is Not Clear (2007) (“[T]he value of the counseling requirement is not clear. The counseling was intended to help consumers make informed choices about bankruptcy and its alternatives. Yet anecdotal evidence suggests that by the time most clients receive the counseling, their financial situations are dire, leaving them with no viable alternative to bankruptcy. As a result, the requirement may often serve more as an administrative obstacle than as a timely presentation of meaningful options. Because no mechanism currently exists to track the outcomes of the counseling, policymakers and program managers are unable to fully assess how well the requirement is serving its intended purpose.”).


to their current monthly mortgage payment, putting debtors further into default.

Relatively few debtor class actions have been brought to address these abuses. Debtors’ account histories are usually incomprehensible, making it nearly impossible for an individual debtor to uncover lenders’ illegal practices. Bankruptcy lawyers without litigation or class action experience are unable and/or unwilling to bring these claims. Moreover, since the damages oftentimes consist of relatively small fees and charges the claims are uneconomical to pursue for individual debtors.\(^\text{277}\)

Moreover, litigants face a complex subject matter jurisdiction issue in these cases.\(^\text{278}\) Even though the Bankruptcy Rules incorporate Federal Rule of Civil Procedure 23 and bankruptcy courts routinely hear claims against lenders for violations of the Bankruptcy Code, there is a split of authority about whether bankruptcy courts have subject matter jurisdiction over debtor class actions.\(^\text{279}\) Lenders have aggressively litigated

\(^{277}\) E.g. Mounce v. Wells Fargo Home Mortgage, Inc. \((In \text{ re Mounce})\), Adversary No. 04-5182-lmc, 2008 WL 2714423, at *9 (July 10, 2008) (denying Wells Fargo’s request for a discovery stay, finding, “…the potential claim that each class member holds against Wells Fargo, if proven, may be a small number by Wells Fargo’s standards, but it could be relatively more significant to those class members who may be a few hundred dollars behind in their mortgage or credit card payments. In this regard, the court finds that the harm to the class members should this court grant Wells Fargo’s stay would be greater than the prospective harm suggested by Wells Fargo in the absence of a stay pending appeal.”).


\(^{279}\) See Bank United v. Manley, 273 B.R. 229 (N.D. Ala. 2001) (affirming certification of a nationwide class of debtors challenging mortgage overcharges); Mounce v. Wells Fargo Home Mortgage, Inc. \((In \text{ re Mounce})\), 390 B.R. 233 (Bankr. W.D. Tex. 2008) (Bankruptcy Court certified a class of Chapter 7 bankruptcy debtors); Noletto v. NationsBanc Mortgage Corp. \((In \text{ re Noletto})\), 281 B.R. 36 (Bankr. S.D. Ala. 2000) (certifying class of debtors who alleged lender’s failure to satisfactorily disclose post-petition, pre-confirmation attorney fees that it included in its proof of claim); Dean v. First Union Mortgage Corp. \((In \text{ re Harris})\), 280 B.R. 876 (Bankr. S.D. Ala. 2001) (in case challenging attorney fees improperly posted to debtors’ mortgage accounts, class certification under Rule 7023(b)(2) was appropriate because most fees had not yet been collected or only partially paid by debtors, and declaratory and injunctive relief removing fees from accounts and providing restitution for those paid was predominant form of relief); Sheffield v. Homeside Lending Inc. \((In \text{ re Sheffield})\), 281 B.R. 24 (Bankr. S.D. Ala. 2000) (certification granted of
this issue, which prolongs and sidetracks the litigation.

As of the date of this article, there are a variety of debtor class actions against mortgage lenders pending in bankruptcy courts. Overall, these actions challenge mortgage lenders’ charging and/or overcharging of improper bankruptcy related fees and costs and/or misapplication of debtors’ payments under their Chapter 13 plans. Such acts violate the provisions of the Bankruptcy Code, debtors’ Chapter 13 bankruptcy plans and various bankruptcy court orders.

Conclusion


282 Nat’l Coal. for the Homeless et al., Joint Report: Foreclosure to
loan modifications. Immediate modification of subprime loans and particularly toxic products, such as Payment Option Arm loans, is crucial because these loans have the highest delinquency rates.

Because the problems are so widespread, class action litigation is a necessary and important mechanism for remedying the foreclosure crisis. An editorial writer for the New York Times recently opined:

Class actions can be a powerful tool in challenging practices, like predatory lending, that affected large numbers of homeowners. Right now the Legal Services Corporation, which provides essential civil legal services to low income Americans, is barred by law from representing clients in class action suits. Congress should lift that and other unwarranted restrictions on legal service providers.

Homelessness 2009: The Forgotten Victims of the Subprime Crisis 5 (2009), available at http://www.nationalhomeless.org/advocacy/ForeclosuretoHomelessness0609.pdf (estimating that more than ten percent of homeless people that social services agencies have assisted over the last year became homeless because of foreclosure).

Testimony of Twomey, supra note 250; U.S. Dep’t of Hous. and Urban Dev., Office of Pol’y Dev. and Research, Interim Report to Congress on the Root Causes of the Foreclosure Crisis 44 (2009), available at http://www.huduser.org/Publications/PDF/int_foreclosure_rpt_congress.pdf (“Loan modifications that include interest rate and/or principal reductions represent the most powerful tool for keeping borrowers in their homes . . .”).

David A. Graham, Fixing Troubled Mortgages for the Elderly, Wall St. J., Oct. 21, 2009, at D1 (referring to an industry expert’s findings that as of August 31, 2009, thirty-two percent of option ARMs and forty-eight percent of subprime loans were delinquent or in foreclosure).

See, e.g., Raymond H. Brescia, Tainted Loans: The Value of a Mass Torts Approach to Subprime Mortgage Litigation, 78 U. Cin. L. Rev. (forthcoming 2010), draft manuscript available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1420792_(concluding that the class action technique is one of the legal interventions best suited to achieve what the author identifies as goals for a legal response to the financial crisis: “reducing the number of foreclosures; correcting for past illegality in the mortgage market to root out and remedy the harmful consequences of such conduct; uncovering and spreading information about the presence of such illegality in the market; promoting the modification of outstanding mortgage loans; applying pressure on banks and other institutions to strengthen and expand voluntary efforts to overcome past abuses in the market; preserving home values to the greatest extent possible; and improving oversight and regulation of this market.”).
Too many Americans urgently need help.\textsuperscript{286} 

The Brennan Center for Justice, a renowned and respected public policy institute, and various legal services organizations agree, declaring, "challenging "illegal but widespread practices" [causing foreclosures] without a class action is "impossible."\textsuperscript{287}

Indeed, years before the federal government took action, class actions have resulted in settlements providing for sustainable and valuable loan modification programs.\textsuperscript{288} Loan modification programs that result from litigation are more valuable than voluntary-based programs because the types of modifications available under these programs consider the illegal and predatory conduct of the lender rather than being based merely on a cost-benefit analysis.\textsuperscript{289} Moreover, lenders have a greater incentive to offer loan modification programs when they are settling costly legal claims against them, as opposed to only doing so on a voluntary basis.\textsuperscript{290}

Private loss mitigation and government programs have not achieved the necessary level of loan modifications to curb the rate of foreclosures.\textsuperscript{291} Despite promises and bailout funds, the country's biggest

\begin{itemize}
\item \textsuperscript{286} Editorial, \textit{Another Kind of Foreclosure Crisis}, N.Y. Times, Oct. 8, 2009, at A30.
\item \textsuperscript{288} In re Household Lending Litigation, No. C 02-1240 CW (N.D. Cal. Apr. 30, 2004) (settlement created a Foreclosure Avoidance Program that required Household to modify class members’ loans based on an ability to pay model).
\item \textsuperscript{289} HAMP contains a net present value test, where servicers compare the net present value of the proceeds of a foreclosure with the net present value of the proceeds of a loan modification. If the proceeds from a loan modification are greater, the servicer is required to modify the loan.
\item \textsuperscript{290} There is a question of carrots and sticks: Under HAMP, servicers receive $1,000 for every loan they modify. On the other hand, the aggregate damages that could be awarded in a successful class action would have a much greater financial impact on lenders.
\item \textsuperscript{291} See Cong. Oversight Panel, October Oversight Report: An Assessment of Foreclosure Mitigation Efforts After Six Months 48 (2009) (finding that only 1.26% of HAMP modifications had become permanent after a three month trial period); Carrie Bay, \textit{Wells Fargo Under Fire for Denied Modifications},
\end{itemize}
mortgage servicers have not delivered.292 The government’s Home Affordable Modification Plan (“HAMP”) was not effectuated swiftly enough and has not produced the desired results.293 These problems exist primarily because the HAMP lacks a clear enforcement mechanism.294 The role of class actions to address the needs of struggling homeowners should be embraced. As detailed above, they can provide restitution to homeowner, disgorgement of ill-gotten gains, opportunities for supervised loan restructuring plans, and injunctive relief to stop the predatory and discriminatory lending practices that caused the foreclosure crisis in the first place.


294 See, Williams v. Timothy F. Geithner, No. 09-1959 ADM/JJG, 2009 WL 3757380, at *6 (D. Minn. Nov. 09, 2009) (finding, “…[HAMP] does not create an absolute duty on the part of the Secretary to consent to loan modifications; it is not “language of an unmistakably mandatory character.”).
As the Obama Administration implements programs to help borrowers keep their homes,\(^1\) it is imperative that we examine the policy choices, laws, and judicial opinions that have created the “subprime foreclosure crisis” and made it necessary to subsidize loan modifications. After reviewing these issues in brief, we offer solutions to further ameliorate the deleterious effects of the crisis and to prevent similar issues from arising in the future.

Ultimately, the set of legal standards that protect lenders and loan purchasers from accountability for predatory loans has resulted in a significant increase in foreclosure filings\(^2\) and the destabilization of financial markets.\(^3\) For many years, Congress, states, regulators, and the courts have shielded lenders and investors from the risks of improvidently extending credit through, \textit{inter alia}, the holder in due course and preemption doctrines, layered on top of anemic standards for origination practices. The industry has long argued that these limitations on


liability increase consumer access to credit and lower transaction costs. Nevertheless, without meaningful rules and remedies, lenders have no incentive to avoid making bad loans in the first place, and purchasers on the secondary market have no incentive to monitor the quality of the loans they buy. Holder in due course status facilitates the securitization of subprime mortgages and misaligns the interests of borrowers, investors, and consumers, which leads to weak underwriting and fraud.

Worse, these doctrines rob many victims of predatory lending of any chance to receive compensation for their losses. Many loan originators are thinly capitalized, and the law provides scant substantive consumer protection for loans originated or assigned to national banks that are not otherwise designated “high-cost.” Finally, not only do individuals face

4 Mark B. Greenlee & Thomas J. Fitzpatrick IV, Reconsidering the Application of the Holder in Due Course Rule to Home Mortgage Notes, 41 UCC L.J. 3 Art. 2 (2009).


8 Id.

9 Kurt Eggert, Held up in Due Course: Predatory Lending, Securitization, and the Holder in Due Course Doctrine, 35 CREIGHTON L. REV. 503, 522-23 (2002) (discussing the infamous Diamond Mortgage example).

10 Engel & McCoy, supra note 6, at 2077.

11 The Home Equity Protection Act (hereinafter “HOEPA”) prohibits balloon payments, negative amortization and prepayment penalties on very high-cost loans, a very small portion of the market, representing the most costly of subprime loans (those with very high interest rates or excessive fees). 15 U.S.C.A. § 1639 (West 2009). Most subprime and nontraditional loan products that contributed to the current economic meltdown would not have been covered by HOEPA. The Truth in Lending Act, of which HOEPA is a
the prospect of not recovering damages, but preemption deters state-led innovation in combating predatory lending, resulting in a “race-to-the-bottom” for consumer protection.

