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**False Security: How Securitization  
Failed to Protect Arrangers and  
Investors from Borrower Claims**

by Kathleen C. Engel and  
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FEDERAL RESERVE BANK OF CLEVELAND

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The future of housing finance is in a state of flux. In February 2011, the Obama Administration released a proposal outlining three plans for the future of housing finance. In all three plans, Freddie Mac and Fannie Mae will be phased out over a period of years and replaced with a private securitization market, which may be backed, in whole or in part, by a government guarantee. Whether the final plan relies upon government-guaranteed securities or private-label securities, Congress will have to resolve a range of complex legal aspects of securitization, from the bankruptcy remoteness of pools of securities to setting national standards for loans and financing. One issue that does not appear to be getting much attention is the potential liability of the parties to a securitization for the unlawful actions of loan originators. In this paper, the authors take the position that any new housing finance system must clarify the liability of participants in the securitization pipeline so that the market can more accurately price securities up front and create incentives for more effective compliance programs to stop problem loans from entering the pipeline.

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## I. Introduction

The future of housing finance is in a state of flux. Fannie Mae and Freddie Mac, the two largest loan arrangers in the United States, are in conservatorship.<sup>2</sup> Private sector securitization of mortgages has almost completely stopped. As a result, Fannie, Freddie and Ginnie Mae now own or guarantee almost all new residential mortgage loans.<sup>3</sup> In February 2011, the Obama Administration released a proposal outlining three plans for the future of housing finance.<sup>4</sup> In all three plans, Freddie and Fannie will be phased out over a period of years and replaced with a private securitization market which may be backed, in whole or in part, by a government guarantee. Whether the final plan relies upon government guaranteed securities or private label securities, and there are strong opinions on both sides,<sup>5</sup> Congress will have to resolve a range of complex legal aspects of securitization from the bankruptcy remoteness of pools of securities to setting national standards for loans and financing.<sup>6</sup>

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<sup>2</sup> Mark Jickling, *Fannie Mae and Freddie Mac in Conservatorship*, CRS REPORT TO CONGRESS (September 15, 2008).

<sup>3</sup> John Krainer, *Recent Developments in Mortgage Finance*, Federal Reserve Bank of San Francisco Economic Letter, Oct. 6, 2009, available at <http://www.frbsf.org/publications/economics/letter/2009/el2009-33.html>.

<sup>4</sup> US DEP'T OF THE TREASURY & US DEP'T OF HOUSING AND URBAN DEVELOPMENT, *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).

<sup>5</sup> See, e.g., Edward Pinto, *The Future of Housing Finance*, WALL STREET JOURNAL, August 17, 2010 (noting the consensus reached at the first meeting and critiquing it).

<sup>6</sup> See, e.g. Cheyenne Hopkins, *Geithner Backs National Servicing Rules*, AMERICAN BANKER, December 17, 2010.

One issue that does not appear to be getting much attention is the potential liability of the parties to a securitization for the unlawful actions of loan originators. In this paper, we take the position that any new housing finance system must clarify the liability of participants in the securitization pipeline so that the market can more accurately price securities up-front and create incentives for more effective compliance programs to stop problem loans from entering the pipeline.

For over a decade, the securitization of home loans<sup>7</sup> 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 them with direct exposure to housing markets with good returns that appeared to be highly liquid and low risk.<sup>8</sup> From its infancy, securitization promised to insulate investors and the arrangers<sup>9</sup> that structured securitization deals from the risk that they could be found liable for the unlawful acts of mortgage loan originators.<sup>10</sup> This

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<sup>7</sup> There is extensive debate about what constitutes a subprime loan. We use the term subprime to mean any loan including Alt-A products that would not qualify as a prime, conforming loan under Fannie Mae or Freddie Mac guidelines.

<sup>8</sup> See generally, Kathleen C. Engel and Patricia A. McCoy, *Turning a Blind Eye: Wall Street Finance of Predatory Lending*, 75 FORDHAM LAW REVIEW 2039 (2007).

<sup>9</sup> Due to the complexity of the securitization process, there are not universally accepted labels for the different entities involved in securitization. In this article "arranger" refers to the party that puts together securitization deals. Arrangers are often referred to as "sponsors" or "depositors," depending on the task they undertake. Arrangers of subprime securitizations were most often commercial banks or investment banks.

<sup>10</sup> There were many risks to investors that securitization sought to eliminate or minimize; this article focuses on just one of those risk: the securities' potential loss of value due to borrower lawsuits based upon unlawful acts that brokers or lenders engaged in at the origination of borrowers' loans.

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 civil litigation, governmental 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 and unfair lending and may open the door for borrower claims further up the lending food chain to arrangers and trusts.

This article proceeds in six parts. Following this introduction, in Part II we briefly describe the history and process of securitization. Part III is a review of the potential claims borrowers can pursue against holders of their loans based on theories of derivative liability, with particular focus on the holder in due course rule. In Part IV, we describe theories that could expose investment banks and other arrangers to direct liability. In part V, we discuss the implications and possible policy responses to assignees' and arrangers' exposure to borrower claims and defenses. 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.

## II. Securitization

Two decades ago, borrowers applied for loans through loan officers at local banks. The loan officers who processed borrower applications and underwrote the loans were employees of the bank and often were members of the communities in which the borrowers lived. The 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 them to try to help the borrowers retain their homes and resume payments. In sum, borrowers had relationships with one institution and that institution processed, underwrote, funded, owned, and serviced the borrowers’ loans. If borrowers alleged wrongdoing at any stage of the lending process, from application to servicing, there was 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.<sup>11</sup> Instead of lenders running the entire show, an atomized<sup>12</sup> financing system emerged, involving mortgage brokers,

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<sup>11</sup> 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 and Patricia A. McCoy, *A Tale of Three Markets: The Law and Economics of Predatory Lending*, 80 TEXAS LAW REVIEW 1255 (2002).

<sup>12</sup> Prof. Michael G. Jacobides was the first person we know of to describe the securitization of home mortgages as an atomized process. Michael G. Jacobides,

lenders, banks, rating agencies, trusts, servicers, and investors. Lenders would make loans to borrowers and an investment bank or other arranger then purchased the loans or pools of loans that they converted into residential mortgage-backed securities (RMBS or MBS) for sale to investors. Ultimately, the loans were transferred to a trust that issued securities backed by the loans

The process of securitizing subprime home loans began with arrangers. Most arrangers were investment banks or the investment arms of financial conglomerates.<sup>13</sup> The role of arrangers was to convert a pool of loans into mortgage-backed securities. In the subprime loan market, arrangers oftentimes bought loans from affiliated entities or through bulk purchases and placed the loans in a pool destined for securitization.<sup>14</sup> Other times, they worked as underwriters of securities that were sponsored by other entities such as independent, subprime lenders. Whether they were underwriting or putting deals together on their own behalf, arrangers required that the originators of subprime loans provide representations and warranties that the loans complied with the law and met specific underwriting criteria (“reps and warranties”).

Arrangers of a subprime securitization had multiple tasks. They conducted due diligence to insure that the loans were as originators promised in their reps and warranties. They divided the income stream from pool of loans into tranches (French for

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*Mortgage Banking Unbundling: Structure, Automation and Profit*, MORTGAGE BANKING (Jan. 1, 2001).

<sup>13</sup> The government sponsored-enterprises (GSEs), Fannie Mae and Freddie Mac, are also arrangers and some firms, like Countrywide Home Loans and Washington Mutual, sponsored their own subprime securitizations.

<sup>14</sup> Dale Whitman, *How Negotiability has Fouled up the Secondary Mortgage Market, and What to do about It*, 37 PEPPERDINE LAW REVIEW 737, 744-45 (2010).

“slices”). Each tranche had different risk-return characteristics.<sup>15</sup> Arrangers also had responsibility for obtaining ratings from the credit rating agencies for the tranches and for complying with rules governing securities disclosures.<sup>16</sup>

Once a deal was put together, arrangers set up bankruptcy-remote special purpose entities, usually trusts, to hold the loans and issue the securities. The trusts purchased the loans from the arrangers either by paying the arrangers in securities issued by the trust and backed by the pool of subprime loans, or by financing the acquisition through the sale of such securities to a broker-dealer, who was often an affiliate of the arranger.<sup>17</sup> Up until the time the loans were transferred to the trust, the arranger owned the loans. 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.

Arrangers were not simply intermediaries between subprime originators and investors. They were the organizers with some level of command over almost every step

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<sup>15</sup> 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 through subordinating loss-positions and other credit enhancements. Typically tranches are classified as senior, mezzanine, or junior, reflecting their subordination status. Senior tranches are paid and mature first, then mezzanine and finally junior tranches. Junior tranches, thus, are the first tranches in the pool to bear losses. ADAM B. ASHCRAFT, UNDERSTANDING THE SECURITIZATION OF SUBPRIME MORTGAGE CREDIT 29-30 (Federal Reserve Bank of New York Staff Report no. 318, 2008).

<sup>16</sup> Kathleen Engel and Patricia McCoy, *The Subprime Virus: Reckless Credit, Regulatory Failure and Next Steps* (Oxford University Press 2011).

<sup>17</sup> *See, e.g.* ADAM B. ASHCRAFT, UNDERSTANDING THE SECURITIZATION OF SUBPRIME MORTGAGE CREDIT 13 (Federal Reserve Bank of New York Staff Report no. 318, 2008).

from loan origination to the selling of securities. Exercising some level of control was natural given arrangers' role as market makers. Many had buy-side and all had 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. Through securitization, arrangers also gave lenders access to the capital markets, either by buying their loans and creating securities backed by the loans or by underwriting the loans for the originators.<sup>18</sup>

As part of their due diligence, arrangers were responsible for reviewing loan files for compliance with originators' representations and warranties. They often contracted with independent due diligence firms to review files, track lenders' practices and financial condition, and monitor pending litigation against originators. Through these processes, arrangers had access to detailed information about subprime lenders and the performance of their loans that was not available to the public. With access to that information and control of originators' funding streams, arrangers had the power to shut off the supply of money when they saw signs that the lenders were engaged in wrongdoing.

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<sup>18</sup> See e.g. Goldman Sachs, Goldman Sachs: Risk Management and the Residential Mortgage Market 3 (date?) (exhibit from Senate Hearings: [http://hsgac.senate.gov/public/\\_files/Financial\\_Crisis/042710Exhibits.pdf](http://hsgac.senate.gov/public/_files/Financial_Crisis/042710Exhibits.pdf)) (describing Goldman Sachs's mortgage market activities).

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. If they served as underwriters, they received underwriting fees. Volume was key to securitization profits. During the subprime heyday, this meant arrangers had a strong incentive to maximize the number of subprime loans that they securitized.

To ensure a steady flow of loans, many arrangers purchased and invested in lenders that could supply them with loans.<sup>19</sup> Arrangers had to manage their relationships with originators to maintain clear boundaries between themselves and loan originators—especially those that were part of the same corporate family-- so they would not be legally responsible for any misdeeds of the loan originators.

The many ways that arrangers could and did influence lending is key to understanding our contention that they 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, which can be trusts or arrangers, are liable, not because of their own actions, but because the loans contain unlawful terms or were the result of unlawful practices, we refer to their liability as derivative. Derivative liability can be either defensive or affirmative. 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

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<sup>19</sup> 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.

grounds that there was some unlawful activity during the origination of the loan that relieves the borrower of the obligation to repay the debt (defensive derivative liability). In addition, there are some laws that permit borrowers to bring claims for damages and other relief against the owners of their loans even if those owners did not engage in any illegal behavior themselves (affirmative derivative liability).<sup>20</sup>

In this section of the article, we describe how owners of loans and investors in RMBS that are backed by loans can be exposed to derivative consumer claims. Direct liability for participation in activities related to unlawful origination practices is covered in section IV. As we discussed in the introduction, depending on the stage in a securitization loans can be owned by the arrangers or securitization trusts. Arrangers become owners when they purchase loans from originators and hold them pending completion of securitization deals, at which point they transfer the loans to a trust. The trust then becomes the legal owner of the loans, although it is the bondholders that own the stream of income from the loans and stand to lose if a trust has derivative liability.<sup>21</sup>

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<sup>20</sup> Borrowers can also bring claims for recoupment. Recoupment 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 the statute of limitations. 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 *Associates Home Equity Services, Inc. v. Troup*, 778 A.2d 529, 539-40 (N.J. Super. Ct. App. Div. 2001).

<sup>21</sup> Michael Gregory, *The Predatory Lending Fracas: Wall Street Comes under Scrutiny in the Subprime Market as Liquidity Suffers and Regulation Looms*, INVESTMENT DEALERS DIGEST (June 26, 2000); Joseph R. Mason, *The Summer of '07 and the Shortcomings of Financial Innovation*, JOURNAL OF APPLIED FINANCE 1, (Spring /Summer 2008). Arrangers can also end up owning loans if they are forced to buy loans back from trusts because the loans do not comply with the terms of the deal.

