

COMPLEXITY, COMPLICITY, AND LIABILITY UP THE SECURITIZATION FOOD CHAIN: INVESTOR AND ARRANGER EXPOSURE TO CONSUMER CLAIMS¹

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Old laws and complex, innovative finance do not make good partners, particularly in the area of consumer law. Today, tremendous uncertainty exists about the extent to which consumers might have claims against arrangers and investment trusts based on misdeeds at the origination of their loans. For financial services firms, the uncertainty impedes their ability to calculate potential legal liabilities, which in turn makes it difficult to accurately price credit and securities backed by loans. Regulators, who are charged with assuring the safety and soundness of banks and thrifts, likewise, cannot readily determine the dent consumer claims might make in banks' balance sheets.

To add to these difficulties, the laws governing consumer lending were a challenge to parse even before home loan financing moved from Main Street to Wall Street. Credit raters, lawyers, and others issued countless reports and white papers during the subprime boom speculating about consumer claims and who might be liable for what types of wrongdoing. Those questions were never resolved and there was little incentive to resolve them. Originators, servicers, arrangers, and investors were all making substantial short-term profits. Borrowers in default rarely brought claims against anyone in the securitization chain because it was easier and far less expensive to refinance than find and engage an attorney to determine the existence of claims and pursue them against defendants with much deeper pockets. But this situation has changed: the availability of mortgage credit has fallen sharply, borrowers are challenging foreclosures in court, and borrowers and states are bringing actions against parties in the securitization chain based on alleged unlawful origination practices.

This Article is the first to assess consumer claims against arrangers and investment trusts in light of the evolution of financial institutions as securitization of home loans took off. Our analysis is critical because the government is embarking on plans for a new system for housing financing, which we contend must clarify the liability of participants in the securitization food chain so that the market can accurately price securities and loans up-front. This system must also create better incentives to encourage the creation of effective compliance programs to stop problem loans from entering the pipeline.

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I. INTRODUCTION

The financial crisis has revealed the complexity of mortgage financing. In a matter of a few years, a multitude of actors have replaced loan officers at local banks. Now, brokers, lenders, and Wall Street arrangers² mediate

² Due to the complexity of the securitization process, there are no universally accepted labels for the entities that control the flow of loans from originators to securitization trusts. In

between borrowers and investors. Most home loans are owned by securitization trusts and investors receive a stream of income from loan payments. The law, which was designed for more deliberative and less complex transactions, did not change with the new structures. Old laws and complex, innovative finance do not make good partners, particularly in the area of consumer law. Today, tremendous uncertainty exists about the extent to which consumers might have claims against arrangers and investment trusts based on misdeeds at the origination of their loans. For financial services firms, the uncertainty impedes their ability to calculate potential legal liabilities, which in turn makes it difficult to accurately price credit and securities backed by loans. Regulators, who are charged with assuring the safety and soundness of banks and thrifts, likewise, cannot readily determine the dent consumer claims might make in banks' balance sheets.

The laws governing consumer lending were a challenge to parse even before home loan financing moved from Main Street to Wall Street. Credit raters, lawyers, and others issued countless reports and white papers during the subprime boom speculating about consumer claims and who might be liable for what types of wrongdoing. Those questions were never resolved, and there was little incentive to resolve them. Originators, servicers, arrangers, and investors were all making substantial short-term profits. Borrowers in default rarely brought claims against anyone in the securitization chain because it was easier and far less expensive to refinance than find and engage an attorney to determine the existence of claims and pursue them against defendants with much deeper pockets. But this situation has changed: the availability of mortgage credit has fallen sharply, borrowers are challenging foreclosures in court, and borrowers and states are bringing actions against parties in the securitization chain based on alleged unlawful origination practices.

This paper is the first to assess consumer claims against arrangers and investment trusts since the securitization of home loans took off and Wall Street firms became key players in the housing market. Our analysis is critical because the government is embarking on plans for a new system for housing finance, which we contend must clarify the liability of participants in the securitization food chain so that the market can accurately price securities and loans up-front.

Equally important, we need better incentives to discourage unfair and risky lending. We contend that enabling borrowers to pursue claims against all the entities responsible for making and financing unlawful loans is a solution that would both provide relief to borrowers and encourage the creation of effective compliance programs.

this article "arranger" refers to the entities that put securitization deals together. Arrangers may be the sponsors or depositors in the issue's pooling and servicing agreement, or arrangers may be a parent or affiliate of the sponsor or depositor. Arrangers of subprime securitizations are most often commercial or investment banks. The government-sponsored enterprises Fannie Mae and Freddie Mac are also arrangers.

This Article proceeds in six parts. Following this introduction, Part II briefly describes the history and process of securitization. Part III reviews the potential claims that borrowers can pursue against owners of their loans based on derivative liability, with particular focus on the holder in due course rule. In Part IV, we describe theories that could expose banks and other arrangers to direct liability. In Part V, we discuss policy responses that would remove the uncertainties about the extent to which arrangers and investment trusts are liable for wrongdoing at loan origination while also creating more effective policing of loan terms and lending practices. In Part VI, we conclude. Throughout the Article, our focus is on the securitization of subprime loans because reports of unlawful lending have been concentrated in the subprime sector.³

II. SECURITIZATION

For over a decade, the securitization of home loans was considered a low-cost method to expand the availability of credit, lower the cost of credit, and make otherwise illiquid assets liquid. From investors' perspective, securitization created attractive bonds that provided direct exposure to housing markets with good returns that appeared to be highly liquid and low risk.⁴ From its infancy, securitization promised to insulate investors and the arrangers that structured securitization deals from the risk that they could be found liable for the unlawful acts of mortgage loan originators.⁵ This protection was important because some lenders—particularly in the subprime market—were known to make loans that violated consumer protection and other laws.

For a short time around 2003, a combination of state anti-predatory lending laws and a lawsuit against Lehman Brothers opened up the possibility that aggrieved borrowers might begin obtaining relief against investors and arrangers. This threat never materialized. Over time, investment banks and other arrangers increased their involvement in financing subprime loans. We believe that, in the process, arrangers ultimately exposed themselves and investors to the very liability they thought they had avoided.

Through a growing body of civil litigation, as well as government investigations, Congressional hearings, and the confessions of market participants, new information is emerging on arrangers' roles in subprime lending. These revelations have shown deep connections between Wall Street money

³ There is extensive debate about what constitutes a subprime loan. We use the term "subprime" to mean any loan secured by residential property that would not qualify as a prime conforming loan under Fannie Mae or Freddie Mac guidelines.

⁴ See generally, Kathleen C. Engel & Patricia A. McCoy, *Turning a Blind Eye: Wall Street Finance of Predatory Lending*, 75 *FORDHAM L. REV.* 2039 (2007).

⁵ Securitization sought to eliminate or minimize several risks to investors. This article focuses on only one of those risks: the securities' potential loss of value due to lawsuits based upon unlawful acts of brokers or lenders at origination.

and unfair lending and may open the door for borrower claims against arrangers and trusts.

A. *The Securitization Process*

Two decades ago, borrowers applied for loans at local banks. The loan officers who processed borrowers' applications and underwrote the loans were employees of the bank and were often members of the borrowers' communities. Funding for the loans came from the bank itself, and the bank kept nearly all its loans in its portfolio. The bank "serviced" the loans by collecting the borrowers' principal and interest payments and escrowing funds for real estate taxes and homeowners' insurance. If borrowers had difficulty meeting their payment obligations, usually because of an unexpected job loss or medical emergency, a loan officer would work with the borrowers to try to help them retain their homes and resume payments. In sum, borrowers had relationships with one institution, which processed, underwrote, funded, owned, and serviced the borrowers' loans. If borrowers alleged wrongdoing at any stage of the lending process, there was only one entity to sue—the bank.

This system was not perfect. Banks were always limited in the amount of loans they could make, and there was a constant queue of qualified borrowers who could not obtain credit. Securitization rapidly changed this market.⁶ Instead of lenders running the entire show, an atomized⁷ financing system emerged, involving mortgage brokers, lenders, banks, credit raters, trusts, servicers, and investors. Lenders made loans to borrowers and an arranger purchased and pooled the loans and then sold the loans to a trust that created residential mortgage-backed securities (RMBS or MBS) for sale to investors.⁸

Arrangers of subprime securitizations had multiple tasks. They guided pools of loans into securitization trusts and divided the income stream from the loans into tranches, each of which had different risk-return characteristics.⁹ Arrangers also had responsibility for structuring the deals, obtaining

⁶ Securitization alone was not responsible for the changes in the home mortgage market. Other factors played critical roles as well but are not relevant to the arguments made in this article. See generally, Kathleen C. Engel & Patricia A. McCoy, *A Tale of Three Markets: The Law and Economics of Predatory Lending*, 80 TEX. L. REV. 1255 (2002).

⁷ Professor Michael G. Jacobides was the first person we know of to describe the securitization of home mortgages as an "atomized" process. Michael G. Jacobides, *Mortgage Banking Unbundling: Structure, Automation and Profit*, MORTG. BANKING (Jan. 1, 2001).

⁸ See, e.g., Dale Whitman, *How Negotiability Has Fouled Up the Secondary Mortgage Market, and What To Do About It*, 37 PEPP. L. REV. 737, 744–45 (2010).

⁹ The primary purpose of creating tranches is to ensure that at least one class of securities in the pool has a high investment-grade rating, typically triple-A. This is accomplished by subordinating loss-positions and other credit enhancements. See, e.g., Adam B. Ashcraft & Til Schuermann, Staff Report No. 318, Fed. Reserve Bank of N.Y., *Understanding the Securitization of Subprime Mortgage Credit*, 29–30 (Mar. 2008), http://www.newyorkfed.org/research/staff_reports/sr318.pdf.

credit ratings for the tranches, and complying with rules governing securities disclosures.¹⁰

Once a deal was put together, arrangers set up bankruptcy-remote special purpose entities,¹¹ usually trusts, to hold the home loans and issue the securities. The trusts purchased the loans from the arrangers, either by paying the arrangers in securities issued by the trust or by financing the acquisition through the sale of such securities to a broker-dealer, who was frequently an affiliate of the arranger.¹² Up until the time the loans were transferred to the trust, the arranger owned the loans, either directly or indirectly. The investors who purchased the securities issued by the trust were typically banks, retirement funds, insurance companies, hedge funds, municipalities, and other large institutional investors.

Pooling and servicing agreements (PSAs) defined the roles and duties of the parties, which in most cases included the originating lenders, the arranger, the servicers, and the trustee. The PSA established how the parties would share in profits and losses, who had indemnification rights and obligations, the standards originators had to meet, who was responsible for servicing and underwriting, who controlled various aspects of the deal, the classes of securities that would be created, and the schedule of distributions from the trust to investors.

B. *The Relationship Between Originators and Arrangers*

Arrangers were not simply intermediaries between subprime originators and investors. They were organizers with some level of command over almost every step from loan origination to selling the RMBS backed by the loans.

Exercising control was natural given arrangers' roles as market makers. Many had buy-side and sell-side operations; they dealt with in-house investors that were interested in buying securities (buy-side), and they also created and issued securities to external investors (sell-side). They created markets by generating investor interest in particular products and then procuring the products to satisfy the demand they had created. They provided liquidity for lenders by giving them billions of dollars in warehouse lines of credit that lenders could tap to make mortgage loans. Arrangers often agreed to purchase these loans as repayment on the lines of credit they extended.¹³

¹⁰ Kathleen Engel & Patricia McCoy, *THE SUBPRIME VIRUS: RECKLESS CREDIT, REGULATORY FAILURE AND NEXT STEPS* 47 (2011).

¹¹ Recent research questions whether the trusts that issue RMBS actually are bankruptcy-remote. John Patrick Hunt, Richard Stanton & Nancy Wallace, *The End of Mortgage Securitization? Electronic Registration as a Threat to Bankruptcy Remoteness* (Aug. 12, 2011) (unpublished manuscript) (on file with author).

¹² See, e.g., Ashcraft & Schuermann, *supra* note 9, at 13.

¹³ See, e.g., *Exhibits: Hearing on Wall Street and the Financial Crisis: The Role of Investment Banks Before the Permanent Subcomm. on Investigations, S. Comm. on Homeland Security and Governmental Affairs*, 111th Cong 3 (Apr. 27, 2010) (describing Goldman Sachs's

To ensure a steady flow of loans, many arrangers acquired ownership interests in lenders that could supply them with loans.¹⁴

Arrangers earned generous fees for their work with subprime lenders. They loaned money to originators for which they received interest and fees. They purchased loans from originators that they then securitized, generating profits on the spread. When they served as underwriters, they received underwriting fees. Volume was a key factor in securitization profits. During the subprime heyday, this gave arrangers a strong incentive to maximize the number of subprime loans they securitized.

Arrangers had access to detailed, private information about originators and the loans they made. As part of the securitization process, arrangers conducted relationship-based due diligence on originators and transaction-based due diligence on loan pools. This included reviewing loan files to ensure they complied with originators' representations and warranties ("reps and warranties") that the loans were legal and that they met specific underwriting criteria. Arrangers typically contracted with independent due diligence firms to review loan files, track lenders' practices and financial condition, and monitor pending litigation against originators. Through these processes, arrangers obtained extensive information about subprime lenders and the performance of their loans. This was information that was not available to the public.

In sum, arrangers had private information about the loans they were securitizing. They could and did influence the loans that were made. Additionally, they had the power to shut off the supply of money to lenders if they saw signs of wrongdoing. These points are essential for understanding our contention that arrangers exposed themselves to lawsuits by consumers.

We now turn to the potential liability of arrangers and investment trusts that own unlawfully originated loans, or loans with unlawful terms.

III. DERIVATIVE LIABILITY

When owners of loans are liable because the loans contain unlawful terms or were the result of others' unlawful practices, the owners' liability is derivative. Derivative liability requires no direct involvement of the current loan owner, and, depending on the cause of action, borrowers can raise derivative liability claims defensively or affirmatively. If, for example, a trust brings a collection action against a borrower who has defaulted on a loan, the borrower may be able to defend on the grounds that during the loan origination there was unlawful activity that would relieve the borrower of the obligation to repay the debt in whole or part. Similarly, specific statutes

mortgage market activities), http://hsgac.senate.gov/public/_files/Financial_Crisis/042710Exhibits.pdf.

¹⁴ For example, Lehman Brothers owned Aurora Loan Services, LLC; Bear Stearns owned Bear Stearns Residential Mortgage Company; and Morgan Stanley owned Morgan Stanley Mortgage Capital Holdings, LLC.

permit borrowers to bring affirmative claims for damages and other relief against the owners of their loans.¹⁵

In this part of the Article, we describe how owners of loans—both arrangers and investment trusts—can be exposed to derivative consumer claims. Direct liability for participation in activities related to unlawful origination practices is covered in Part IV.

As we discussed in the introduction, depending on the stage of a securitization, loans can be owned by the arrangers or securitization trusts. Arrangers become owners when they hold loans pending completion of securitization deals, before the loans are transferred to a trust. It is also important to note that even though the trust is the legal owner of the loans, it is the owners of the RMBS that stand to lose if a trust has derivative liability.¹⁶

A. *Fraud, Unconscionability and Holder in Due Course*

When a borrower defaults on a home loan, the owner of the note typically brings a collection or foreclosure action.¹⁷ The borrower can attempt to defend the claim on the basis that the note arose out of an unlawful act at origination and that the unlawful act negates, fully or partially, the borrower's obligation to repay the loan. Fraud and unconscionability are the most frequent *common law* defenses against collection or foreclosure actions brought by note owners.¹⁸ The success of these defenses turns on the sufficiency of the evidence of fraud or unconscionability as well as on whether

¹⁵ Borrowers can also bring claims for recoupment. These claims must arise out of the same transaction that formed the basis of the creditor's claim against the borrower. Such claims are equitable in nature and are not barred by statutes of limitation. If borrowers are successful in recoupment claims against assignees, their debt is reduced but they have no right to any affirmative relief. For a discussion of recoupment in response to a complaint to foreclose, see *Assoc. Home Equity Servs., Inc. v. Troup*, 778 A.2d 529, 539–40 (N.J. Super. Ct. App. Div. 2001).

For a survey of laws that can give rise to derivative liability, see Elizabeth Renuart, *The Cost of Credit* § 12.12 (4th ed. 2009).

¹⁶ See Michael Gregory, *The Predatory Lending Fracas: Wall Street Comes Under Scrutiny in the Subprime Market as Liquidity Suffers and Regulation Looms*, INV. DEALERS' DIG. (June 26, 2000); Joseph R. Mason, *The Summer of '07 and the Shortcomings of Financial Innovation*, 18 J. APPLIED FIN. 8 (2008). Arrangers can also end up owning loans if they are forced to buy them back from trusts because the loans do not comply with the deal terms.

There are other entities that bear some of the risk when consumers are successful in claims against trusts or when defending claims by trusts. As part of securitization, there are credit enhancements such as insurance that absorb some of the losses. Engel & McCoy, *supra* note 4, at 2047–48.

¹⁷ In a state with a judicial foreclosure scheme, the holder of the note files a claim against the borrower. In jurisdictions that have a non-judicial procedure, borrowers must initiate judicial review by seeking an injunction to stop the foreclosure.

¹⁸ Our focus is on the defensive use of fraud and unconscionability because that is usually how borrowers raise such claims. It is worth noting that some courts have rejected affirmative unconscionability claims altogether. Renuart, *supra* note 15, at § 12.7.5.

Fraud and unconscionability can be brought as affirmative claims against assignees in recoupment claims. See U.C.C. § 3-305(a)(3) (2010).

the owner of the note is a holder in due course (HDC), and therefore not liable for the vast majority of illegal acts that occur at origination.

1. *Fraud*

Fraud is recognized in every jurisdiction in the United States and the elements of fraud are generally consistent across jurisdictions. Courts' interpretations of the elements, however, vary widely. To establish fraud in tort, the victim must prove that the party who committed fraud made a false statement of material fact¹⁹ with knowledge of the falsity and intent to deceive, on which the victim justifiability relied, and which caused the victim injury.²⁰ In some jurisdictions, acceptance of the fruits of a fraud with knowledge that they were fraudulently obtained will, in itself, establish fraud.²¹

Courts have recognized fraud claims when borrowers were misled about a loan's interest rate prior to closing,²² when brokers falsely promised to obtain the best rate possible for borrowers,²³ and when borrowers were deceived as to the purpose of the documents they were signing.²⁴ Courts have also recognized fraud when brokers or originators hid finance charges,²⁵ falsified borrowers' employment and income,²⁶ and made loans for

¹⁹ Alternatively, the first element may be satisfied if the defendant induced another to undertake a fraudulent act. *See Knapp v. Americredit Fin. Servs., Inc.*, 245 F. Supp. 2d 841, 852 (S.D.W. Va. 2003).