For the rights that do exist, courts have gradually tightened proof standards and barred certain avenues of relief. For instance, although the Truth in Lending Act (“TILA”) was passed to promote “the informed use of credit” by assuring “meaningful disclosure of credit terms,” federal courts have fashioned a nearly impossible to satisfy test for consumers seeking actual damages in TILA claims and have also barred class-wide rescissions under the Act. Because lenders only face relatively small statutory damages liability and individualized rescissions of illegal loans, these judicial opinions have diminished the incentives to comply with TILA.

Even if a consumer manages to pass these gauntlets, there are significant tax liabilities created by the receipt of damages, especially for principal write downs and punitive damages. Given that many victims of predatory lending are already economically insecure, this tax burden can deprive them of any real chance of fully recovering from the fraud perpetrated upon them. Congress has partially recognized the tax liability problems created by unaffordable mortgages and, in response, has temporarily suspended the taxation of some principal reductions. While temporary suspension is valuable for many innocent borrowers, it makes little sense to tax proven victims of predatory lending.


Finally, while borrowers can have the principal and interest of all types of loans reduced in Chapter 13 bankruptcy, homeowners do not have the same rights with respect to their principal residences.\textsuperscript{21} This is especially problematic because loan servicers are—in large part—unwilling to significantly modify loans voluntarily, even though such modifications would benefit all parties concerned.\textsuperscript{22} One reason frequently cited for failure to modify is that servicers fear investor lawsuits.

The policy and litigation barriers that prevent borrowers from keeping their homes also make it difficult to fight predatory lending on an ongoing basis. Nevertheless, multiple solutions exist. One of the best strategies in the current crisis for achieving loan modifications on a much larger scale would be to lift the ban on judicial modifications of home loans by allowing consumers to have the principal and interest of their loans modified in Chapter 13 bankruptcy. Bankruptcy is advantageous because it costs taxpayers very little and avoids many of the above-stated barriers to voluntary modifications. It is also likely to encourage voluntary modifications because servicers face the prospect of a borrower filing for bankruptcy. The Obama Administration has already implemented policies to reduce foreclosures such as the Making Home Affordable Program. The Program has made funds available to improve incentives for loan servicers to do more loan modifications and provide guidelines for what successful modifications would look like.

Holder in due course rules, moreover, should be abrogated for most residential loans, so as to create incentives for investors to demand more careful underwriting of residential loans. In tandem with expanded assignee liability, federal banking regulations should not bar state-specific consumer protection laws that will ensure better local control over unique and ever-evolving predatory lending problems.

While the expansion of state consumer protection laws would curb predatory lending in many respects, new federal laws should also improve requirements for sound underwriting standards, such as making

\textsuperscript{21} See William Norton Jr., Norton Bankruptcy Law and Practice § 149:8 (3d ed. 2008) (“[Section] 1322(b)(2) permits a Chapter 13 debtor to modify the rights of the holders of secured claims or unsecured claims ‘other than a claim secured only by a security interest in real property that is the debtor’s principal residence.’”).

sure lenders consider a borrower’s ability to repay the loan, and ban financial incentives like yield spread premiums (“YSPs”), which reward brokers for steering consumers to more expensive loans, as well as other incentives that drive predatory lending. To provide borrowers with more meaningful remedies and deter widespread abuse, TILA should be amended to clarify that actual damages should be awarded without proof of detrimental reliance, the statutory damages cap should be drastically increased, and that TILA class actions rescissions should be specifically permitted. Finally, tax laws should be redrafted to end penalties for receiving settlements or judgments related to predatory lending disputes.

II. Barriers to Holding Culpable Parties Accountable for Predatory Lending

While there are many difficulties in litigating predatory lending matters, chief among them are the holder in due course (“HDC”) doctrine and, in many cases, the preemption of state law claims. The HDC doctrine prevents consumers from holding the assignees of loans – often the ultimate funders of the loan – accountable for violations of laws intended to protect against predatory lending practices. Preemption, on the other hand, shields federally-supervised financial institutions from state predatory lending statutes. This has led to a considerable weakening of consumer rights since the federal bank regulators, whose budgets are supported by fees of the institutions they regulate, have not created meaningful protections to replace the preempted state laws. Federal preemption has further discouraged states from doing enough to protect consumers where they can because states fear an uneven playing field for

24 Engel & McCoy, supra note 6, at 2041.
25 Eggert, supra note 9, at 528.
27 Id. at 356.
state-supervised institutions and states listen to claims by federal regulators that state protections do not work or are not needed.\textsuperscript{29} To protect the consumer and the integrity of the market, the HDC doctrine must be abrogated or weakened in the consumer lending market. Moreover, states should be able to supplement federal anti-predatory laws so that protections against abusive mortgage lending practices are strong across the board, regardless of the type of lender.

\section*{A. The Holder in Due Course Doctrine}

The HDC doctrine insulates mortgage assignees from most of the claims that a consumer could assert against the original lender.\textsuperscript{30} The Uniform Commercial Code outlines the requirements for HDC status: (1) the instrument when issued or negotiated to the holder does not bear such apparent evidence of forgery or alteration or is not otherwise so irregular or incomplete as to call into question its authenticity; and (2) the holder took the instrument (i) for value, (ii) in good faith, (iii) without notice that the instrument is overdue or has been dishonored or that there is an uncured default with respect to payment of another instrument issued as part of the same series, (iv) without notice that the instrument contains an unauthorized signature or has been altered, (v) without notice of any claim to the instrument described in § 3-306, and (vi) without notice that any party has a defense or claim in recoupment described in § 3-305(a).\textsuperscript{31}

\begin{itemize}
\item There are only limited ways to overcome HDC status, including in some
\end{itemize}

\begin{footnotesize}
\begin{itemize}
\item \textsuperscript{29} See, e.g., Review of the National Bank Preemption Rules: Hearing Before the S. Comm. on Banking, Hous., & Urban Aff., 108th Cong. 6-7 (2004) (statement of John D. Hawke, Jr., Comptroller of the Currency), available at http://www.occ.treas.gov/ftp/release/2004-28b.pdf (“Some may ask, why not allow State and local predatory lending laws to apply as well? Isn’t more regulation better? To that I would answer, not unless there has been a demonstration that more regulation is needed because the existing regulatory scheme does not work. That is not the case with respect to the national banking system.”).
\item \textsuperscript{30} Eggert, \emph{supra} note 9, at 528.
\item \textsuperscript{31} U.C.C. § 3-302(2005).
\end{itemize}
\end{footnotesize}
cases with the right fact pattern, through the civil conspiracy\textsuperscript{32} or the close connectedness doctrine.\textsuperscript{33} First, a civil conspiracy exists when “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.”\textsuperscript{34} If a civil conspiracy claim is warranted, that would break the barrier between the loan originator and the securitizer, the latter often having more resources to pay judgments\textsuperscript{35} and without whom the market for predatory loans would have been much smaller.\textsuperscript{36} While an agreement between these entities is unlikely to include an explicit solicitation of illegal loans, there may be circumstantial evidence of the securitizer’s acquiescence to predatory tactics.\textsuperscript{37} Second, the “close connectedness” doctrine abrogates the HDC doctrine when, for example, the financier provides the sales contract, which is simultaneously assigned upon execution.\textsuperscript{38} The rationale for the close connectedness doctrine is that HDC status was created in order to facilitate the free negotiability of commercial paper amongst strangers; the more connected parties are, however, the less free negotiability should be a concern.\textsuperscript{39}

Unfortunately, often these “solutions” to the HDC problem are difficult to prove, especially based on evidence available to the consumer. Further, by the time the abuse is discovered, and particularly in the current economic environment, the original perpetrators of improvident lending

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\item \textsuperscript{35} Engel & McCoy, \textit{supra} note 6, at 2077.
\item \textsuperscript{37} Peterson, \textit{supra} note 34, at 2251.
\item \textsuperscript{38} Greene, 488 F. Supp. at 180.
\item \textsuperscript{39} Unico v. Owen, 232 A.2d 405, 410, 417 (N.J. 1967).
\end{itemize}
are increasingly out of business or have been taken over by the Federal Deposit Insurance Corporation ("FDIC"). The FDIC receivership process is particularly difficult for consumers because failed bank assets are bifurcated and new owners purchase only the benefits (i.e. the right to enforce a security interest), while leaving behind any potential claims for predatory lending. The FDIC keeps the potential liability but enjoys "super holder in due course" status, which leaves consumers with little or no recourse for their losses.

The HDC doctrine has, to a large extent, made securitization possible. That is, investors will not purchase and rating agencies will not put their imprimatur on pools of mortgages unless there is minimal liability for predatory tactics. While securitizers could expend the time and money to evaluate the quality of loans they sell, the industry has found it more efficient to rely upon HDC law. Because loan originators are thinly capitalized and pass loans quickly to securitizers, they also have little incentive to properly underwrite loans. In the end, this leads to a disconnect between the interests of all the parties to the transaction and the consequent production of unaffordable and unsustainable loans.

The best way to prevent a recurrence of Wall-Street-fueled predatory lending is for Congress to require the secondary market to have "skin in the game" (i.e. a financial interest in the underlying loans that make up an asset-based security) through meaningful assignee liability. Risk associated with the origination of a loan needs to travel with the loan, rather than be stripped from the loan when the loan is securitized. In that way, when Wall Street purchases high-risk mortgages and any

40 Engel & McCoy, supra note 6, at 2077.
43 FDIC v. Wood, 758 F.2d 156, 161 (6th Cir. 1985) (holding that the FDIC is not liable for a flagrantly usurious note, as super holder in due course status is necessary to effectuate the FDIC's congressional purpose).
44 Engel & McCoy, supra note 6, at 2098.
45 Peterson, supra note 34, at 2243.
46 Eggert, supra note 9, at 550.
47 Statement of Ben S. Bernanke, supra note 7.
48 Id.
corresponding financial benefits, it also accepts responsibility for what its purchases will encourage at the origination level. The holder of the loan (i.e. the individual or entity that is entitled to foreclose on the loan if the homeowner defaults) should maintain some level of ultimate responsibility for the terms of the loan. The result of meaningful secondary market liability is that the market can accurately price risk and thereby police itself.

While both the borrower and the ultimate note holder may, in most situations, be without specific responsibility for creating abusive loans, the holder is in a far better position than the homeowner to bear the risk of a bad mortgage for three reasons. First, the holder can spread this loss across thousands of other loans, while the borrower has but one home. Second, the holder can choose from whom to buy their loans and can therefore choose reputable originators who are likely to make quality mortgages and who are strong enough to purchase the loans back if they violate the representations and warranties that the secondary market purchaser imposes. Third, the holder can conduct stringent due diligence to ensure that it is not unwittingly purchasing bad mortgages.

**B. Preemption of State Anti-Predatory Lending Statutes**

Under the Supremacy Clause, Congress may preempt state law, provided that it does so within its constitutionally delegated powers. Preemption occurs under two main circumstances: “when a conflict between federal and state law preclude[s] obedience to both sovereigns, or when a federal statute so completely occupie[s] a field that it left no room for additional state regulation.”

The National Bank Act and Home Owner’s Loan Act have long blocked states from completely regulating nationally charted banks and thrifts. The Office of Thrift Supervision (“OTS”) preempts the

49 U.S. Const. art. VI, cl. 2.
entire field of lending regulation, which prohibits states from regulating certain features of the lending process, *inter alia*, by passing laws that mandate lender licensing or limit loan terms related to amortization, disbursement, and repayments for its chartered entities. In addition, the Office of the Comptroller of the Currency (“OCC”) has asserted a broad interpretation of conflict preemption resulting in all but field preemption over lending activities of national banks, despite Supreme Court precedent to the contrary.