As the loans change hands, they are assigned to their new owners and thus all loan purchasers are called assignees.

A. Fraud, Unconscionability and Holder in Due Course

When a borrower defaults on a loan, the owner of the note typically brings a collection or foreclosure action against the borrower. The borrower can attempt to defend the claim on the basis that the note arose out of some 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 common defenses to collection or foreclosure actions brought by owners of notes.

The success of these defenses turns on the sufficiency of the evidence of fraud or unconscionability *and* on whether the holder of the note is a holder in due course (HDC). HDCs are 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.<sup>22</sup> To establish fraud, the victim of the fraud must prove

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There are also insurers and other entities that may have to step in when trusts experience losses.

<sup>22</sup> Compare *Williams v. Aetna Finance Co.*, 83 Ohio St.3d 464, 475, 700 N.E.2d 859, 868 (1998) (holding that a party accused of fraud must either know 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); *Neilson v. Union Bank of California, 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). Alternatively, the first element may be satisfied if the defendant induced another to undertake a fraudulent act. See *Knapp v. Americredit Financial Services, Inc.*, 245 F.Supp.2d 841, 852 (S.D.W.V. 2003).

that the party who committed fraud made a false statement of material fact with knowledge of the falsity and intent to deceive, on which the victim justifiably relied, and which caused the victim injury. In some jurisdictions, acceptance of the fruits of a fraud with knowledge that they were fraudulently obtained will, in itself, establish fraud.<sup>23</sup>

Courts have recognized fraud claims when borrowers have been misled about a loan's interest rate prior to closing,<sup>24</sup> when brokers falsely promised to obtain the best rate possible for borrowers,<sup>25</sup> and when borrowers were deceived as to the purpose of the documents they were signing.<sup>26</sup> Courts have also recognized fraud when brokers or originators hide finance

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<sup>23</sup> See e.g. *Pulphus v. Sullivan*, 2003 WL 1964333 (N.D. Ill. 2003).

<sup>24</sup> 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 (April 9, 2008), available at <http://www.npr.org/templates/story/story.php?storyId=89505982>. See also *Hays v. Bankers Trust Co. of California*, 46 F.Supp.2d 490 (S.D.W.V. 1999) (where a borrower attempted to rescind within the 3-day window granted by TILA, but instead 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 Investments*, 93 F.Supp.2d 718, 721-22 (S.D.W.V., 2000) (allowing an affirmative fraud claim against an assignee where an originator had promised to refinance at a lower rate after a year of timely payments and borrowers were not offered an opportunity to refinance at the rate).

<sup>25</sup> See *Herrod v. First Republic Mortgage Corp.*, 218 W. Va. 611, 620, 625 S.E.2d 373, 382 (2005) (in dicta, suggesting that it may amount to fraud when brokers falsely promise to get borrowers "the best rate" they can). Interviews with former mortgage brokers suggest that promises to get the best rate possible were not uncommon. Chris Arnold, *Ex-Subprime Brokers Help Troubled Homeowners*, National Public Radio (April 9, 2008), available at <http://www.npr.org/templates/story/story.php?storyId=89505982>.

<sup>26</sup> See *Pulphus v. Sullivan*, 2003 WL 1964333 (N.D. Ill. 2003) (holding that obtaining a borrower's signature on a promissory note and mortgage by falsely stating that the paperwork related to a weatherization program amounted to fraud).

charges,<sup>27</sup> falsify borrowers' employment and income,<sup>28</sup> and make loans for home repairs with knowledge that the people making the home repairs are unlikely to finish their work.<sup>29</sup>

## 2. Unconscionability

Unconscionability is another defense that borrowers can raise when owners of notes bring collection actions. It can also be asserted as an affirmative claim against assignees.<sup>30</sup> Contracts can be unconscionable if borrowers had no meaningful choice about the terms and the terms unreasonably favored the lender.<sup>31</sup> Most courts require that

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<sup>27</sup> See *In re First Alliance Mortgage Co.* 471 F.3d 977 (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 Financial Services*, 245 F.Supp.2d 841 (S.D.W.V. 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).

<sup>28</sup> See *Matthews v. New Century Mortgage Corp.*, 185 F.Supp.2d 874 (S.D. Ohio 2002) (holding that brokers committed a fraud on borrowers by falsifying the borrowers' income and employment status on their loan applications).

<sup>29</sup> See *Williams v. Aetna Finance Co.* 83 Ohio St.3d 464, 700 N.E.2d 859 (1998) (holding that making a loan to pay for home repair services with knowledge that the work would never be done amounted to fraud).

<sup>30</sup> *Herrod v. First Republic Mortgage Corp.*, 218 W.Va. 611; 635 S.E.2d 373 (2005).

<sup>31</sup> *Williams v. Walker-Thomas Furniture Co.*, 350 F.2d 445, 449 (C.A.D.C. 1965).

Determining unconscionability requires application of many factors. See e.g. *Sosa v. Paulos*, 924 P.2d 357 (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

borrowers prove both procedural and substantive unconscionability,<sup>32</sup> although the analysis is not rigid, and some terms can be both procedurally and substantively unconscionable.<sup>33</sup> When a contract or one or more of its clauses is unconscionable, courts can reform or refuse to enforce the contract.<sup>34</sup>

Procedural unconscionability is marked by oppression and unfair surprise.<sup>35</sup> An oppressive transaction denies the borrower meaningful choice through a gross inequality of bargaining power.<sup>36</sup> In the lending context, surprise occurs most frequently when supposedly

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omitted).

<sup>32</sup> See, e.g. *Tillman v. Commercial Credit Loans, Inc.*, 362 N.C. 93, 655 S.E.2d 362, 370 (2008) (holding “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 unconscionability. See, e.g. *Tjart v. Smith Barney, Inc.*, 107 Wash. App. 885, 28 P.3d 823 (2001).

<sup>33</sup> See e.g. *Matter of Friedman*, 64 AD 2d 70, 85 (NY App. Div. 1978) (“The concept of unconscionability must necessarily be applied in a flexible manner depending upon all the facts and circumstances of a particular case. Courts have identified various elements of the unconscionable contract that may be characterized as substantive and procedural”).

<sup>34</sup> See generally Restatement 2d., Contracts.

<sup>35</sup> UCC 2-302, Note 1; 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).

<sup>36</sup> *Williams v. Walker-Thomas Furniture Co.*, 350 F.2d 445, 449 (C.A.D.C. 1965), stating, in part:

Whether a meaningful choice is present in a particular case can only be determined by consideration of all the circumstances surrounding the transaction. In many cases the meaningfulness of the choice is negated by a gross inequality of bargaining power. The manner in which the contract was entered is also relevant to this consideration. Did each party to the contract, considering his obvious education or lack of it, have a reasonable opportunity to understand the terms of the contract, or were the important terms hidden in a maze of fine print and minimized by deceptive sales practices? Ordinarily,

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 negotiated previously.<sup>37</sup> The procedural prong of unconscionability will often be satisfied in abusive lending situations.<sup>38</sup>

Substantive unconscionability is not well-defined, but courts have found common terms to be substantively unconscionable. For example, courts have found mandatory arbitration clauses unconscionable.<sup>39</sup> Others have held that when lenders, without

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one who signs an agreement without full knowledge of its terms might be held to assume the risk that he has entered a one-sided bargain. But when 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.

<sup>37</sup> *A&M Produce v. FMC Corp.*, 135 Cal. App. 3d 473, 486 (1982) (holding “[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 borrowers can be surprised even when they signed and initialed disclosure documents. *Moore v. Mortgagestar, Inc.*, 2002 U.S. Dist. LEXIS 27457 (S.D. W.V.) (holding that the borrowers’ initials and signatures on disclosure documents was not evidence of a lack of surprise where the borrowers testified they left the loan transaction confused and the loan documents contained inconsistencies); *Green v. Gibraltar Mortgage*, 488 F. Supp. 177, 180 (D.C.D.C. 1980) (holding that a borrower taking a second mortgage to avoid imminent foreclosure lacked any meaningful choice of going elsewhere when the true terms of the note were disclosed at closing).

<sup>38</sup> *Matthews v. New Century Mortgage Corp.*, 185 F.Supp.2d 874 (2002) (denying defendant’s motion to dismiss 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); *Herrod v. First Republic Mortgage Corp.*, 218 W.Va. 611; 635 S.E.2d 373 (2005) (noting that plaintiff’s 10th grade education, lack of familiarity with general loan transactions and specific loan terms, as well as the loan closing being rushed all support procedural unconscionability).

<sup>39</sup> *See, e.g. Tillman v. Commercial Credit Loans, Inc.* 362 N.C. 93, 655 S.E.2d 362 (2008) (holding that an arbitration clause was substantively unconscionable because (1) the daily arbitration cost of \$1,225 borrowers could face was prohibitively high for

borrower's knowledge, inflate the borrower's income in order qualify the borrower for a loan, the inflation can introduce an element of unconscionability.<sup>40</sup> When individual contract terms are not, standing alone, substantively unconscionable, some courts have held that a combination of unfair terms can amount to substantive unconscionability.<sup>41</sup>

Although loan prices can theoretically be unconscionable,<sup>42</sup> courts have been reluctant to deem price terms unconscionable.<sup>43</sup> There are, however, several cases in

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borrowers who were living paycheck to paycheck; (2) the arbitration clause was excessively one-sided because it allowed the lender to bring some claims in court but required borrowers to arbitrate and (3) the clause prohibited joinder of claims and class actions); *see also Luna v. Household Fin. Corp.*, 236 F.Supp.2d 1166 (W.D. Wash. 2002) (holding a mandatory arbitration clause in a consumer home loan substantively unconscionable when it prohibited class actions, granted access to courts to the lender but not the borrower, required arbitration awards to be kept confidential, and the borrower's arbitration costs were significantly greater than court costs would be); *but see In re Peoples Choice Home Loan, Inc.*, 225 S.W.3d 35 (Ct. App. Tex. 2005) (holding that a mandatory arbitration clause in a contract of adhesion was not unconscionable, despite its one-sided nature in allowing the lender access to the courts, but not the borrower, without proof of inequality of bargaining power or oppressive cost); *In re Firstmerit Bank, N.A.*, 52 S.W.3d 749, 44 Tex. Sup. Ct. J. 900 (2001) (holding that arbitration clauses are not unconscionable when they lack mutuality of obligation).

<sup>40</sup> *City Fin. Services v. Smith*, 2000 WL 288469 (Cuyahoga County Mun. Ct. Ohio) (holding that the lender's enhancement of Ms. Smith's income to reflect a 25% [tax] deduction level, which never existed, created an element of unconscionability in the contract when it was made).

<sup>41</sup> *Herrod v. First Republic Mortgage Corp.*, 218 W.Va. 611; 635 S.E.2d 373 (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 was evidence of substantive unconscionability).

<sup>42</sup> *See* 1 Arthur L. 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"); *Paulman v. Filtercorp*, 899 P.2d 1259 (Wash. 1995) (two dissenters positing that a loan that was exempt from state usury laws was "so outrageous as to be unconscionable and against public policy"); *Besta v. Beneficial Loan Co.*, 855 F.2d 532 (8<sup>th</sup> cir, 1988) (holding that a loan with an extremely high interest rate was unconscionable).

which courts have found that loans are unconscionable if the price of the loan—in terms of the borrower’s monthly payment—is unaffordable.<sup>44</sup> 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 the price was *per se* unconscionable.

Unconscionability claims are not easy to prove especially when borrowers have recently engaged in similar transactions, and were given adequate disclosures of the terms of their loans and the risks associated with the loans, e.g. that payments would increase if interest rates rose on adjustable rate loans.<sup>45</sup> Consistent with this approach, courts have denied unconscionability claims when borrowers have undergone loan counseling prior to signing their loan documents, were provided an opportunity to ask questions about the loans, and believed they were able to make their monthly mortgage payments.<sup>46</sup>

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<sup>43</sup> Kathleen C. Engel and Patricia A. McCoy, *A Tale of Three Markets: The Law and Economics of Predatory Lending*, 80 TEXAS LAW REVIEW 1255, 299-1301(2002).

<sup>44</sup> *Matthews v. New Century Mortgage Corp.*, 185 F.Supp.2d 874 (S.D. Ohio 2002); *Family Fin. Servs. v. Spencer*, 677 A.2d 479 (Conn. App. Ct. 1996) (upholding a finding of unconscionability 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. Services v. Smith*, 2000 WL 288469 (Cuyahoga County Mun. Ct. Ohio) (holding a loan is unconscionable when it would have, among other factors, left plaintiff with only \$120 per month in disposable income).