²⁰ *Compare Williams v. Aetna Fin. Co.*, 83 Ohio St.3d 464, 475 (1998) (holding that a party accused of fraud must either know that the alleged fraudulent statement is false or must have made it with "such utter disregard and recklessness as to whether it is true or false that knowledge may be inferred"), *with Neilson v. Union Bank of Cal., N.A.*, 290 F. Supp. 2d 1101, 1141 (C.D. Cal. 2003) (holding that the party accused of fraud must have actual knowledge that the statement made was false).

²¹ *See, e.g., Pulphus v. Sullivan*, 02-C-5794, 2003 WL 1964333, at *17-20 (N.D. Ill. Apr. 28, 2003).

²² Some former mortgage brokers report that it was common practice to mislead borrowers about loan terms. *See Chris Arnold, Ex-Subprime Brokers Help Troubled Homeowners*, NATIONAL PUBLIC RADIO (Apr. 9, 2008), <http://www.npr.org/templates/story/story.php?storyId=89505982>; *see also Hays v. Bankers Trust Co. of Cal.*, 46 F. Supp. 2d 490, 498 (S.D.W. Va. 1999) (allowing a fraud claim where a borrower was falsely promised that if timely payments were made for a year the loan would be refinanced at a significantly lower rate); *England v. MG Invs.*, 93 F. Supp. 2d 718, 721-22 (S.D.W. Va. 2000) (allowing an affirmative fraud claim against an assignee where an originator had falsely promised to refinance at a lower rate after a year of timely payments).

²³ *See Herrod v. First Republic Mortg. Corp.*, 625 S.E.2d 373, 382 (2005) (suggesting that it may amount to fraud when brokers falsely promise to get borrowers "the best rate" they can).

²⁴ *See Pulphus*, 2003 WL 1964333, at *15, 21 (holding that obtaining a borrower's signature on a promissory note and mortgage by falsely stating that the documents signed related to a weatherization program amounted to fraud).

²⁵ *See In re First Alliance Mortg. Co.*, 471 F.3d 977, 985 (9th Cir. 2006) (holding that a sales presentation that led borrowers to believe the "amount financed" represented the "loan amount" amounted to fraud); *Knapp v. Americredit Fin. Servs.*, 245 F. Supp. 2d 841, 845, 852 (S.D.W. Va. 2003) (holding a fraud claim against a lender survives summary judgment when a car dealer concealed finance charges required to be disclosed by the Truth in Lending Act, and the lender had knowledge of the concealment).

home repairs with knowledge that the people making them were unlikely to finish their work.²⁷

In a recent spate of decisions, California courts allowed borrowers with pay-option loans to proceed with fraudulent omission claims against their lenders.²⁸ Pay-option loans permitted borrowers to choose from several payment options. The options included paying principal and interest (the fully amortizing payment amount), only the monthly interest charge, or an amount less than the monthly interest due, in which case the unpaid interest was tacked onto the principal up to a set maximum. This last option resulted in negative amortization. The loan disclosures included a payment schedule based on a thirty-day teaser rate and stated that negative amortization might occur. However, because the payment schedule was based on a teaser rate that increased after thirty days, negative amortization was certain to occur if borrowers adhered to the payment schedule in the disclosures. Based on this evidence, courts have denied lenders' motions for summary judgment and allowed the plaintiffs to go forward with their claims of fraud by omission.

2. Unconscionability

Unconscionability is another defense that borrowers can raise when note owners bring collection actions. Contracts can be unconscionable if borrowers had no meaningful choice about the terms and the terms unreasonably favored the lender.²⁹ Most courts require that borrowers prove both procedural and substantive unconscionability,³⁰ although the analysis is not

²⁶ See *Matthews v. New Century Mortg. Corp.*, 185 F. Supp. 2d 874, 891 (S.D. Ohio 2002) (denying motion to dismiss fraud claim where allegations were, inter alia, that brokers defrauded borrowers by falsifying the borrowers' income and employment status on their loan applications); *Carroll v. Fremont Inv. & Loan*, 636 F. Supp. 2d 41, 52 (D.D.C. 2009) (holding that a lender falsifying a borrower's income and assets on a loan application so that they would qualify for a loan they could not afford amounts to a fraud on the borrowers).

²⁷ See *Williams v. Aetna Fin. Co.*, 83 Ohio St.3d 464 (1998) (holding that making a loan to pay for home repair services with knowledge that the work would never be done amounted to fraud).

²⁸ *Peel v. Brookamerica Mortg. Corp.*, No. 8:11-cv-0079-JST (RNBx), 2011 WL 2174373 (C.D. Cal. June 1, 2011); *Jordan v. Paul Fin., LLC*, 745 F. Supp. 2d 1084 (N.D. Cal. 2010); *Ralston v. Mortg. Investors Grp.*, No. C 08-536 JF (PVT), 2010 WL 3211931 (N.D. Cal. Aug. 12, 2010).

²⁹ *Williams v. Walker-Thomas Furniture Co.*, 350 F.2d 445, 449-50 (D.C. Cir. 1965).

Determining unconscionability requires application of many factors. See, e.g., *Sosa v. Paulos*, 924 P.2d 357, 362 (Utah 1996) (weighing the following factors: "(1) whether each party had reasonable opportunity to understand terms and conditions of agreement, (2) whether there was a lack of opportunity for meaningful negotiation, (3) whether the agreement was printed on duplicate or boilerplate form drafted solely by the party in the strongest bargaining position, (4) whether the terms of the agreement were explained to the weaker party, (5) whether the weaker party had a meaningful choice or instead felt compelled to accept the terms of the agreement, and (6) whether the stronger party employed deceptive practices to obscure key contractual provisions.") (citations omitted).

³⁰ See, e.g., *Tillman v. Commercial Credit Loans, Inc.*, 655 S.E.2d 362, 370 (2008) ("A party asserting that a contract is unconscionable must prove both procedural and substantive unconscionability."). Some jurisdictions only require proof of *either* procedural *or* substantive

rigid.³¹ When a contract—or one or more of its clauses—is unconscionable, courts can reform or refuse to enforce the contract.³²

Procedural unconscionability is marked by oppression and unfair surprise.³³ An oppressive transaction denies the borrower meaningful choice through a gross inequality of bargaining power.³⁴ In the lending context, surprise occurs most frequently when supposedly agreed-upon terms are hidden from the borrower in clauses that are lengthy, complex, or otherwise confusing, or when the terms of the note at closing differ from those that had been previously negotiated.³⁵ The procedural prong of unconscionability will often be satisfied in abusive lending situations.³⁶

Substantive unconscionability is not well-defined, but courts have found some common terms to be substantively unconscionable. For example, there are courts that have found mandatory arbitration clauses unconscionable.³⁷ Others have held that when lenders, without the borrower's knowledge, inflate the borrower's income in order to qualify the borrower for a loan, the inflation can introduce an element of unconscionability.³⁸ When individual contract terms are not by themselves substantively unconscionable, some

unconscionability. *See, e.g.*, *Tjart v. Smith Barney, Inc.*, 28 P.3d 823, 831 (Wash. Ct. App. 2001).

³¹ *See, e.g.*, *Matter of Friedman*, 64 AD 2d 70, 85 (N.Y. App. Div. 1978) (stating in dicta that “[t]he concept of unconscionability must necessarily be applied in a flexible manner depending upon all the facts and circumstances of a particular case”).

³² *See*, RESTATEMENT (SECOND) OF CONTRACTS § 208 (2011); U.C.C. § 2-302 (2010).

³³ *See* U.C.C. § 2-302, note 1 (2010); Craig Horowitz, *Reviving the Law of Substantive Unconscionability, Applying the Covenant of Good Faith and Fair Dealing to Excessively Priced Consumer Credit Contracts*, 33 UCLA L. Rev. 940, 944–46 (1986).

³⁴ *Williams*, 350 F.2d at 449 (“In many cases the meaningfulness of the choice is negated by a gross inequality of bargaining power. . . . [W]hen a party of little bargaining power, and hence little real choice, signs a commercially unreasonable contract with little or no knowledge of its terms, it is hardly likely that his consent, or even an objective manifestation of his consent, was ever given to all the terms.”).

³⁵ *A&M Produce v. FMC Corp.*, 135 Cal. App. 3d 473, 486 (1982) (holding that “[s]urprise involves the extent to which the supposedly agreed-upon terms of the bargain are hidden in a prolix printed form drafted by the party seeking to enforce the disputed terms”). Courts have found that borrowers can be surprised even when they signed and initialed disclosure documents. *Moore v. Mortgagestar, Inc.*, No. 2:01-0226, 2002 U.S. Dist. LEXIS 27457, at *34–35 (S.D.W. Va. Dec. 18, 2002) (holding that the borrowers’ initials and signatures on disclosure documents were not necessarily evidence of a lack of surprise); *Green v. Gibraltar Mortg. Inv. Corp.*, 488 F. Supp. 177, 180 (D.D.C. 1980) (holding that a borrower taking out a second mortgage to avoid imminent foreclosure lacked any meaningful choice).

³⁶ *See, e.g.*, *Matthews v. New Century Mortg. Corp.*, 185 F. Supp. 2d 874, 892–93 (2002) (denying defendant’s motion to dismiss unconscionability claim where mortgage brokers had significantly greater bargaining power, business acumen, and experience than plaintiffs, and plaintiffs were not given a meaningful opportunity to read the closing contracts before signing).

³⁷ *See, e.g.*, *Tillman v. Commercial Credit Loans, Inc.*, 655 S.E.2d 362, 373 (2008) (holding that an arbitration clause was substantively unconscionable); *Luna v. Household Fin. Corp.*, 236 F. Supp. 2d 1166 (W.D. Wash. 2002) (same). *But see, e.g.*, *In re Peoples Choice Home Loan, Inc.*, 225 S.W.3d 35, 44–46 (Tex. App. 2005) (holding that a mandatory arbitration clause in a contract of adhesion was not unconscionable); *In re Firstmerit Bank*, 52 S.W.3d 749, 758 (Tex. 2001) (same).

³⁸ *City Fin. Servs. v. Smith*, No. 97 CVF 00679, 2000 WL 288469, at *2 (Ohio Mun. Ct. Jan. 4, 2000) (holding that the lender’s enhancement of borrower’s income to reflect a 25%

courts have held that a combination of unfair terms can amount to substantive unconscionability.³⁹

Although loan prices can theoretically be unconscionable,⁴⁰ courts have been reluctant to deem them so.⁴¹ In several cases, however, courts have found that a loan was unconscionable if the borrower's monthly payment was unaffordable.⁴²

Unconscionability claims are not easy to prove, especially when borrowers have recently engaged in similar transactions—for example, they previously financed a home—and were given adequate disclosure of the terms of their loans and the associated risk.⁴³ Consistent with this approach, courts have denied unconscionability claims when borrowers underwent loan counseling before signing their loan documents, had an opportunity to ask questions about the loans, and believed they were able to make their monthly mortgage payments.⁴⁴

3. *Holders in Due Course*

Even when borrowers can prove that their loans were procured through fraud or contained unconscionable terms, they may not be able to success-

income tax deduction level, which never existed, created an element of unconscionability in the contract when it was made).

³⁹ Herrod v. First Republic Mortg. Corp., 625 S.E.2d 373 (Ga. Ct. App. 2005) (finding that fees in excess of 10.5%, evidence of appraisal inflation, and a statement from a state real estate appraiser board that the appraiser deviated from generally accepted standards could be evidence of substantive unconscionability).

⁴⁰ See Arthur Linton Corbin, CORBIN ON CONTRACTS § 129 (1963) (stating that in the absence of usury statutes, interest rates will be enforced “up to the point at which ‘unconscionability’ becomes a factor”); Besta v. Beneficial Loan Co., 855 F.2d 532, 536 (8th Cir. 1988) (holding that a lender's failure to disclose a lower-cost option to an “exorbitantly expensive” interest rate was unconscionable).

⁴¹ Engel & McCoy, *supra* note 6, at 1299–1301.

⁴² See, e.g., Matthews v. New Century Mortg. Corp., 185 F. Supp. 2d 874 (S.D. Ohio 2002); Family Fin. Servs. v. Spencer, 677 A.2d 479 (Conn. App. Ct. 1996) (denying motion to dismiss unconscionability claim where, among other factors, the borrower's financial situation made it “apparent that [the borrower] could not reasonably expect to repay the second mortgage”); City Fin. Servs. v. Smith, No. 97 CVF 00679, 2000 WL 288469 (Ohio Mun. Ct. Jan. 4, 2000) (holding that a loan is unconscionable when it would have, among other factors, left plaintiff with only \$120 per month in disposable income).

Some anti-predatory lending laws require that lenders take into account whether borrowers can afford to repay their loans. In these cases, the courts have considered the price terms, but only to determine the affordability of the credit. In none of these cases did the courts deem that the price was per se unconscionable. See, e.g., D.C. Code § 28-3904(r)(1) (2001); Carroll v. Fremont Inv. & Loan, 636 F. Supp. 2d 41, 51–52 (D.D.C. 2009).

⁴³ See, e.g., In re Strong, 356 B.R. 121, 131 (Bankr. E.D. Pa. 2004), *aff'd*, No. 01-35854BIF, 2005 WL 1463245 (E.D. Pa. June 20, 2005) (denying a borrower's unconscionability claim where the borrower reviewed disclosure documents, consciously opted not to rescind, had entered a similar refinance agreement the prior year to the refinancing at issue, and the court found the loan terms reasonable given the borrower's financial situation).

⁴⁴ See, e.g., Cheshire Mortg. Serv. v. Montes, 612 A.2d 1130, 1138 (Conn. 1992) (denying borrowers' claim that a second mortgage was unconscionable where the borrowers had loan terms explained at closing and had undergone loan counseling prior to the original home purchase).

fully defend against foreclosure or collection actions. This is because the HDC rule can shield note owners.⁴⁵ Under contract law, if a loan is sold, the new owner is subject to any claims or defenses that the borrower could have asserted against the original party to the contract unless the owner is a HDC. The HDC rule traces its origins to the 1700s, when Lord Mansfield sought to encourage the use of promissory notes as cash in an economy with no official paper currency. He achieved this by limiting the claims to which the holders of promissory notes could be subject.⁴⁶ The rule applies to loans secured by real property and impedes almost all defenses to payment on a note, including unconscionability and most fraud.⁴⁷

Although the HDC rule has been part of contract law for hundreds of years, it played only a minor role in mortgage markets until recently. Historically, when notes were originated and held in the portfolios of banks, the HDC rule was irrelevant because borrowers' notes were not sold. Thus, borrowers usually had the right to defend against lenders' foreclosure claims by asserting fraud or unconscionability. Once securitization of home loans took off, lenders began selling the loans they made. And, once the loans were sold, the HDC rule attached and limited borrowers' ability to raise fraud and unconscionability defenses.

To satisfy the requirements of the HDC rule, purchasers must prove that they are the holders of a negotiable instrument, purchased in the ordinary course of business, for value, in good faith, and without notice that the note was overdue, had been dishonored, or was subject to any defenses.⁴⁸ If a note owner is not a HDC, consumers can defend nonpayment.

⁴⁵ For a general discussion of the impact of the HDC rule on borrower claims, see 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. 225, 237–39 (2009); Deborah Goldstein & Matthew Brinegar, *Policy and Litigation Barriers to Fighting Predatory Lending*, 2 NORTH-EASTERN U. L.J. 167, 167–74, (2010); Whitman, *supra* note 8, at 756–57.

⁴⁶ See generally Mark B. Greenlee & Thomas J. Fitzpatrick IV, *supra* note 45; Michael Sinclair, *Codification of Negotiable Instruments Law: A Tale of Reiterated Anachronism*, 21 U. TORONTO L. REV. 625, 634–635 (1989).

⁴⁷ U.C.C. §§ 3-305(a), (b) (2010). There is a small set of defenses that can be raised even against a HDC. These defenses include: (1) infancy of the obligor to the extent it is a defense to a simple contract; (2) duress, lack of legal capacity or illegality of the transaction, which completely nullify the obligation; (3) fraud that induced the note to be signed without knowledge or reasonable opportunity to learn the terms of the instrument or that the document was a negotiable instrument; and (4) the discharge of the note maker in insolvency proceedings. These defenses are limited to the most extreme violations of law. *Id.*

⁴⁸ U.C.C. § 3-302. For a history of the doctrine, see Edward L. Rubin, *Learning from Lord Mansfield: Toward a Transferability Law for Modern Commercial Practice*, 31 IDAHO L. REV. 775, 777–86 (1995); Greenlee & Fitzpatrick, *supra* note 45, at 228–35.

Although the HDC standard appears straightforward, courts construe the standard in ways that lead to inconsistent results. For example, in a series of cases in which numerous borrowers brought separate claims based on broker fraud against the owners of their loans, the courts that heard the claims reached divergent results on the issue of the applicability of the HDC doctrine despite identical operative facts. See Kurt Eggert, *Held Up in Due Course: Predatory Lending, Securitization, and the Holder in Due Course Doctrine*, 35 CREIGHTON L. REV. 503, 522–31.

a. *Negotiable Instrument*

For a holder to qualify as a HDC of a home mortgage note, the note must be a negotiable instrument. Because of the powerful protections that holders of negotiable instruments receive, courts limit the types of paper that qualify as such, as we discuss below.⁴⁹ In particular, negotiable instruments must contain an unconditional promise to pay and require no additional undertakings.

i. *Unconditional Promise*

All negotiable instruments must contain an “unconditional promise or order to pay” a specified sum of money.⁵⁰ A promise or order is conditional if it contains an express condition to payment, a statement that the loan incorporates another writing, or a statement that the rights or obligations with respect to the promise are stated in other writings.⁵¹ Courts have interpreted the unconditional promise requirement as creating a “four corners” test, under which an instrument is not negotiable unless the note, on its face, makes clear that the promise to pay is unconditional.⁵²

Although standard-form home loans do not employ express conditions because of the risk that they will undermine an assignee’s status as a HDC, there is a standard term, referred to as a “usury savings clause” that may

⁴⁹ See, e.g., *Geiger Fin. Co. v. Graham*, 123 Ga. App. 771, 775 (1971) (“The drafters of the U.C.C. (and our legislature by its adoption) were careful to limit the type of instrument which would carry the powerful magic of negotiability under Article 3 [of the U.C.C.]”).

⁵⁰ U.C.C. §§ 3-104(a), 3-106 (2010). See also, *Nagel v. Cronebaugh*, 782 So.2d 436, 439 (Fla. Dist. Ct. App. 2001) (ruling that a note that did not specify a fixed amount that was due was not a negotiable instrument). Arguably, loans with negative amortization could be for uncertain sums because the principal balance can increase over time, albeit to a set limit of usually between 110% and 115% of the original loan amount. But see *Goss v. Trinity Sav. & Loan Ass’n*, 813 P.2d 492, 497 (Okla. 1991) (rejecting borrowers’ claim that a negatively amortizing loan was not a negotiable instrument).

⁵¹ U.C.C. § 3-106(a)(i)-(a)(iii) (2010). See also, *Reid v. Pyle*, 51 P.3d 1064, 1067 (Colo. App. 2002) (holding that a promissory note containing a provision expressly conditioning the obligation to pay on the sale or transfer of the property was not a negotiable instrument).