Historically, the Supreme Court justified the OCC’s preemption rule by stating that inconsistent state law would frustrate the purpose of the National Bank Act and impair banking institutions’ ability to efficiently discharge their duties. Banks, moreover, defend the preemption of state law as a way to provide cheaper consumer services, alleging that compliance with multiple state laws increases transaction costs.

The value of state regulation of lending, regardless of the charter of the entity, is manifold, particularly with the current consolidation of financial institutions that has resulted in an increased dominance of

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54 Silvas v. E*Trade Mortg. Co., 514 F.3d 1001, 1005 (9th Cir. 2008).
55 12 C.F.R. § 560.2(b) (2009).
56 Indeed, some critics argue that the practical import of preemption efforts has been to achieve field preemption in practice, if not through clear declaration as such. Wilmarth, *supra* note 26, at 234; 12 C.F.R. §§ 7.4007-9 (2009), 34.3-.4 (2009).
57 Atherton v. FDIC, 519 U.S. 213, 222-23 (1997); Barnett Bank of Marion County, N.A. v. Nelson, 517 U.S. 25, 33 (1996) (holding that “in defining the pre-emptive scope of statutes and regulations granting a power to national banks, these cases take the view that normally Congress would not want States to forbid, or to impair significantly, the exercise of a power that Congress explicitly granted.”). According to the OCC, preemption does not ban consumer lawsuits against national banks *in toto*: “[S]tate laws escape preemption only ‘to the extent that they only incidentally affect the lending operations of Federal savings associations . . . .’” *In re* Ocwen Loan Servicing, LLC Mortg. Servicing Litig., 491 F.3d 638, 643 (7th Cir. 2007) (quoting 61 Fed. Reg. 50951, 50966 (Sept. 30, 1996)) (emphasis added). Therefore, basic common law claims for breach of contract and fraud remain. *Id.* at 643-44.
58 The OTS has issued similar regulations pertaining to thrifts and consumer lawsuits. 12 C.F.R. § 560.2(c) (2009).
nationally chartered banks over the lending market. First, states can act as “‘laboratories’ in experimenting with new banking products, structures, and supervisory approaches, and Congress has subsequently incorporated many of the states’ successful innovations into federal legislation.” Second, state laws tend to be more ideologically aligned with their citizens’ views of consumer protection. Third, federal law enforcement is unlikely to prosecute small-time lenders.

Robust preemption of state law, on the other hand, has led to a race to the bottom of consumer protection. For instance, banks may switch from a state to a federal charter (or vice versa) in order to find the most hospitable regulations. This, in combination with federal agency interest in attracting banks to regulate, leads to weak consumer protection. Federal regulators have disputed the need for stronger consumer protections, and these comments, along with a desire to maintain a level playing field for state-supervised institutions, have made some states reluctant to pursue meaningful reforms on behalf of consumers.

The solution is to end or severely limit preemption for consumer financial products. Federal law should act as a floor, not a ceiling, and enforcement efforts at the federal and state levels should be complementary, not in competition for territory. Limits on preemption will allow states to experiment with the allocation for risk between consumers and business.

In the first half of 2009, Wells Fargo and Bank of America originated approximately 50 percent of all mortgages. In contrast, the top three lenders accounted for only 37 percent of the market share in 2007. Leslie Scism et al., Slump Spurs Grab for Markets, WALL ST. J., Aug. 24, 2009, at A1.


63 Id. at 1362.

64 Statement of Sheila C. Bair, supra note 12.

65 Forrester, supra note 62, at 1370.

66 Id.

67 See generally Hawke, supra note 29.
in accordance with their constituents’ wishes. As stated above, it will also inspire more innovation in the delivery of banking services.

III. Clear and Reasonable Underwriting Standards

In light of what has happened in the mortgage market, it is more essential than ever that TILA be strengthened with sensible lending rules to permit the mortgage market to resume functioning properly, but also to prevent abusive, unsustainable lending in the future. The key to reform is to realign the incentives of the market with as many bright-line rules as possible, while also providing adequate remedies to ensure that no one will fall through the cracks.

To change the incentives for mortgage originators, all mortgage originators should have a duty of good faith and fair dealing. Among other things, this requirement would mandate that an originator make reasonable efforts to secure a home mortgage loan that is appropriately advantageous to the consumer. The originator would have to sell a product that was appropriate with respect to product type, rates, charges, and repayment terms of the loan.

Independent mortgage brokers, however, should be held to an even higher standard than retail lenders: they should have a fiduciary duty to their customers – just as stockbrokers do. Experts on mortgage financing have long raised concerns about the problems inherent in a market dominated by broker originations. For example, the chairman of the Federal Reserve Board, Ben S. Bernanke, noted that placing significant pricing discretion in the hands of financially motivated mortgage brokers in the sales of mortgage products can be a prescription for trouble, as it can lead to behavior not in compliance with fair lending laws. Similarly, a report issued by Harvard University’s Joint Center for Housing Studies,

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68 Unlike retail lenders, who are obviously in business to sell loans to consumers, brokers hold themselves out to consumers as trusted advisers for navigating the complex mortgage market. Like stockbrokers, that is the value-added service they sell, and it is the service consumers assume they are buying. Yet most mortgage brokers and their trade associations deny that they have any legal or ethical responsibility to refrain from selling inappropriate, unaffordable loans, or to avoid benefiting personally at the expense of their borrowers.

stated, “[h]aving no long term interest in the performance of the loan, a broker’s incentive is to close the loan while charging the highest combination of fees and mortgage interest rates the market will bear.”

A. **Yield Spread Premiums**

The way brokers are compensated creates strong incentives for them to sell unconscionably expensive loans to their customers, even when those customers qualify for better loans. Currently, most brokers receive a YSP in return for making a loan on behalf of a lender. Abusive YSPs create a perverse incentive for mortgage brokers to steer borrowers into loans that are more costly and dangerous even though they could qualify for a more affordable product. Lenders then provide additional

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70 Credit, Capital and Communities: The Implications of the Changing Mortgage Banking Industry for Community Based Organizations, JOINT CTR. FOR HOUSING STUDIES (Harvard Univ., Cambridge M.A.), Mar. 9, 2004, at 4. Moreover, broker-originated loans “are also more likely to default than loans originated through a retail channel, even after controlling for credit and ability-to-pay factors.” Id. at 42 (citing Alexander et al., Some Loans are More Equal Than Others: Third Party Originations and Defaults in the Subprime Mortgage Industry, 30(4) Real Estate Econ. 667-97 (2002)).

71 Keith Ernst, Debbie Bocian & Wei Lei, CTR. FOR RESPONSIBLE LENDING, Steered Wrong: Brokers, Borrowers and Subprime Loans (2008), available at http://www.responsiblelending.org/mortgage-lending/research-analysis/steered-wrong-brokers-borrowers-and-subprime-loans.html. Mortgage lending legislation should also absolutely prohibit racially discriminatory steering. While an efficient financial market theoretically would provide equally qualified borrowers with equally competitive prices on subprime home loans, both quantitative research and anecdotal evidence show that some borrowers, particularly African-American and Latino families, pay more than necessary for subprime mortgages. In May 2006, CRL analyzed data submitted by mortgage lenders for loans made in 2004 to assess the effects of race and ethnicity on pricing in the subprime market while controlling for the major risk factors used to determine loan prices. Our findings showed that, for most types of subprime home loans, African-American and Latino families were at greater risk of receiving higher-rate loans than white borrowers, even after controlling for legitimate risk factors. In other words, if two families received subprime loans, one African American and one white, and they had the same credit score and were similarly qualified in every other way, the African-American family has a significant chance of receiving a higher-cost loan. See, e.g., Jeffrey D. Dillman, Samantha Hoover & Carrie Pleasants, Housing Research &
compensation to brokers to lock borrowers into these higher-rate loans with a prepayment penalty to provide an income stream to pay off that upfront YSP payment. Banning YSPs would significantly reduce incentives for brokers to upsell borrowers into more expensive and riskier loans than those for which they qualify.\footnote{72}

In theory, consumers can use YSPs to buy down upfront origination costs. However, the reality is that, especially in the subprime and nontraditional mortgage markets, this trade-off rarely (if ever) occurs. The Department of Housing and Urban Development ("HUD"), in the regulatory review accompanying the issuance of their recently-enacted proposed rule in March 2008, cited extensive evidence that, even in the prime market, borrowers with YSPs pay in the aggregate more in fees, interest, and other closing costs than borrowers who do not pay YSPs.\footnote{73}

B. Prepayment Penalties

Similarly, prepayment penalties, a pervasive and insidiously harmful feature of the now-collapsed subprime market, should be banned on mortgage loans generally. During the current crisis, many families that might have escaped their mortgage by refinancing before housing values became prohibitively low found themselves trapped by a prepayment penalty. Commonplace in the subprime market, a prepayment penalty on a $250,000 loan could be expected to range from $8,000 to $10,000.

\footnote{72} Alternatively, YSPs should be banned for subprime and nontraditional loans and permitted in the prime market only when they are a true trade-off, i.e., when (1) the borrower pays no origination costs, either out of pocket or from the loan proceeds (except for fees paid to government officials or amounts to fund escrow accounts for taxes and insurance); and (2) the loan does not contain a prepayment penalty. If that approach is taken, any payment of such a premium by a lender should be recognized as a per se acknowledgment of agency between the broker and originating lender, with liability for the broker’s acts and omissions irrebuttably attaching to the originating lender and subsequent holders of the note.

– enough to prevent or discourage refinancing. Independent research has fixed the increased risk of default on subprime mortgages with prepayment penalties from sixteen to twenty percent over already high baseline rates.\textsuperscript{74}

Contrary to some industry claims, empirical analysis of the effects of anti-predatory lending laws, including those with limitations on prepayment penalties, shows that banning prepayment penalties causes a decrease in the targeted abuse, without any restriction in access to credit.\textsuperscript{75} In fact, in states that have limited prepayment penalties as part of their approach to curbing predatory lending, interest rates have stayed the same or lower compared with control states where such protections are absent.\textsuperscript{76} Eliminating prepayment penalties and YSPs would be a major


\textsuperscript{75} Wei Li & Keith S. Ernst, Ctr. for Responsible Lending, \textit{The Best Value in the Subprime Market: State Predatory Lending Reforms} 2-3, 13-17 (2006).

\textsuperscript{76} Id. at 6. The study ranked states as to six substantive protections, prepayment penalties among them, as well as the scope of coverage to which the protections applied and the remedies available. The lowered interest rates likely result from the perverse relationship between YSPs and prepayment penalties in the subprime market, as we discuss above. We also note that at least thirty-five states regulate prepayment penalties, including eleven states that have prepayment penalty bans on broad categories of mortgage loans. There is no evidence that consumers feel deprived of “choice” in those states. \textbf{Alabama} (unless approved mortgagee under National Housing Act or where creditor is exempt from licensing, per \textit{Ala. Code} § 5-19-31 (LexisNexis 1996 & Supp. 2008) (this version of the law only effective until November 21, 2009)); (\textit{Ala. Code} § 5-19-4(c) (LexisNexis 1996 & Supp. 2008)); \textbf{Alaska} (except federally insured loans requiring prepayment penalty) (\textit{Alaska Stat.} § 45.45.010(g) (2008)); \textbf{Indiana} (prepayment penalty banned for a consumer loan (key requirement: secured by an interest in land or by personal property that is the borrower’s principal dwelling) that is not “primarily secured by an interest in land” (i.e., that is not a first lien mortgage) as well as for a refinancing or consolidation (junior lien)) (\textit{IND. Code Ann.} § 24-4.5-3-209 (West 2006 & Supp. 2008) (limitation on penalty); § 24-4.5-3-104 (West 2006) (definition of “consumer loan”); § 24-4.5-3-105 (West 2006) (explanation of “primarily secured by land”)); \textbf{Iowa} (purchase money or refinanci
step forward in protecting consumers and returning fairness to the market for responsible lenders.