<sup>45</sup> *In re Strong*, 356 B.R. 121, 131 (PA Bankruptcy court 2004) (denying a borrower’s unconscionability claim where the borrower attempted to borrow \$10,000, which ended up being \$53,000 with an additional \$5,000 in fees, 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); *New South Fed. Sav. Bank v. Anding*, 414 F. Supp. 2d 636, 644 (S.D. MI, 2005) (holding that arbitration agreements are not procedurally unconscionable when they appear in a stand-alone document and the effect of the arbitration agreement is in capitalized, bold-faced type).

<sup>46</sup> *Cheshire Mortgage Serv. v. Montes*, 223 Conn. 80 (CT Sup.Ct, 1992) (denying borrowers’ claim that a second mortgage was unconscionable where the borrowers had

### 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 defend against a collection action. The holder in due course (HDC) rule can shield owners of notes from those defenses if certain formalities are observed.<sup>47</sup> 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 holder in due course. 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.<sup>48</sup> The rule applies to loans secured by real property and impedes almost all defenses to non-payment on a note, including unconscionability and most fraud.<sup>49</sup>

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loan terms explained at closing and had undergone loan counseling prior to the original home purchase).

<sup>47</sup> For a general discussion of the impact of the holder in due course 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, 237-239 (2009), Deborah Goldstein and Matthew Brinegar, *Policy and Litigation Barriers to Fighting Predatory Lending*, 2 NORTHEASTERN UNIVERSITY LAW JOURNAL 193, 197-201 (2010) and Dale Whitman, *How Negotiability has Fouled up the Secondary Mortgage Market, and What to do about It*, 37 PEPPERDINE LAW REVIEW 737, 756-57 (2010).

<sup>48</sup> See generally Mark B. Greenlee & Thomas J. Fitzpatrick IV, *Reconsidering the Application of the Holder in Due Course Rule to Home Mortgage Notes* 41 UCC LAW JOURNAL 225 (2009); Michael Sinclair, *Codification of Negotiable instruments Law: A Tale of Reiterated Anachronism*, 21 U. Toledo L. Rev. 625, 634-635 (1989).

<sup>49</sup> U.C.C. §§ 3-305(a), (b). There is a small set of defenses that can be raised even against a holder in due course. 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

Although the HDC rule has been part of contract law for hundreds of years, until recently it played only a minor role in mortgage markets. 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 lenders' foreclosure claims with defenses based on 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 a holder in due course, purchasers must prove that they are the holder of a negotiable note, purchased in the ordinary course of business, for value, in good faith, and without notice that the note is overdue, has been dishonored or is subject to any defenses.<sup>50</sup> If an owner of note is not a holder in due course, consumers can defend non-payment based unconscionability and fraud.

a.  Holders of Notes

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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.

<sup>50</sup> Uniform Commercial Code § 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 LAW REVIEW 775, 777-86 (1995); Mark B. Greenlee & Thomas J. Fitzpatrick IV, *Reconsidering the Application of the Holder in Due Course Rule to Home Mortgage Notes* 41 UCC LAW Journal 225, 228-235 (2009).

Although the holder in due course 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 holder in due course doctrine. Some barred the claims on the grounds that the owners of the notes were holders in due course while others rejected the application of the HDC Rule even though the operative facts were the same. Kurt Eggert, *Held Up in Due Course: Predatory Lending, Securitization, and the Holder in Due Course Doctrine* 35 CREIGHTON L. REV. 503, 522-31.

The first HDC requirement is that the party seeking to enforce the notes must be a holder of the note.<sup>51</sup> To be a holder, one must have possession of the note and have the right to enforce the note. A person in possession may enforce notes that are either payable to the person in possession or are “bearer paper.”<sup>52</sup> Bearer paper does not specify a payee or is made out to cash. Transferring bearer paper does not require any endorsement. Notes that are payable to an identified person or entity can be transferred through endorsement, just as payees on checks can endorse checks and pass ownership on to another person or entity. And, like checks, notes can have multiple endorsements.

The private securitization market did not always insure that the owners of notes had actual possession of notes or that the notes had the required endorsements.<sup>53</sup> There

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<sup>51</sup> U.C.C. § 3-302(a).

Owners are not always able to 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 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 Dale Whitman, *How Negotiability has Fouled up the Secondary Mortgage Market, and What to do about It*, 37 PEPPERDINE LAW REVIEW 737, 759-61 (2010) (arguing that owners of notes cannot lose something they never possessed); U.C.C. § 3-309(a)(i).

<sup>52</sup> An instrument’s holder is the party in possession of bearer paper or the identified person in possession of an instrument made payable to an identified party. U.C.C. §§ 1-201(20), 3-109(b); UCC § 3-109(a). See, e.g. *SMS Fin. v. ABCO Homes*, 167 F.3d 235, 238-239 (5th Cir. 1999) (distinguishing between the holder and owner of a note); In re Governor’s Island, 39 B.R. 417, 421 (E.D.N.C. 1984) (“Peoples Bank has a properly perfected security interest in the PCA note, but Peoples Bank is not a “holder” of the note. The PCA note was not indorsed to Peoples Bank by Barbour, and without an indorsement there can be no negotiation.”).

<sup>53</sup> Dale Whitman, *How Negotiability has Fouled up the Secondary Mortgage Market, and What to do about It*, 37 PEPPERDINE LAW REVIEW 737, 757-58 (2010); see also Ariana Eunjung Cha, *B of A official: Countrywide mortgage documents were not*

are numerous instances where sellers of notes did not endorse the notes or the endorsements were not legally adequate to make the assignees actual holders of the notes. In some situations, people who endorsed notes did not have the proper authority. Courts have held that such infirmities in endorsements can preclude owners of notes from establishing holder status.<sup>54</sup>

b. Negotiable Instrument

In order for holder to qualify as a holder in due course of a home mortgage note, the note must be a negotiable instrument.<sup>55</sup> Because of the powerful protections that the holders

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*transferred properly to trust*, THE WASHINGTON POST (11/24/10) (documenting the failure of Countrywide Mortgage to transfer possession of notes to assignees).

<sup>54</sup> *Hays v. Bankers Trust Co. of California*, 46 F.Supp.2d 490 (S.D.W.V. 1999) (holding that a master servicer to whom a note was not endorsed is not a holder, and thus cannot be a holder in due course); *Crossland Savings Bank v. Constant*, 737 S.W.2d 19 (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 Federal Rule of Civil Procedure 17(a) or its state law counterparts), because lenders were unable to produce a properly endorsed note. *See In re Foreclosure Cases*, 521 F.Supp.2d 650 (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 U.S. Dist. LEXIS 84011, 2007 WL 3232430 (N.D. Ohio) (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); *Wells Fargo Bank, N.A. v. Byrd*, Case No. A0700643, Court of Common Pleas of Hamilton County, OH (Dec. 12, 2007) (same); *HSBC Bank v. Antrobus*, 2008 WL 2928553 (N.Y. Sup.), (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*, 2008 WL 2309006 (N.Y. Sup.) (dismissing plaintiff's foreclosure with prejudice where multiple assignments were made by the same person, who claimed to be acting as an agent of two mortgage companies on the same day without proof of an agency relationship).

of negotiable instruments receive, courts have limited the types of paper that qualify as such, which we discuss below.<sup>56</sup> 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.<sup>57</sup> A promise or order is conditional if it contains an express condition to payment, a statement that the loan is subject to another writing, or a statement that the rights or obligations with respect to the promise are stated in another writing.<sup>58</sup> Courts have interpreted the unconditional promise requirements 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.<sup>59</sup>

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<sup>55</sup> U.C.C. § 3-302(a) (holder means the holder of an instrument); U.C.C. § 3-104(b) (“Instrument” means a negotiable instrument”). In home loan transactions the instrument that must be negotiable is the promissory note, not the mortgage. *The Provident Bank v. Community Home Mortgage Group*, 498 F. Supp.2d 558, 564 (E.D.N.Y. 2007) (“The mortgage document creates a security interest in the real property, while the note or bond represents the debt that is secured by the mortgage.”).

<sup>56</sup> *See, e.g. Geiger Finance Company 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.]”).

<sup>57</sup> UCC §§ 3-104(a), 3-106; *see e.g. Nagel v. Cronebaugh*, 782 So.2d 436 (Fla. 5<sup>th</sup> DCA 2001) (ruling that a note that did not specify a fixed amount that was due was not a negotiable instrument).

<sup>58</sup> UCC § 3-106(a)(i)-(a)(iii); *Ried v. Pyle*, 51 P.3d 1064, 1067 (Colo. Ct. 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. § 3-10(b)(i). However, when notes go beyond a mere reference and incorporate the terms of another writing, such as incorporating by reference waivers,

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 destroy negotiability.<sup>60</sup> 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.<sup>61</sup> To the extent that courts hold that usury savings clauses are conditions on payment, the notes containing such clauses are not negotiable instruments and assignees of such notes will be unsuccessful asserting their HDC status.

ii. Additional Undertakings

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consents, and acknowledgements of the debtor, they are not negotiable instruments. *See, e.g. FFP Marketing v. Long Lane Master Trust IV*, 169 S.W.3d 402, 408-09 (Tex. Ct. 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").

<sup>59</sup> *In re APPONLINE.COM*, 285 B.R. 805, 816 (2002) ("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").

<sup>60</sup> Ronald J. Mann, *Searching for Negotiability in Payment and Credit Systems*, 44 UCLA L. Rev. 951, 976-77 (1997).

<sup>61</sup> The usury savings clauses in single-family Fannie Mae and Freddie Mac notes state:

If a law, which applies to this loan and which sets maximum loan charges, is finally interpreted so that the interest or other loan charges collected or to be collected in connection with this loan exceed the permitted limits, then: (a) any such loan charge shall be reduced by the amount necessary to reduce the charge to the permitted limit; and (b) any sums already collected from me which exceeded permitted limits will be refunded to me. The Note Holder may choose to make this refund by reducing the Principal I owe under this Note or by making a direct payment.

Negotiable instruments must not contain “any other undertaking or instruction by the person promising or ordering payment to do any act in addition to the payment of money.”<sup>62</sup> For example, in *Insurance Agency Managers v. Gonzales*,<sup>63</sup> a home improvement contractor sold a home improvement loan to a bank. Upon the borrower’s default, the bank claimed it was a holder in due course. The court disagreed and concluded that the promise to pay was conditional because, among other problematic provisions, the contract required the borrower to use the property securing the note only “for personal, family or household purposes.”<sup>64</sup> Likewise, courts have held that clauses requiring borrowers keep their property insured prevent notes from being negotiable.<sup>65</sup>

Another provision that could defeat the negotiability of mortgage notes requires borrowers to notify lenders, in writing, if they plan to prepay their loans.<sup>66</sup> Whether the prepayment notice requirement is an additional undertaking has yet to be tested in courts.

c. Taking in Good Faith and Without Notice

Holders of negotiable instruments must also prove that they took notes in good faith and without notice that the borrowers were behind on payments or that the notes were subject to any defenses in order to achieve HDC status. Good faith is defined as

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<sup>62</sup> UCC §§ 3-104(a).

<sup>63</sup> 578 S.W.2d 803 (Texas Ct. App., 1<sup>st</sup> Dist. 1979).

<sup>64</sup> *Id.* at 805.

<sup>65</sup> *P & K Marble, Inc v. La Paglia*, 147 A.D.2d 804, 805 (1989) (holding a note was not negotiable because it contained numerous promises not authorized by U.C.C. Article 3, such as to keep the mortgaged property insured).

<sup>66</sup> Ronald J. Mann, *Searching for Negotiability in Payment and Credit Systems*, 44 UCLA L. Rev. 951, 971-72 (1997); Dale Whitman, *How Negotiability has Fouled up the Secondary Mortgage Market, and What to do about It*, 37 PEPPERDINE LAW REVIEW 737, 749-50 (2010).

honesty in fact in the conduct or transaction concerned.<sup>67</sup> Lack of good faith can be difficult to prove, particularly in states that apply a subjective good faith standard.

Notice uses an objective standard and is defined as actual knowledge, receipt of notice or notification, or from all the facts and circumstances known to the owners at the time in question, there was reason to know the fact.<sup>68</sup> As we discuss below, a borrower's loan file, a close connection between the parties involved in the mortgage and financing, or agency relationships can put an assignee on notice.

i. Loan Files

Loan files can contain information that will put assignees on notice that a note is defective. In *Fairbanks Capital Corp. v. Summerall*,<sup>69</sup> an assignee brought a collection action against a borrower in default on a home mortgage note. Before the assignee

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<sup>67</sup> U.C.C. § 1-201(20). The 2001 revisions to the UCC changed the definition of good faith to honesty in fact and observance of reasonable commercial standards of fair dealing, but most states use the pre-2001 definition of good faith.