Notes may reference other writings for a statement of rights regarding the collateral. U.C.C. § 3-106(b)(i). However, when notes go beyond a mere reference and incorporate the terms of another writing, such as incorporating by reference waivers, consents, and acknowledgements of the debtor, they are not negotiable instruments. See, e.g., *FFP Mktg. v. Long Lane Master Trust IV*, 169 S.W.3d 402, 408–09 (Tex. App. 2005) (“In addition, the notes fail the requirement for an unconditional promise because each note specifically ‘incorporates by reference’ the terms of other documents, requiring one to examine those documents to determine if they place conditions on payment”).

⁵² See, e.g., In re *APPONLINE.COM*, 285 B.R. 805, 816 (Bankr. E.D.N.Y. 2002), *aff’d*, 321 B.R. 614 (E.D.N.Y. 2003), *aff’d*, 128 F. App’x 171 (2d Cir. 2005) (“The test to employ in this case is whether the notes in question contain an unconditional promise to pay a sum certain which can be determined from the face of the notes, or whether the language of the notes, fairly construed, require one to look outside the notes to determine terms of repayment.”).

destroy negotiability.⁵³ Usury savings clauses provide that if the interest rate on a loan is usurious, the borrower is not required to pay amounts above the legal limit. In other words, the borrowers' duty to pay is expressly condition on the rate being non-usurious. To the extent that courts hold that usury savings clauses create conditions to payment, notes containing such clauses are not negotiable instruments and assignees of the notes are not holders in due course.

ii. Additional Undertakings

Negotiable instruments must not require "any other undertaking or instruction by the person promising or ordering payment to do any act in addition to the payment of money."⁵⁴ A standard provision that could defeat the negotiability of mortgage notes requires borrowers to notify lenders, in writing, if they plan to prepay their loans.⁵⁵ Whether a prepayment notice requirement is an additional undertaking has yet to be tested in courts.

b. Holders of Notes

If the party seeking to enforce a note passes the negotiability hurdle, the party must still prove it is a "holder" of the note.⁵⁶ To be a holder, one must have possession of the note and the right to enforce it. A person in possession may enforce notes that are either payable to the person in possession or are "bearer paper," where a payee is not specified.⁵⁷ Thus, to be a holder, a person must possess bearer paper or be the person to whom the loan is payable. Notes that are payable to an identified person or entity can be transferred through endorsement and delivery; with bearer paper delivery alone qualifies as a transfer.⁵⁸

In the rush to securitize loans, market actors did not always ensure that note owners had actual possession of notes or that the notes had the required

⁵³ Ronald J. Mann, *Searching for Negotiability in Payment and Credit Systems*, 44 UCLA L. Rev. 951, 976-77 (1997).

⁵⁴ U.C.C. § 3-104(a) (2010).

⁵⁵ Mann, *supra* note 53, at 971-72; Whitman, *supra* note 8, at 749-50.

⁵⁶ U.C.C. § 3-302(a)(2) (2010).

Owners cannot always establish that they possess the notes they own. To get around this problem, the U.C.C. allows owners of notes to enforce loans if the notes were lost, destroyed, or wrongfully in the possession of another person so long as the owners can prove that they have the right to enforce the notes. U.C.C. § 3-309. Most commentators contend that this provision only applies to notes that were actually *possessed* by the owner at some point. *See* Whitman, *supra* note 8, at 759-61; *see also* U.C.C. § 3-309(a)(i).

⁵⁷ U.C.C. §§ 1-201(20), 3-109(b), 3-109(a). *See, e.g.*, SMS Fin. v. ABCO Homes, 167 F.3d 235, 238-39 (5th Cir. 1999) (distinguishing between the holder and owner of a note).

⁵⁸ U.C.C. § 3-203. This speaks only to the requirements under the U.C.C. There may be additional requirements at the state level to transfer an interest in property. *See, e.g.*, In re Grioux, No. 08-14708-JNF, 2009 WL 1458173 (Bankr. D. Mass. May 21, 2009), *aff'd sub nom.* Mortg. Elec. Registration Sys., Inc. v. Agin, 09-CV-10988-PBS, 2009 WL 3834002 (D. Mass. Nov. 17, 2009); MERS v. Agin, No. 09-CV-10988-PBS, 2009 WL 3834002, *4-5 (D. Mass. Nov. 17, 2010); U.S. Bank Nat'l Ass'n v. Ibanez, 941 N.E.2d 40, 53 (Mass. 2011).

endorsements.⁵⁹ In some situations, people who endorsed notes did not have the legal authority to do so. Courts have held that such infirmities in endorsements can preclude owners of notes from establishing holder status.⁶⁰

c. Taking in Good Faith and without Notice

To achieve HDC status, holders of negotiable instruments must also prove that they took the notes in good faith, and without notice that the borrowers were behind on payments or that the notes were subject to any defenses. The U.C.C. employs an objective test that defines good faith as honesty in fact and the observance of reasonable commercial standards of fair dealing.⁶¹ Some states have rejected the U.C.C. approach and require a subjective test, which poses a higher hurdle for those claiming lack of good faith.

Notice is defined as actual knowledge, receipt of notice or notification, or that all the facts and circumstances known to the owners at the time in

⁵⁹ Whitman, *supra* note 8, at 757–58; *see also* Ariana Eunjung Cha, *B of A Official: Countrywide Mortgage Documents Were Not Transferred Properly to Trust*, POLITICAL ECONOMY, WASH. POST, (Nov. 24, 2010, 10:53 AM) (documenting the failure of Countrywide Mortgage to transfer possession of notes to assignees), http://voices.washingtonpost.com/political-economy/2010/11/bofa_official_countrywide_mort.html; Office of the Assessor-Recorder, San Francisco, FORECLOSURE IN CALIFORNIA: A CRISIS OF COMPLIANCE 7 (Feb. 2012) (documenting the lack of endorsements on securitized loans).

⁶⁰ *See, e.g.*, *Hays v. Bankers Trust Co. of Cal.*, 46 F. Supp. 2d 490, 497 (S.D.W. Va. 1999) (holding that a master servicer to whom a note was not endorsed is not a holder, and thus could not be a HDC); *Crossland Sav. Bank v. Constant*, 737 S.W.2d 19, 21–2 (Tex. Ct. App. 1987) (upholding the trial court’s finding of no valid endorsements when the purported endorsements were not attached to the notes themselves, but were in a group of documents that included the notes).

Courts have routinely dismissed foreclosure cases due to lenders’ failure to prove they were the true party in interest (as required by Fed. R. Civ. P. 17(a) or its state law counterparts), or lenders were unable to produce a properly endorsed note. *See In re Foreclosure Cases*, 521 F. Supp. 2d 650, 654–55 (N.D. Ohio, 2007) (holding that foreclosure actions based upon diversity jurisdiction must include, among other things, a copy of the promissory note and an affidavit documenting that the named plaintiff is the owner and holder of the note and mortgage); *In re Foreclosure Cases*, 2007 WL 3232430, at *1, 3 (N.D. Ohio Oct. 31, 2007) (dismissing without prejudice numerous foreclosure actions where the plaintiff failed to show it was the holder of the notes and mortgages at the time the foreclosure complaints were filed); *HSBC Bank v. Antrobus*, No. 43299/07, 2008 WL 2928553, at *4 (N.Y. Sup. Ct. July 31, 2008) (dismissing plaintiff’s uncontested foreclosure where it was unclear that the parties executing note assignments were employees of the note owners with authority to assign them); *Wells Fargo Bank v. Farmer*, No. 27296/07, 2008 WL 2309006, at *1, 6–7 (N.Y. Sup. Ct. June 5, 2008) (dismissing plaintiff’s foreclosure with prejudice where multiple assignments of a note and mortgage were made by the same person, who claimed to be acting as an agent of two mortgage companies on the same day without any proof of an agency relationship); *Deutsche Bank Nat’l Trust v. Brumbaugh*, 270 P.3d 151 (Okla. 2012) (overturning grant of summary judgment for foreclosure where there was evidence that the note had not been properly endorsed, in which case, according to the Court, the plaintiff would not be a “holder”)

⁶¹ U.C.C. § 3-101(a)(4) (2011). Although U.C.C. § 1-201(20) defines good faith as honesty in fact in the conduct or transaction concerned, the comments state that this is a floor, not a ceiling. *Id.* cmt. 20. The 2001 revisions to the UCC redefined of good faith to mean honesty in fact and observance of reasonable commercial standards of fair dealing, but most states use the pre-2001 definition.

question provided reason to know the fact.⁶² As we discuss below, a borrower's loan file, a close connection between the parties involved in the loan origination and financing, or agency relationships can put an assignee on notice.

i. Loan files and notice

Loan files can contain information that will put assignees on notice that a note is defective. As we discussed earlier, in the flurry of securitizations, loan originators did not always deliver borrowers' notes to the new owners and did not always endorse the loans.⁶³ Oftentimes, owners corrected the deficiencies *after* borrowers sued them or after the borrowers had defaulted.⁶⁴ This means that when the owners became holders they had notice that the notes were defective, which could preclude them from being HDCs. This, in turn, could enable borrowers to raise defenses to foreclosure or collection actions brought by assignees. In *Fairbanks Capital Corp. v. Summerall*,⁶⁵ an assignee brought a collection action against a borrower in default. Before the assignee purchased the loan, the borrower's loan file included information that the borrower had defaulted and had defenses to payment.⁶⁶ In light of these facts, the court held that the assignee had notice and was not a HDC. Other courts have reached similar conclusions when purchasers of loans have notice that a note is overdue or otherwise defective.⁶⁷

⁶² UCC § 1-201(25–27). The definition of “notice” varies by jurisdiction. For instance, in *Wilson v. Toussie*, the court held that in New York owners of notes are holders in due course unless they had “actual knowledge,” the highest standard listed in the U.C.C.’s definition. 260 F. Supp. 2d 530 (E.D.N.Y. 2003).

⁶³ The issue whether an assignee is a HDC is different from the question of standing that has arisen when owners of notes have attempted to foreclose based on notes that lacked valid endorsements. Whitman, *supra* note 8, at 762–63; *see also* Gretchen Morgenson, *How One Borrower Beat the Foreclosure Machine*, N.Y. TIMES, July 27, 2008, available at <http://www.nytimes.com/2008/07/27/business/economy/27gret.html?scp=1&sq=howard%20rothbloom&st=cse> (discussing a borrower's successful effort to defeat a foreclosure action based on flawed documentation). Without possession of the notes and the endorsements necessary to establish a valid chain of ownership, owners of notes may not have the right to foreclose.

⁶⁴ *See Carroll v. Fremont Inv. & Loan*, 636 F. Supp. 2d 41, 55–56 (D.D.C. 2009) (holding that borrower's lawsuit prior to the note owner becoming a holder put the holder on notice of the borrower's defenses to non-payment). Becoming a holder after legal proceedings have been initiated was standard in some cases. Cha, *supra* note 59.

⁶⁵ *Fairbanks Capital Corp. v. Summerall*, No. 02AP-864, 2003 WL 1700487 (Ohio Ct. App. Mar. 31, 2003).

⁶⁶ *Id.* at *3. The loan file contained a notice from the borrower's lawyer stating that the borrower was rescinding the transaction due to violations of the Truth in Lending Act, and that the loan was delinquent at the time of purchase.

⁶⁷ *See, e.g., First Union Nat'l Bank v. Curtis*, 882 A.2d 796, 799 n.6 (2005) (“The general rule is that a purchaser of an overdue note and mortgage, with notice that the note was overdue, cannot be a holder in due course and is subject to defenses.”).

Incidents involving purchases of loans that are in default are not isolated. *See, e.g., Wells Fargo Bank, N.A. v. Guy*, No. 33690/07, 2008 WL 1903535, at *2 (N.Y. Sup. Ct. May 1, 2008) (noting that Wells Fargo had purchased a “nonperforming loan”); *HSBC Bank USA, N.A. v. Yeasmin*, No. 34142/07, 19 Misc. 3d 1127(A), at *4 (N.Y. Sup. Ct. 2008) (stating in dicta “[I]njustly, the Court requires a satisfactory explanation from an officer of HSBC how, in

ii. *Close connectedness doctrine and agency relationships*

Courts have also imputed knowledge when there is a close connection between an assignee and the seller of the loan.⁶⁸ In *England, et al. v. MG Investments, et al.*, the court held that evidence that an assignee had committed to buy a borrower's loan prior to the actual closing of the loan was sufficient to defeat the assignee's motion for summary judgment on a fraud claim brought by the borrower.⁶⁹ In so ruling, the court stated that the evidence "reasonably suggest[ed] that, rather than simply making . . . loans on its own and then pooling them for sale to [the assignee], [the originator] was actually making the loans on behalf of [the assignee], that is as [the assignee's] agent."⁷⁰ In another case, a court refused to give an assignee HDC protection when the assignee bought a loan immediately after origination, at a substantial discount, and without investigating the credit quality of borrower.⁷¹ Courts have similarly denied HDC status when note owners exercised extensive control over the originator's operations and acted as the sole purchaser of the originator's notes.⁷²

At times, courts have imputed notice of defects to assignees because of agency relationships between originators and assignees, for example, when a single signatory acted for both the assignor and assignee (a practice that was not uncommon).⁷³ Similarly, in *First Union National Bank v. Curtis*, the

the middle of our national subprime mortgage financial crisis, plaintiff HSBC purchased . . . a nonperforming loan"); U.S. Bank, Nat'l Ass'n v. Videjus, No. 7171/07, 19 Misc. 3d 1125(A), at *4 (N.Y. Sup. Ct. 2008) (stating in dicta that "the court requires an explanation from an officer of plaintiff U.S. Bank why . . . plaintiff U.S. Bank [would] purchase . . . a nonperforming loan").

⁶⁸ Renuart, *supra* note 15, at § 10.6.1.3.2; *see also* Kurt Eggert, *Held Up in Due Course: Codification and the Victory of Form over Intent in Negotiable Instrument Law*, 35 CREIGHTON L. REV. 363, 416 (2002).

⁶⁹ 93 F. Supp. 2d 718 (S.D.W. Va. 2000).

⁷⁰ *Id.* at 723; *see also* LaChapelle v. Toyota Motor Credit Corp., 102 Cal.App.4th 977, 990 (2002) ("[The] assignee's connection with the original . . . transaction is so close as to justify viewing the assignee as the original creditor"); Price v. Franklin Inv. Co. 574 F.2d 594, 599-02 (D.C. Cir. 1978) (holding that where "a seller of goods executes a loan contract with the customer, and then immediately assigns the contract to a finance company" the assignee could be found liable for TILA violations on the grounds that the originator was acting as a conduit for the assignee).

⁷¹ *See* Greene v. Gibraltar Mortg. Inv. Corp., 488 F. Supp 177, 180-81 (D.D.C. 1980).

⁷² *See* Unico v. Owen, 232 A.2d 405, 412-13 (N.J. Sup. Ct. 1967); *see also* Bishop v. Quicken Loans, Inc., No. 2:09-01076, 2010 WL 3522128, at *4 (S.D.W. Va. Sept. 8, 2010) (denying assignee's motion to dismiss on the grounds that allegations that the assignee had "a continuing business relationship" with the loan originator could defeat the status of the assignee as a holder in due course).

⁷³ *See, e.g.*, Wells Fargo Bank, N.A. v. Farmer, No. 27296/07, 2008 WL 2309006, at *1 (N.Y. Sup. Ct. June 5, 2008) (stating in dicta "[w]hile both assignments list the offices of ARGENT and AMERIQUEST at different locations in Orange, California, both assignments were executed by "Jose Burgos-Agent," before the same notary public, in Westchester County, New York"); HSBC Bank USA v. Valentin, No. 15968/07, 2008 WL 4764816, at *2 (N.Y. Sup. Ct. Nov. 3, 2008) (stating in dicta "[t]he court is troubled that Mr. Anderson acted as both assignor of the instant mortgage loan [as Vice President of MERS], and then as the Vice President of Ocwen, assignee HSBC's servicing agent"); Deutsche Bank Nat'l Trust Co.

Court denied HDC status to an assignee because the originator and assignee utilized the same third-party loan servicer, who had notice that the loan was delinquent at the time the loan was sold to the assignee.⁷⁴ The Court reasoned that the servicer acted as a common agent for the assignor and assignee; thus, the assignee had actual or constructive knowledge of the delinquency.⁷⁵ The Supreme Judicial Court of Maine vacated the trial court's judgment on other grounds, but the Court noted that First Union had purchased an overdue note with knowledge that it was overdue.⁷⁶

Although most of the reported cases that examine the close-connectedness doctrine involve loan purchasers who were not arrangers, the factual bases for defeating HDC status apply regardless whether assignees intend to hold or securitize the loans they buy. Thus, the close-connectedness exception can pose a hurdle to arrangers who seek to establish themselves as HDCs, particularly if they are actively involved with the lenders who originate the loans they purchase.

d. Takes in the Ordinary Course of Business

In order for a holder of a negotiable instrument taken in good faith and without notice to acquire rights as a HDC, the holder must also purchase the note in the ordinary course of business. The protections of a HDC will be denied if the assignee acquires the note in a bulk purchase outside the ordinary course of business or in a bankruptcy sale or similar proceeding.⁷⁷ This exception has become more important because of the recent wave of insolvencies and bankruptcies among loan originators, and the resulting acquisitions and mergers of mortgage divisions. If a seller of loans is insolvent or the seller seeks to liquidate a substantial portion of loans, entities that purchase the loans might not be able to secure HDC status.⁷⁸ Likewise, in

v. Maraj, No. 25981/07, 18 Misc. 3d 1123(A), 2008 WL 253926, at *1 (N.Y. Sup. Ct. Jan. 31, 2008) (stating in dicta “[t]he assignment of MERS, on behalf of INDYMAC, was executed by Erica Johnson-Sec, Vice President of MERS Twenty-eight days later, the same Erica Johnson-Sec executed plaintiff’s affidavit submitted in support of the instant application for default judgment. Ms. Johnson-Sec, in her affidavit, states that she is ‘an officer of Deutsche Bank National Trust Company. . . .’”).

⁷⁴ First Union Nat’l Bank v. Curtis, No. Civ.A RE-01-42, 2004 WL 2153521 (Me. Super. Ct. Sept. 8, 2004), *vacated*, 2005 ME 108 (2005).

⁷⁵ *Id.* at *2 (ruling that [the servicer] “is a common agent to [the assignor] and [the assignee], and thus knowledge of the ‘nonperforming’ status of the account while held by [the assignor] can be attributed to [the assignee]”).

⁷⁶ *Curtis*, 2004 WL 2153521, at *4, n.6.