C. Excessive Fees

Another key protection, and one that has long been at the forefront of preventing predatory lending, is limiting excessive fees. Historically, mortgage loans primarily generated income and profits through the performance of the loans and the payment of interest. In recent years, this model was abandoned for quick payments generated at closing that were divorced from the long-term sustainability of the loan. The result has been the loss of home equity for families and an unstable and unsustainable mortgage system that has badly wounded our overall economy.


77 When widespread abusive lending practices in the subprime market initially emerged during the late 1990s, the primary problems involved equity stripping—that is, charging homeowners exorbitant fees or selling unnecessary products on refinanced mortgages, such as single-premium credit insurance. By financing these charges as part of the new loan, unscrupulous lenders were able to disguise excessive costs. To make matters worse, these loans typically came with costly and abusive prepayment penalties, meaning that when homeowners realized they qualified for a better mortgage, they had to pay thousands of dollars before getting out of the abusive loan. See, e.g., Eric Stein, Ctr. for Responsible Lending, Quantifying the Economic Costs of Predatory Lending 4 (2001), available at http://www.selegal.org/Cost%20of%20Predatory%20Lending.pdf.
interest rate. This provides pricing transparency, which is essential for
competition to work, and it rewards lenders who provide sustainable
loans instead of lenders who extract the greatest amount of equity at
closing. To the extent loans that exceed these limits are permitted, there
should be additional safeguards and lender responsibilities to ensure that
homeowners benefit from any additional charges.

D.  

Failure to Consider the Borrower’s Ability to Repay

Perhaps one of the most astonishing aspects of the recent reckless
lending spree was that the market utterly ignored whether a borrower
could actually afford the mortgage. This core underwriting principle –
a basic, common-sense business principle that would be understood by
virtually anyone – was not only ignored, it was affirmatively shunned.
The mortgages that sparked the market meltdown were “designed to
terminate” specifically to ensure a continuing stream of new originations.
TILA should require an analysis of a borrower’s ability to repay, and it
should take into account the borrower’s debt-to-income ratio and residual
income. Lenders should also be required to verify income through written
materials and escrow for taxes and insurance.

The failure to consider a borrower’s ability to repay was especially
dangerous in the case of adjustable rate mortgages (“ARMs”) that
incorporated an element of payment shock to the borrower. Payment
shocks are created by a variety of dangerous loan structures: loans made
without documenting incomes because the families simply did not afford
the payment; subprime exploding ARMs where the payment increases
by thirty percent to forty percent after the second year, even if rates in
the economy stay constant; interest-only loans where the payment can
increase by fifty percent when the loan starts amortizing over a shorter
remaining life; and payment option ARMs where the payment can
double when it recasts at the fifth year, for lenders who require recasting
at that time rather than ten years out. If these loans were not carefully
underwritten at the fully indexed, fully amortizing payment when made,

78 Souphala Chomsisengphet, Timothy Murphy & Anthony Pennington-Cross,
Product Innovation and Mortgage Selection in the Subprime Era, UNIV. OF IOWA
uiowa.edu/dnn4/PenningtonCross_Anthony.pdf (referring to loans “designed
to terminate”).
as many lenders failed to do, they set the borrowers up for almost certain failure.\footnote{79}

What is more, during the recent heyday of reckless lending, loan originators – particularly independent mortgage brokers – encouraged borrowers to take out so-called “no doc” or stated-income loans even when those borrowers had easy access to their W-2s. Without adequate income verification, a lender’s approval of a loan is meaningless. Borrowers often do not understand that they are paying a higher interest rate so as not to document their income, even though their W-2s are readily available. They also often do not realize that the broker has inflated their income on the loan application. A review of a sample of stated-income loans disclosed that ninety percent had inflated incomes compared to IRS documents and almost sixty percent of the stated amounts were exaggerated by more than fifty percent.\footnote{80} Overstated incomes lead to overestimated repayment ability and then to foreclosures.

Finally, federal legislation should mirror successful state laws requiring a net tangible benefit for mortgage refinances. Loan flipping has been a prime tool for stripping the equity from homeowners since the beginning of the subprime market. These state laws prevent the serial refinancing by unscrupulous originators and have been shown not to reduce access to legitimate credit.\footnote{81}

\footnote{79} Most loan originators understood that they were putting borrowers into loans that were unsustainable and that would need to be refinanced prior to reset. In 2004, the General Counsel of New Century, then the nation’s second-largest subprime lender, referred to its 2/28 interest-only product and stated that “we should not be making loans to borrowers with the expectation that the borrower will be able to refinance in a couple years.” Debra Cassens Weiss, \textit{New Century GC Sounded Early Warning About Subprime Exposure}, A.B.A. JOURNAL, Mar. 31, 2008, http://www.abajournal.com/index.php?/news/new_century_gc_sounded_early_warning_about_subprime_exposure/.


\footnote{81} The practices of IndyMac, one of the largest originators of Alt A loans until it went defunct, demonstrate that perverse incentives drove abuse even outside of the subprime market. IndyMac routinely avoided including income
IV. THE APPARENT EROSION OF TRUTH IN LENDING ACT REMEDIES

The Truth in Lending Act\textsuperscript{82} was passed in 1968 and has been modified substantially since then, primarily to cap and limit statutory damages with regard to triggering violations (not amount).\textsuperscript{83} Remedies in TILA serve two purposes: (1) they make the borrower whole or return them to where they were before the predatory transaction took place; and (2) the threat of strong remedies deters bad lending practices. Lately, however, courts have gone further than Congress in limiting relief by functionally banning actual damages\textsuperscript{84} and loan rescissions for classes of borrowers.\textsuperscript{85} This has made fighting predatory lending substantially more difficult because the economies of scale associated with class actions\textsuperscript{86} make the possibility of helping large numbers of consumers more feasible. As such, Congress needs to clarify that detrimental reliance is not required to receive actual damages (in a class context or otherwise) and that rescissions of illegal loans can be done on a class-wide basis.

A. The End of Actual Damages under the Truth in Lending Act

In recent years, courts have defied long-settled TILA precedent\textsuperscript{87} and uniformly required detrimental reliance for actual damages.\textsuperscript{88} This standard is nearly impossible for individuals to satisfy, as they have to prove information on their loans or pushed through loans with inflated income data, even from retirees. As recently as the first quarter of 2007, only 21 percent of IndyMac’s total loan production involved “full-doc” mortgages. IndyMac Bancorp Inc., Current Report (Form 8K) (May 12, 2008).

\begin{itemize}
\item \textsuperscript{84} Perrone v. Gen. Motors Acceptance Corp., 232 F.3d 433, 436-40 (5th Cir. 2000).
\item \textsuperscript{85} Peters v. Jim Lupient Oldsmobile Co., 220 F.3d 915 (8th Cir. 2000).
\item \textsuperscript{86} Elizabeth J Cabraser, \textit{Enforcing the Social Compact Through Representative Litigation}, 33 Conn. L. Rev. 1239, 1255 (2001).
\item \textsuperscript{87} \textit{In re Murray}, 239 B.R. 728, 734 (Bankr. E.D. Pa. 1999).
\end{itemize}
they understand often complicated disclosures and would have shopped for and received a better deal in an often uncompetitive marketplace. Moreover, the standard has no support in the plain meaning or legislative history of TILA. As a result, commentators have sounded the death knell for actual damages class actions, if not for individual cases.

Because statutory damages are unavailable for many TILA violations, lenders are now virtually free to violate many disclosure regulations. Moreover, statutory class action damages are capped at a miniscule $500,000 or one percent of the lender's net worth – whichever is lower. This will hardly deter multi-billion dollar banks from wholesale violations, especially because some disclosure violations (and the consequent fees earned from hoodwinked consumers that would follow) could be more profitable than any potential liability. Given that lenders no longer have sufficient incentive to properly disclose loan terms, these recent court decisions have undermined the primary purpose of TILA: to incentivize the more informed use of credit.

To remedy this erosion of TILA rights, Congress should clarify that consumers need not show detrimental reliance to receive actual damages, which is similar to many state unfair and deceptive trade practices acts. Instead, consumers should receive the benefit of the bargain (the difference between what was disclosed and what they were actually charged) or restitution of the improperly disclosed charges. This would make TILA violations more expensive for unscrupulous lenders, thereby restoring incentives for better and more transparent loan disclosures.

89 Id. at 437.
90 Elizabeth Renuart & Kathleen Keest, Nat’l Consumer Law Ctr., Truth In Lending § 8.5.4 (6th ed. 2007).
94 See, e.g., Vallies v. Sky Bank, 583 F.Supp.2d 687, 688, 694 (W.D. Pa. 2008) (limiting Sky Bank's liability to $500,000 because detrimental reliance was required to award actual damages and since auto-finance company failed to properly disclose $395 for Guaranteed Auto Protection, the total loss for a potential class of 10,000 members would have been $3,950,000).
B. The Judicially Imposed Ban on TILA Rescission Class Actions

Similar to actual damages, courts have read a prohibition against class-wide rescissions into TILA, despite the lack of any statutory or legislative history support. TILA allows consumers to pursue rescission only where a non-purchase money mortgage is secured by the borrower’s principal dwelling. Nothing in the statute’s text limits this right to individual lawsuits. Moreover, TILA was amended in 1995 to limit rescissions from the overstatement of finance charges and related disclosures. This modification occurred after a temporary moratorium on TILA class actions. Had Congress intended to permanently limit class-wide relief for rescissions or any other avenues of relief, it certainly could have. Because neither the plain meaning nor the legislative history of TILA excludes TILA class-wide rescissions, the default rules of civil procedure, which permit class actions, should apply.

Congress should revisit TILA to make the right of rescission on a class-wide basis explicit. As with damages cases, the economies of scale offered by the class action mechanism helps to ensure that many more consumers will have access to competent representation to rescind their loans. More importantly, because more borrowers will have the means to

96 Andrews, 545 F.3d 571 (7th Cir. 2008); McKenna v. First Horizon Home Loan Corp., 475 F.3d 418 (1st Cir. 2007). Both of these cases find support for their ban on class-wide TILA rescissions in a mistaken reading of James v. Home Constr. Co. of Mobile, Inc., 621 F.2d 727 (5th Cir. 1980), Andrews, 545 F.3d at 571, and McKenna, 475 F.3d at 423. Two months after James, the same panel directed that a homeowner be included as a class member in a rescission class action settlement, a ruling that is contrary to the interpretation in McKenna that James ruled out rescission class actions. See Tower v. Moss, 625 F.2d 1161, 1163 (5th Cir. 1980).


101 See Johnson v. W. Suburban Bank, 225 F.3d 366, 369 (3d Cir. 2000); see also Califano v. Yamisaki, 442 U.S. 682, 700 (1979) (“In absence of direct expression by Congress of intent to depart from usual course of trying all suits of civil nature under Rules of Civil Procedure established for such purpose, class relief is appropriate in civil actions brought in federal court . . . .”).
rescind their loans, lenders will have an additional incentive to make sure their disclosures comply with TILA.

V. The Tax Burdens of Winning a Predatory Lending Case

Even if a consumer manages to overcome preemption and the HDC doctrine for their common law claims and the diminishing remedies for TILA violations, a large tax burden awaits for those who receive significant damages. This tax burden can render a house unaffordable. There are several ways to circumnavigate this tax problem: for example, if the debt in question is not bona fide, and thus is a “disputed debt,” it is not subject to taxation. Also, many consumers who are victims of predatory lending are insolvent at the time the debt is forgiven, which negates any tax liability.

In contrast to the litigation context, the Mortgage Forgiveness Debt Relief Act of 2007, while helpful, only applies to individuals whose principal has been written down pursuant to a voluntary loan modification. The loan must have been used to acquire, construct, or substantially improve their principal residence. Thus, the Act will not reach many lower-income borrowers because most subprime loans originated in the last few years were home equity loans, the proceeds of which were often used to pay off unsecured debt (i.e. hospital debts).