<sup>68</sup> UCC § 1-201(25). The definition of "notice" varies by jurisdiction. For instance, in *Wilson v. Toussie*, 260 F. Supp. 2d 530 (E.D.N.Y. 2003), 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 UCC's definition.

In recent testimony before the Financial Crisis Inquiry Commission, a former bank executive reported: "During 2006 and 2007 I witnessed many changes to the way the credit risk was being evaluated for these pools during the purchase process. These changes included the Wall Street Chief Risk Officer's reversing of large numbers of underwriting decisions on mortgage loans from "turn down" to "approved." And variances from accepted Citi credit policy were made. Subprime mortgage pools, many over \$300 million, were purchased even through the minimum credit-policy-required criteria was [sic] not met." SUBPRIME LENDING AND SECURITIZATION AND GOVERNMENT SPONSORED ENTERPRISES (GSES) BEFORE THE FIN. CRISIS INQUIRY COMM'N 111th Cong. 2 (2010) (statement of Richard M. Bowen, III, Former Senior Vice President and Business Chief Underwriter CitiMortgage Inc., at 2).

<sup>69</sup> 2003 WL 1700487 (Ohio App. 10 Dist.).

purchased the loan, the borrower's loan file included information that the borrower had defaulted and had defenses to payment.<sup>70</sup> In light of these facts, the court held that the assignee had notice and was not a holder in due course. Other courts have reached similar results when purchasers of loans have notice that a note is overdue or otherwise defective.<sup>71</sup>

ii. Close Connectedness Doctrine & Agency Relationships

Courts have also imputed knowledge when there is a close connection between an assignee and the seller of the loan.<sup>72</sup> In *England, et al. v. MG Investments, et al.*,<sup>73</sup> 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

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<sup>70</sup> 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. *Id.* at \*3.

<sup>71</sup> *First Union Nat'l Bank v. Curtis*, 2005 ME 108, 882 A.2d 796, 799 n.6 (2005) (holding that "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 v. Guy et al.*, 2008 WL 1903535 at \*2 (N.Y. Sup.) (stating in dicta "The court needs to know if WELLS FARGO performed due diligence in purchasing this nonperforming loan"); *HSBC Bank USA v. Yeasmin et al.*, 19 Misc. 3d 1127(A) at \*4 (N.Y. Sup. 2008) (stating in dicta "Lastly, the Court requires a satisfactory explanation from an officer of HSBC how, in the middle of our national subprime mortgage financial crisis, plaintiff HSBC purchased...a nonperforming loan."); *U.S. Bank, N.A. v. Videjus*, 19 Misc. 3d 1125(A) at \*4 (N.Y. Sup. 2008) (stating in dicta "the court requires an explanation from an officer of plaintiff U.S. Bank why...would plaintiff U.S. Bank purchase...a nonperforming loan").

<sup>72</sup> Elizabeth Renuart, THE COST OF CREDIT, § 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 LAW REVIEW 363, 416 (2002).

<sup>73</sup> 93 F. Supp. 2d 718 (S.D. W.V. 2000).

judgment on a fraud claim brought by the borrower. 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.”<sup>74</sup>

The close connectedness exception has greatest relevance to note owners who are arrangers. This is because arrangers are pipeline intermediaries who are actively involved with the lenders who originate loans. Some even belong to the same corporate family. Even where there is no corporate familial relationship, courts have denied HDC status to assignees that purchased loans from lenders immediately after origination at a substantial discount, and without investigating the credit quality of borrowers.<sup>75</sup> Courts have similarly denied HDC status when assignees exercise extensive control over the originator’s operations and act as the sole purchaser of the originator’s notes.<sup>76</sup>

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<sup>74</sup> 93 F. Supp. 2d 718, 723 (S.D. W.V. 2000). *See also Williams v. Central Money Co.*, 974 F.Supp 22, 26 (D.D.C. 1997) (denying an assignees motion to dismiss a fraud claim because an officer of the originator was alleged to be a principal and shareholder of the assignee, which raised an issue as to whether the originator had knowledge of the originator’s fraudulent conduct); *Rutter v. Troy Mortgage Servicing Co., et al.*, 145 Mich. App. 116, 124 (1985) (denying summary judgment on a consumer protection claim where the assignee was an officer of the assignor corporation). *LaChapelle v. Toyota Motor Credit Corp.*, 102 Cal.App.4th 97, 990 (2002) (holding “[The] assignee’s connection with the original. . . transaction is so close as to justify viewing the assignee as the original creditor”); *Price v. Franklin Investment Co., Inc.* 574 F.2d 594, 599-602 (D.C. Cir. 1978) (holding 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 for TILA violations on the grounds that the originator was acting as a conduit for the assignee).

<sup>75</sup> *Greene v. Gibraltar*, 488 F. Supp 177, 180-81 (D.D.C. 1980).

<sup>76</sup> *Unico v. Owen*, 232 A2d 405, 412-13 (N.J. Sup. Ct. 1967).

At times, courts have imputed notice of defects to assignees because of agency relationships between assignors and assignees. Courts have so ruled when a single signatory acted for both the assignor and assignee, a practice that was not uncommon prior to the financial crisis.<sup>77</sup> Similarly, in *First Union Nat. Bank v. Curtis*<sup>78</sup> the court denied HDC status to an assignee because the originator and assignee utilized the same third-party loan servicer, which had notice that a loan was delinquent at the time of the sale of the loan. The court reasoned that the servicer acted as a common agent for the assignor and assignee, and thus, the assignee had actual or constructive knowledge of the delinquency.<sup>79</sup> Although the Supreme Judicial Court of Maine vacated the trial court's

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<sup>77</sup> See, e.g. *Wells Fargo Bank, N.A. v. Farmer et al.*, 2008 WL 2309006 at \*1 (N.Y. Sup. 2008) (stating in dicta “While 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*, 2008 WL 4764816 at \*2 (N.Y. Sup. 2008) (stating in dicta “The 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 National Trust Company v. Maraj*, 18 Misc. 3d 1123(A), 2008 WL 253926 at\*1 (N.Y. Sup. 2008) (stating in dicta “The 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”).

<sup>78</sup> 2004 WL 2153521, *vacated on other grounds in* 2005 ME 108 (2005).

<sup>79</sup> *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].”); See also *Pulphus v. Sullivan*, 2003 WL 1964333 (N.D. Ill. April 28, 2003) (holding that where contracts between assignors and assignees required the assignors to seek approval before using any agents, the assignors could be deemed agents of the assignee, in which case the assignees could be liable for fraud by the assignors’ agents); *but see Rosemond, et al. v. Campbell, et al.*, 288 S.E.2d 641, 644 (S.C. App. 1986) (holding that even though assignee was a principal in assignor’s business, when the assignor made misrepresentations to the borrower, he was not acting as an agent of the assignee).

judgment on other grounds, the Court noted that First Union had purchased an overdue note with knowledge that it was overdue.<sup>80</sup>

iii. Post- Ownership Notice

The recent and ongoing foreclosure crisis has highlighted a potentially critical problem related to notice. As we discussed earlier, in the flurry of securitizations, originators of loans did not always deliver borrowers' notes to the new owners and did not always endorse the loans. Without possession of the notes and the endorsements necessary to establish a valid chain of ownership, owners of notes do not have the right to foreclose.<sup>81</sup> Oftentimes, the owners don't correct the deficiencies until *after* borrowers have defaulted and they are preparing to foreclose.<sup>82</sup> This means that at the time the owners become 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 any foreclosure or collection actions the holders bring.

d. Takes in the ordinary course of business

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<sup>80</sup> *First Union Nat'l Bank v. Curtis*, 2004 WL 2153521 at \*4, n.6.

<sup>81</sup> This is not to say that foreclosing entities comply with these requirements. In judicial foreclosure states, many foreclosures are essentially administrative without any meaningful judicial review of the paperwork because foreclosures are typically the result of default judgments. In states that do not have a judicial foreclosure process, the only way borrowers can raise issues of standing to foreclose is by filing a complaint seeking an injunction to stop the foreclosure, or by challenging the foreclosure action in bankruptcy court. Thus, there are few incentives for owners of notes to comply with the letter of the law. Dale Whitman, *How Negotiability has Fouled up the Secondary Mortgage Market, and What to do about It*, 37 PEPPERDINE LAW REVIEW 737, 762-63 (2010); see also Gretchen Morgenson, *How One Borrower Beat the Foreclosure Machine*, THE NEW YORK TIMES (July 27, 2008) (documenting a borrower's successful effort to defeat a foreclosure action based on flawed documentation).

<sup>82</sup> Ariana Eunjung Cha, *B of A official: Countrywide mortgage documents were not transferred properly to trust*, THE WASHINGTON POST (11/24/10).

In order for a holder of a negotiable instrument taken in good faith and without notice to acquire rights as a holder in due course, the holder must also purchase the note in the ordinary course of business. The protections of an 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.<sup>83</sup> The bulk sale exception has become more relevant because of the wave of insolvencies and bankruptcies among loan originators and assignees, and the resulting acquisitions and mergers of mortgage divisions. If a seller of loans is insolvent or the seller is seeking to liquidate a substantial portion of loans that it would normally hold, HDC status might not attach to protect assignees.<sup>84</sup> Likewise, in most circumstances the merger of

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<sup>83</sup> UCC § 3-302(c) (emphasis added). In *Diversified Loan Service Co. v. Diversified Loan Service Co.* 181 W.Va. 320 (1989), Diversified purchased several home mortgage notes from the bankrupt estate of a Savings and Loan company. When Diversified attempted to enforce the notes, the note makers claimed defenses of usury, failure of consideration, and fraud. The court denied Diversified holder in due course 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 by purchase of it at a judicial sale or by taking under legal process.” *Id.* at 323.

<sup>84</sup> UCC § 3-302 cmt. 5. The Comments give a few examples of bulk purchases outside the ordinary course of business:

For example, it applies to the purchase by one bank of a substantial part of the paper held by another bank which is threatened with insolvency and seeking to liquidate assets. Subsection (c) would also apply when a new partnership takes over for value all of the assets of an old one after a new member has entered the firm, or to a reorganized or consolidated corporation taking over the assets of a predecessor.

Courts have held that in order for the bulk purchase exception to block HDC status, the assignee must purchase a *substantial* portion of the notes held by the failing institution. See *Schwegmann Bank & Trust Co. of Jefferson v. Simmons*, 880 F.2d 838, 844. (5<sup>th</sup> Cir. 1989) (holding that the acquisition of less than 10 percent of the portfolio of an institution threatened with insolvency is not a substantial portion). Moreover, if the seller remains viable after the purchase the bulk purchase exception will not attach. See *First Alabama*

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.<sup>85</sup>

When the Federal Deposit Insurance Corporation (FDIC) arranges bulk acquisitions of failing institutions or their assets through purchase or assumption, unique holder in due course 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 the purchaser does not have time to investigate the quality of the assets 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.<sup>86</sup> In 1982, the

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*Bank of Guntersville v. Hunt*, 402 So. 2d 992, 994 (Ala. Civ. App. 1981) (holding 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).

<sup>85</sup> See *Rosa v. Colonial Bank*, 542 A.2d 1112, 1115 (1988). (“Several cases have held that a bank does not become a holder in due course when it purchases a substantial part of the paper held by another bank, which is threatened with insolvency and seeking to liquidate its assets...We conclude 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 v. Avrutick*, 740 F.Supp 222, 235 (US Dist. Court N.D. NY 1990) (holding a bank acquiring notes through a merger could still exercise the rights of a holder in due course by virtue of the shelter rule).

<sup>86</sup> Courts are split on whether the FDIC can be a holder in due course when it acts as a receiver for a failed institution. See, e.g. *In Re 604 Columbus Avenue Realty Trust*, 968 F.2d 1332, 1349 (1st Cir. 1992) (holding that holder in due course status does not attach when the FDIC is a receiver); *FDIC v. Laguarda*, 939 F.2d 1231, 1239 n.19 (5th Cir. 1991) (same); *Campbell Leasing, Inc. v. FDIC*, 901 F.2d 1244, 1249 (5th Cir. 1990) (holding that holder in due course protection 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 holder in due course status is appropriate for Federal Savings and Loan Insurance Corporation as receiver).

11th Circuit held that the FDIC cannot become a holder in due course when the low-quality asset put is exercised, because they are bulk purchases not in the ordinary course of business. Nonetheless the court extended complete protection to the FDIC from state and common law fraud claims under a federal common-law rule so long as the FDIC acquires the notes through a purchase and assumption transaction, for value, and in good faith.<sup>87</sup>

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 have actual or imputed knowledge that a loan is

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<sup>87</sup> See e.g. *Gunter v. Hutcheson*, 674 F.2d 862, 872-73 (11<sup>th</sup> Cir. 1982) (justifying the rule on the grounds that the FDIC would not be able to determine whether a liquidation or assumption and purchase would result in a greater loss to the FIDC without access to legal protection from borrower claims. In the absence of such protection, the court claimed no assets held by the failing depository institution could be properly valued).