⁷⁷ U.C.C. § 3-302(c). In *Miller v. Diversified Loan Serv. Co.*, 382 S.E.2d 514 (W. Va. 1989), Diversified purchased several home mortgage notes from the bankrupt estate of a savings and loan company. Diversified attempted to enforce the note as a HDC, but the Court refused to accord it HDC status, stating “It is quite clear under the Uniform Commercial Code, [U.C.C. § 3-302(c)], that one cannot become a holder in due course of an instrument ‘[b]y purchase of it at a judicial sale or by taking under legal process.’” *Id.* at 517.

⁷⁸ U.C.C. § 3-302 cmt. 5.

See *Schwegmann Bank & Trust Co. of Jefferson v. Simmons*, 880 F.2d 838, 844 (5th Cir. 1989) (holding that the acquisition of less than 10% of the portfolio of an institution threatened with insolvency is not a substantial portion).

most circumstances, the merger of two lending institutions is a transaction occurring outside the ordinary course of business, and the transfer of loans from one entity to another would not make the transferee a HDC.⁷⁹

When the Federal Deposit Insurance Corporation (FDIC) arranges bulk acquisitions of failing institutions or their assets through purchase or assumption, unique HDC issues arise. In a purchase or assumption transaction, the FDIC acts as a receiver for a failed institution and immediately arranges a sale of substantially all of the institution's assets to another institution. In order to preserve the going-concern value of the institution in receivership, these agreements are often consummated overnight, so purchasers do not have time to investigate the quality of the assets that the FDIC sold them. To mitigate this information friction, the FDIC acts as an insurer, granting the purchasing institution a put (back to the FDIC) for low-quality assets.⁸⁰ In 1982, the 11th Circuit held that the FDIC cannot become a holder in due course when the low-quality asset put is exercised because the FDIC has made bulk purchases not in the ordinary course of business. Nonetheless, the court extended complete protection from state and common law fraud claims under a federal common law rule, so long as the FDIC acquired the notes through a purchase and assumption transaction, for value, and in good faith.⁸¹

If the seller remains viable after the purchase, the sale will be considered in the ordinary course of business and the bulk purchase exception will not attach. *See* First Ala. Bank of Guntersville v. Hunt, 402 So. 2d 992, 994 (Ala. Civ. App. 1981) (holding that an assignment will still be deemed to be in the ordinary course of business provided the seller remains viable after the transfer even when the purchase is a one-time transaction).

⁷⁹ *See* Rosa v. Colonial Bank, 542 A.2d 1112, 1115 (1988) (“That there is not a significant difference between a bank acquiring most of the assets of another bank, which is threatened with bankruptcy, and a bank acquiring all of the assets of another bank through merger.”); *but see* Fidelity Bank, Nat'l Ass'n v. Avrutick, 740 F. Supp 222, 235 (S.D.N.Y. 1990) (holding that a bank acquiring notes through a merger could still exercise the rights of a HDC by virtue of the shelter rule).

⁸⁰ Courts are split on whether the FDIC can be a HDC when it acts as a receiver for a failed institution. *See, e.g.*, In re 604 Columbus Ave. Realty Trust, 968 F.2d 1332, 1349 (1st Cir. 1992) (holding that HDC status does not attach when the FDIC is a receiver); Fed. Deposit Ins. Corp. v. Laguarda, 939 F.2d 1231, 1239 n.19 (5th Cir. 1991) (same); Campbell Leasing, Inc. v. F.D.I.C., 901 F.2d 1244, 1249 (5th Cir. 1990) (holding that HDC status is appropriate when the FDIC is a receiver); Firstsouth, F.A. v. Aqua Const., Inc., 858 F.2d 441, 443 (8th Cir. 1988) (holding that HDC status is appropriate when the Federal Savings and Loan Insurance Corporation acts as a receiver).

⁸¹ *See* Gunter v. Hutcheson, 674 F.2d 862, 872–73 (11th Cir. 1982).

Over time, federal courts developed a federal HDC rule that applied to the FDIC. *See, e.g.*, Fed. Deposit Ins. Corp. v. Wood, 758 F.2d 156, 161 (6th Cir. 1985) (“[W]hen the FDIC in its corporate capacity, as part of a purchase and assumption transaction, acquires a note in good faith, for value, and without actual knowledge of any defense against the note, it takes the note free of all defenses that would not prevail against a holder in due course.”).

The current state of the federal HDC rule is unclear in the wake of *O'Melvin & Myers v. F.D.I.C.*, in which the Supreme Court held “there is no federal general common law.” 512 U.S. 79, 83 (1994). Since *O'Melvin*, some courts have held that the FDIC's status as a holder in due course is subject to state HDC law. *See, e.g.*, DiVall Insured Income Fund Ltd. P'ship v. Boatman's First Nat'l Bank of Kansas City, 69 F.3d 1398, 1403 (8th Cir. 1995) (holding that “the holder in due course issue must be decided under state law”); Calaska Partners Ltd. v. Corson, 672 A.2d 1099, 1103–04 (Me. 1996) (same).

e. Shelter Rule

A final note on the HDC rule merits mention. Although there are numerous ways to demonstrate that the purchaser of a loan is not a holder in due course, the U.C.C. provides shelter for some holders who do not qualify as a HDC on their own. The so-called “shelter rule” provides that an assignee has the rights of a holder in due course so long as an earlier owner was a HDC and the assignee did not engage in any illegal acts affecting the instrument.⁸² This means, for example, that if an arranger purchased a loan and met all the requirements required to be deemed a HDC, a subsequent assignee would have the rights of a HDC, so long as the assignee did not actively participate in making the loan. This is true even if the assignee, for example, knew that the borrower had a defense to payment.

B. Statutory Claims

Thus far, we have focused on derivative common law claims that borrowers might be able to pursue against the owners of their notes. We now turn to derivative *statutory* liability. Under various state and federal statutes, borrowers can bring affirmative claims or raise defenses against owners of notes, even if the owners are holders in due course. On the federal level, the Home Ownership Equity Protection Act (HOEPA) holds assignees liable for certain high-cost loans, and the FTC Rule preserves assignee liability for loans used to pay for consumer goods or services. Other laws, like the federal Truth in Lending Act (TILA), allow borrowers to exercise rights of rescission against the owners of their notes. States have adopted analogues to some or all of these laws. In this section of the Article, we describe these laws, their complex interactions with each other and with other laws, and their implications for arrangers who own loans as well as RMBS investors.

1. Truth in Lending Act

The Truth in Lending Act⁸³ requires specific disclosures to borrowers in consumer credit transactions. TILA and the rules written pursuant to it mandate that creditors “provide a good faith estimate of the loan costs, including a schedule of payments, within three days after a consumer applies for [and

⁸² U.C.C. § 3-203(b).

⁸³ 15 U.S.C. §§ 1601 *et seq.* The Federal Reserve Board (FRB), which was given the authority to implement TILA, has issued regulations, known as “Reg Z,” that further define TILA’s requirements. Elizabeth Renuart & Kathleen Keest, *TRUTH IN LENDING* 13–14 (6th ed. 2007).

The Dodd-Frank Wall Street Reform and Consumer Protection Act, Publ. L. No. 111-203, 124 Stat. 1376 (2010), amended TILA to allow borrowers to assert set-off or recoupment claims against assignees who bring foreclosure or collection actions if the originator of the loan did not determine that the borrower could afford the loan or if the originator provided financial incentives for steering the borrower to a more expensive loan product.

before the borrower has to pay any fees] any mortgage loan secured by a consumer's principal dwelling."⁸⁴

TILA's disclosure rules vary based on whether loans have an adjustable rate (ARM) or fixed rate and whether they are open-ended lines of credit or closed-end loans, the details of which are beyond the scope of this Article.⁸⁵ TILA contains a complex remedial scheme. For violations of TILA, consumers may be entitled to recover actual and statutory damages and attorney's fees and costs.⁸⁶ TILA also provides a right of rescission. With some restrictions,⁸⁷ borrowers can rescind loans within three days of origination of their loans or within three days of receipt of the required disclosures. The statute of limitations for rescission is three years. This means that borrowers who do not receive TILA disclosures at origination have up to three years to exercise their rescission rights.⁸⁸

There are two avenues through which investors in MBS and owners of loans potentially bear derivative liability for TILA violations. First, owners of notes are strictly liable for statutory damages under TILA if the violations were "apparent on the face of the disclosure statement . . . or other documents assigned."⁸⁹ Second, if the TILA disclosures were incomplete or contained errors, the borrower can rescind the loan within three years after it was consummated, even when such violations were not apparent on the face of the loan documents. These rescission rights act against whoever owns the notes.⁹⁰ When a borrower exercises the right to rescind, the holder of the loan must return to the borrower all of the finance charges the borrower paid between consummation and rescission, and the security interest is lost or held in abeyance by courts until the borrower tenders the proceeds of the loan less any damages.⁹¹

⁸⁴ See generally, 15 U.S.C. § 1638(b)(1)–(2); 12 C.F.R. §§ 226.17(c)(2), 226.19(a)(1).

⁸⁵ For a full treatment of TILA, including the rules governing open-ended credit, see Renuart & Keest, *supra* note 83; Patricia A. McCoy, *Rethinking Disclosure in a World of Risk-Based Pricing*, 44 HARV. J. ON LEGIS. 123 (2007).

⁸⁶ 15 U.S.C. § 1640(a)(1) and (2)(A); Renuart & Keest, *supra* note 83, at 577–78; Elizabeth Renuart, STOP PREDATORY LENDING 97 (2002).

⁸⁷ For example, rescission rights do not apply to purchase money mortgages. Renuart, *supra* note 15, at 100.

⁸⁸ *Id.*

⁸⁹ 15 U.S.C. § 1641(a) (2010).

An assignee's knowledge that creditors have a general business practice of making fraudulent disclosures cannot be used to prove that an assignee knew that a TILA disclosure in a particular loan was "inaccurate or incomplete." *Jackson v. S. Holland Dodge, Inc.*, 755 N.E.2d 462, 469 (Ill. 2001) (citing *Taylor v. Quality Hyundai, Inc.*, 150 F.3d 689, 694 (7th Cir. 1998)); see also *Knapp v. Americredit Fin. Servs., Inc.*, 245 F. Supp. 2d 841, 848 (S.D.W. Va. 2003) (holding that assignees who know that a creditor's practices violate TILA are not liable for TILA violations so long as there was no evidence of irregularities apparent on the face of the documents).

⁹⁰ 15 U.S.C. § 1641 (2010).

⁹¹ 15 U.S.C. § 1635(b) (2010).

The right of rescission has been attacked by industry and undermined by some courts. For full discussion of the controversy, see Lea Krivinskas Shepard, *It's All about the Principal*:

2. Home Ownership and Equity Protection Act

The Home Ownership and Equity Protection Act (HOEPA)⁹² amended TILA to require special disclosures three days before closing and to prohibit various terms in high-cost loans.⁹³ HOEPA applies to closed-end consumer credit transactions secured by a borrower's principal residence but not to purchase money or construction loans.⁹⁴ In addition, only loans that meet specific interest rate and points and fees "triggers" are subject to HOEPA.⁹⁵ Borrowers can bring affirmative HOEPA claims and raise HOEPA as a defense to collection efforts by the holders of their notes. There is a one-year statute of limitations on affirmative claims but no limit on defensive claims.⁹⁶

Assignees are liable for violations of HOEPA unless they can prove that "a reasonable person exercising ordinary due diligence" could not have determined that the loan met the definition of a high-cost loan under HOEPA.⁹⁷ Unlike TILA claims, borrowers do not have to prove that HOEPA violations

Preserving Consumers' Right of Rescission under the Truth in Lending Act, 89 N.C. L. REV. 171 (2010).

⁹² 15 U.S.C. § 1639(a)-(l) (2010).

⁹³ 15 U.S.C. § 1639(a), (c)-(f)(2010); 12 C.F.R. § 226.32(c)(1)(2), (3), (5) (2008).

⁹⁴ 15 U.S.C. § 1602(bb)(1) (2010).

⁹⁵ *Id.* The interest rate trigger is loans with interest rates at least 8% above the yield on treasuries with comparable maturities in the case of first-lien mortgages and 10% in the case of junior-lien mortgages. 12 C.F.R. § 226.32(a)(1)(i) (2008). HOEPA's points and fees trigger is loans with points and fees that exceed either 8% of the total loan amount or an annually adjusted amount based on the Consumer Price Index. 12 C.F.R. § 226.32(a)(1)(ii) (2008). As of January 1, 2011, this figure was \$592. 75 Fed. Reg. 46,837 (Aug. 4, 2010) (final rule, staff commentary) (codified at 12 C.F.R. § 226 Supplement I). See Regulation Z, 12 C.F.R. § 226.32(b) for a description of the total points and fees calculation.

On July 30, 2008, the Federal Reserve Board issued new HOEPA regulations, one feature of which is a new class of regulated loans called higher-priced loans that have lower triggers than HOEPA loans. *Final Rule, Truth in Lending*, 73 Fed. Reg. 44,522 (July 30, 2008) (codified at 12 C.F.R. 226.34)

The new regulations prohibit prepayment penalties if the loan payment can change in the first four years of the loan and ban prepayment penalty periods of more than two years in HOEPA and higher-priced loans. *Id.* at 44,603 (codified at 12 C.F.R. 226.32(d)(6) and (7) and 226.35(b)(2)). The regulations also eliminate a former HOEPA requirement that borrowers prove a "pattern and practice" of equity-based lending. *Id.* at 44,539.

Assignees are not liable for damages for violations of provisions governing higher-priced loans although failure to comply with prepayment penalty restrictions on such loans can trigger rescission. *Id.* at 44,551. See also Elizabeth Renuart, TRUTH IN LENDING 100-08 (2008 Supp.) (detailing the higher-priced loans regulations).

⁹⁶ 15 U.S.C. § 1640(e) (2010).

⁹⁷ 15 U.S.C. § 1641(d)(1). The statute does not define the counters of the due diligence standard. One court has defined due diligence under HOEPA as "requiring (1) a review of the documentation required by TILA, the itemization of the amount financed, and other disclosure of disbursements; (2) an analysis of these items; and (3) whatever further inquiry is objectively reasonable given the results of the analysis." *Cooper v. First Gov't Mortg. & Investors Corp.*, 238 F. Supp. 2d 50, 56 (D.D.C. 2002); but see *Jenkins v. Mercantile Mortg. Co.*, 231 F. Supp. 2d 737, 746 (N.D. Ill. 2002) (holding that in evaluating whether a loan is governed by HOEPA, an assignee "can rely on the documentation it receives from its assignor and has no obligation to investigate its accuracy")

are apparent on the face of the documents.⁹⁸ Damages for violations of HOEPA's disclosure and substantive provisions include attorney's fees and "enhanced damages" equal to the sum of all finance charges and fees the borrower paid, if the creditor's violations are "material."⁹⁹ TILA rescission applies to violations of HOEPA's disclosure requirements; all violations are material for the purpose of triggering the right of rescission under TILA.¹⁰⁰

HOEPA also allows borrowers with HOEPA loans to bring all claims and defenses against assignees "that [they] could . . . raise[] against the original lender."¹⁰¹ This has been interpreted to mean that borrowers with HOEPA loans can bring claims under common law theories and statutes other than HOEPA based on wrongdoing by loan originators. Borrowers can recover the outstanding balance due plus the total amount they already paid less any amount they recovered on any TILA claims.¹⁰²

There is some uncertainty concerning the language subjecting assignees "to all claims and defenses." One view is that this clause allows plaintiffs with HOEPA loans to bring claims or raise any defenses against assignees under any laws, even if the particular law does not contemplate—or even bans—assignee liability. The argument supporting this view is that HOEPA's assignee liability provision trumps any laws that expressly preclude or are silent on assignee liability.¹⁰³ Several courts have implicitly adopted this position. In *Bryant v. Mortgage Capital Resource Corp.*, the court allowed the plaintiffs to go forward with state fraud and RICO claims against the assignees of their HOEPA loans.¹⁰⁴ In so ruling, the court held that the borrowers had the "affirmative right to assert claims against [the assignee] based solely upon [the originator's] independent and allegedly unlawful conduct in connection with the issuance of plaintiffs' loans."¹⁰⁵ The court construed HOEPA to impose assignee liability without any reference to the language in the laws the borrowers were seeking to enforce. In a similar case, *Short v. Wells Fargo*, the presenting issue was whether the borrowers' loan was covered by HOEPA.¹⁰⁶ The court held that there was sufficient evidence for a

⁹⁸ See *In re Murray*, 239 B.R. 728, 733 (Bankr. E.D. Pa. 1999).

⁹⁹ 15 U.S.C. § 1640(a) (2010). These remedies are not available in claims against involuntary assignees. 15 U.S.C. § 1641(a) (2010).

¹⁰⁰ 15 U.S.C. §§ 1602(v) (2008), 1639(j) (2009).

¹⁰¹ Federal Reserve System, Final Rule, Truth in Lending, 66 Fed. Reg. 65604, 65612 (Dec. 20, 2001) (clarifying that the term "claims and defenses" encompasses non-TILA claims and defenses).

¹⁰² 15 U.S.C. § 1641(d)(2)–(3) (2010).

¹⁰³ Barbara S. Mishkin & Kevin M. Toth, *Assignee Liability: How Far Does It Extend?* 5 CONSUMER FIN. SERVS. REP. 19 (Apr. 10, 2002).

¹⁰⁴ *Bryant v. Mortg. Capital Resource Corp.*, 197 F. Supp. 2d 1357, 1364–65 (N.D. Ga. 2002); *but see Pulphus v. Sullivan*, No. 02 C 5794, 2003 WL 1964333, at *21 n.11 (N.D. Ill. Apr. 28, 2003) (stating in dicta that the court in *Bryant v. Mortgage Capital Resource Corporation*, 197 F. Supp. 2d 1357 (N.D. Ga. 2002), took the incorrect approach and dismissing the RICO and common law fraud claims).

¹⁰⁵ *Bryant*, 197 F. Supp. 2d at 1365.

¹⁰⁶ *Short v. Wells Fargo Bank Minn., N.A.*, 401 F. Supp. 2d 549 (S.D.W. Va. 2005).

jury to find that the loan was subject to HOEPA.¹⁰⁷ In so holding, the court allowed the borrowers to pursue affirmative claims against the assignee under West Virginia's Consumer Credit and Protection Act, which prohibits unfair and deceptive acts in the "conduct of . . . trade or commerce."¹⁰⁸

Other courts, in contrast, focus on the actual provisions of the laws under which borrowers with HOEPA loans assert assignee liability. If the underlying laws require participation or some other "act" by the assignee to establish a statutory violation, those courts refuse to extend assignees' liability beyond the limits imposed by the particular law. For example, in *In re Barber*, the court dismissed plaintiff's Equal Credit Opportunity Act (ECOA) claim on the grounds that HOEPA's general assignee liability provision had to yield to ECOA's provision "eliminat[ing] an assignee's liability for ECOA violations unless the assignee participated in the violation or knew or had reasonable notice of the act that constituted the violation."¹⁰⁹ In so holding, the court stated:

In situations when a general statute, such as the HOEPA assignee liability provision of § 1641(d), and a specific statute, such as ECOA's definition of creditor of § 1691a(e), appear to be in conflict, courts have relied upon the general rule that 'a more specific statute covering a particular subject is controlling over a provision covering the same subject in more general terms Where there is no clear intention otherwise, a specific statute will not be con-

¹⁰⁷ *Id.* at 562.