103 See Zarin v. Comm’r of Internal Revenue, 916 F.2d 110 (3d Cir. 1990).


107 Id.


Thus, a victim of predatory lending may have to pay taxes on damages, while a homeowner who is only harmed by a declining market for real estate pays none.

The solution is to carve out a specific tax exemption for damages received in compensation for predatory lending. This would further stabilize neighborhoods by keeping individuals in their homes and ensure full compensation for victims of disreputable lending tactics.

VI. LARGE SCALE LOAN MODIFICATIONS DURING THE CURRENT FORECLOSURE CRISIS

Since the subprime foreclosure crisis began, over 1.5 million homes have already been lost to foreclosure, and another two million families with subprime loans are currently delinquent and in danger of losing their homes in the near future. New projections of foreclosures on all types of mortgages during the next five years estimate that there will be thirteen million defaults from 2008 until 2014. The spillover costs are massive, even if only subprime mortgages are considered. At least forty million homes – households where, for the most part, people have paid their mortgages on time every month – are suffering a decrease in their property values that amounts to hundreds of billions of dollars in losses. These losses, in turn, are impacting nearly every aspect of American Predator Lending, Predatory Lending Report 33 (July 15, 2000), available at http://www.treas.gov/press/releases/reports/treasrpt.pdf (“[A] survey by the National Home Equity Mortgage Association found that approximately 45 percent of subprime home equity loans (second lien) are used for debt consolidation, 30 percent for covering medical, educational, and other expenses, and 25 percent for home improvement.”).

110 Cohen & Sager, supra note 18, at 14.


113 Continued Decay, supra note 111, at 3.
communities, from police and fire protection to community resources for education. So far, voluntary, loan-by-loan modification efforts are not effectively stemming the tide of foreclosures. The modifications that are made are too often unsustainable. In addition, there are many structural, legal, and financial obstacles to making modifications at all.

Streamlined and sustainable modifications are necessary to get ahead of the foreclosure curve, and servicers and creditors need substantial incentives to get them to participate in such programs. Thus far, two of the most promising proposals have been to remove the ban on judicial loan modifications for personal residences under the Bankruptcy Code and President Obama’s Home Affordability Modification Program (“HAMP”), which is intended to provide incentives to encourage standardized loan modifications that are likely to succeed.

Currently, judicial modification of loans in bankruptcy court is available for owners of commercial real estate and yachts, as well as subprime lenders like New Century and investment banks like Lehman Brothers. Yet current law makes a mortgage on a primary residence the only debt that bankruptcy courts are not permitted to modify in Chapter 13 payment plans.114 Eliminating this exception will provide a backstop for homeowners in trouble and an incentive for mortgage holders to participate in voluntary modification programs. By providing an alternative to foreclosure for homeowners whose servicers or lenders will not or cannot agree to economically rational modifications, court-supervised loan modifications would provide an important last resort for homeowners with no other option.

A. Home Affordability Modification Program

The Obama Administration’s Making Home Affordable Program, which includes HAMP115, represents a minor step forward. The Program includes concrete and pragmatic measures to counter the perverse incentives that severed the interests of servicers from those of the borrowers and investors and led servicers to pursue foreclosure even where the homeowner could afford a loan modification that would

produce greater returns for investors as a whole.\textsuperscript{116} It also recognizes that, without government action, relying on servicers and investors to voluntarily modify troubled loans does not work. In particular, HAMP includes several key improvements to realign misplaced incentives, bring relief to struggling families, and get the housing market back on track.

First, it sets a standard to establish the basic requirements of a sustainable loan modification for troubled mortgages. Among other things, the modification must be set so that the homeowner’s first mortgage debt-to-income ratio (“DTI”) is no higher than thirty-one percent based on the homeowner’s documented income.\textsuperscript{117} This goes a long way toward ensuring that the loan is affordable, thus protecting the homeowner, the investor, and the taxpayer by lowering the risk of re-default. Second, it incentivizes servicers and investors to meet this standard by sharing the cost with investors to move the borrower from a thirty-eight percent DTI to a more affordable thirty-one percent ratio. Servicers get a $1,000 up-front payment for each qualifying loan modification. Further, an additional “pay for success” fee rewards homeowners for five years because the loan remains current, and rewards servicers for three years because the loan avoids default.\textsuperscript{118} Investors also receive payments as compensation for declines in property value. These incentives both encourage sustainable loan modifications and compensate servicers for the costs entailed. Third, the program encourages lenders and servicers to work with at risk borrowers before they default by providing bonus payments to both the investor and the servicer for modifying loans in which default is imminent and the borrower is still current.\textsuperscript{119}

However, unfortunately HAMP has not lived up to its original promise. As of October 2009, only 500,000 consumers have enrolled in trial modifications.\textsuperscript{120} The Congressional Oversight Panel, which is charged with overseeing HAMP, reports that a paltry 1,711 homeowners


\textsuperscript{118} Id. at 24.

\textsuperscript{119} Id.

\textsuperscript{120} Peter S. Goodman, In Trial Phase, Mortgage Bills Fall for 500,000, N.Y. Times, Oct. 9, 2009, at B1.
graduated to permanent modifications by September 2009.\footnote{Cong. Oversight Panel, October Oversight Report: An Assessment of Foreclosure Mitigation Efforts After Six Months at 48 (2009), available at http://cop senate.gov/documents/cop-100909-report.pdf.} Given that 5.2 million foreclosures were started between July 2007 and August 2009,\footnote{Id. at 3.} this number barely impacts the mortgage market.

We propose several minor adjustments to HAMP that could result in a significant increase in the number of homeowners saved from foreclosure. Chief amongst them is compelling investors to write down a portion of the principal balance of loans to allow consumers to get their payments down to thirty-one percent of DTI. As of now, servicers need only forebear a limited percentage of principal (provided that investors approve) as a last resort to get consumers into the HAMP program.\footnote{Home Affordable Modification Program Supp. Directive, supra note 118, at 9.} Studies have demonstrated that principal reductions lead to fewer defaults.\footnote{John Geanakoplos, The Leverage Cycle, Cowles Foundation Discussion Paper No. 1715, July 2009, at 4, available at http://cowles.econ.yale.edu/~gean/crisis/d1715.pdf.} Further, the risk of foreclosure increases significantly if borrowers owe more than their house is worth.\footnote{Kristopher Gerardi, Adam Hale Shapiro and Paul S. Willen, Subprime Outcomes: Risky Mortgages, Homeownership Experiences, and Foreclosures, Federal Reserve of Boston Working Papers No. 07-15, May 4, 2008, at 1, available at http://www.bos.frb.org/economic/wp/wp0715.htm.}

HAMP can also be improved by making the Net Present Value (“NPV”) test more transparent. The NPV is used by servicers to determine whether the present value of the modified loan is worth more than the expected foreclosure value of the property.\footnote{Home Affordable Modification Program Supp. Directive, supra note 118, at 4.} If it is, then the servicer (once again, consistent with investor rules) is required to modify the loan.\footnote{Id.} The NPV test, however, is not accessible to the general public, which makes it impossible for consumers and advocates to understand why loan modifications are denied. The Treasury Department’s new Supplemental Directive 09-08, which does not become effective until January 1, 2010, is an improvement, but it only requires servicers to disclose the numbers put into the NPV test and not the source or reasoning behind those
numbers.\textsuperscript{128} For example, servicers are not compelled to disclose how consumers’ homes are valued. Without this information, homeowners are unable to fully challenge any flaws in property valuation and prevent erroneous HAMP denials.

Additionally, while Supplemental Directive 09-08 does require servicers to provide a generic notice of why HAMP applications are denied, the Treasury Department still does not afford homeowners complete due process protections. Servicers need only re-run the NPV test upon receiving a notice by a consumer of a mistake and subsequent verification that the consumer’s new numbers are accurate.\textsuperscript{129} Homeowners do not have a right to appeal or an independent review of their eligibility.

Finally, HAMP needs to be amended to stop all foreclosure-related activity during the application process. Currently, servicers are prohibited from completing a foreclosure sale while a borrower is applying for a HAMP modification, but they are permitted to continue with all other steps toward foreclosure.\textsuperscript{130} However, because the foreclosure and loss mitigation proceed along entirely separate tracks with different personnel, numerous foreclosure sales are going forward while the borrower is still being considered for the modification.\textsuperscript{131} Therefore, HAMP should be amended to force servicers to better manage internal communications to prevent unnecessary costs and mistakes.

\textbf{VII. Conclusion}

Today’s financial crisis is a result of destructive lending practices – bad lending that never before had been practiced on such a large scale and with so little oversight. These practices have now undermined not only the entire United States economy but the world economy as well. There is no single solution to the challenges we face today, but many of the


\textsuperscript{129} Id.

\textsuperscript{130} Home Affordable Modification Program Supp. Directive 09-01, supra note 118, at 14.

proposals outlined in this article could help to strengthen the mortgage market and keep many more borrowers in their homes.

As our nation struggles in the ruins of a broken mortgage market, it is important to remember that the benefits of homeownership have not changed. Long-term homeownership remains one of the best and most reliable ways that families can build a better economic future, and we all have a strong national interest in ensuring that the mortgage market works to build our economy, not tear it down. In an effective home lending market, lenders and borrowers will enter transactions with the same fundamental measure of success – sustainable home mortgages that build wealth. Reforms that prevent abuses on the front-end, increase remedies for borrowers, and facilitate sustainable loan modifications will help to encourage sensible home loans, competent risk management, profitable mortgage-backed investments, and sustainable homeownership.
Defending Foreclosure Actions by Bringing in Third Parties

Turning Foreclosure Defense into a Plaintiff's Action

Michelle Weinberg

The current mortgage crisis requires zealous consumer advocates to use all available tools and strategies in defending foreclosures. Many homeowners facing foreclosure have been the victims of fraud, “predatory lending,” or unfair and deceptive practices at the time they entered into the mortgage loans. Nonetheless, because the foreclosing institution is seldom the entity that originally made the loan, the homeowner may not be able to raise these issues as a defense against the current holder of the loan. Therefore, oftentimes the strongest and most sympathetic claims lie against persons other than the entity that filed the foreclosure action.¹

Foreclosure plaintiffs in such cases, typically the investment trusts and servicers of bundles of pooled mortgages, argue that, as assignees, they are remote from the subject transactions. Thus, they argue that they are not liable for fraud and abuse committed by mortgage brokers, loan originators, title companies, closing agents, and others involved in the loan origination. Claims against foreclosure plaintiff assignees may be limited by statute. For example, portions of the Truth In Lending Act (“TILA”) require that a violation be “apparent on the face of the

¹ This article is written from the perspective of a judicial foreclosure state. In non-judicial foreclosure states, advocates should be able to use these theories to bring in additional defendants as part of their affirmative case.

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documents assigned.” 2 Traditional holder-in-due-course doctrines may also limit claims against the foreclosing entity.

Borrower claims may also be preempted by federal regulations applicable to national banks. Nonetheless, “basic common-law-type remedies” are not generally preempted under federal preemption of national bank entities. 3 Therefore, common law fraud and breach of fiduciary duty claims are not preempted even if the originator was a national bank. Moreover, statutory codifications of unconscionability law found in state unfair and deceptive practices statutes should qualify as “common-law-type remedies,” and thus should also not be preempted under that standard.