Over time, federal courts developed a federal HDC rule that applied to the FDIC, See, e.g. *FDIC v. Wood*, 758 F.2d 156, 161 (6<sup>th</sup> Cir. 1985) (holding “that when 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’Melviny v. FDIC*, in which the Supreme Court held “there is no federal general common law.” 512 U.S. 79, 83 (1994). In dicta, the Court explained that there are already extensive statutory protections for the FDIC as a receiver, and that additional common law rules would not supplement the scheme, it would alter it. Since *O’Melviny*, some courts have held that the FDIC’s status as a holder in due course is subject to state HDC law. *DiVall Insured Income Fund v. Boatman’s First Nat’l Bank of Kansas City*, 69 F.3d 1398, 1403 (holding “the holder in due course issue must be decided under state law.”); *Calaska Partners v. Corson*, 672 A.2d 1099, 1103-04 (Me. 1996) (same).

defective. The “shelter rule”<sup>88</sup> provides that an assignee has the rights of a holder in due course so long as the entity from which it purchased the note was a holder in due course, and the subsequent assignee did not engage in any illegal acts affecting the instrument. 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 even if the assignee knew of defects or defenses to payment, so long as the assignee did not actively participate in creating the defects or defenses to payment. Because the assignee is only “sheltered” if the seller had HDC status, it is unclear how often this rule will apply.

#### B. Statutory Claims

Thus far, we have focused on derivative common law claims that borrowers might be able to pursue against owners of their notes. We now turn to derivative statutory liability. Under several different state and federal statutes, borrowers can bring affirmative or defensive claims 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 holds creates assignee liability for loans used to pay for consumer goods or services. States have adopted analogue laws. Other laws, like the federal Truth in Lending Act (TILA), allow borrowers to exercise rights of rescission against the owners of their notes. In this section of the article, we describe these various laws, their complex interactions with each other and other laws, and the implications they have for arrangers that own whole loans and the trusts that issued subprime mortgage-backed securities.

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<sup>88</sup> U.C.C. § 3-203(b).

## 1. Truth in Lending Act

The Truth in Lending Act<sup>89</sup> requires specific disclosures to borrowers in consumer credit transactions. TILA and the rules written pursuant to TILA 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 before the borrower has to pay any fees] any mortgage loan secured by a consumer's principal dwelling.”<sup>90</sup>

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.<sup>91</sup> TILA contains a complex

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<sup>89</sup> 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. The FRB has amended Reg. Z and published Official Board Interpretations of Reg Z in response to uncertainties that arose in the law and regulations. Elizabeth Renuart & Kathleen Keest, TRUTH IN LENDING 13-14 (6th ed. 2007).

The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, sec. 1413 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 into a more expensive loan product.

<sup>90</sup> 15 U.S.C. § 1638(b)(1)and(2); 12 C.F.R. §§ 226.17(c)(2), 226.19(a)(1).

<sup>91</sup> For full treatment of TILA, including the rules governing open-ended credit, *see* Elizabeth Renuart & Kathleen Keest, TRUTH IN LENDING (6th ed. 2007); Patricia A. McCoy, *Rethinking Disclosure in a World of Risk-Based Pricing*, 44 HARV. J. ON LEGIS. 123 (2007).

For fixed rate, closed-end loans, TILA requires lenders to disclose the amount financed (the principal), the total finance charge, and the cost of credit calculated as an annual percentage rate. Elizabeth Renuart, STOP PREDATORY LENDING 85-86 (2002). Lenders must also provide borrowers with a statement of all charges included in the finance charge. This includes amounts to be disbursed to the consumer and third parties. Other requirements include notifying the consumer of the payment schedule, the total number of payments, and any security interests. *Id.* at 87-90. All TILA disclosures must

remedial scheme. For violations of TILA's disclosure rules, consumers can recover statutory damages of twice the finance charge.<sup>92</sup> Actual damages are available for any TILA violation, but only if borrowers can prove that they relied to their detriment on the erroneous disclosure.<sup>93</sup> Borrowers, whether they seek statutory or actual damages are entitled to attorney's fees and costs.<sup>94</sup> TILA's statute of limitations is one year from the date the loan was originated for affirmative claims, but the statute of limitations does not apply to counterclaims for set-off or recoupment in response to collection or foreclosure actions.<sup>95</sup> Successful plaintiffs can have their debt reduced by the amount of their TILA damages.<sup>96</sup>

TILA also provides a right of rescission. With some restrictions,<sup>97</sup> 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

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be "conspicuously separated from other terms, data or information provided in connection with the transaction." 15 U.S.C. § 1632(a).

For ARMs, consumers must also receive a brochure, before paying an application fee, explaining both ARMs generally and the particular products the consumers are considering. TILA also requires lenders to disclose the loan's maximum interest rate and to provide borrowers with advanced notice every time the interest rate is going to change. Elizabeth Renuart & Kathleen Keest, *TRUTH IN LENDING* 91 (6th ed. 2007).

<sup>92</sup> 15 U.S.C. § 1640(a)(2)(i).

<sup>93</sup> Elizabeth Renuart & Kathleen Keest, *TRUTH IN LENDING* 577-78 (6th ed. 2007).

<sup>94</sup> Elizabeth Renuart, *STOP PREDATORY LENDING* 97 (2002).

<sup>95</sup> 15 U.S.C. §1640(e).

<sup>96</sup> Elizabeth Renuart & Kathleen Keest, *TRUTH IN LENDING* 489 (6th ed. 2007).

<sup>97</sup> For example, rescission rights do not apply to purchase money mortgages. Elizabeth Renuart, *STOP PREDATORY LENDING* 100 (2002).

means that borrowers who did not receive TILA disclosures at origination have up to three years to exercise their rescission rights.<sup>98</sup>

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.”<sup>99</sup> Second, if the TILA disclosures were incomplete or contained errors the borrower can rescind the loan within three years after the loan 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.<sup>100</sup> 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 borrower must tender the proceeds of the loan less any damages.<sup>101</sup>

## 2. Home Ownership and Equity Protection Act (HOEPA)

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<sup>98</sup> *Id.*

<sup>99</sup> 15 U.S.C. § 1641(a).

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. South Holland Dodge*, 755 N.E.2d. 462, 469 (Ill. 2001); *see also Knapp v. Americredit Financial Services, Inc.*, 245 F.Supp. 2d 841, 848 (S.D. W.Virg. 2003) (holding that assignees, who know that a creditor’s practices violate TILA, are not liable for TILA violations so long as they reviewed the loan documents for evidence of irregularities).

<sup>100</sup> 15 U.S.C. § 1641(c).

<sup>101</sup> 15 U.S.C. § 1635(a) – (i).

The Home Ownership and Equity Protection Act (HOEPA)<sup>102</sup> amended TILA to require special disclosures three days before closing and to prohibit various loan terms in high-cost loans.<sup>103</sup> HOEPA only applies to closed-end consumer credit transactions secured by the borrowers' principal residence.<sup>104</sup> The statute does not apply to purchase money or construction loans.<sup>105</sup> In addition, only loans that meet specific interest rate and points and fees "triggers" are subject to HOEPA.<sup>106</sup>

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<sup>102</sup> 15 U.S.C. § 1639(a) – (l).

<sup>103</sup> HOEPA's disclosure provisions require lenders to disclose the APR, the dollar amount of the periodic payments, the size of any balloon payments, the amount borrowed, and any charges for optional credit insurance or debt-cancellation coverage. 15 U.S.C. § 1639(a); 12 C.F.R. § 226.32(c)(2), (3), (5). For ARMs, the lender must state the regular monthly payment and the monthly payment at the highest possible interest rate. In addition, lenders must provide written notification to borrowers that borrowers "are not required to complete [the loan] merely because [they] received [] disclosures or [] signed a loan application." 15 U.S.C. § 1639(a)(1)(A); Reg. Z, § 226.32(c)(1). They must also warn borrowers that they could lose their homes and any money they put into their homes if they default. 15 U.S.C. § 1639(a)(1)(B); Reg. Z, § 226.32(c)(1).

When adjustable-rate mortgages fall under HOEPA, lenders must disclose that the interest rate and monthly payment could increase. HOEPA also prohibits certain loan terms. HOEPA-governed loans cannot: (1) include terms allowing owners of loans to increase the interest rate upon default; (2) contain balloon payments in loans with terms shorter than five years; or (3) provide for negative amortization. 15 U.S.C. §§ 1639(d), (e) and (f). It is also a violation to make a loan that contains a prepayment penalty in certain situations. 15 U.S.C. § 1639(c). As of October 1, 2009, HOEPA prohibits lenders from making loans based solely on borrowers' equity in their homes.

<sup>104</sup> 15 U.S.C. § 1602(a)(a)(1). Open-ended loans are covered under HOEPA if they were designed to avoid HOEPA's triggers. For instance, when a home equity line of credit is fully extended at origination, courts have held that the home equity line of credit is still a "covered" loan.

<sup>105</sup> 15 U.S.C. § 1602(w).

<sup>106</sup> 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). HOEPA's points and fees trigger is loans with points and fees that exceed either 8% of the total loan amount or an

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 for affirmative claims, but no limit on defensive claims.<sup>107</sup> 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.<sup>108</sup> Unlike TILA claims, borrowers do not have to prove that

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annually adjusted amount based on the Consumer Price Index. As of January 1, 2011, this figure was \$592. 12 C.F.R. § 226.32(a)(1)(ii); *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 the regulations is a new class of regulated loans called higher-priced loans that have lower triggers than HOEPA loans.

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. The regulations also eliminate a former requirement in HOEPA that borrowers prove a “pattern and practice” of equity-based lending.

Assignees are not liable for damages for violations of provisions governing higher-priced loans although failure to comply with prepayment penalty restrictions on higher-priced loans can trigger rescission. Federal Reserve System, *Final Rule, Truth in Lending*, 73 FED. REG. 44522 (July 30, 2008); *see also* Elizabeth Renuart, TRUTH IN LENDING 108-100 (2008 Supp.) (detailing the higher-priced loans regulations).

<sup>107</sup> 15 U.S.C. § 1640(e).

<sup>108</sup> 15 U.S.C. § 1641(d)(1). The statute does not define the contours 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 Mort. Co.*, 231 F. Supp. 2d 737, 746 (N.D. Ill. 2002) (holding that, in evaluating whether 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”).

HOEPA violations are apparent on the face of the documents.<sup>109</sup> 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.”<sup>110</sup> Any violations of HOEPA are deemed material for the purpose of triggering the right of rescission under TILA.<sup>111</sup>

HOEPA also allows borrowers with loans subject to HOEPA to bring all claims and defenses against assignees “that [they] could . . . raise[ ] against the original lender.”<sup>112</sup> This means that borrowers with HOEPA loans can bring claims under common law theories and statutes other than TILA and HOEPA based on wrongdoing by loan originators. For these non-TILA claims, borrowers can recover the outstanding balance due plus the total amount they already paid less any amount they recovered on any TILA claims.<sup>113</sup>

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

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<sup>109</sup> *In re Murray*, 239 B.R. 728, 733 (Bankr. E.D. Penns. 1999).

<sup>110</sup> 15 U.S.C. § 1640(a) (2008) and 15 U.S.C. § 1641(d)(2)(A) (1994). Materiality is a common law standard, not TILA materiality, and the burden is on the assignee to prove that the violation is not material. Elizabeth Renuart, *THE COST OF CREDIT*, 231 n.313 (Supp. 2008). These remedies are not available in claims against involuntary assignees. 15 U.S.C. § 1641(a).

<sup>111</sup> 15 U.S.C. §§ 1602(u) (2008), 1639(j) (2009).

<sup>112</sup> Federal Reserve System, *Final Rule, Truth in Lending*, 66 FED. REG. 65612 (December 20, 2001) (clarifying that the term “claims and defenses” encompasses non-TILA claims and defenses).

<sup>113</sup> 15 U.S.C. §1641(d)(2), (3).

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.<sup>114</sup> 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.<sup>115</sup> In so ruling, the Court held that the borrowers had the "affirmative right to assert claims against [the assignee] based solely on [the originator's] independent and allegedly unlawful conduct in connection with the issuance of plaintiff's loans."<sup>116</sup> 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*,<sup>117</sup> the presenting issue was whether the borrowers' loan was covered by HOEPA. The court held that there was sufficient evidence for a jury to find that the loan was subject to HOEPA. In so holding, the court allowed the borrowers to pursue affirmative claims against the assignee under the West Virginia's Consumer Credit and Protection Act, which prohibited unfair and deceptive acts in the "conduct of . . . trade or commerce."<sup>118</sup>

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<sup>114</sup> Barbara S. Mishkin & Kevin M. Toth, *Assignee Liability: How far does it extend?* 5 CONSUMER FIN. SERVS. REP. 19 (April 10, 2002).