¹⁰⁸ The Act prohibits "unfair or deceptive acts or practices in the conduct of any trade or commerce." W. Va. Code, § 46A-6-104 (1974). *See also* *Bynum v. Equitable Mortg. Grp.*, No. Civ.99 CV2266-SBC-JMF, 2005 WL 818619, at *5 (D.D.C. Apr. 7, 2005) ("Ordinarily, a HOEPA loan assignee's argument that it is not liable for the mistakes of the assignor is without merit."); *Reiser v. Residential Funding Corp.*, 380 F.3d 1027, 1028-29 (7th Cir. 2004) (discussing the viability of plaintiffs' claims against assignee under the Illinois Interest Act, affirming that "[n]ormally the holder-in due course doctrine would foreclose litigation against the purchaser [of the loan], but a portion of the Home Ownership and Equity Protection Act overrides this doctrine for high-interest mortgage loans"); *Mason v. Fieldstone Mortg. Co.*, No. 00 C 0228, 2000 WL 1643589, at *1 (N.D. Ill. Oct. 20, 2000) (allowing a common law fraud claim against the assignee of a HOEPA loan); *Schwartz v. Bann-Cor Mortg.*, 197 S.W.3d 168, 179 (Mo. Ct. App. 2006) (allowing plaintiffs to go forward with consumer protection claims against assignees of HOEPA loans regardless of arguably contradictory state law provisions).

¹⁰⁹ *In re Barber*, 266 B.R. 309, 321 (Bankr. E.D. Pa. 2001). *See also* *Faircloth v. Nat'l Home Loan Corp.*, 313 F. Supp. 2d 544, 551 n.11 (M.D.N.C. 2003) (stating in dicta that "HOEPA does not create a new right or claim that would not be otherwise cognizable under the law. Specifically, under North Carolina law, only the alleged perpetrator of a fraud . . . and not a subsequent assignee, can be held liable for an unfair or deceptive trade practice"); *Durham v. Loan Store, Inc.*, No. 04 C 6627, 2005 WL 2420389, at *8-9 (N.D. Ill. Sept. 30, 2005) (dismissing a Consumer Fraud Act claim involving a HOEPA loan where there were no allegations that the assignee had directly violated the Act); *Dowdy v. First Metro. Mortg. Co.*, No. 01C7211, 2002 WL 745851, at *2 (N.D. Ill. Feb. 8, 2002) (same).

trolled or nullified by a general one, regardless of the priority of enactment.¹¹⁰

The *Barber* court did not, however, dismiss the borrower's claim under the state's deceptive trade practices statute, impliedly because the statute did not have a participation requirement that would negate HOEPA's broad assignee liability provision.¹¹¹

One court has taken the position that HOEPA contemplates assignee liability for HOEPA loans only when the laws explicitly provide for assignee liability. In *Bank of New York v. Heath*,¹¹² the court rejected a borrower's claim under the Real Estate Settlement Practices Act (RESPA) on the grounds that HOEPA "does not create a claim or defense where one did not previously exist. Under RESPA, only a 'lender' may be held liable for claims under the Act."¹¹³ The *Heath* court also held that the debtor could not maintain a claim under the state's Unfair and Deceptive Acts Practices statute because the statute only permitted recovery against perpetrators.¹¹⁴

3. State Anti-Predatory Lending Laws

Most states have enacted their own mini-HOEPA laws, some of which mirror HOEPA. Others, however, provide broader protection by lowering the interest rate and points and fee triggers and expanding the scope of prohibited or restricted loan terms and practices.¹¹⁵ States take an array of approaches to assignee liability in their anti-predatory lending laws (APLs). Most limit assignee liability to claims involving high-cost loans. Within those states, there are further variations. Some have safe harbors that immunize assignees that engage in due diligence to avoid purchasing high-cost loans. There are also states with safe harbors that limit, but do not eliminate, the relief borrowers can obtain against assignees. Generally, state APLs are more generous—have longer statutes of limitation, for example—toward

¹¹⁰ *Barber*, 266 B.R. at 321 (quoting *In re Sullivan*, 254 B.R. 661, 666 (Bankr. D.N.J. 2000)).

¹¹¹ *Id.* at 320. See also *Cazares v. Pac. Shore Funding*, No. CV04-2548DSF(SSX), 2006 WL 149106, at *8 (C.D. Cal. Jan. 3, 2006) (noting in a claim involving a HOEPA loan that the defendants failed to "provide[] authority that [California's Unfair Competition Law] precludes assignee liability as a matter of law"); *In re Harvey*, No. 02-32412DWS, 02-1386, 2003 WL 21460063, at *7 (Bankr. E.D. Pa. June 9, 2003) (allowing claim to go forward under the Real Estate Settlement Procedures Act (RESPA) against assignees of HOEPA loans because "[u]nlike ECOA, RESPA does not expressly discuss claims against assignees").

¹¹² *Bank of N.Y. v. Heath*, No. 98-CH-8721, 2001 WL 1771825 (Ill. Cir. Ct. Oct. 26, 2001).

¹¹³ *Id.* at *3.

¹¹⁴ *Id.* at *2.

¹¹⁵ See *Engel & McCoy*, *supra* note 4, at 2091–93.

Banks and thrifts with national charters were not subject to these laws because their regulators issued broad preemption rules that relieved them from having to comply with state APLs. Kathleen C. Engel and Patricia A. McCoy, *Federal Preemption and Consumer Financial Protection: Past and Future*, 31 BANKING & FINANCIAL SERVICES POLICY REPORT 25, 25–26 (2012)

borrowers if they are defending foreclosure or collection actions by assignees than if they are bringing affirmative claims against assignees.¹¹⁶

When states enacted APLs, some protested that the new laws “could throw a monkey wrench into both the residential mortgage-backed securities and subprime housing markets” by making arrangers and trusts legally liable for loans that violated the state statutes.¹¹⁷ In fact, when Georgia passed an APL that subjected assignees to uncapped liability for originators’ misdeeds, credit rating organizations refused to rate RMBS backed by loans made in Georgia because they claimed they could not shield investors from borrowers’ predatory lending claims. Although there are state APLs that expose assignees to potential liability, industry protests and the response to Georgia’s APL led most states to shy away from strong assignee liability provisions in their APLs. Ultimately, Georgia retreated from its broad assignee liability provision.

4. FTC Holder Rule

There is yet another channel through which assignees are exposed to potential derivative liability. The Federal Trade Commission (FTC) issued a Trade Regulation (“the FTC Rule” or “the Rule”)¹¹⁸ in 1975 that effectively bans the HDC defense in consumer credit contracts for the sale of goods or services and permits both affirmative and defensive actions against owners of notes.¹¹⁹ Because the FTC Rule applies only to the sale of goods and services, most mortgage loans are not subject to the Rule. The FTC Rule does apply if a note was originated in connection with home repairs, goods and services, or manufactured housing.

The Rule states that it is an unfair or deceptive trade practice under the Federal Trade Commission Act¹²⁰ to take or receive a consumer credit contract that fails to include a notice that assignees take it “subject to the consumer’s claims and defenses.”¹²¹ Sellers who finance transactions must include this notice. Similarly, if a seller refers a customer to a lender or is

¹¹⁶ See *id.*

¹¹⁷ Bill Shepherd, *Perils and Phantasms*, 69 INVESTMENT DEALERS’ DIGEST 26 (Feb. 3, 2003).

¹¹⁸ For a comprehensive discussion of the FTC Rule, see generally Carolyn L. Carter & Jonathan Sheldon, UNFAIR AND DECEPTIVE ACTS AND PRACTICES 650–76 (7th ed. 2008); Eugene J. Kelley, John L. Ropiequet & Georgia Logothetis, *Assignee Liability: Through the Minefield*, 61 CONSUMER FIN. L. Q. REP. 279 (2007).

¹¹⁹ 16 C.F.R. § 433.2 (1975). If the consumer obtains financing directly and not through the seller of goods, the FTC Rule does not apply. Carter & Sheldon, *supra* note 118, at 686.

¹²⁰ 15 U.S.C. §§ 41–58.

¹²¹ 16 C.F.R. § 433.2 (1975). See also Renuart, *supra* note 15, at 489–90.

Many states have adopted parallel provisions as part of their trade practices acts. See, e.g., *State ex rel. Easley v. Rich Food Servs., Inc.*, 535 S.E.2d 84, 89 (N.C. Ct. App. 2000); *State v. Excel Mgmt. Servs., Inc.*, 331 N.W.2d 312, 316 (Wis. 1983); *Rosemond v. Campbell*, 343 S.E.2d 641, 646 (S.C. Ct. App. 1986).

affiliated with a lender that provides the financing, the seller must include the notice in the sales contract.¹²²

The easiest way to understand the FTC Rule is as a regulation that subjects holders of loans to any claims a borrower might have against the seller of the goods or services, including tort or contract causes of action.¹²³ Borrowers can raise these claims against an assignee, even if the assignee had no connection with the sale giving rise to the note. Under the FTC Rule, “the consumer’s maximum recovery . . . is cancellation of all remaining indebtedness plus an affirmative recovery of the amount already paid in on the debt.”¹²⁴ This cap applies to all claims under state or federal law brought pursuant to the FTC Rule.¹²⁵

Courts disagree about how to resolve conflicts between the FTC Rule and state law claims brought pursuant to the Rule. This issue arises when a borrower pursues a claim against an assignee based on the actions of a seller of goods or services, even though the borrower could not have asserted the claim against the assignee because, for example, the law requires some level of participation that was absent.¹²⁶ This was the situation in *Nations Credit v. Pheanis*.¹²⁷ The assignee of a contract to finance the purchase of a mobile home brought suit for nonpayment against the borrower. The borrower counterclaimed, asserting that the assignee was liable for the seller’s violation of the Ohio Consumer Sales Practices Act (CSPA). The alleged violation of CSPA was that the seller sold the mobile home without a permit, which prevented the borrower from obtaining a certificate of title. In upholding the borrower’s claim, the court made clear that under the FTC Rule, a holder could have derivative liability even if it would not have direct liability under the state law. In contrast, in *LaBarre v. Credit Acceptance Corp.*,¹²⁸ a federal court applying state law refused to permit the FTC Rule to override a state law that restricted consumer claims against assignees to defensive actions.¹²⁹

With the passage of TILA, the creditors’ bar began challenging the scope of the FTC Rule. Assignees argued that borrowers could not harness the FTC Rule to claim that assignees were liable for TILA violations that

¹²² 16 C.F.R. § 433.1(d). For a discussion of what constitutes a referral or affiliation, see David Szwak, *The FTC “Holder” Rule*, 60 CONSUMER FIN. L.Q. REP. 361, 362–63 (2006).

¹²³ 41 Fed. Reg. 20023–24 (May 14, 1976).

¹²⁴ Carter & Sheldon, *supra* note 118, at 660; FTC, Advisory Opinion Regarding the Federal Trade Commission’s Trade Regulation Rule Concerning Preservation of Consumers’ Claims and Defenses (May 3, 2012)

¹²⁵ 41 Fed. Reg. 20023–24 (May 14, 1976). This provision does not limit borrowers’ right to recover greater sums under legal theories that do not rely on application of the FTC Rule. Carter & Sheldon, *supra* note 118, at 668.

¹²⁶ Carter & Sheldon, *supra* note 118, at 658.

¹²⁷ 656 N.E.2d 998, 1004 (Ohio Ct. App. 1995).

¹²⁸ 175 F.3d 640 (8th Cir. 1990).

¹²⁹ See *id.* at 644; see also *Herrera*, 2002 WL 253019, at *4–5 (Feb. 15, 2002) (holding that consumers could not obtain relief against assignee under the Illinois Consumer Fraud Act where the contract included the FTC notice partly because the assignee did not “participate” in making the loan as required under the Consumer Fraud Act).

were not apparent on the face of the loan documents.¹³⁰ To do so, they claimed, would be to nullify TILA's assignee liability provisions in consumer financing. The courts have generally agreed, ruling that the FTC Rule cannot be used to "sidestep" TILA's limits on assignee liability.¹³¹ Courts have reached the same result when applying state law analogues to the FTC Rule, holding that the assignee liability provisions of TILA preempt broad assignee liability under state laws that parallel the FTC Rule.¹³²

Although the relationship between TILA and the FTC Rule is now well-established, questions remain about how to reconcile TILA, the FTC Rule, and state law claims. One issue is whether a borrower can bring a state Unfair and Deceptive Acts or Practices (UDAP) claim against an assignee under the FTC Rule based on misrepresentations in the disclosures when the disclosures did not violate TILA. In a highly controversial decision, the Illinois Supreme Court held, in *Jackson v. South Holland Dodge*,¹³³ that where there were no facial TILA violations that would subject the assignees of loans to liability under TILA, the borrowers could not invoke the FTC Rule to assert claims against the assignees under state law based on the inadequacy of the disclosures. The *Jackson* court suggested that borrowers' coupling of the FTC Rule and state law to recover against assignees for disclosure violations was an attempt to bypass TILA preemption of the FTC Rule. Few courts have addressed the complex relationship between TILA, the FTC Rule, and state law claims. Thus, the extent to which jurisdictions outside Illinois will follow *Jackson* is unknown.

Even if *Jackson* becomes the dominant paradigm, borrowers can still invoke the FTC Rule to bring deceptive trade practices claims against assignees based on sellers' misconduct that is not related to disclosures.¹³⁴ For example, in *Nations Credit v. Pheanis*, the borrowers' defense to the assignee's collection action was that the original creditor had violated the state's deceptive trade practices act by selling them a mobile home without a license. Imposing liability under the FTC Rule in situations like this would not run afoul of TILA preemption.¹³⁵

¹³⁰ Eugene J. Kelley, Jr. & John L. Ropiequet, *Assignee Liability under State Law after Jackson v. South Holland Dodge*, 56 CONSUMER FIN. L.Q. REP. 16 (Winter 2002) (discussing the courts' unwillingness to hold that the FTC Rule trumps limitations on assignee liability under the Truth in Lending Act).

¹³¹ See, e.g., *Taylor v. Quality Hyundai, Inc.*, 150 F.3d 689, 694-95 (7th Cir. 1998).

¹³² See, e.g., *Alexiou v. Brad Benson Mitsubishi*, 127 F. Supp. 2d 557, 565 (D.N.J. 2000); *Vickers v. Interstate Dodge*, 882 So.2d 1236, 1241 (La. Ct. App. 2004); Kelley, Ropiequet & Logothetis, *supra* note 118, at 283-84 (describing the intersection of TILA and the FTC Rule).

¹³³ 755 N.E.2d 462, 468-70 (Ill. 2001).

¹³⁴ *Carter & Sheldon*, *supra* note 118, at 665.

¹³⁵ 656 N.E.2d 998, 1000 (Ohio Ct. App. 1995); see also *Carter and Sheldon*, *supra* note 118, at 665-66.

*C. Deal Provisions Failed to Protect Assignees from
Risk of Derivative Liability*

The parties involved in securitizations were cognizant that investors in RMBS could lose if borrowers successfully raised claims under contract or tort law, TILA, HOEPA, the FTC Rule, or state anti-predatory lending laws.¹³⁶ To assuage these concerns about legal liability, securitization deals were structured to protect investors from the risk of borrower claims.¹³⁷ The terms of the deals typically required originators (1) to provide reps and warranties that none of the loans were governed by laws that could impose liability on the trusts; and (2) to agree to buy back any loans that were found to violate the reps and warranties or to substitute the offending loans with loans that were not covered by laws that permitted assignee liability.¹³⁸ The purpose of such recourse provisions was to force originators to retain the risk that borrowers might have claims for which assignees could be liable.

Despite the reps and warranties, originators sold loans that violated deal provisions. For example, one industry article dating back to 2000 estimated that some securitization portfolios contained as many as 30% HOEPA loans even though the reps and warranties stated that none of the loans were governed by HOEPA.¹³⁹ For a time, buyers of loans were not overly concerned by loans that were exceptions to lenders' underwriting guidelines because the

¹³⁶ See generally Gregory, *supra* note 16.

¹³⁷ See, e.g., Standard & Poor's (S&P), HIGH-COST MORTGAGE LOANS: STANDARD & POOR'S APPROACH (Aug. 16, 2001) (discussing steps taken in subprime securitizations).

¹³⁸ The following excerpt from a Morgan Stanley prospectus provides an example:

Violations of certain provisions of . . . federal, state and local laws as well as actions by governmental agencies, authorities and attorneys general . . . could subject the issuing entity to damages and administrative enforcement (including disgorgement of prior interest and fees paid). In particular, an originator's failure to comply with certain requirements of these federal and state laws could subject the issuing entity (and other assignees of the mortgage loans) to monetary penalties, and result in the obligors' rescinding the mortgage loans against either the issuing entity or subsequent holders of the mortgage loans.

Accredited Home Lenders, Inc. or the sponsor, as applicable, has also represented or will represent that none of such mortgage loans is covered by the Home Ownership and Equity Protection Act of 1994 or is classified as a "high cost home," "threshold," "covered," "high risk home" or "predatory" loan under any other applicable federal, state or local law. In the event of a breach of any of such representations, Accredited Home Lenders, Inc. or the sponsor, as applicable, will be obligated to cure such breach or repurchase or, for a limited period of time, replace the affected mortgage loan.

Prospectus and Prospectus Supplement, Mortgage Pass Through Certificates, Series 2007-HE7, Morgan Stanley ABS Capital I Inc. Trust 2007-HE7, S 17-18 (on file with authors).

Securitization deals also often included provisions requiring that lenders buy back loans that defaulted within the first few months of origination. See, e.g., Vikas Bajaj, *Subprime Mortgage Lending: A Cross-Country Blame Game*, N.Y. TIMES, May 8, 2007, available at http://www.nytimes.com/2007/05/08/business/worldbusiness/08iht-subprime.4.5623442.html?_r=1

¹³⁹ Gregory, *supra* note 16.

purchasers could shed the loans, if needed, by exercising their recourse rights.

What loan purchasers did not appear to appreciate was the possibility that major subprime originators could go bankrupt, thus precluding enforcement of recourse provisions. This is exactly what happened in 2004, when US Bancorp settled class action suits in which borrowers asserted that the bank was liable for HOEPA violations as an assignee. US Bancorp had purchased the challenged loans from Firstplus, which was declared bankrupt in 1999. Because Firstplus was out of business, it was impossible for US Bancorp to unload the loans that violated HOEPA. The attorney for Firstplus explained that the loan purchasers were “relying on reps and warranties . . . but [they do not] protect the buyer if the seller goes bankrupt.”¹⁴⁰

US Bancorp’s experience presaged what was to come. In 2006, trusts and arrangers began increasing their demands that originators repurchase loans for violations of reps and warranties. By 2007, the number of such demands had escalated further.¹⁴¹ A former executive at a subprime lender described the subprime industry as choking “on the volume of loans put back to them.”¹⁴² Lenders claimed they did not have the money to buy back loans and many sought bankruptcy protection. A startling example is New Century Financial Corp., which had over \$8 billion in repurchase demands in March 2007. The next month the firm announced it was bankrupt.¹⁴³

When originators cannot honor recourse provisions, the owners of the notes—usually the securitization trusts—have to retain ownership of the loans. And, as owners, they can be subject to the kinds of affirmative claims

¹⁴⁰ Erick Bergquist, *Guess What? Loan Buyers Liable under Federal Law*, AM. BANKER, May 7, 2004.