This article examines a number of nuts-and-bolts theories for how to defend a foreclosure by raising affirmative third party claims against a variety of players in the mortgage loan process. 4

I. Determining What Legal Claims Are Available

The borrower will likely have strong claims that she has been the victim of misrepresentations or fraudulent conduct by the broker, appraiser, notaries, or others involved in the loan origination process. Typical claims against brokers, closing agents, and notaries may include common law fraud, violation of unfair and deceptive practices or consumer fraud statutes, breach of fiduciary duty, 5 unjust enrichment, and notarial

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3 In re Ocwen Loan Servicing, 491 F.3d 638, 643 (7th Cir. 2007).
4 The current crisis has rendered many responsible parties insolvent, and numerous financial institutions, small and large, have dissolved or disappeared. Unfortunately, you cannot sue a ghost, but perhaps this article will still be of some use for advocates representing homeowners. Given the cyclical nature of our economy, it can be predicted that, at some point, the mortgage market will recover, and history tells us that when that happens, scams and schemes will be revived as well.
5 Note that generally speaking, a lender owes no fiduciary duty to a borrower. However, a mortgage broker who is retained and paid by the borrower to shop around for the best terms or advise the borrower as to loan products appropriate to the borrower’s situation does have such a duty. See DeLeon v. Beneficial Constr. Co., 998 F. Supp. 859, 865 (N.D. Ill. 1998) (“DeLeon I”); see also DeLeon v. Beneficial Constr. Co., 55 F. Supp. 2d 819, 827 (N.D. Ill. 1999) (“DeLeon II”).
misconduct. Additional claims that the borrower can raise against brokers and lenders include civil conspiracy, commercial bribery, interference with contractual relationship (against the lender who induced the broker to breach its fiduciary duty to the borrower), and violation of the Real Estate Settlement Procedures Act (“RESPA”),6 for unlawful kickbacks in the form of Yield Spread Premiums (“YSP”), where the lender paid the broker “outside closing” in order to increase the interest rate above the rate for which the borrower otherwise qualified.7 Where the loan terms are particularly harsh or the borrower never had any hope of affording the loan, the borrower can allege improvident lending as an unfair practices claim.

If the advocate can plead sufficient facts to assert a claim for common law fraud, claims for breach of fiduciary duty and violation of unfair and deceptive practices statutes will easily follow.

A. Common Law Fraud

The claim of common law fraud generally encompasses five or six elements, depending on how they are phrased. To establish a cause of action, the plaintiff must allege and prove the following:

(1) a false statement of material fact; (2) the party making the statement knew or believed it to be untrue; (3) the party to whom the statement was made had a right to rely on the statement; (4) the party to whom the statement was made did in fact rely on the statement; (5) the statement was made for the purpose of inducing the other party to act; and (6) the reliance by the person to whom the statement was made led to that person’s injury.8 9

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9 It is also important to keep in mind that claims sounding in fraud generally require pleading of facts with particularity. See Fed. R. Civ. P. 9(b).
Most mortgage fraud falls into the category of “fraud in the inducement,” where the victim is persuaded to enter into the mortgage loan based on misrepresentations as to the terms or benefits of the transaction. “Fraud in the factum,” sometimes called “real fraud,” occurs when someone misleads the victim into signing a document by representing that it is something entirely different than what it really is. For example, the borrower believed she was signing an application, but instead she signed a promissory note or a deed transferring title to her house. Such fraud with respect to the execution of the document is a viable defense to collection efforts even by a holder in due course.

Not all frauds fit strictly within the traditional elements, however. For example, forgery is clearly fraudulent. Actual fraud is a much broader concept than plain misrepresentation. Representations that are technically correct may be actionable if they are found to be misleading. Further, the court should consider the circumstances and relative position of the parties. “The financial sophistication of a borrower can be critically important, [particularly where] their lack of financial sophistication prevented them from appreciating the inordinate cost of the refinancing.” Fraud may include “anything calculated to deceive

11 Laborers’ Pension Fund v. A & C Envtl., Inc., 301 F.3d 768, 780 (7th Cir. 2002).
13 In re Vitanovich, 259 B.R. 873, 877 (B.A.P. 6th Cir. 2001) (citing McClellan v. Cantrell, 217 F.3d 890, 893 (7th Cir. 2000)).
and may consist of a single act, a single suppression of truth, suggestion of falsity, or direct falsehood, innuendo, look or gesture.” 17 The court should examine “all the circumstances surrounding the transaction including the manner in which the contract was entered into, whether each party had a reasonable opportunity to understand the terms of the contract, and whether important terms were hidden in a maze of fine print.” 18

While simple failure to perform as promised is generally viewed as a breach of contract, not fraud, a systematic pattern of intentionally failing to perform as promised can certainly be the basis of a fraud claim. 19 An exception to the general rule that fraud cannot be based on promissory statements is where there was no intent to fulfill the promise at the time it was made. 20

B. Unfair and Deceptive Practices Act – Consumer Fraud Statutes

Most states’ consumer fraud statutes provide that the plaintiff need not establish all of the elements of common law fraud in order to prevail under the statute. 21 Therefore, if the plaintiff can establish all of

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21 A full examination of the many different state statutes is beyond the scope of this article. Practitioners should be very familiar with the consumer fraud
the elements of common law fraud, the plaintiff can necessarily establish a violation of the statute as well. For example, justifiable reliance is often not required, although courts may require the plaintiff to establish that the deceptive act or practice caused the alleged injury. Additionally, it may be easier to assert a statutory claim for omission or concealment of a material fact where a common law duty to disclose does not exist.

Most, if not all, states’ consumer fraud statutes provide that in determining whether a practice is unfair or deceptive, the court should consider interpretations under section five of the Federal Trade Commission Act (“FTCA”). An “unfair practice” under FTCA section five has been interpreted as one that “offends established public policy and . . . is immoral, unethical, oppressive, unscrupulous, or substantially injurious to consumers.”

C. But They Signed the Documents...

Many defendants in fraud cases point to disclosures and other contract documents signed by the borrowers, claiming that all the information was available and therefore no misrepresentations were made, regardless of what the individual broker said to the borrower. Contract defenses simply do not apply to claims of deception, however. Parol evidence is admissible in fraud cases, even if the oral representations are completely contradicted by the documents, especially if the borrower was unable to read or understand the contents of the documents. “[A] party

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Defending Foreclosure Actions by Bringing in Third Parties

Defendants' purported “disclosures,” which essentially assert, “don’t believe a word we say, and we didn’t say anything,” do not create a defense to fraud. As the Fourth Circuit has stated:

There is nothing in law or in reason which requires one to deal as though dealing with a liar or a scoundrel, or that denies the protection of the law to the trustful who have been victimized by fraud. The principle underlying the caveat emptor rule was more highly regarded in former times than it is today; but it was never any credit to the law to allow one who had defrauded another to defend on the ground that his own word should not have been believed.29

The case of Bellville National Bank v. Rose30 explains one exception to the general rule that parties have a duty to ascertain the effect of the documents they sign and are bound regardless of whether they actually read the documents, as long as they had an opportunity to read them.


28 Bauer v. Giannis, 359 Ill.App.3d 897, 908 (Ill. App. Ct. 2005); Sound Techniques, Inc. v. Hoffman, 737 N.E.2d 920, 924 (Mass. App. Ct. 2000) (“Whether we refer to the clause in question as a merger clause, an integration clause, or an exculpatory clause, the settled rule of law is that a contracting party cannot rely upon such a clause as protection against claims based upon fraud or deceit.”); see also Restatement (second) of Contracts § 196.

29 Schmidt v. Milhauser, 130 A.2d 572, 576 (Md. 1957) (quoting Bishop v. E.A. Strout Realty Agency, 182 F.2d 503, 505 (4th Cir. 1950)).

Where a misrepresentation is made to an inexperienced or under-educated person – where there is a “manifestly unequal position of the parties” – the existence of signed documents does not bar a claim for fraud. As the court explained, “fraud in the execution of an instrument is practiced ‘where the instrument is misread to the party signing it, or where there is a surreptitious substitution of one paper for another, or where by some other trick or device a party is made to sign an instrument which he did not intend to execute.’”

II. Who Are the Third Party Defendants?

In some particularly egregious cases virtually everyone involved in the loan transaction is potentially liable, including the originating lender, the mortgage broker, title companies, closing agents and notaries, appraisers, and home improvement contractors. Successful prosecution of these claims requires an understanding of state agency law. Some of the parties are agents of the borrower. Moreover, whereas a lender is not the agent of the borrower, traditional agency law operates to make lenders liable for the misconduct of their agents who dealt directly with the borrower.

Because the companies might no longer be in business, it is important to name both the entities and individuals as well. It is well established that an individual is personally liable for fraud where her participation in the fraud was active and direct. Moreover, a person who controls a corporation is liable if she knowingly permits illegal activities on the part of the corporation because a corporation can only act through

32 Bellville Nat'l Bank, 456 N.E.2d at 283 (citations omitted).
33 Although, given the fractured nature of the mortgage market, it is not likely that the foreclosure was filed by the original lender. If the original lender is the plaintiff on a fraudulently induced or predatory loan, the homeowner’s counsel should file counterclaims as well.
the human beings who manage and control it.\textsuperscript{35}

Under basic agency law, an agent is someone “who undertakes to manage some affairs to be transacted for another by his authority, on account of the latter, who is called the principal . . . The test of agency is the existence of the right to control the method or manner of accomplishing a task by the alleged agent, as well as the agent’s ability to subject the principal to liability.”\textsuperscript{36} An agent owes fiduciary duties to his principal as a matter of law, including a duty of exercising reasonable care, skill, and diligence on behalf of the principal. The principal can recover under common law for any loss or damage resulting from the agent’s breach of this duty.\textsuperscript{37}

Mortgage brokers are the agents of the borrowers when they hold themselves out as having the expertise to provide financial advice and undertake to act as the borrower’s fiduciary by functioning as her broker to obtain financing from a third party lender. Mortgage brokers purport to help their customers find a lender that can provide a mortgage with terms best suited to the customer’s situation. Therefore, a principal and agent relationship is created when one party undertakes to find financing


on behalf of another.\textsuperscript{38} Under the typical facts of a predatory lending case, the breach of fiduciary duty is a species of fraud.

Title companies and closing agents are primarily the agents of the lender,\textsuperscript{39} although the title company is also the agent of the borrower with respect to certain functions. A loan closing agent often acts as an agent for several parties to the transaction: the title company’s agent for the purpose of examining the title and issuing title insurance; the lender’s agent for the purpose of delivering loan documents, obtaining the borrower’s signature, and for the purpose of recording mortgage liens; and as an escrow agent of both the borrower and lender in disbursing the loan proceeds.\textsuperscript{40} Even in a case in which the closing agent was actually the borrower’s attorney, one court has held that in his capacity as the settlement agent, the borrower’s attorney functioned as an agent for the title insurer and its insured.\textsuperscript{41}

As the court explains in\textit{Bell v. Safeco Title Insurance Co.}, an escrow closer has a special fiduciary duty to both the borrower and lender.

The fiduciary duty consists of (1) the duty of loyalty.

\textsuperscript{38} DeLeon v. Beneficial Constr. Co., 998 F. Supp. 859, 865 (N.D. Ill. 1998); DeLeon v. Beneficial Constr. Co., 55 F. Supp. 2d 819, 827 (N.D. Ill. 1999); Weller v. Accredited Home Lenders, Inc., No. 08-2798, slip op. at 9 (D. Minn. Mar. 31, 2009) (“Residential mortgage originators who solicit or receive an advance fee in exchange for assisting a borrower located in this state in obtaining a loan secured by a lien on residential real estate, or who offer to act as an agent of the borrower located in this state in obtaining a loan secured by a lien on residential real estate shall be considered to have created a fiduciary relationship with the borrower”). \textit{Cf.} Ellipso, Inc. v. Mann, et al., 541 F. Supp. 2d 365, 373-74 (D.D.C. 2008) (lender normally has no fiduciary duty to borrower, but duty may arise if “special relationship of trust of confidence” exists).