<sup>115</sup> 197 F. Supp. 2d 1357, 1364-5 (N.D. Ga. 2002); *see also Pulpfus v. Sullivan*, 2003 WL 1964333, at \*21 (N.D. Ill. Apr. 28, 2003) (stating in dicta that the court in *Bryant* took the correct approach).

<sup>116</sup> 197 F. Supp. 2d 1357, 1365 (N.D. Ga. 2002).

<sup>117</sup> 401 F. Supp. 2d 549 (S.D. W.V. 2005).

<sup>118</sup> 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.*

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 will refuse to extend assignees’ liability beyond the limits imposed by the particular law. For example, in *In Re Barber*,<sup>119</sup> the court dismissed plaintiff’s Equal Credit Opportunity Act 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.” In so holding, the court stated:

[i]n 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

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*Group*, 2005 WL 818619, at \*5 (D.D.C. April 7, 2005) (stating that “[o]rdinarily, 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) (in discussing the viability of plaintiffs’ claims against assignee under the Illinois Interest Act, reciting 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*, 2000 WL 1643589, at \*1 (N.D. Ill. Oct. 20, 2000) (allowing a common law fraud claim against the assignee of a HOEPA loan); *see also Schwartz v. Bann-Mar Corp.*, 197 S.W. 3<sup>rd</sup> 168, 179 (2006) (allowing plaintiffs to go forward with consumer protection claim against assignees of HOEPA loans regardless of arguably contradictory state law provisions).

<sup>119</sup> 266 B.R. 309, 321 (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) (in dicta, stating 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. The Loan Store*, 2005 WL 2420389, at \*8-9 (N.D. Ill.) (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.*, 2002 WL 745851, at \*2 (N.D. Ill.) (same).

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 controlled or nullified by a general one, regardless of the priority of enactment.’<sup>120</sup>

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.<sup>121</sup>

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*,<sup>122</sup> 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.”<sup>123</sup> The Heath Court also held that the debtor could

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<sup>120</sup> *In re Barber*, 266 B.R. 309, 321 (E.D. Pa. 2001), quoting *In re Sullivan*, 254 B.R. 661, 666 (Bankr. N.J. 2000).

<sup>121</sup> 266 B.R. 309, 320 (E.D. Pa. 2001); *see also Cazares v. Pacific Shore Funding*, 2006 WL 149106, at \*8 (C.D. Cal. Jan. 3, 2006) (in a claim involving a HOEPA loan, noting that the defendants failed to “provide[] authority that [California’s Unfair Competition Law] precludes assignee liability as a matter of law”); *Harvey v. EMC Mortg. Corp.*, 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 loan because “[u]nlike ECOA, RESPA does not expressly discuss claims against assignees”).

<sup>122</sup> 2001 WL 1771825 (Ill. Cir. Ct. Oct. 26, 2001).

<sup>123</sup> *Id.* at \*3.

not maintain a claim under the state UDAP statute because the statute only permitted recovery against perpetrators.<sup>124</sup>

### 3. State Anti-Predatory Lending Laws

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.<sup>125</sup> 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, e.g. have longer statutes of limitation, toward borrowers if they are defending foreclosure or collection actions by assignees than if they are bringing affirmative claims against assignees.<sup>126</sup>

When states enacted APLs, some protested that the new laws “could throw a monkey wrench into both the MBS and subprime housing markets,” by making arrangers and trusts legally liable for loans that violated the state statutes.<sup>127</sup> In fact, when Georgia passed an APL that subjected assignees to uncapped liability for originators’ misdeeds,

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<sup>124</sup> *Id.* at \*2.

<sup>125</sup> Kathleen C. Engel and Patricia A. McCoy, *Turning a Blind Eye: Wall Street Finance of Predatory Lending* 75 *FORDHAM LAW REVIEW* 2039, 2091-93 (2007).

<sup>126</sup> *Id.* at 2091-9

<sup>127</sup> Bill Shepherd, *Perils and Phantasms*, 69 *INVESTMENT DEALERS’ DIGEST* 26 (February 3, 2003).

the rating agencies 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<sup>128</sup>

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") in 1975 that effectively bans the holder in due course defense in consumer credit contracts for the sale of goods or services and permits both affirmative and defensive actions against owners of notes.<sup>129</sup> Because the FTC Rule applies only to the sale of goods or services, most mortgage loans are not subject to the Rule. The exceptions are loans made in connection with home repairs or goods and services, and manufactured housing.

The Rule states that it is an unfair or deceptive trade practice under the Federal Trade Commission Act<sup>130</sup> to take or receive a consumer credit contract that fails to

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<sup>128</sup> For a comprehensive discussion of the FTC Rule, see Carolyn L. Carter & Jonathan Sheldon, UNFAIR AND DECEPTIVE ACTS AND PRACTICES 650-76 (7th ed. 2008); Eugene J. Kelley, John L. Ropiequet, and Georgia Logotheitis, *Assignee Liability: Through the Minefield*, 61 CONSUMER FINANCE LAW QUARTERLY REPORT 279 (2007).

<sup>129</sup> 16 C.F.R. § 433.2 (2001). If the consumer obtains financing directly and not through the seller of goods, the FTC Rule does not apply. Carolyn L. Carter & Jonathan Sheldon, UNFAIR AND DECEPTIVE ACTS AND PRACTICES 686 (7th e d. 2008).

<sup>130</sup> 15 U.S.C. §§ 41-58

include a notice that assignees take it “subject to the consumer’s claims and defenses.”<sup>131</sup>

Sellers who finance transactions must include this notice. Similarly, if a seller refers a borrower to a lender or is affiliated with a lender that provides the financing, the seller must include the Notice in the sales contract.<sup>132</sup>

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.<sup>133</sup> 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, consumers who prove their claims have the right to have their remaining debt extinguished and to recover damages up to the original amount of the loan. This cap applies to all claims under state or federal law brought pursuant to the FTC Rule.<sup>134</sup> Some courts further restrict a consumer’s remedies if the damages exceed

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<sup>131</sup> 16 C.F.R. § 433.2 (1986); *see also* Elizabeth Renuart, THE COST OF CREDIT, 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 Services, 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); *see also* Elizabeth Renuart, THE COST OF CREDIT, 489-90.

<sup>132</sup> 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 (Summer 2006).

<sup>133</sup> 41 FED. REG. 20023-24 (May 14, 1976).

<sup>134</sup> 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

the amount of the outstanding debt. These courts rely on the FTC's 1975 Statement of Basis and Purpose for the Rule to require that the creditor's breach be substantial and that the consumer received nothing of value in the transaction in order to recover monies already paid.<sup>135</sup> This view is not uniform across courts and more recent FTC Staff Commentary disavows this interpretation.<sup>136</sup>

Courts also disagree about how to resolve conflicts between the FTC Rule and state law claims brought pursuant to the Rule. Similar to court disagreements about the reach of HOEPA, this issue arises when a borrower pursues a claim against an assignee based on the actions of a seller of the goods or services, even though the borrower could not have asserted the claim against the assignee because, for example, the law requires

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FTC Rule. Carolyn L. Carter & Jonathan Sheldon, *UNFAIR AND DECEPTIVE ACTS AND PRACTICES* 668 (7th ed. 2008).

The remedies construct under this Rule has caused some confusion. The simplest way to understand it is that “the consumer’s maximum recovery . . . is cancellation of all remaining indebtedness plus an affirmative recovery of the amount already paid in on the debt.” *Id.*

<sup>135</sup> 40 Fed. Reg. 53524, 53527 (Nov. 18, 1975); *See, e.g., Ford Motor Co. v. Morgan*, 536 N.E.2d 587 (Mass. 1989); *see also Irby-Greene v. M.O.R., Inc.*, 79 F. Supp. 2d 630, 635-36 (E.D. Va. 2000) (stating that “most courts have concluded that the primary purpose of the [FTC Rule] is to provide a defense to claims brought by the creditor; any affirmative use of the clause has generally been limited to the rare situation when the seller’s breach renders the transaction practically worthless to the consumer”); *Herrera v. North & Kimball Group, Inc.*, 2002 WL 253019, at \*5 (N.D. Ill. Feb. 20, 2002) (refusing to consider liability of the assignee under the FTC Rule where “the complaint lack[ed] any allegation that [the originator’s] conduct warrant[ed] complete rescission of the contract”).

<sup>136</sup> Carolyn L. Carter & Jonathan Sheldon, *UNFAIR AND DECEPTIVE ACTS AND PRACTICES* 661-63 (7th ed. 2008); *see, e.g., Beemus v. Interstate Nat’l Dealer Servs., Inc.*, 823 A.2d 979 (Pa. Super. Ct. 2003) (quoting the FTC staff commentary).

some level of participation that was absent.<sup>137</sup> This was the situation in *Nations Credit v. Pheanis*.<sup>138</sup> The assignee of a contract to finance the purchase of a mobile home brought suit for non-payment against the plaintiff who was obliged on the loan. The plaintiff 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 plaintiff'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.*,<sup>139</sup> 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.<sup>140</sup>

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 were not apparent on the face of the loan documents. 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

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<sup>137</sup> Carolyn L. Carter & Jonathan Sheldon, *UNFAIR AND DECEPTIVE ACTS AND PRACTICES* 658 (7th ed. 2008).

<sup>138</sup> 656 N.E.2d 998 (Ohio App. 1995).

<sup>139</sup> 175 F.3d 640 (8th Cir. 1990).

<sup>140</sup> *Id.* at 644; see also *Herrera v. North & Kimball Group, Inc.*, 2002 WL 253019, at \*4-5 (N.D. Ill. Feb. 20, 2002) (holding that consumers could not obtain relief against assignee under the Illinois Consumer Fraud Act where the contract included the FTC notice because, in part, the assignee did not "participate" in making the loan as required under the Consumer Fraud Act).

Rule cannot be used to “side step” TILA’s limits on assignee liability.<sup>141</sup> Courts have reached the same result when applying state law analogues to the FTC Rule, holding that the assignee liability provisions of TILA preempt the broad assignee liability in state rules.<sup>142</sup>

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 deceptive trade 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 in *Jackson v. South Holland Dodge*<sup>143</sup> held 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 adequacy 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

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<sup>141</sup> See, e.g., *Taylor v. Quality Hyundai, Inc.*, 150 F.3d 689 (7th Cir. 1998). See also Eugene J. Kelley, Jr. and 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 unwillingness of courts to hold that the FTC Rule trumps limitations on assignee liability under the Truth in Lending Act).

<sup>142</sup> *Alexiou v. Brad Benson Mitsubishi*, 127 F. Supp. 2d 557, 565 (D.N.J. 2000); see also *Vickers v. Interstate Dodge*, 882 So.2d 1236, 1241 (La. App. 2004) (same); see also Eugene J. Kelley, John L. Ropiequet, and Georgia Logothetis, *Assignee Liability: Through the Minefield*, 61 CONSUMER FINANCE LAW QUARTERLY REPORT 279, 283-4 (2007) (describing the intersection of TILA and the FTC Rule).

<sup>143</sup> 755 N.E.2d. 462, 468-70 (Ill 2001).

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* does become the dominate 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.<sup>144</sup> For example, in the *Nations Credit* case,<sup>145</sup> 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 permit. Imposing liability under the FTC Rule in situations like this would not run afoul of TILA preemption.<sup>146</sup>

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

The parties involved in securitizations were cognizant that investors could lose if borrowers successfully raised claims under contract or tort law, TILA, HOEPA, the FTC Rule and state anti-predatory lending laws.<sup>147</sup> To assuage these concerns about legal liability, securitization deals were structured to protect investors from the risk of borrower claims.<sup>148</sup> The terms of the deals typically required originators: (1) to provide

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<sup>144</sup> Carolyn L. Carter & Jonathan Sheldon, UNFAIR AND DECEPTIVE ACTS AND PRACTICES 665 (7th ed. 2008).

<sup>145</sup> 656 N.E.2d 998 (Ohio App. 1995)

<sup>146</sup> Carolyn L. Carter & Jonathan Sheldon, UNFAIR AND DECEPTIVE ACTS AND PRACTICES 665-66 (7th ed. 2008).

<sup>147</sup> Michael Gregory, *The Predatory Lending Fracas: Wall Street Comes under Scrutiny in the Subprime Market as Liquidity Suffers and Regulation Looms*, INVESTMENT DEALERS DIGEST (June 26, 2000).