¹⁴¹ See Vikas Bajaj and Christine Haughney, *Tremors at the Door: More People with Weak Credit are Defaulting on Mortgages*, N.Y. TIMES, Jan. 26, 2007, available at http://www.nytimes.com/2007/01/26/business/26mortgage.html?_r=1&oref=slogin.

Prior to filing for bankruptcy, Lehman Brothers was embroiled in lawsuits against loan originators trying to force them to buy back loans that did not comply with reps and warranties. Vikas Bajaj, *If Everyone’s Finger-Pointing, Who’s to Blame?* N.Y. TIMES, Jan. 22, 2008, available at <http://www.nytimes.com/2008/01/22/business/22legal.html?pagewanted=all>. See also Paul Muolo, *The B&C Meltdown: It’s All About Capital*, 11 MORTG. SERVICING NEWS 5, Mar. 2007 (describing Wall Street’s efforts to make subprime lenders take back defaulted loans).

Not all the repurchase demands involved claims that could expose trusts to liability for claims by borrowers. More often the claims were that the originators misrepresented the quality of the loans or that the loans had early defaults. See Ruth Simon, *Investors Press Lenders on Bad Loans*, WALL ST. J., May 28, 2008, available at <http://online.wsj.com/article/SB121193306681924605.html>; see also Bajaj, *supra* note 138.

¹⁴² Zachary Goldfarb & Alec Klein, *The Bubble: How Homeowners’ Missed Mortgage Payments Set Off Widespread Problems and Woke Up the Fed*, WASH. POST, June 16, 2008, available at <http://www.washingtonpost.com/wp-dyn/content/story/2008/06/16/ST200806160096.html>

¹⁴³ See Carrick Mollenkamp, James Hagerty & Randall Smith, *Banks Go on Subprime Offensive*, WALL ST. J., Mar. 13, 2007, at C1; Bradley Keoun & Steven Church, *New Century, Biggest Subprime Casualty, Goes Bankrupt*, BLOOMBERG.COM, Apr. 2, 2007, available at <http://www.bloomberg.com/apps/news?pid=newsarchive&refer=home&sid=aXHDSbOcAChc>

and defenses to nonpayment we have discussed. In other words, the assignees bear a risk that they thought they had avoided through the reps and warranties.¹⁴⁴

Originators' bankruptcy does not always mean that trusts are "stuck" owning potentially unlawful loans. Depending on the reps and warranties that came with the deals and how much time has passed, trusts can have the power to force arrangers to repurchase loans. This poses a significant risk for arrangers: one analyst was quoted in the *New York Times* as saying that the view that arrangers might have to repurchase loans "should not be talked about out loud."¹⁴⁵

D. Derivative Liability: Recap

Complexity muddies any effort to understand when and where owners of notes could have derivative liability. The holder in due course doctrine, which was crafted in simpler times, is a shifting terrain with new and often conflicting applications as loan terms and securitization practices have changed. The courts have yet to consistently sort out HDC given the new market for housing finance. Likewise, when it comes to statutory causes of action, the courts are not in agreement on the scope of liability of assignees of loans. For the housing market, the uncertainty makes it difficult to assess potential liability and price loans. For regulators, who are concerned about safety and soundness, the uncertainty makes it difficult to know banks' exposure to risk. For borrowers, it means that it is not clear who is responsible for unlawful loans. And, no one entity feels it is its responsibility to make sure that lenders are complying with the law.

IV. ARRANGER LIABILITY BASED ON ACTIVE WRONGDOING

Thus far, when describing arrangers' liability, we have focused on the possibility that arrangers as owners of notes can be derivatively liable. In this section of the paper, we consider the possibility that arrangers have direct liability to borrowers for illegal acts of originators. For these claims, liability would not depend on arrangers' status as owners of the notes, but instead would be based on their involvement in securitization activities.¹⁴⁶ In order for arrangers to be directly liable, they must have participated in loan origination, had some level of knowledge that the loans were being illegally originated, or exercised some control over what loans were originated.

¹⁴⁴ See Steven Schwarcz, *Protecting Financial Markets: Lessons from the Subprime Mortgage Meltdown*, 93 MINN. L. REV. 373, 389 (2008).

¹⁴⁵ Gretchen Morgenson, *A Road Not Taken by Lenders*, N.Y. TIMES, Apr. 6, 2008, at BU1.

¹⁴⁶ Renuart, *supra* note 15, at § 10.6.1.2.2; see also *Cazares v. Pac. Shore Funding*, No. CV04-2548DSF, 2006 WL 149106, at *7 (C.D. Cal. Jan 3, 2006) (distinguishing between finding a lender liable as an assignee and as a direct participant).

In the next sections, we describe how arrangers operated in the most information-rich environment in the securitization chain. They conducted due diligence on originators and loan pools. They interacted with RMBS investors. And, they knew what products could be sold on the secondary market. This information allowed them to steer significant amounts of capital to originators who could produce loans with the terms that arrangers requested based upon investors' demand.

A. Arrangers' Knowledge: Evidence from Lawsuits and Investigations

Arrangers' direct liability for unlawful origination practices requires that arrangers at least be aware of lenders' wrongdoing. Recent federal and state investigations, private lawsuits, whistle blowers, and academic analyses have all uncovered evidence that some arrangers knew or disregarded the fact that the lending operations they were financing were making loans on potentially illegal grounds, including making loans that borrowers could not afford and misrepresenting loan terms.¹⁴⁷ Many of these defects have come to light in the context of claims that arrangers were passing off poorly underwritten securities to investors; some of this evidence could also be used in consumer lawsuits against arrangers.¹⁴⁸

Through due diligence, arrangers collected an array of information on lenders' operations. This included consumer complaints and lawsuits alleging unlawful origination practices or loan terms. Transactional due diligence included a review of loan files and underwriting practices, which many times revealed that lenders were not complying with their own underwriting standards. This did not stop arrangers from putting the loans through the securitization pipeline.¹⁴⁹

Over time, the dominant subprime lenders became more lax in terms of adhering to their credit policies. Increasing default rates reflected their weak underwriting. As early as 2003, loans began defaulting within a few months

¹⁴⁷ Additional sources of information on potential consumer protection violations could come from investigations of depository institutions by regulators. More general information on deficits in underwriting and other problems within financial firms can be found in industry publications.

¹⁴⁸ For evidence that arrangers knew of abuses in the subprime market, see Engel & McCoy, *supra* note 10, at 61–64.

¹⁴⁹ See, e.g., *Jordan v. Paul Fin., LLC*, 745 F. Supp.2d 1084, 1097 (N.D. Cal. 2010) (stating that the master loan purchase agreement granted RBS, the arranger, the right to underwrite the loans and review the mortgage files and loan portfolios “for issues including but not limited to credit, documentation, litigation, default and servicing related concerns as well as a thorough compliance review with loan level testing”) (citation omitted).

In 2006, Bear Stearns overrode a due diligence firm's conclusions that 56% of the time loans should not be purchased for securitizations. First Amended Complaint at 14, *AMBAC Assurance Corp. v. EMC Mortg. Corp.* (S.D.N.Y. July 28, 2010) (No. 08 Civ. 9464) (citing an Internal Report produced by Clayton Holdings, Inc., CLAY-AMBAC 0001770-80 at 1777). More explicit evidence comes from internal Bear Stearns correspondences showing that Bear Stearns was aware of the low quality of the loans it was securitizing. In this correspondence, the deal manager referred to securitization SACO 2006-8 as “SACK OF SHIT.” *Id.* at 10–11.

of origination—a red flag that the loans were unaffordable from the start.¹⁵⁰ This should have prompted arrangers to engage in deeper investigations, particularly because numerous states have laws prohibiting the making of loans that borrowers cannot afford to repay.

Some arrangers had actual knowledge that they were securitizing poorly underwritten loans, yet they continued to finance originators.¹⁵¹ Worse yet, at the same time that evidence of bad lending practices was mounting, arrangers actually reduced the number of loans they examined as part of their due diligence review.¹⁵²

¹⁵⁰ See, e.g., *id.* at 5 (citing the deposition of Bear Stearns' managing director).

¹⁵¹ *Subprime Lending and Securitization and Government Sponsored Enterprises (GSES) Before the Fin. Crisis Inquiry Comm'n*, 111th Cong. 1, 8 (2010) (statement of Richard M. Bowen, III, Former Senior Vice President and Business Chief Underwriter CitiMortgage Inc.) (describing how Citi continued to buy and sell "mortgage loans after artificially increasing their quality").

For example, in 2006, Goldman Sachs and Washington Mutual (WaMu) joined forces to securitize loans generated by one of WaMu's loan originators, Long Beach Mortgage Company. The parties entered this deal even though Long Beach had experienced record rates of early payment defaults—defaults that happen within a few months after loans are originated—and whose securities were performing poorly relative to the rest of the market. See *Wall Street and the Financial Crisis: The Role of Investment Banks Before the Fin. Crisis Inquiry Comm'n*, 111th Cong. 6 (2010) (Exhibit 1a, memorandum from Senators Carl Levin and Tom Coburn to Members of the Permanent Subcommittee on Investigations) [hereinafter *Role of Investment Banks*], available at http://hsgac.senate.gov/public/_files/Financial_Crisis/042710Exhibits.pdf.

In April 2006, a Washington Mutual executive alerted WaMu's top management that "Long Beach's 'delinquencies are up 140% and foreclosures close to 70% . . . It is ugly.'" Carrick Mollenkamp & Serena Ng, *Investors Lost, Goldman Won on WaMu Deal*, WALL ST. J., Apr. 26, 2010, at C1. By the start of the next year, a Goldman banker expressed concern about the Long Beach loans and worried that their poor performance was "creat[ing] extreme pressure, both economic and reputational . . ." *Id.*

The Long Beach securitizations were not aberrations. In 2007, Goldman Sachs securitized more than one billion dollars in loans originated by Fremont Investment and Loan Fremont even though Fremont was already under close scrutiny by regulators for its role in making loans that people could not afford to repay. See *Role of Investment Banks* at 6–7.

¹⁵² See, e.g., Vikas Bajaj & Jenny Anderson, *Inquiry Focuses on Withholding of Data on Loans*, N.Y. TIMES, Jan. 12, 2008, available at <http://www.nytimes.com/2008/01/12/business/12lend.html?pagewanted=all>; Engel & McCoy, *supra* note 10, at 61–4.

Typically, arrangers contracted with due diligence firms to determine whether a lender's loans adhered to the lender's promised underwriting criteria. Loans that deviated from the criteria were called "exceptions." Clayton Holdings, which conducted due diligence reviews, reported that 28% of the loans it reviewed in 2006 and the first half of 2007 were exceptions. Of these, securitizers waived 39%. Clayton Holdings, All Clayton: Trending Reports: 1st Quarter 2006 – 2nd Quarter 2007 (on file with authors). In other words, arrangers converted almost half the loans that failed Clayton's due diligence review into securities, often using the exceptions to justify reducing the price they would pay lenders for the loans. *Role of Investment Banks*, *supra* note 151, at 166. There were also situations in which some arrangers agreed not to reject more than a specified percent of loans in a package. They reached these agreements before they had conducted due diligence and, thus, before they knew how many exceptions a pool of loans contained. See Final Report of Michael J. Missal, In re New Century TRS Holdings, Inc., 386 B.R. 11 (Bankr. D. Del. 2008) (No. 07-10416); Engel & McCoy, *supra* note 10, at 45–46.

B. Arrangers' Knowledge: Inside Information at Vertically Integrated Firms

Vertical integration was a valuable strategy for investment and commercial banks. A managing director at Moody's Investors Service noted that:

[I]f you have a significant distribution platform, there are many things you can do to move those assets—through securitization and outright resale, among other things. What you need is product to feed the machine. Having an origination platform in addition to a platform of acquisition of assets from correspondents, brokers, and others can be a helpful additional arrow in your quiver to feed your overall plant.¹⁵³

Arrangers that streamlined their operations by vertically integrating their companies¹⁵⁴ had the potential to acquire valuable proprietary information from their subsidiaries and affiliates that they could use to gain a financial advantage. Evidence of that phenomenon comes from a study of the bidding patterns of investment banks when they were deciding whether to bid on securities they underwrote. After controlling for information that was available to all investors, researchers found that the pools that investment banks did not bid on ultimately performed worse than those they had bid on.¹⁵⁵ These findings suggest that proprietary information was passing affiliated arrangers and affiliated broker-dealers, despite legally-required information blocking devices. A more recent study, likewise, found evidence that private information was flowing between commercial lenders and affiliated arrang-

¹⁵³ Todd Davenport, *What's Behind Wall Street Players' Mortgage Deals?* AM. BANKER (Aug 14, 2006).

Goldman Sachs, for example, bought subprime loans from mortgage originators and also originated loans through its own lender, Senera Funding. Goldman also extended credit lines to mortgage originators to fund their lending activities. Once loans were made and securitized, Goldman frequently serviced them through its Avelo servicing platform. Lastly, Goldman structured and underwrote securities, which it frequently was later involved in selling. See *Wall Street and the Financial Crisis: The Role of Investment Banks Before the Fin. Crisis Inquiry Comm'n*, 111th Cong. 2 (2010) (Exhibit 22, Goldman Sachs, Presentation to GS Board of Directors: Subprime Mortgage Business on March 26, 2007), available at http://hsgac.senate.gov/public/_files/Financial_Crisis/042710Exhibits.pdf.

Owning a subprime loan originator was not completely free of risk. As Goldman Sachs recognized in an internal memo, there could be "outsized" contingent liabilities based on lending practices. *Id.* at 15.

¹⁵⁴ It was not uncommon for a single arranger to own a subprime loan originator, a servicer, an underwriter, and a broker/dealer arm. See Jeffrey M. Levine, *The Vertical-Integration Strategy*, 67 MORTG. BANKING 58, 60. (2007) (documenting commercial banks' and investment banks' purchases of mortgage originators); Engel & McCoy, *supra* note 10, at 57–8 (discussing vertical integration within investment bank holding companies).

¹⁵⁵ Steven Drucker & Christopher Mayer, *Inside Information and Market Making in Secondary Mortgage Markets* 24 (Jan. 6, 2008) (unpublished manuscript), available at <http://www4.gsb.columbia.edu/realestate/research/papers> ("[T]he ability of vertically-integrated underwriters to exploit inside information might also help explain why investment banks have been purchasing originators and servicers in the securitization markets in recent years.").

ers.¹⁵⁶ The authors wrote, “our findings suggest that, despite the purported Chinese Walls, financial analysts still have access to superior information from lending relationships.”¹⁵⁷

In the summer of 2012, the most compelling evidence that banks were illegally providing information across functional units arose at Barclays Bank. The Barclays scandal involved manipulation of the London Interbank Offered Rate (LIBOR), the rate at which London banks make short-term loans to one another. Each day, major London banks report what other banks are charging them to borrow money. The LIBOR is the average of their submissions. An investigation by the Commodity Futures Trading Commission revealed that swaps traders at Barclays pressured co-workers, who submitted the daily LIBOR reports, to engineer their reports in ways that benefited the trading desk.¹⁵⁸ In response to such requests, the LIBOR submitters would respond with affirmations like, “Done . . . for you big boy.”¹⁵⁹

The evidence that financial institutions were breaching internal firewalls not only suggests widespread unlawful activity, but also raises the possibility—and potentially the likelihood—that subprime lenders were sharing information with affiliated arrangers that could expose arrangers to direct liability under the theories we describe in subsequent sections.

C. Arrangers’ Influence on Lenders

Arrangers had powerful levers that they could use to influence the originators who were dependent on them for financing their operations and purchasing their loans. Arrangers were market makers that often told lenders the types of products they wanted for securitization and the number of loans they needed. As an executive from Washington Mutual, a notoriously risky lender, wrote in an email, “we always need to worry a little about Goldman because we need them more than they need us.”¹⁶⁰

There is evidence that some arrangers used their purchasing power to shape lending practices. For example, *New York Times* reporter, Vikas Bajaj, reported that Ownit Mortgage Solutions loosened its underwriting standards “reluctantly and under pressure from . . . investors, particularly Merrill Lynch.”¹⁶¹ Merrill Lynch was not alone. The Commonwealth of Massachu-

¹⁵⁶ Ting Chen & Xiumin Martin, *Do Bank-Affiliated Analysts Benefit from Lending Relationships*, 49 J. OF ACCT. RES. 633 (2011).

¹⁵⁷ *Id.* at 635.

¹⁵⁸ In the Matter of Barclays PLC, Barclays Bank PLC and Barclays Capital, Inc., CFTC Docket No. 12-25 at 3, and 7-8 (June 27, 2012), available at <http://www.cftc.gov/ucm/groups/public/@Irenforcementactions/documents/legalpleading/enfbarclaysorder062712.pdf>.

¹⁵⁹ *Id.* at 10.

¹⁶⁰ Carrick Mollenkamp & Serena Ng, *supra* note 151.

¹⁶¹ Bajaj, *supra* note 138.

The dependence was not one way. At the same time, arrangers “were loath to imperil their relationship with lenders . . . [A]s long as Wall Street’s lucrative mortgage factories were

setts has contended that Morgan Stanley would agree to buy loans from lender New Century according to parameters that Morgan Stanley had set before the loans had even been made—a practice known as selling forward. New Century would then make loans based on Morgan Stanley’s “order.”¹⁶²

D. *The Threat of Litigation Against Arrangers*

Growing evidence suggests that arrangers knew or had reason to know of the unlawful lending practices that frequently accompanied high-risk loans. When, despite this knowledge, arrangers continued to fund subprime lenders, buy their loans, and create securities backed by the loans, they may have exposed themselves to direct liability.