\textsuperscript{40} Hickey v. Great W. Mortgage Corp., No. 94 C 3638, 1995 U.S. Dist. LEXIS 4495, at *13 (N.D. Ill. Apr. 4, 1995); Cowen v. Bank United of Texas, FSB, 70 F.3d 937, 942 (7th Cir. 1995) (“The title company in this case was wearing two hats. Primarily it was an insurance company, with its own interest in removing the prior liens. In this respect it was a principal in the transaction. It was also the closing agent, which means that it was the agent of the bank. Sibley v. Fed. Land Bank, 597 F.2d 459, 462-63 (5th Cir.1979).”). Bell v. Safeco Title Ins. Co., 830 S.W.2d 157, 161 (1992) (holding title company agent not liable for failing to explain to aging attorney-seller the consequences of changes to the documents in a real estate transaction); Wilson v. Carver Fed. Savings & Loan Ass’n, et al., 774 S.W.2d 106, 107 (Tex. App. 1989).

\textsuperscript{41} Sears Mortgage Corp. v. Rose, 134 N.J. 326, 342-343 (1993).
(2) the duty to make full disclosure, and (3) the duty to exercise a high degree of care to conserve money and pay it only to the persons entitled to it. A fiduciary must act with utmost good faith and avoid any act of self-dealing that places his personal interest in conflict with his obligations to the beneficiaries.  

In addition to presenting the documents and disclosing the terms of the loan, a loan closer may also be called upon to respond to the borrower’s questions during the closing transaction. Where the closing agent participated in or turned a blind eye to obvious broker fraud at the closing, it could be argued that although an escrow agent may not have a duty to explain all of the possible consequences of taking out a loan, the closing agent does have a “duty to point out the interlineations,” or changes in the basic terms of the transaction, to the borrower.  

The typical practices of closing agents demonstrate that the title company is the lender’s agent for the purpose of conducting the loan closing, delivering the documents, obtaining borrower signatures, etc., notwithstanding the fact that the contract between the lender and closing agent states that the closer is an “independent contractor.” For example, in *Wargel v. First Nat’l Bank of Harrisburg*, the evidence established that a bank was the agent of an insurance company, despite the contrary statement in the written contract between them, because the insurance company prescribed the forms, procedures, and guidelines used by the bank in processing insurance applications in connection with loans. The insurance company authorized the bank to accept premiums, notify the borrower that her application had been approved, and send documents

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44 Bell, 830 S.W.2d at 161.

to the insured borrower.\textsuperscript{46} Thus, the court held that the bank acted as the insurance company’s agent.\textsuperscript{47} Similarly, in a mortgage transaction, the originating lender prescribes and provides the closing instructions, forms, documents, procedures, and guidelines to be used at the closing.

The lender is deemed present at the closing through its agent. Therefore, the knowledge of the agent is attributable to the lender if the closing agent had actual or constructive knowledge of the fraudulent conduct.\textsuperscript{48} Bank lenders do not simply send prepared loan documents arbitrarily to random brokers and title agents, or authorize the signing of documents obliging them to extend a loan in a state where the bank maintains no offices, without first entering into agreements with those who generate and consummate the loans on the bank’s behalf. Moreover, the lender cannot delegate its TILA obligations to the title agent, and thus remains responsible for the disclosures made or not made by the agent.

Where the plaintiff is a third party to this agency relationship, the existence of an agency relationship will be liberally construed in the plaintiff’s favor.\textsuperscript{49} Moreover, where an intentional tort by an employee is motivated in part by intent to serve the employer’s purpose, the employer may be vicariously liable.\textsuperscript{50} An employer’s liability for the intentional tort of an individual employee will also depend in part on whether the act was a predictable outgrowth of acts the employer authorized the employee to

\textsuperscript{46} Id.
\textsuperscript{47} Id.
\textsuperscript{50} Sunseri v. Puccia, 422 N.E.2d 925, 930 (Ill. App. Ct. 1981) (tavern liable for bartender’s fistfight with customer where employee’s action was conducted substantially within authorized time and location of employment and was motivated at least in part to further employer’s business); Olson v. Connerly, 457 N.W.2d 479, 490 (Wis. 1990) (even a small motivation to serve an employer can be considered working within the scope of one’s employment); Martin \textit{et al.} v. Cent. Ohio Transit Auth. \textit{et al.}, 590 N.E.2d 411, 417 (Ohio Ct. App. 1990) (citing Tarlecka v. Morgan, 181 N.E. 450, 452 (Ohio 1932)) (“The act of an agent is the act of the principal within the course of the employment when the act can fairly and reasonably be deemed to be an ordinary and natural incident or attribute of the service to be rendered, or a natural, direct, and logical result of it”); Lange v. Nat’l Biscuit Co., 211 N.W.2d 783, 785-86 (Minn. 1973) (scope of employment under Minnesota law).
perform. In *Maras v. Milestone*, the court noted that a “tort can fall within the scope of a person’s employment even if the conduct was unauthorized or forbidden by the employer.” Here, it is entirely predictable and expected that an individual closer or mortgage broker might misrepresent loan terms or the broker-borrower-lender relationship, as they generally only get paid if the loan is consummated. In many mortgage fraud cases, the alleged acts of the corporate defendant’s employees are no further afield than that in *Sunseri* and *Maras* and are natural examples of the sort of behavior that may be a result of dual motivation to serve both the employer and the individual employee.

The title company is also liable for closing agent misconduct. The notary or individual closer is obviously the employee or agent of the title company hired or permitted by the lender to conduct the closing. Presumably, the title companies expect the individual closers to follow the instructions provided by the lender. Apparently, however, title companies often have done nothing to determine whether the closer actually followed those instructions. Traveling notaries are acting within the apparent scope of their duties when they bring documents to the borrower’s home to be signed. These agents are also acting within the apparent scope of their duties when they misleadingly instruct or advise borrowers, for example, by telling them that they could cancel within three days by simply making a phone call, instead of sending in the three-day cancellation notice. In such cases, it follows that the title company is liable for the misrepresentations of its agent-employee.

In a slightly different context, the Sixth Circuit noted that a principal may be vicariously liable for an agent’s tortious conduct based upon an apparent authority theory, “if . . . [the principal] held the agent out to third parties as possessing sufficient authority to commit the particular act in question, and there was reliance on the apparent authority . . . liability is based upon the fact that the agent’s position facilitates the consummation of the fraud, in that from the point of view of the third person the transaction seems regular on its face and the agent appears to

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51 Sunseri, 422 N.E.2d at 930 (employer liable for employee’s intentional torts which are not unexpected in view of employee’s duties); Maras v. Milestone, Inc., 809 N.E.2d 825, 829 (Ill. App. Ct. 2004) (residential disabled-child care facility liable for intentional battery by worker); Restatement (Second) of Agency §§ 228(1)(d) (1958).

52 Maras, 348 Ill. App. 3d at 1007.
be acting in the ordinary course of the business provided to him.\textsuperscript{53}

Under the same common law agency principles, the mortgage broker may be found to be the agent of the lender where the originating lender had no local offices, made no direct loans, had a close relationship with the broker, purchased most or all of its generated loans, provided guidelines and marketing materials, and essentially relied on brokers to sell its products.\textsuperscript{54} Therefore, it is important to explore the relationship between the broker and originating lender. The necessary information may not be obtainable without discovery, however. In cases where the title company gave the loan documents to the broker to conduct a closing in the borrower’s home, the broker actually becomes the agent for the originating lender, thus allowing additional claims against the originating lender.

A. *Defendants Who Knowingly Accept the Fruits of the Fraud Are Liable to the Same Extent As the Perpetrator of the Fraud*

Courts in numerous jurisdictions have recognized that tort liability can go beyond the immediate wrongdoer to those who have planned, assisted, encouraged or ratified the wrongdoer’s acts.\textsuperscript{55} Therefore, a defendant who knowingly accepts the fruits of the fraud is liable to the same extent as the perpetrator of the fraud.\textsuperscript{56}


\textsuperscript{56} Moore v. Pinkert, 171 N.E.2d 73, 78 (Ill. App. Ct. 1960); Cumis Ins. Soc’y, Inc. v. Peters et al., 983 F. Supp. 787, 795 (N.D. Ill. 1997) (creditor sued collection agency for not paying proper share of amounts collected; held under Illinois law defendant liable if he “either knowingly participated in the fraud or
Defending Foreclosure Actions by Bringing in Third Parties

The lender is liable where the evidence indicates that the lender knew or should have known of the broker’s fraud, for example, where there is a close relationship between the remote lender and the broker, a high volume of dealings between the entities, or other information available to the lender from the transaction documents that suggests a fraud has occurred. In addition, a defendant who does not guard against reasonably foreseeable fraud is liable even when the defendant did not make any representations directly to the plaintiff.

knowingly accepted the fruits of the fraudulent conduct); Terrell v. Childers, 920 F. Supp. 854, 866 (N.D. Ill. 1996) (defendant held liable where evidence showed she had accepted commissions she knew were based on fraudulent transactions); Servpro Indus., Inc. v. Schmidt, 905 F. Supp. 475, 481 (N.D. Ill. 1995); Shacket v. Philko Aviation, Inc., 590 F. Supp. 664, 668 (N.D. Ill. 1984) (fraud in sale of airplane, held a person “who knowingly accepts the fruits of fraudulent conduct is also guilty of that fraud”); Beaton & Assocs. v. Joslyn Mfg. & Supply Co., 512 N.E.2d 1286, 1291 (Ill. App. Ct. 1987) (defendant “accepted the fruits of the fraud knowing of the means by which they were obtained”). See also Cenco Inc. v. Seidman & Seidman, 686 F.2d 449, 452-53 (7th Cir. 1982) (securities fraud action against auditors who allegedly covered up fraud by corporation management); Beaver v. Union Nat’l Bank & Trust Co., 414 N.E.2d 1339, 1341 (Ill. App. Ct. 1980) (holding trustee bank not liable for fraud by beneficial owner of real estate where bank had no knowledge of the fraud citing 37 C.J.S. Fraud § 61 at 347 (1943) (defendant not liable absent participation or ratification of misconduct)); Callner v. Greenberg et al., 33 N.E.2d 437, 440 (Ill. 1941) (“At law, it has been held that a knowing beneficiary of a fraud may be held liable with the perpetrator”); Walters v. Maloney, 758 S.W.2d 489, 500 (Mo. Ct. App. 1988) (realtor held not liable because she did not know of the fraud, but one who knows about fraud, does not personally participate in it, but receives the fruits of the fraud may be held liable); Malakul v. Altech Ark., Inc., 766 S.W.2d 433, 436 (Ark. 1989) (wife liable for husband’s fraud of investors because she knowingly received the fruits thereof); Childs, et al. v. Charske et al., 822 N.E.2d 853, 858 (Ohio Ct. Com. Pl. 2004) (“Willful blindness exists ‘only where it can almost be said that the defendant actually knew. He suspected the fact; he realised [sic] its probability; but he refrained from obtaining the final confirmation because he wanted in the event to be able to deny knowledge.’”).


O’Brien v. B.L.C. Ins. Co., 768 S.W.2d 64, 68-69 (Mo. 1989) (insurance company liable for failing to obtain salvage title prior to selling wrecked car to a dealer, because it knew dealer was unlikely to disclose to true condition of the
Courts have repeatedly held defendants liable where they accepted the benefits of the fraud and knew of the means by which they were obtained, even when they did not personally participate in the fraud. Therefore, an assignee may be found liable where the evidence indicates that the lender knew or should have known of the broker’s fraud. The “fruits of the fraud” doctrine reflects a policy choice to hold those who passively participate in fraud as responsible as those who actually make the fraudulent misrepresentations. Liability for actively perpetrating fraud is not limited to those who have actual knowledge that the statements they made are false. Rather, liability can be imposed if the defendant made the statements with reckless disregard for their truth or falsity. Given the Illinois courts’ decision to treat the perpetrators and the conscious beneficiaries of fraud identically, the same knowledge standard should apply to both. Thus, we hold that plaintiffs can state fruits of the fraud claims against [the defendant lenders] if they allege that those defendants deliberately ignored facts that suggested the loans were fraudulent. 59

B. A Party is Deemed to Have Knowledge of the Fraud Where It Willfully Blinded Itself to Obvious Indications

Where a claim requires proof of intent to defraud, knowledge of the fraud can be shown where the defendant had limited information but “failed to inquire further because he was afraid of what the inquiry would yield. Willful blindness is knowledge enough.” 60 A person engages car absent the salvage title).