<sup>148</sup> See, e.g. Standard & Poor's (S&P), HIGH-COST MORTGAGE LOANS: STANDARD & POOR'S APPROACH (August 16, 2001) (discussing steps taken in subprime securitizations).

representations and warranties (“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 substitute the offending loans with loans that were not covered by laws that permitted assignee liability.<sup>149</sup> The

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In addition, there was little concern that consumers would bring lawsuits that would have an impact on securitization trusts. Keith Wofford, *Predatory Lending and Home Equity Securitizations*, MOODY’S INVESTMENT SERVICE (April 28, 2000). Over time, the ratings agencies began requiring increased credit enhancements for state anti-predatory lending laws that had terms that made it difficult to quantify potential damages. S& P, STANDARD AND POOR’S CLARIFIES CREDIT RISK POSED BY ANTI-PREDATORY LENDING LAWS (May 13, 2004)

<sup>149</sup> The following language 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.

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 the 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.<sup>150</sup> From investors' perspective, small numbers of loans that violated the reps and warranties were not a significant problem because they could shed the loans, if needed, by exercising their recourse rights. What they didn't appear to appreciate was the possibility that when faced with large number of putbacks, 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.

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

Securitization deals also often included provisions requiring that lenders buy back loans that defaulted within the first few months of origination. Vikas Bajaj, *A Cross-Country Blame Game*, THE NEW YORK TIMES (May 8, 2007).

<sup>150</sup> Michael Gregory, *The Predatory Lending Fracas: Wall Street Comes under Scrutiny in the Subprime Market as Liquidity Suffers and Regulation Looms*, INVESTMENT DEALERS DIGEST (June 26, 2000).

The attorney for Firstplus explained that the loan purchasers were “relying on reps and warranties . . . but [they don’t] protect the buyer if the seller goes bankrupt.”<sup>151</sup>

U.S. 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 escalated further.<sup>152</sup> A former executive at a subprime lender described the subprime industry as choking “on the volume of loans put back to them.”<sup>153</sup> In response, lenders claimed they did not have the money to buy back loans and many sought bankruptcy protection.<sup>154</sup> A startling

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<sup>151</sup> Erick Bergquist, *Guess What? Loan Buyers Liable under Federal Law*, AMERICAN BANKER (May 7, 2004)

<sup>152</sup> Vikas Bajaj and Christine Haughney, *Tremors at the Door: More People with Weak Credit are Defaulting on Mortgages*, NEW YORK TIMES (Jan. 26, 2007).

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?* NEW YORK TIMES (January 22, 2008); *see also The B & C Meltdown: It’s ALL About Capital*, MORTGAGE LINE (March 14, 2007) (describing Wall Street’s efforts to get subprime lenders to 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. Ruth Simon, *Investors Press Lenders on Bad Loans*, WALL STREET JOURNAL (May 28, 2008); Vikas Bajaj, *A Cross-Country Blame Game*, NEW YORK TIMES (May 8, 2007). Regardless of the reason leading to the demand, if the originators have gone under there is no entity against which investors can exercise recourse. Michael Gregory, *The Predatory Lending Fracas*, INVESTMENT DEALERS DIGEST (June 26, 2000).

<sup>153</sup> Zachary Goldfarb and Alec Klein, *The Bubble: How Homeowners’ Missed Mortgage Payments Set Off Widespread Problems and Woke Up the Fed*, WASHINGTON POST (June 16, 2008).

<sup>154</sup> Carrick Mollenkamp, James Hagerty, and Randall Smith, *Banks Go on Subprime Offensive*, WALL STREET JOURNAL (March 13, 2007). The website Implode-O-Meter (<http://ml-implode.com>) tracks this surge in bankruptcy filings.

example is New Century Financial Corp., which in March 2007, had over \$8 billion in repurchase demands. The next month the firm announced it was bankrupt.<sup>155</sup>

When originators cannot honor the recourse provisions in PSAs, the trusts may have to retain ownership of the loans. And, as owners, they are subject to potential affirmative claims and defenses to non-payment by borrowers. In other words, the assignees bear a risk that they thought they had avoided through the reps and warranties.<sup>156</sup>

Originators' bankruptcy does not always mean that investors are "stuck" owning potentially unlawful loans. Depending on the reps and warranties that came with the deals and how much time has passed, investors may be able 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."<sup>157</sup>

#### D. Loss of Security Interest

There is one other way that securitization failed to protect owners of subprime RMBS, though it is not related to derivative liability. As we have described, foreclosures actions have revealed flawed paperwork that has impaired the ability of owners of notes to foreclose. Some

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<sup>155</sup> Carrick Mollenkamp, James Hagerty, and Randall Smith, *Banks Go on Subprime Offensive*, WALL STREET JOURNAL (March 13, 2007); Bradley Keoun and Steven Church, *New Century, Biggest Subprime Casualty, Goes Bankrupt*, BLOOMBERG.COM (April 2, 2007).

<sup>156</sup> Steven Schwarcz, *Protecting Financial Markets: Lessons from the Subprime Mortgage Meltdown*, 93 MINN. L. REV. 373 at 389 (Dec. 2008).

<sup>157</sup> Gretchen Morgenson, *A Road not Taken by Lenders*, NEW YORK TIMES (April 6, 2008).

courts have looked unkindly on such wrongful foreclosures and ordered the release of the security interest that note holders have in borrowers' property. When this happens, the owners of the notes are simply unsecured creditors.

In an illustrative New York case, a borrower sought relief from a foreclosure action by petitioning for bankruptcy. The loan servicer filed a proof of claim asserting that U.S. Bank, as trustee for a securitization trust, owned the note, but when the servicer could not come forward with the proof, the court rejected U.S. Bank's claim for \$461,263. In the words of the lawyer representing U.S. Bank, "[i]n the secondary market, there are many cases where assignment of mortgages, assignment of notes, don't happen at the time they should. It was standard operating procedure for many years." At the end of the day, the trust's assets were depleted by \$461,263 plus incalculable amounts of interest, losses that were ultimately passed onto investors.<sup>158</sup>

In a similar case, a bankruptcy court in Massachusetts rejected Bank of America's claim that it held a secured interest in a debtor's property because the bank had not recorded the required paper work at the time the loan was made. As a result of the ruling, Bank of America lost the right to foreclose on the property.<sup>159</sup> How many courts will follow suit remains to be seen.

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<sup>158</sup> Gretchen Morgenson, *If Lenders Say "The Dog Ate Your Mortgage,"* NEW YORK TIMES (Oct. 25, 2009).

<sup>159</sup> Sheri Qualters, *Defective Paperwork Strips Mortgage Holder of Foreclosure Rights*, LAW.COM (November 19, 2009). *See In re Grioux*, 2009 WL 1458173 (Bankr. D. Mass. 2009), *aff'd, cert. denied MERS v. Agin*, 2009 WL 3834002 (D. Mass. 2010) (holding that the borrower's name not appearing on the acknowledgement that is required to be filed with mortgages in Massachusetts is a material defect such that the recordation of the mortgage is incapable of giving constructive notice to a bona fide purchaser, thus rendering the mortgage subject to avoidance in bankruptcy). *See also In re Bower*, 2010 WL 4023396 (Bankr. D. Mass) (following *In re Grioux*); *but see In re Stewart*, 256 B.R.

#### IV. Arranger Liability Based on Active Wrongdoing

Thus far, when describing the liability of arrangers, we have focused on the possibility that arrangers as owners of notes can be derivatively liable. In this section of the paper, we turn to 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.<sup>160</sup> 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, depending on the legal claims brought against them. As it turns out, having some level of knowledge and exercising control were not uncommon during the past decade.

##### A. Arrangers' Knowledge: Evidence from Lawsuits and Investigations

Arrangers' direct liability for unlawful origination practices requires that they were, at least, aware of those practices. As we discuss in subsection E below, this could be actual knowledge of an originator's illegal actions or reckless disregard of them. Recently federal and state investigations, 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

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259, 261 (Bankr. S.D. Ohio 2000) (holding that "any recorded mortgage, whether defective or not, would serve as constructive notice to any bona fide purchaser whose interest arose after that date").

<sup>160</sup> Elizabeth Renuart, *THE COST OF CREDIT: REGULATION AND LEGAL CHALLENGES* § 10.6.1.2.2. See also *Cazares v. Pacific Shore Funding*, 2006 WL 149106 (C.D. Cal. 2006) (distinguishing between finding a lender liable as an assignee and as a direct participant).

grounds. This included everything from misrepresentation and other types of fraud to making loans that borrowers could not afford. Although many of these defects have come to light in the context of claims that arrangers were passing off poorly underwritten securities to investors, the same evidence could expose these arrangers to lawsuits by consumers.<sup>161</sup>

Internal emails suggest that some arrangers knew for years that lenders were not complying with their own underwriting standards and some of these standards served to protect borrowers from abuses.<sup>162</sup> Additionally, internal due diligence that is conducted on an originator before starting a business relationship would have uncovered consumer complaints against originators that would suggest a pattern of unlawful origination. Over time, many lenders became more lax in terms of adhering to their credit policies. At the same time these lenders were lowering their standards, most arrangers were reducing the number of loans they examined as part of their due diligence review for securitization, instead of acting on the results of their due diligence.<sup>163</sup> Loans that did not meet a

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<sup>161</sup> For evidence that arrangers knew of abuses in the subprime market, *see* Kathleen Engel and Patricia McCoy, *THE SUBPRIME VIRUS: RECKLESS CREDIT, REGULATORY FAILURE AND NEXT STEPS* (Oxford University Press 2011), 61-4.

<sup>162</sup> For example, according to internal emails, Bear Stearns was aware of the low quality of the loans it was securitizing as early as 2006, when the arranger's deal manager referred to securitization SACO 2006-8 as "SACK OF SHIT [2006-]8." First Amended Complaint at 7, *AMBAC Assurance Corp v. EMC Mortgage Corp.*, No. 08 Civ. 9464 (S.D.N.Y. filed July 28, 2010) (citing a 2006 email from then Bear Stearns' vice president and deal manager to its Managing Director of Trading). That same year Bear Stearns overrode the conclusions of due diligence firms that loans should not be purchased for securitizations 56% of the time. *Id.* at 10 (citing an Internal Report produced by Clayton Holdings, Inc., CLAY-AMBAC 0001770-80 at 1777).

<sup>163</sup> Vikas Bajaj & Jenny Anderson, *Inquiry Focuses on Withholding of Data on Loans*, N.Y. TIMES, Jan. 12, 2008; Kathleen Engel and Patricia McCoy, *THE SUBPRIME VIRUS: RECKLESS CREDIT, REGULATORY FAILURE AND NEXT STEPS* (Oxford University Press 2011), 61-4.

lender's promised underwriting criteria were called exceptions. Clayton Holdings, which conducted due diligence reviews of loans for arrangers as part of securitization deals, reported that over 40 percent of the loans it reviewed in 2006 and the first half of 2007 were exceptions. Rather than rejecting exception loans, arrangers purchased and converted those exceptions into securities.<sup>164</sup>

There are also situations in which some arrangers agreed not to reject more than a set percent of the loans in a package even if the percent of exceptions exceeded the cap. They reached these agreements before they had conducted due diligence and, thus, before they knew how many exceptions a pool of loans contained.<sup>165</sup> Evidence of problematic loans came from other sources, as well. As early as 2003, loans began defaulting within a few months after they had been originated—a clear “red flag” that the loans were unaffordable from the start. This should have prompted more investigation, because in many states making loans that borrowers could not afford to repay was unlawful.<sup>166</sup>

If courts interpret arranger's lack of further investigation or failure to take even stronger action as reckless disregard of the possibility that the loans they purchased were unlawful, arrangers could be directly liable for the unlawful originations.

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<sup>164</sup> Clayton Holdings, All Clayton: Trending Reports: 1<sup>st</sup> Quarter 2006- 2<sup>nd</sup> Quarter 2007 (on file with authors).

<sup>165</sup> Final Report of Michael J. Missal Bankruptcy Court Examiner at 135, *In re New Century Holdings*, 386 B.R. 11 (Bankr. D. Del. 2008); Kathleen Engel and Patricia McCoy, *THE SUBPRIME VIRUS: RECKLESS CREDIT, REGULATORY FAILURE AND NEXT STEPS* (Oxford University Press 2011), 45-6.

<sup>166</sup> See, e.g. First Amended Complaint at 11, *AMBAC Assurance Corp v. EMC Mortgage Corp.*, No. 08 Civ. 9464 (S.D.N.Y. filed July 28, 2010) (citing the deposition of Bear Stearns' managing director).