When securitization of subprime mortgages first emerged, there was concern that arrangers could be on the hook for financing originators who were engaged in predatory lending. In 2000, a Wall Street publication reported that industry insiders did not know “whether any of the underwriters [of subprime securitizations] could be held liable for companies’ practices, if they [we]re found to be illegal.”¹⁶³ The article went on to state that “[t]he legal issues are complicated ones that are just starting to wend their way through the courts.”¹⁶⁴ The first, and for a long time the only, case asserting a claim against an arranger was a consumer suit against the now-defunct Lehman Brothers for its involvement in the misdeeds of First Alliance Mortgage Company (FAMCO). Wall Street “warily eye[d]” the lawsuit against Lehman.¹⁶⁵ Ultimately, after protracted litigation, a jury found that Lehman was 10% responsible for FAMCO’s unlawful lending practices and ordered Lehman to pay more than \$5 million of a \$51 million damage award.¹⁶⁶ This was the first time that consumers “penetrated the asset-backed securities world.”¹⁶⁷

Shortly after the Lehman verdict, arrangers increased vertical integration of, and lending to, subprime originators. Had Lehman been hit with a more substantial damage award, arrangers might have become averse to having close relationships with lenders. Instead, arrangers moved from buying

humming, it needed loans to stoke them.” Gretchen Morgenson, *Seeing vs. Doing*, N.Y. TIMES, July 24, 2010, at BU1. New Century, a now-defunct subprime lender, supposedly pressured Morgan Stanley to purchase loans that failed to meet New Century’s underwriting standards, by suggesting that otherwise it would take its business elsewhere. Assurance of Discontinuance at 9–10, *In re Morgan Stanley & Co Inc.*, (10-2538) (Mass. Super. Ct. June 24, 2010), <http://www.mass.gov/ago/docs/press/2010/2010-06-24-ms-settlement-attachment3.pdf>

¹⁶² *Id.* at 9–10.

¹⁶³ Gregory, *supra* note 16.

¹⁶⁴ *Id.*

¹⁶⁵ Michael Gregory, *ABS World Warily Eyes New Suit Against Lehman*, 66 INV. DEALERS’ DIGEST 5, 5 (2000).

¹⁶⁶ *In re First Alliance Mortg. Co.*, 471 F.3d 977, 988, 1003 (9th Cir. 2006).

¹⁶⁷ Gregory, *supra* note 165.

whole loans from unaffiliated originators to buying groups of loans directly from newly-acquired subprime lending affiliates.¹⁶⁸

For almost a decade, as arrangers were streamlining their securitization machines, the Lehman-FAMCO decision stood out as the only major consumer lawsuit that extended up the securitization food chain. In 2010, the tide began to shift when the Commonwealth of Massachusetts initiated a “market wide investigation” into “the finance, purchasing and securitization of allegedly unfair residential mortgages” by investment banks.¹⁶⁹ As a result of these investigations, both Goldman Sachs and Morgan Stanley settled with the Commonwealth—Goldman for \$60 million,¹⁷⁰ and Morgan Stanley for \$102 million.¹⁷¹ Following the Goldman Sachs agreement, the Massachusetts Attorney General, Martha Coakley, stated that “‘there’s no dispute that Goldman Sachs and other securitizers have been involved intricately in this whole process by which loans were made to homeowners and as we have argued, in many instances, destined to fail.’”¹⁷²

E. Legal Theories for Arranger Liability

There are at least three theories under which arrangers may be directly liable for the unlawful acts of originators: aiding and abetting, conspiracy, and joint venture.¹⁷³ These theories are not independent causes of action.

¹⁶⁸ See, e.g., John Dunbar & David Donald, *Who’s Behind the Financial Meltdown? The Top 25 Subprime Lenders and their Wall Street Backers*, CENTER FOR PUBLIC INTEGRITY (last visited Mar. 29, 2012), http://www.publicintegrity.org/investigations/economic_meltdown/; Levine, *supra* note 154, at 58–60.

¹⁶⁹ Assurance of Discontinuance, *supra* note 161, at 1.

Attorney General Martha Coakley used her authority to issue Civil Investigative Demands “to unravel the securitization process behind loans originated by subprime lenders in Massachusetts.” Press Release, Martha Coakley, Royal Bank of Scotland to Pay \$52 Million for Securitization Role in Subprime Meltdown, Nov. 28, 2011, *available at* <http://www.mass.gov/ago/news-and-updates/press-releases/2011/2011-11-28-rbs-settlement.html>.

¹⁷⁰ Jenifer B. McKim, *State Reaches \$60M Subprime Deal with Goldman Sachs*, BOS. GLOBE, May 11, 2009, at 1, *available at* http://www.boston.com/business/ticker/2009/05/state_reaches_6.html

¹⁷¹ Assurance of Discontinuance, *supra* note 161.

Massachusetts later settled with the Royal Bank of Scotland for \$52 million, based on similar allegations. Coakley, *supra* note 169.

In September 2011, Nevada settled with Morgan Stanley based on allegations that the latter’s activities as an arranger substantially assisted deceptive lending practices. Sandra Cherb, *Nev. AG Announces Settlement with Morgan Stanley*, BLOOMBERG BUS. WEEK, Sept. 27, 2011.

¹⁷² Kathleen M. Howley & Christine Harper, *Goldman to Pay \$60 Million in Subprime Settlement*, BLOOMBERG, May 11, 2009, *available at* <http://www.bloomberg.com/apps/news?pid=newsarchive&sid=a3CNXozRFpRk>.

¹⁷³ Evidence that would support a finding of liability for aiding and abetting, joint venture, or civil conspiracy would likely also defeat any claims by an arranger, who owned the loans, that it was a holder in due course.

It is also possible that arrangers could be found to have violated the Fair Housing Act (FHA), 42 U.S.C. §§ 3601–3619 (1968), and its state analogues. The FHA makes it unlawful for anyone who purchases loans or provides “other financial assistance” to discriminate against people based on their race, color, religion, sex, handicap, familial status, or national origin when engaged in such transactions. 42 U.S.C. § 3605. Some cases have recognized the

Rather, they allow plaintiffs to bring claims against defendants who did not directly engage in the unlawful conduct leading to the plaintiffs' injuries but enabled the wrongful conduct to occur.

Aiding and abetting, conspiracy, and joint venture claims against arrangers are still rare. There are signs, however, that this pattern is changing. Increasingly, consumers and public entities are pursuing those theories against arrangers. And, numerous courts have indicated a willingness to consider pooling and servicing agreements, master loan purchasing agreements, and similar contracts as evidence of joint ventures, civil conspiracies, and aiding and abetting. To the extent such claims succeed, the potential financial exposure of arrangers is significant.

potential applicability of an FHA claim in this context. *See, e.g.,* *Eva v. Midwest Nat'l Mortg. Banc, Inc.*, 143 F. Supp. 2d 862, 889 (N.D. Ohio 2001) (refusing to dismiss plaintiffs' claims under §3605 where the defendant did not lend money directly to the borrowers, but it allegedly had a "connection to the financing of residential real estate . . . [and] may have unlawfully discriminated in the context of housing in violation of the FHA").

Some state unfair and deceptive acts and practices (UDAP) laws contain broad provisions that could encompass arranger activities. Those that follow the FTC Act contain general prohibitions on unfair or deceptive acts. Others contain only specific prohibitions on clearly specified activities. Some allow private rights of action, while others mimic the FTC Act and only permit agency enforcement. There are also acts that exclude specific entities from coverage. *See generally*, Carolyn L. Carter, National Consumer Law Center, Inc., *Consumer Protection in the States: A 50-State Report on Unfair and Deceptive Acts and Practices Statutes* (Feb. 2009), available at http://www.nclc.org/images/pdf/car_sales/UDAP_Report_Feb09.pdf. To the extent states have adopted the more general UDAP standard and arrangers do not fall under any exclusions, arrangers could be subject to UDAP claims.

The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 also prohibits unfair, deceptive, or abusive acts or practices. Dodd-Frank Act § 1031(a). The Act does not create a private right of action for consumers; however, state AGs and the CFPB have enforcement authority within certain parameters. *See* Arthur E. Wilmarth, *The Dodd-Frank Act's Expansion of State Authority to Protect Consumers of Financial Services*, 36 J. CORP. L. 893, 924 (2011).

In addition, arrangers could find themselves defendants in claims brought under the Racketeering Influenced and Corrupt Practices Act. RICO prohibits anyone from (a) using income received from a pattern of racketeering activity or from the collection of an unlawful debt to acquire an interest in an enterprise affecting interstate commerce; (b) acquiring or maintaining through a pattern of racketeering activity or through collection of an unlawful debt an interest in an enterprise affecting interstate commerce; (c) conducting or participating in the conduct of the affairs of an enterprise affecting interstate commerce through a pattern of racketeering activity or through collection of an unlawful debt; and (d) conspiring to participate in any of these activities. *See* 18 U.S.C. § 1962. A "pattern of racketeering activity" requires proof of commission of two or more predicate acts, among which are mail fraud and wire fraud. 18 U.S.C. § 1961. Plaintiffs must also establish the existence of the enterprise, a connection between the enterprise and the racketeering activity, and that the plaintiff suffered an injury as a result. For a discussion of a RICO claim based on predatory lending, *see* *Hargraves v. Capital City Mortg. Corp.*, 140 F. Supp. 2d 7, 23–27 (D.D.C. 2000); *Eva*, 143 F. Supp. 2d at 900 (granting a motion to dismiss RICO claims based on mortgage fraud with respect to some but not all of the defendants); *Gray v. Upchurch*, No. 5:05cv210-KS-MTP, 2007 WL 2258906, at *4–5 (S.D. Miss. Aug. 3, 2007) (dismissing a RICO claim against the lender due to plaintiffs' failure to establish requisite evidence of enterprise or association); Margaret Cronin Fisk & Thom Weidlich, *Citigroup, Ally Sued for Racketeering over Database*, BLOOMBERG, Oct. 4, 2010 (describing a RICO claim that borrowers brought alleging a plan to wrongfully foreclose on borrowers' homes), available at <http://www.bloombergs.com/news/2010-10-04/citigroup-ally-sued-by-homeowners-alleging-racketeering-over-mortgages.html>.

1. *Aiding and Abetting Originators' Unlawful Originations*

When an arranger enables an originator's unlawful conduct, borrowers harmed by that conduct can claim that the arranger aided and abetted the originator. The elements necessary to hold a party liable as an aider and abettor vary across jurisdictions, but generally they require that the defendant knowingly and substantially assisted another in the commission of an unlawful act. To establish knowledge, some jurisdictions require actual knowledge of the illegal act, while others allow claims to go forward if there are allegations that the defendant recklessly ignored facts that suggested the illegal act.¹⁷⁴ The substantial assistance element can be satisfied by either affirmative acts or failures to act.¹⁷⁵ The assistance must have a substantial causal connection to the harm suffered by the plaintiff.¹⁷⁶

The Restatement of Torts, on which many courts rely, identifies the following six factors for determining whether a defendant knowingly provided substantial aid:

- (1) the nature of the act encouraged by the defendant;
- (2) the amount of the defendant's assistance;
- (3) the defendant's presence or absence at the time of the tortious act;
- (4) the defendant's relation to the other parties;
- (5) the defendant's state of mind; and
- (6) foreseeability by the defendant of the acts in question.¹⁷⁷

Applying these factors to arrangers' activities—for example, the information sharing and control that accompanied vertical integration, the financing arrangements between arrangers and originators, and knowledge of poor underwriting—aiding and abetting claims against arrangers are a real possibility.

Aiding and abetting was the theory borrowers pursued in the case against Lehman Brothers.¹⁷⁸ The borrowers claimed that Lehman was liable for its role in financing the lending activities of FAMCO. According to the complaint, FAMCO used unlawful sales tactics to obfuscate prepaid interest,

¹⁷⁴ See, e.g., *Hashimoto v. Clark*, 264 B.R. 585, 598 (D. Ariz. 2001) (stating that California law requires an aider and abettor to have actual knowledge); *Tew v. Chase Manhattan Bank, N.A.*, 728 F. Supp. 1551, 1568–69 (S.D. Fla. 1990) (holding that recklessness satisfies the aiding and abetting knowledge requirement under Florida law).

¹⁷⁵ *Id.* at 1569 (“[T]he jury must also find that the failure to speak and the alleged affirmative misrepresentations represented ‘substantial assistance’ to [the defendant’s] officers and directors in concealing the fraud.”).

¹⁷⁶ *Neilson v. Union Bank of Cal., N.A.*, 290 F. Supp. 2d 1101, 1135 (C.D. Cal. 2003) (“Causation is an essential element of an aiding and abetting claim, i.e., plaintiff must show that the aider and abettor provided assistance that was a substantial factor in causing the harm suffered.”).

¹⁷⁷ RESTATEMENT (SECOND) OF TORTS § 876(b) cmt. b (1979).

Although the arrangers were not present at the time of originators' unlawful actions, this should not defeat aiding and abetting claims because the nature of arrangers' involvement did not require their physical presence at the time of the illegal act.

¹⁷⁸ *In re First Alliance Mortg. Co.*, 471 F.3d 977, 983, 989 (9th Cir. 2006).

fees, and the principal amount of loans from borrowers who were targeted because they had equity in their homes.

Before establishing a business relationship with FAMCO, Lehman conducted due diligence that uncovered FAMCO's questionable tactics and numerous consumer complaints against the company, demonstrating that the firm was a likely candidate for governmental intervention.¹⁷⁹ There was also evidence that Lehman's officers discussed FAMCO's potential liability during Lehman's due diligence review.¹⁸⁰ Thus, Lehman had actual knowledge of FAMCO's unlawful originations.¹⁸¹

Lehman acted as FAMCO's investment bank arranger and supplied a warehouse line of credit to finance FAMCO's activities, in exchange for which Lehman received stock warrants. The credit was repaid with proceeds from the securitization of FAMCO's mortgages, which were underwritten by Lehman. Because Lehman satisfied all of FAMCO's financing needs, the plaintiffs alleged that Lehman substantially assisted the company's tortious conduct.¹⁸² The court agreed.¹⁸³

California courts have recently followed the FAMCO decision, holding that when arrangers help design disclosures containing fraudulent omissions, provide lines of credit, and commit to purchase the originator's loans, they can be found liable for the fraudulent omissions as aiders and abettors.¹⁸⁴

Aiding and abetting is also the theory advanced by the Commonwealth of Massachusetts in its investigation of Morgan Stanley and Goldman Sachs. The Commonwealth never filed complaints against either company, but in an Assurance of Discontinuation with Morgan Stanley, the Commonwealth stated that "Morgan Stanley aided and financed the business of originating unfair loans to Massachusetts borrowers in violation of Massachusetts law" by providing "substantial assistance to New Century, through its warehouse funding, forward purchasing, and other activities that enabled New Century

¹⁷⁹ See *In re First Alliance Mortg. Co.*, 298 B.R. 652, 660–61 (C.D. Cal. 2003).

¹⁸⁰ *In re First Alliance Mortg. Co.*, 471 F.3d at 994 (stating that "in one report, a Lehman officer noted his concern that if First Alliance 'does not change its business practices, it will not survive scrutiny'").

¹⁸¹ See *In re First Alliance Mortg. Co.*, 298 B.R. at 668.

¹⁸² *In re First Alliance*, 298 B.R. at 662, 664; *In re First Alliance*, 471 F.3d at 994. Lehman never exercised the warrants. It is also noteworthy that the former chief financial officer at Shearson Lehman Mortgage Corp. was the President of FAMCO.

¹⁸³ *In re First Alliance*, 298 B.R. at 668.

¹⁸⁴ See, e.g., *Peel v. BrooksAmerica Mortg. Corp.*, 788 F. Supp. 2d 1149, 1161 (C.D. Cal. 2011) (refusing to dismiss claim based on allegations that the assignee drafted loan documents for the lender to use to make the loans that the assignee would then purchase); *Jordan v. Paul Fin., LLC*, 745 F. Supp. 2d 1084, 1097 (N.D. Cal. 2010) (refusing to dismiss claim based on allegations that a purchasing and servicing agreement "specified an ongoing business enterprise" between the lender and assignee, that the assignee participated in crafting loan documents and loan terms, and that assignee reviewed loan portfolios); *Ralston v. Mortg. Investors Grp.*, No. C 08-536 JF (PVT), 2010 WL 3211931, at *5 (N.D. Cal. Aug. 12, 2010) (refusing to dismiss claim based on allegations that assignee was involved in the scheme to market loans, was involved in designing and approving loan documents, provided financing to the lender, and agreed to purchase loans the lender originated).

to make” loans that borrowers could not afford to repay in violation of the Massachusetts UDAP statute.¹⁸⁵

The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 codifies the common law on aiding and abetting when it comes to UDAP claims. Under the new law, it is unlawful for “any person to *knowingly or recklessly provide substantial assistance* to a covered person or service provider in violation” of prohibitions on unfair, deceptive, or abusive acts or practices.¹⁸⁶ Going forward, arrangers will be paying close to attention to the parameters of this provision.

2. Civil Conspiracy

Civil conspiracy, like aiding and abetting, is not an independent cause of action in tort.¹⁸⁷ Borrowers alleging civil conspiracy must show that one or more conspirators perpetrated some underlying unlawful conduct.¹⁸⁸ Parties can be liable as co-conspirators even if they did not engage in the underlying illegal act.¹⁸⁹ For example, if appraisers inflate property appraisals as part of a scheme to defraud homebuyers, they can be liable for damages even if their actions did not satisfy the elements of fraud.¹⁹⁰

The focus of civil conspiracy is a close relationship between the alleged co-conspirators. Generally, there are five elements to a civil conspiracy claim: (1) an agreement; (2) by two or more persons; (3) to accomplish an unlawful act or a lawful act in an unlawful manner; (4) an overt act performed in furtherance of the scheme; and (5) injury to a person or property.¹⁹¹ The requirement of proof of an agreement distinguishes civil conspiracy from aiding and abetting.¹⁹²

¹⁸⁵ Assurance of Discontinuance, *supra* note 161, at 15 ¶ 43.

¹⁸⁶ Dodd-Frank Act § 1036(a)(3) (emphasis added).

¹⁸⁷ *In re Methyl Tertiary Butyl Ether Prods. Liab. Litig.*, 175 F. Supp. 2d 593, 633 (S.D.N.Y. 2001) (citing California, Florida, Illinois, and New York law). All but one jurisdiction, Wyoming, recognizes civil conspiracy as a cause of action. Elizabeth Renuart, *supra* note 15, at 595.

¹⁸⁸ *See, e.g.,* *Urbanek v. All State Home Mortg. Co.*, 898 N.E.2d 1015, 1020 (Ohio Ct. App. 2008) (“Having found that [plaintiff] offered no evidence to create an issue of material fact as to the existence of any fraud committed by the defendants, he cannot as a matter of law prove a conspiracy to commit fraud.”).

¹⁸⁹ *Halberstam v. Welch*, 705 F.2d 472, 481 (D.C. Cir. 1983) (holding that “once the conspiracy has been formed, all its members are liable for injuries caused by acts pursuant to or in furtherance of the conspiracy. A conspirator need not participate actively in or benefit from the wrongful action in order to be found liable.”).

¹⁹⁰ *See, e.g.,* *Hoffman v. Stamper*, 843 A.2d 153, 186–87 (Md. Ct. Spec. App. 2004).

¹⁹¹ *See, e.g.,* *Matthews v. New Century Mortg. Corp.*, 185 F. Supp. 2d 874, 889 (S.D. Ohio 2002) (listing the elements).