60 Louis Vuitton S.A. v. Lee, 875 F.2d 584, 590 (7th Cir. 1989) (trademark infringement by selling counterfeit goods); United States v. Campbell, 977 F.2d 854, 857 (4th Cir. 1992) (“A defendant is willfully blind when he ‘purposefully and deliberately contrive[s] to avoid learning all the facts.’”); United States v. Flood, No. 08-2937, slip op. at 2-3 (Del. App. 2009) (jury instruction on deliberate or intentional ignorance or willful blindness). See also Bill Spreen Toyota, Inc. v. Jenquin, 294 S.E.2d 533, 537 (Ga. Ct. App. 1982) (car dealer liable for misrepresentation of vehicle that consisted of two halves of vehicles
in “knowing” conduct when he intentionally avoids actual knowledge by closing his eyes to facts that should prompt him to investigate. Intentionally avoiding knowledge “implies something verging on knowledge, combined with a desire to escape the consequences of knowledge.” 

Defendants who deliberately close their eyes so as not to discover what they suspect is occurring can be charged with a form of knowledge or reckless disregard for the truth. 

A defendant “cannot escape liability by deliberately avoiding knowledge of the illegal nature of the scheme.” In other words, a person’s reckless disregard for the truth is equivalent to intent to defraud. “Culpable ignorance” of the falsity is the same as knowing the statement was untrue.

Therefore, where the evidence indicates that the lender knew or should have known of the broker’s or title company’s fraud – for example, through red flags in the closing file – it is possible to successfully seek relief from the lender.

III. Determining Whether Your Client Has Viable Third Party Claims

In order to determine whether your client has been the victim of fraud, deceptive practices, statutory violations, predatory loan terms, or welded together; dealer’s claimed lack of knowledge rejected because one “may not blind himself to truth or falsity of a condition which he recklessly represents to his own advantage; such refusal to know, like admitted knowledge, involves actual, moral guilt”) (internal citations omitted).

United States v. Josefik, 753 F.2d 585, 589 (7th Cir. 1985) (possession of stolen goods).

Bosco v. Serhant, 836 F.2d 271, 276 (7th Cir. 1987) (involving brokerage’s liability in securities fraud case).


Hurley v. Frontier Ford, 299 N.E.2d 387, 390 (Ill. App. Ct. 1973) (rejecting used car buyer’s fraudulent breach of warranty claim failed because he signed clear “as is” statement, but it is “well established” that action for fraud lies where defendant made a reckless false representation about a matter as to which he had no knowledge).

Gordon v. Dolin, 434 N.E.2d 341, 347 (Ill. App. Ct. 1982) (explaining that fraud plaintiff must establish that defendant made a false statement, and such statement may have been made intentionally, recklessly or otherwise with culpability).
improvident lending, and therefore may have strong third party claims against the individuals and companies with whom she dealt when she agreed to the loan, a thorough understanding of the facts surrounding the loan application process is necessary. Since we are primarily looking for fraud and deceptive practices claims, start with a thorough interview of the client: the who, what, when, where, and everything that was said about the loan, before, during, and after the closing. Where it appears that the borrower was the victim of deception or unfair practices, this interview should take at least an hour, if not longer. Take the client through every step she went through to get the loan in question, from start to finish. Ask the client how she found or chose the broker, for example, whether she responded to any advertisements or telemarketing calls. Ask whether the client was referred by a friend, such as an acquaintance from church.

Establish what the client told her broker about her financial situation and her intended purpose for the loan. Ask what the broker or other individuals, such as home improvement contractors, said to her about the transaction—was anything promised and not delivered? Was there any aggressive solicitation or a high-pressure sales technique? Did they discuss interest rates or monthly payments? Was there any “bait and switch,” meaning did the interest rate or monthly payment end up being much higher than initially represented? If the client complained about or questioned a high interest rate or payment, did the broker persuade her to sign with a promise to refinance at a lower rate in six months to a year? If English is the client’s second language, did the mortgage representatives speak her native language? If so, were any of the documents translated?

In order to get a thorough understanding of the circumstances surrounding your client’s loan process and therefore whether your client has a valid claim, it is imperative to nail down the chronological sequence of events. Ask the client when she first spoke to the broker or when she first completed the application. Establish when the client signed the documents and check whether the dates are accurate? Did she sign the documents at more than one time? Did she sign at home or in an office, in a fast food restaurant or on the hood of a car? Are any of the signatures forged? Was the notary present when they signed? Did she read the documents, either before or after she signed? Ask what the

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66 In this writer’s experience, it seems that if a church acquaintance is involved, it is more likely to be fraudulent.
client understood from looking at the documents. Did she get copies of everything she signed at the time she signed? Was anything mailed to her? If home improvements were involved, was the work completed correctly and timely? Ask whether the client knew that she had the right to cancel the application for three days (where applicable). Were there any surprises at closing or after? Does the client feel that she was lied to in any way?

Because the court will consider the circumstances and relative position of the parties, including financial sophistication, it is also essential to evaluate the client’s credibility, vulnerability, physical and mental disability, literacy, and language barriers. Inquire about her education, business experience, and profession or line of work. Ask if she takes medications that affect her alertness or ability to concentrate, if she wears reading glasses, and, if so, whether she was wearing her glasses when she signed the paperwork. Note whether she kept her papers organized or likely lost some of the documents through shuffling, as opposed to not having received them in the first place. Make a determination about the client’s knowledge or experience in real estate and mortgage transactions. How long has she owned the home? How many times has she refinanced?

After the client interview, review the documents and investigate potential defendants. Ask the client to give you every scrap of paper relating to the loan in question. If the client has entered into several loans within a short time, get the earlier loan documents as well. If you can, get the loan file from the plaintiff as soon as possible. You may find things that are omitted from the client’s closing package, such as correspondence between the broker and lender or the broker and the title company, demonstrating that the broker or closer was the agent of the lender.

It is also important to review with the client all of the financial data on the loan application for accuracy. If the loan application contains inflated or fictitious income or assets, determine whether the client was aware of this falsification. Try to discern whether the lender processed the application with little or no verification of income, as a “no doc,” “low doc,” or “NINJA” (no income, no job, no assets) loan. At the height of the mortgage bubble, many lenders made loans primarily on the basis of the appraised value of the property rather than on the borrower’s ability to pay. Many borrowers went into these loans believing that the bank would not approve them for the loans unless the bank thought they could make
the payments.

Review the loan terms, fees, and costs, and see whether all the required TILA disclosures were accurate. Is it a fixed rate or adjustable; was there a low teaser rate? Does the interest rate seem unusually high? Are the various closing costs reasonable or outrageous as compared to similarly situated properties? Was a Yield Spread Premium (“YSP”) paid to the broker? Are there any “exotic” terms such as “payment option” or “Pick-A-Payment” (which give the borrower an “option” to make minimum payments of less than all accruing interest), or large “balloon” payments? Did the client purchase credit insurance? Does the loan contain excessive prepayment penalties (over 3% of the principal balance or payable more than three years after the loan date)? Do the monthly payments include taxes and insurance escrows? Ask whether the representative of the broker or the lender told the client that tax and insurance would be included in the monthly payments. One common misrepresentation occurs when the representative states that the new loan has a lower monthly payment, without disclosing that the new payment does not include escrow. Determine the loan to value ratio as set forth in the loan documents, keeping in mind the possibility of fraudulently inflated appraisals.

The next critical step to representing your client is to check the borrower-broker agreement for compliance with state regulations and any representations of interest rates or terms. Even if the agreement’s fine print says the broker is not the borrower’s agent, agency may be found due to verbal misrepresentations or indications that the broker held herself out as an expert or trustworthy advisor.

You should also try to get copies of all of the loan checks from the title company – did the client receive or endorse those made payable to her? Were checks given to the broker or others that should have gone to the client? Were any unsecured debts paid out of the loan proceeds? Did contractors steal the money? Did any of the disbursements differ from those listed on the HUD-1 Settlement Statement? Does it appear that the HUD-1 was altered after signing (some have a time/date stamp)?

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67 A full evaluation of TILA compliance and other direct foreclosure defenses should be done; however, that is not the focus of this article.

68 This document, also known as a “RESPA” (Real Estate Settlement Procedures Act) in the mortgage business, is a final accounting of all fees, charges, and payouts from the loan proceeds, listed on numbered lines from 100 to 1400.
Evaluate realistically whether the client can afford the home, with or without a potential modification of the interest rate if the rate is very high. Determine the monthly payment as a percentage of household income. Was this a loan that the client could never afford? Or did she lose income as a result of a job loss, illness, or the death of a spouse? Determine whether changes in income are likely to be temporary or permanent. Were there changes in the amount of the monthly payment due to interest rate adjustments? Was the client able to make the payments before the rate and payment change?

Estimate the current value of the property and the amount of equity above the loan balance, then consider whether the lender’s appraisal was an accurate estimate at the time of the loan. Find out whether property taxes have been paid and whether there are additional liens on the property. A thorough review of the client’s financial situation and capabilities is necessary to determine whether she can ultimately retain the home; if she cannot, consider how much, if any, equity would be available if the house is sold. Keep in mind that at the end of the day, the client is still likely to owe a substantial sum of money. The client will be required to either refinance or obtain a loan modification in settlement. If the client cannot reasonably afford the payments, she will likely have to sell the house to satisfy the balance due.

Finally, it is critical to investigate the various parties involved in the transaction in order to determine what parties to name in the complaint. Find out if the brokerage or originating lender is still in business. Sometimes the individual broker has moved to a different company; however, she may still be personally liable for fraud or deceptive practices. Check the licenses of the brokers and appraisers and whether there have been any consumer complaints to the licensing authorities. Check the court in your jurisdiction to see if they have been sued by other consumer borrowers or if there have been any actions brought by the state Attorney General against the wrongdoers.

IV. Conclusion

To summarize, where the client has been the victim of fraud,

69 Consider a reverse mortgage if the client is over age sixty-two and there is sufficient equity in the property.
deceptive practices, statutory violations, predatory loan terms, or improvident lending, she may have strong third party claims against the individuals and companies with whom she dealt when she agreed to the loan. A thorough understanding of the applicable state law in the areas of common law fraud, consumer fraud or unfair and deceptive practices statutes, agency law, fiduciary duties of brokers and title companies, and notary misconduct law is essential.

Foreclosure cases are extremely labor-intensive. If the parties responsible for defrauding the borrower are insolvent or have disappeared, it may be possible to get a judgment but be unable to collect, and, therefore, bringing suit would likely be a waste of time. If you have a case in which, even if you obtain all of the reasonably available relief, the client is still left with an unaffordable loan and no equity in the house, question whether you really want to put two or three years of litigation effort into the case if the client is ultimately going to lose the house. Many advocates insist that foreclosure clients pay monthly into an escrow account or the attorney’s client trust account as a way of demonstrating their ability to make payments and to have a lump sum in the event of settlement. Even in the current climate, where the lending entity is still in business or individual defendants can be named, it is often possible to cobble together a global settlement from relatively small contributions from a number of defendants that could operate to reduce the principal balance owed and thereby save the home from foreclosure.