¹⁹² *Halberstam*, 705 F.2d at 478 (“The prime distinction between civil conspiracies and aiding-abetting is that a conspiracy involves an agreement to participate in a wrongful activity.”). Some jurisdictions also require that all conspirators be personally bound by a duty owed to the plaintiff. *See, e.g.,* *Neilson v. Union Bank of Cal., N.A.*, 290 F. Supp. 2d 1101, 1133 (C.D. Cal. 2003).

There is little guidance on whether arrangers can be held liable, as civil conspirators, for originators' fraudulent acts.¹⁹³ To the extent courts have addressed the issue, they have held that a question of material fact exists as to whether an assignee is a civil conspirator when the tortious conduct of the originator was "apparent on the face of the loan."¹⁹⁴ In other cases, borrowers have survived motions for summary judgment with evidence that the assignee was working closely with lenders to falsify documents and inflate fees.¹⁹⁵ In 2011, a federal district court decision in the Western District of Washington signaled that deal terms may be important factors in determining the existence of a conspiracy.¹⁹⁶ The court was ruling, in part, on a motion to dismiss filed by an arranger. At issue was whether the plaintiff had adequately stated a claim that the arranger had conspired with the originating lender to make unlawful loans. The court denied the motion, relying in part on allegations that:

- the arranger bought mortgages valued at over three billion dollars from the lender over a five month period
- the arranger "was aware of lending abuses in the nation's mortgage market when it contracted with [the lender]"
- the lender had a reputation as a predatory lender

¹⁹³ Many recent home-mortgage-related cases have raised conspiracy to commit a tort as an issue but have been dismissed because they were poorly pled. *See, e.g.*, *Hafiz v. Greenpoint Mortg. Funding, Inc.*, 652 F. Supp. 2d 1039 (N.D. Cal. 2009); *Hafiz v. Aurora Loan Services*, No. C-09-1963 SI, 2009 WL 2029800, (N.D. Cal. July 14, 2009); *Cruz v. HSBC Bank, N.A.*, No. 100629, 2008 WL 5191428, (N.Y. Sup. Ct. Nov. 12, 2008); *Singh v. Wells Fargo Bank, N.A.*, No. C-09-2035 SC, 2009 WL 2365881, (N.D. Cal. July 30, 2009); *Fortaleza v. PNC Fin. Servs. Grp., Inc.*, No. C 09-2004 PJH, 2009 WL 2246212 (N.D. Cal. July 27, 2009).

¹⁹⁴ *Hays v. Bankers Trust Co. of Cal.*, 46 F. Supp. 2d 490, 498 (S.D.W. Va. 1999). In *Hays*, the borrowers brought a claim against an assignee for conspiracy to commit fraud. The originator had engaged in a bait and switch, substituting the promised loan with a loan with more onerous terms. The loan was transferred to the assignee on the closing date, and the evidence of the bait and switch was in the loan file. 46 F. Supp. 2d at 494.

¹⁹⁵ *See, e.g.*, *Knapp v. Americredit Fin. Servs.*, 245 F. Supp. 2d 841, 852-53 (S.D.W. Va. 2003) (denying defendant's motion for summary judgment on a conspiracy claim where plaintiff produced evidence that the assignee "worked with [the lender] to carry out creation of false paystubs, false down payments and charging an acquisition fee in addition to interest of twenty-one percent").

Most of the civil conspiracy cases involving subprime lending have involved claims that lenders conspired with brokers to defraud borrowers. For example, in *Matthews v. New Century Mortgage* the court denied a lender's motion to dismiss where the plaintiffs alleged that the lender's agents had close personal ties with at least one mortgage broker who had falsified the borrowers' loan applications. The Matthews' Court held that the plaintiffs had set forth facts tending to show that New Century conspired with the mortgage brokers and caused injury to the borrowers. 185 F. Supp. 2d 874, 890 (S.D. Ohio 2002); *but see Williams v. 2000 Homes Inc.*, No. 09-CV-16 (JG) (JMA), 2009 U.S. Dist. LEXIS 65433, *18-19 (E.D.N.Y. July 29, 2009) (dismissing borrower's conspiracy to defraud claim where there was no evidence the lenders had any knowledge of illegally inflated appraisals).

¹⁹⁶ *Villalobos v. Deutsche Bank Nat'l Trust Co.*, No. C09-1450-JCC (W.D. Wash. May 3, 2011), <http://www.nclc.org/images/pdf/unreported/Villalobos.pdf>.

The plaintiffs also brought aiding and abetting and joint venture claims against the arranger and trust.

- the arranger securitized the plaintiffs' loan
- the lender and arranger were parties to a pooling and servicing agreement giving the lender responsibility for originating the loans, out of which the arranger created securities
- disclosure violations were apparent on the loan documents¹⁹⁷

3. Joint Venture

Joint venture, like civil conspiracy and aiding and abetting, is not an independent cause of action. A joint venture arises out of a contractual relationship between the parties that may be express or implied, written, or oral. Generally, there are five elements to a joint venture¹⁹⁸: (1) there must be an express or implied agreement between two or more parties to enter into an enterprise for profit; (2) the parties must intend to be a part of the joint venture; (3) all parties must contribute either money or services to promote the venture; (4) there must be joint control over the venture; and (5) the parties must agree to share the profits and losses. Each member of a joint venture is jointly and severally liable for the torts of co-venturers, so long as the torts are committed within the scope of the venture.¹⁹⁹ Unlike aiding and abetting and civil conspiracy, however, a lack of knowledge of wrongdoing, in and of itself, does not absolve a joint venturer of liability.

Of the cases where a borrower has tried to assert a joint venture in the context of fraudulent loan origination practices, *Short v. Wells Fargo Bank*²⁰⁰ has probably received the most attention. In *Short*, a borrower's claim that the parties to a pooling and servicing agreement (PSA) were engaged in a joint venture survived summary judgment. In denying the defendant's motion for summary judgment, the court in *Short* reasoned that the PSA contractually defined the relationships among the parties to a securitization. The court held that the PSA could satisfy the elements of a joint venture because it was a contract that controlled the operations of the securitization and contained provisions through which the parties shared profits and losses.²⁰¹ The parties eventually settled the case without any appellate ruling.

¹⁹⁷ *Villalobos v. Deutsche Bank Nat'l Trust Co.*, 2011 WL 2415543 (W.D. Wash. June 14, 2011).

¹⁹⁸ See, e.g., *Short v. Wells Fargo Bank Minn., N.A.*, 401 F. Supp. 2d 549, 563 (S.D.W. Va. 2005) (listing elements).

¹⁹⁹ *Short*, 401 F. Supp. 2d at 563 (“Members of a joint venture are . . . jointly and severally liable for all obligations pertaining to the joint venture, and the actions of the joint venture bind the individual co-venturers.”) (quoting *Armor v. Lantz*, 535 S.E.2d 737, 742 (W. Va. 2000)).

²⁰⁰ *Short*, 401 F. Supp. 2d at 549.

²⁰¹ *Id.* at 565; see also *Herrod v. First Republic Mortg. Corp.*, 625 S.E.2d 373, 383–84 (W. Va. 2005) (holding that evidence that brokers used lenders' rate sheets and were compensated through yield spread premiums was sufficient to defeat motion for summary judgment of joint venture claim against lender).

The recent California decisions discussed in the aiding and abetting section²⁰² also recognized that PSAs and similar loan purchase and servicing agreements in combination with underwriting guidelines such as rate sheets are sufficient evidence for a joint venture claim to survive summary judgment.²⁰³

V. A CRITICAL MOMENT FOR POLICY-MAKING

The laws governing consumer lending are scattered across state and federal statutes and state common law. There is little uniformity among the laws when it comes to who can be liable for various unlawful activities related to lending. To compound this complex scheme, many laws contain ambiguities regarding the types of entities that can be liable and the behavior that gives rise to liability. This is not because the laws were particularly ambiguous when they were written but because the market for home loans changed and the laws, which were written for a simpler time, did not keep pace.

Policymakers should address the tangle of liability under consumer protection laws while housing finance is still in a state of flux. Fannie Mae and Freddie Mac, the two largest loan arrangers in the United States, are in conservatorship. Private sector securitization of subprime mortgages has stopped completely and even private securitization of prime loans is rare. As a result, Fannie and Freddie now own or guarantee almost all new residential mortgage loans.²⁰⁴ In February 2011, the Obama Administration released a proposal outlining three plans for the future of housing finance. In all three plans, Freddie and Fannie would be phased out over a period of years and replaced with a private securitization market that may be backed, in whole or in part, by a government guarantee.²⁰⁵ At the same time, the new Consumer Financial Protection Bureau has inherited a hodgepodge of federal lending laws and has been charged with writing rules governing mortgages.

Going forward, the goal should be to establish a clear liability scheme that allows accurate pricing of risk, enables bank regulators to effectively

²⁰² *Supra* text accompanying note 182.

²⁰³ *See, e.g.,* *Jordan v. Paul Fin., LLC*, 745 F. Supp. 2d 1084, 1097 (N.D. Cal 2010) (holding a master loan purchase agreement between the arranger and originator could be sufficient to establish a joint venture); *Peel v. BrooksAmerica Mortg. Corp.*, 788 F. Supp. 2d 1149, 1161 (C.D. Cal 2011) (holding that allegations that arrangers pre-approved the disclosures at issue in the case, provided underwriting guidelines and rate sheets, and committed to purchase the loans originated by the lenders was sufficient to overcome the arranger's motion to dismiss a joint venture claim).

²⁰⁴ This has been the case for the past few years. *See* John Krainer, Recent Developments in Mortgage Finance, Federal Reserve Bank of San Francisco Economic Letter, Oct. 6, 2009, <http://www.frbsf.org/publications/economics/letter/2009/el2009-33.html>.

²⁰⁵ US Dep't of the Treasury & US Dep't of Housing and Urban Dev., REFORMING AMERICA'S HOUSING FINANCE MARKET: A REPORT TO CONGRESS 27-30 (2011), available at <http://www.treasury.gov/initiatives/Documents/Reforming%20America%27s%20Housing%20Finance%20Market.pdf> (last visited Feb. 2011).

exercise their oversight responsibilities, and creates an incentive structure that encourages market participants to police the home financing market. At the same time, the law should not cripple the mortgage-backed securitization market, which is an incredibly powerful innovation that channels investment capital to borrowers in need of credit and gives institutional investors direct, and relatively liquid, exposure to credit markets.

The designers of securitization sought to insulate investors and arrangers by erecting legal structures that would shield them from liability arising from the actions of loan originators. As this article demonstrates, those structures are not as solid as investors and arrangers expected. Instead, what we have is a complicated system of laws that makes liability for all loan purchasers uncertain. We contend that the solution is clear rules imposing assignee liability. There are several rationales for our approach. First, secondary market actors are in the best position to scrutinize lenders' practices to detect signs of abusive lending. Second, there is a precedent for allowing consumers to bring claims against the owners of their notes. The FTC preserved assignee liability in consumer goods and services transactions to incentivize loan purchasers to rein in rogue sellers of financed goods.²⁰⁶ Third, protecting purchasers of mortgage loans from claims by borrowers may have made sense when transactions were truly arms-length and purchasers of loans could not assess the credit quality of borrowers, but arrangers' knowledge of and influence over the origination process make it difficult to apply the same justifications today. Fourth, the complexity of the law creates unnecessary costs and inefficiencies as attorneys and their clients attempt to parse liability. A simple structure of liability would reduce these costs. Lastly, unrestrained lending sparked the financial crisis that almost crippled the world. Better policing at loan origination is key to preventing another crisis.

Our rationales speak to the need to change the current liability system to make it easier to predict and price liability and to put the brakes on abusive lending. The goal of the proposals we describe below is not to create

²⁰⁶ When issuing the FTC Rule, the FTC explained that:

As a practical matter, the creditor is always in a better position than the buyer to return seller misconduct costs to sellers, the guilty party. . . . The creditor financing the transaction is in a better position to do this than the consumer because (1) he engages in many transactions where the consumers deal infrequently; (2) he has access to a variety of information systems which are unavailable to consumers; (3) he has recourse to contractual devices which render the routine return of seller misconduct costs to sellers relatively cheap and automatic, and (4) the creditor possess the means to initiate a lawsuit and prosecute it to judgment where recourse to the legal system is necessary.

We believe that a rule which compels creditors to either absorb seller misconduct costs or return them to sellers, by denying sellers access to cut-off devices, will discourage many of the predatory practices and schemes. . . . Creditors will simply not accept the risks generated by the truly unscrupulous merchant. The market will be policed in this fashion and all parties will benefit accordingly.

40 Fed. Reg. 53,506, 53,522-23 (Nov. 18, 1975).

new causes of action. Rather, we seek to simplify the legal environment and create a coherent incentive system that encourages secondary market actors to adopt practices that prevent unlawful loans from entering the securitization pipeline. Crafting such rules is no easy task.

A. Assignee Liability

The easiest way to eliminate the complex liability schemes and preserve consumer claims is to impose liability on the owners of loans for lender violations of consumer protection laws. For owners of notes, liability would not be based on whether they were holders in due course or whether a law was state or federal. Rather, liability for affirmative and defensive claims would arise simply from holding the note, just as the law currently stands under the FTC Act and HOEPA.²⁰⁷ Alternatively, the law could allow consumers to raise defenses to collection claims or foreclosures brought by owners of notes, but only allow affirmative claims against the owners of notes if the originator was insolvent. This would encourage secondary market entities to purchase loans from adequately capitalized or insured originators. Both paths would clarify assignee liability by eliminating the complexity in extant laws, while at the same time encouraging entities that finance lending to identify and cut off funding to unscrupulous originators.²⁰⁸

Purchasers of loans will likely exit the market if the law subjected them to unlimited liability for damages. To avoid this scenario, policy makers should implement a remedial scheme that would enable owners of notes to quantify their exposure to borrower claims. This could be accomplished through liquidated penalties or damages caps based on the amount of the finance charge, the loan amount, a multiplier of either one, or some combination thereof.²⁰⁹

B. Arranger Liability

Assignee liability does not address the liability of arrangers unless they are owners of notes. We propose that the law impose liability on arrangers under a theory similar to joint venture with a constructive knowledge standard. Under this approach, arrangers would incur liability for any consumer claims if they provided substantial assistance to originators and if arrangers

²⁰⁷ See Engel & McCoy, *supra* note 4, at 2081–94.

The Dodd-Frank Act does allow borrowers to defend foreclosure actions by assignees for specific violations of the Act. See *supra* note 88.

²⁰⁸ See *id.* at 2098–99.

In response to market pressures, the securitization industry is already developing new standards and tools that allow arrangers and investors to investigate loan pools in a granular fashion. AMERICAN SECURITIZATION FORUM, *ASF RMBS Disclosure and Reporting Packages* (July 15, 2009), http://www.americansecuritization.com/uploadedFiles/ASF_Project_RESTART_Final_Release_7_15_09.pdf

²⁰⁹ See Engel & McCoy, *supra* note 4, at 2090 (discussing a possible approach).

should have known of the originator's unlawful acts or illegal loan terms based upon available information. A constructive knowledge, or "should have known," standard contrasts with actual knowledge in important ways. All else being equal, if arrangers are only liable if they actually know about a specific unlawful act or practice, it reduces their incentive to investigate lenders or the loans they make. In contrast, if arrangers are liable when they "should have known" of unlawful acts or practices, they will have a greater incentive to investigate and act on information they obtain through due diligence and from other sources.

C. Prudential Supervision

Financial institutions' potential liability to consumers is akin to hidden leverage: it is not readily apparent during boom times, and it amplifies losses in a financial crisis. Prudential supervisors can respond by adopting practices that could immediately reduce firms' and investors' exposure to litigation and protect consumers at the same time, all without making any change to the law.

The complexity of financial institutions and the deals in which they are involved make banks' potential liability opaque. It is, thus, critical that bank examiners understand the intricacies of institutions, their deals, and the ways in which risk can be hard to detect. Bank examinations typically follow legal structures: they look at the depository arms of institutions. This approach fails to take into account the reality that firms conduct business along functional business lines, which can involve affiliates and subsidiaries that are not depositories.²¹⁰

We contend that robust compliance testing requires testing along functional business lines. Regulators can accomplish this through consolidated corporate risk management reviews. Consolidated risk management provides the opportunity to design compliance systems along business lines, rather than according to the way parents, subsidiaries, and affiliates are legally organized. Under this supervision scheme, firms may be required to expand their due diligence when acquiring and securitizing loans, adopt plans to address issues identified in due diligence, conduct audits to ensure the necessary legal formalities are observed, and promptly correct problems as they are identified. With consolidated risk management, regulators can be more certain about firms' balance sheets and protect consumers at the same time.

²¹⁰ See Thomas J. Fitzpatrick IV, Mark B. Greenlee & James B. Thomson, *Resolving Large, Complex Financial Firms*, ECONOMIC COMMENTARY no. 2011-16 (Fed. Reserve Bank of Cleveland), Aug. 31, 2011, available at <http://www.clevelandfed.org/research/commentary/2011/2011-16.cfm>.

VI. CONCLUSION

As Congress, regulators, Wall Street, and consumer advocates hammer out the details of financial reform, investors in RMBS and arrangers should expect more borrower litigation and the potential for large damage awards.²¹¹

The environment is ripe for consumers, state attorneys general, and federal agencies to pursue claims against entities further up the securitization food chain, especially given increasing evidence that Wall Street failed to observe the formalities that might have insulated arrangers and investors from most consumer claims. Judges and juries, who, in the past, may not have considered the possibility that Wall Street financiers could be involved with fraud on borrowers, appear to be increasingly sympathetic to such claims.

The Dodd-Frank Act addresses many problems that arose in loan origination, but it is not a panacea. There are holes in the regulations, and new practices will arise that Congress did not anticipate when writing the law. And, no matter how committed the CFPB is to protecting consumers, rule-making and enforcement is a slow process.

For now, the market is effectively curtailing abusive lending by restricting credit for home loans unless the loans meet the requirements for purchase by Fannie Mae or Freddie Mac. Eventually, the secondary market will recover, and we should expect that there will be new tools to help minimize the kinds of risk that led investors and arrangers to lose money on RMBS. Whether those tools will also protect consumers is not known. It is possible that investors and arrangers can be insulated, in which case the tangle of laws will persist and consumers will be left with uncertain recourse.

It will be years before the liability dust settles, but we are confident of a few things: securitization has made it harder for aggrieved borrowers to obtain relief and has reduced the incentives for the housing market to police itself; investment trusts and arrangers should be worried about litigation risk; and the failure of the law to keep pace with securitization has created costly uncertainty.

²¹¹ As we discussed in the aiding and abetting section, a group of California courts have allowed cases of fraud to go forward against arrangers based on option ARM disclosures. To the extent other courts render similar rulings in California and on other option ARM loans, of which there are about \$160 billion outstanding, arranger liability has the potential to substantially increase. ASF MARKET REVIEW (Aug. 2011), *available at* <http://1010data.com/downloads/asf/Aug/ASF-Non-Agency-Review-August-2011-Remittance-Mid-Month-Update.pdf>.