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

Another potential source of arranger's knowledge or reckless disregard of unlawful lending practices is through their subsidiary loan originators. Arrangers that streamlined their operations by vertically integrating their companies had even greater access to information about originators' lending practices than those that purchased loans from independent originators. It was not uncommon for arrangers to own a subprime loan originator, a servicer, an underwriter, and a broker/ dealer arm.<sup>167</sup> Goldman Sachs, for example, bought subprime loans from mortgage originators and also originated loans through its own lender, Senderra 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 then involved in selling.<sup>168</sup>

Vertical integration was a valuable strategy for investment and commercial banks.

As a managing director at Moody's Investors Service described:

if 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.

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<sup>167</sup> Jeffrey M. Levine, *The Vertical-Integration Strategy*, MORTGAGE BANKING, February 2007 at 60 (documenting commercial banks' and investment banks' purchases of mortgage originators ); *see also* Kathleen Engel and Patricia McCoy, *THE SUBPRIME VIRUS: RECKLESS CREDIT, REGULATORY FAILURE AND NEXT STEPS* (Oxford University Press 2011), 57-8 (discussing vertical integration within investment bank holding companies).

<sup>168</sup> 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](http://hsgac.senate.gov/public/_files/Financial_Crisis/042710Exhibits.pdf).

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.<sup>169</sup>

Vertical integration also made it easier for various subsidiaries and affiliates, who were part of the same corporate family, to share valuable proprietary information to advantage their firms. Evidence of that phenomenon comes from a study of the bidding patterns of investment bank arrangers when they were deciding whether to bid on the securities they underwrote. After controlling for information that was available to all investors, the researchers found that the pools that arrangers did not bid on ultimately performed worse than those that they did bid on.<sup>170</sup> Again, if courts interpret these results as suggesting that arrangers, by virtue of their relationships with originators, knew better than anyone else in the market when originators were engaged in problematic lending practices, arrangers may find themselves directly liable for those practices.

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<sup>169</sup> Todd Davenport, *What's Behind Wall Street Players' Mortgage Deals?* AMERICAN BANKER (AUG. 14, 2006).

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. 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](http://hsgac.senate.gov/public/_files/Financial_Crisis/042710Exhibits.pdf).

<sup>170</sup> Steven Drucker and Christopher Mayer, *Inside Information and Market Making in Secondary Mortgage Markets* 23 (Working Paper, January 6, 2008), *available at* <http://www4.gsb.columbia.edu/realestate/research/papers> (concluding that “the 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.”)

### C. Arrangers' Influence on Lenders

In addition to knowledge or a reckless disregard of facts suggesting unlawful originations, arrangers usually have to exercise some control over the unlawful origination in order to be liable for it. Arrangers had powerful levers that they could use to influence originators because the lenders were dependent on arrangers for financing and purchasing loans to be converted into securities. This was especially true when arrangers were also market makers. For example, an executive from Washington Mutual, a notoriously risky lender that went under, wrote an email stating “we always need to worry a little about Goldman because we need them more than they need us.”<sup>171</sup> When this influence was exercised in a way that encouraged unlawful origination practices, arrangers could find themselves directly liable.

There is evidence that some arrangers used their purchasing power to shape lending. Ownit Mortgage Solutions founder, William Dallas, claims that his firm loosened underwriting standards “reluctantly and under pressure from his investors, particularly Merrill Lynch, which wanted more loans to package into lucrative securities.”<sup>172</sup> According to documents filed by the Commonwealth of Massachusetts,

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<sup>171</sup> Carrick Mollenkamp and Serena Ng, *Investors Lost, Goldman Won on WaMu Deal*, WALL STREET JOURNAL (April 26, 2010).

<sup>172</sup> Vikas Bajaj, *A Cross-Country Blame Game*, NEW YORK TIMES (May 8, 2007).

The dependence was not one-way. At the same time, arrangers “were loath to imperil their relationship with lenders . . . ; as long as Wall Street’s lucrative mortgage factories were humming, it needed loans to stoke them.” Gretchen Morgenson, *Seeing v. Doing*, NEW YORK TIMES (July 24, 2010). 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 it would take its business elsewhere. *In re Morgan Stanley, Assurance of Discontinuance*, p. 9-10 par. 24-6 (June 24, 2010).

Morgan Stanley would agree to buy loans from lender New Century according to parameters that Morgan Stanley 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.”<sup>173</sup>

#### D. The Threat of Litigation Against Arrangers

The evidence coming to light may result in courts holding that some 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 tainted loans, they may have exposed themselves to direct liability.<sup>174</sup>

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 didn’t know “whether any of the underwriters [of subprime securitizations] could be held liable for companies’ practices, if they [we]re found to be illegal.” The article went on to state that

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<sup>173</sup> *In re Morgan Stanley, Assurance of Discontinuance*, p. 5 par. 11 (June 24, 2010).

<sup>174</sup> Carrick Mollenkamp and Serena Ng, *Investors Lost, Goldman Won on WaMu Deal*, WALL STREET JOURNAL (April 26, 2010); WALL STREET AND THE FINANCIAL CRISIS: THE ROLE OF INVESTMENT BANKS BEFORE THE FIN. CRISIS INQUIRY COMM’N 111th Cong. 2 (2010) (Exhibit 1a, memorandum from Senators Carl Levin and Tom Coburn to Members of the Permanent Subcommittee on Investigations), *available at* [http://hsgac.senate.gov/public/\\_files/Financial\\_Crisis/042710Exhibits.pdf](http://hsgac.senate.gov/public/_files/Financial_Crisis/042710Exhibits.pdf); Kathleen Engel and Patricia McCoy, *THE SUBPRIME VIRUS: RECKLESS CREDIT, REGULATORY FAILURE AND NEXT STEPS* (Oxford University Press 2011), 45-47.

“[t]he legal issues are complicated ones that are just starting to wend their way through the courts.”<sup>175</sup>

The first, and for a long time only, case asserting a claim against an arranger was a consumer suit against 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.<sup>176</sup> Ultimately, after protracted litigation, a jury found that Lehman was 10% responsible for FAMCO’s unlawful lending practices and ordered Lehman to pay over \$5 million of a \$51 million damage award.<sup>177</sup> This was the first time that consumers “penetrated the asset-backed securities world.”<sup>178</sup>

Shortly after the Lehman verdict, arrangers began purchasing subprime originators and extending lines of credit to them, which originators repaid by selling the loans to the arrangers. Had Lehman been hit with a more substantial damage award, arrangers may have been averse to having close relationships with lenders. Instead, arrangers moved from buying whole loans from unaffiliated originators to buying pools of loans directly from subprime lending affiliates.<sup>179</sup>

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<sup>175</sup> Michael Gregory, *The Predatory Lending Fracas: Wall Street Comes under Scrutiny in the Subprime Market as Liquidity Suffers and Regulation Looms*, INVESTMENT DEALERS DIGEST (June 26, 2000).

<sup>176</sup> Michael Gregory, *ABS World Warily Eyes New Suit against Lehman*, INVESTMENT DEALERS’ DIGEST, May 8, 2000.

<sup>177</sup> *In re First Alliance Mortgage Co.*, 471 F.3d 977, 989 (9th Cir. 2006).

<sup>178</sup> Michael Gregory, *ABS World Warily Eyes New Suit against Lehman*, INVESTMENT DEALERS’ DIGEST, May 8, 2000.

<sup>179</sup> John Dunbar and David Donald, WHO’S BEHIND THE FINANCIAL MELTDOWN? THE TOP 25 SUBPRIME LENDERS AND THEIR WALL STREET BACKERS (Center for Public Integrity, May 6, 2009); Jeffrey M. Levine, *The Vertical-Integration Strategy*, MORTGAGE BANKING, February 2007 at 58.

For almost a decade, as arrangers were streamlining their securitization machines, there were no major consumer lawsuits extending up the securitization food chain except the FAMCO decision. 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.<sup>180</sup> As a result of these investigations, both Goldman Sachs and Morgan Stanley settled with the Commonwealth. Goldman’s settlement was \$60 million.<sup>181</sup> Morgan Stanley paid \$102 million in its settlement.<sup>182</sup> Following the Goldman Sachs agreement, the Massachusetts Attorney General, Martha Coakley, stated: “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.”<sup>183</sup> These cases, and others like them, provide guidance on different ways arrangers may be liable to borrowers for unlawful origination practices, which we now discuss.

#### E. Legal Theories for Arranger Liability

There are at least three theories under which arrangers may be liable: aiding and abetting, conspiracy, and joint venture.<sup>184</sup> These are not independent causes of action like

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<sup>180</sup> *In re Morgan Stanley, Assurance of Discontinuance*, p. 1 par. 1 (June 24, 2010).

<sup>181</sup> Jenifer B. McKim, *State Reaches \$60M Subprime Deal with Goldman Sachs*, BOSTON GLOBE (May 11, 2009).

<sup>182</sup> *In re Morgan Stanley, Assurance of Discontinuance* (June 24, 2010).

<sup>183</sup> Kathleen M. Howley and Christine Harper, *Goldman to Pay \$60 Million in Subprime Settlement*, BLOOMBERG.COM (May 11, 2009).

<sup>184</sup> It is also possible that arrangers could be found to violate the Fair Housing Act (FHA), 42 U.S.C. s 3601 et seq., and its state analogues. The FHA makes it unlawful for anyone who purchases loans or provides “other financial assistance” to discriminate

fraud or unconscionability. Rather, they allow plaintiffs to join parties as defendants to an underlying cause of action when the defendants did not directly engage in the unlawful conduct leading to the plaintiffs' injuries, but directly enabled the wrongful conduct to occur. The idea undergirding this principal is that willful blindness to unlawful behavior should result in liability for the damages caused by that behavior.<sup>185</sup>

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against people based on their race, color, religion, sex, handicap, familial status, or national origin when engaged in such transactions. 42 U.S.C. s 3605. *See e.g. Eva v. Midwest National Mortgage Banc, Inc.* 143 F.Supp.2d 862, 889 (N.D. Ohio 2001) (refusing to dismiss plaintiffs' claims under s 3605 where 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").

In addition, arrangers could find themselves defendants in claims brought under the Racketeering Influenced and Corrupt Practices Act, which has complex elements that could be difficult for plaintiffs to establish in claims against arrangers. 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. A "pattern of racketeering activity" requires proof of commission of two or more predicate acts, among which are mail fraud and wire fraud. 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. 19 U.S.C. sec. 1961, *et seq.* For a detailed discussion of a RICO claim based on predatory lending, *see Hargraves, et al. v. Capital City Mortgage Corp., et al.*, 140 F.Supp.2d 7, 23-27 ( D.D.C. 2000); *see also* Margaret Cronin Fisk and Thom Weidlich, *Citigroup, Ally Sued for Racketeering over Database*, NEW YORK TIMES (Oct. 4, 2010) (describing a RICO claim borrowers brought alleging a plan to wrongfully foreclose on borrowers' homes); *Eva v. Midwest National Mortgage Banc, Inc.* 143 F.Supp.2d 862 (N.D. Ohio 2001) (ruling on motions to dismiss RICO claims based on mortgage fraud); *Gray v. Upchurch, et al.*, 2007 WL 2258906 (S.D. Miss. 2007) (dismissing a RICO claim against lender based on abusive lending by broker).

<sup>185</sup> In the words of Judge Vincent Broderick "If a fraud is involved in a transaction, a financing entity which deliberately shuts its eyes to clues concerning the fraud may be

## 1. Aiding and Abetting Originators' Unlawful Originations

When an arranger enables an originator's unlawful loan originations, borrowers harmed by that conduct can claim that the arranger aided and abetted the originator. The elements necessary to join a party as an aider and abettor vary across jurisdictions, but generally a party who does not directly engage in unlawful origination must knowingly and substantially assist another in the commission of an illegal act to be an aider and abettor. To establish knowledge, some jurisdictions require actual knowledge of an illegal act, while others allow claims to go forward if there are allegations that the defendant recklessly ignored facts suggesting the illegal act.<sup>186</sup> The substantial assistance element can be satisfied by either affirmative acts or failures to act, depending on the facts of the case.<sup>187</sup> The assistance must have a substantial causal connection to the harm suffered by the plaintiff.<sup>188</sup>

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unable to enforce promissory notes signed as a result of the fraud.” *Estate of Sheradsky v. West One Bank*, 817 F. Supp. 423, 425 (S.D.N.Y. 1993).

<sup>186</sup> See, e.g. *Hashimoto v. Clark*, 264 B.R. 585, 598 (D. Ariz. 2001) (stating California law requires an aider and abettor to have actual knowledge); *Tew v. Chase Manhattan Bank N.A.*, 728 F. Supp. 1551, 1569 (S.D. Fla. 1990) (holding recklessness satisfies the aiding and abetting knowledge requirement under Florida law).

<sup>187</sup> *Tew v. Chase Manhattan Bank N.A.*, 728 F. Supp. 1551, 1569 (S.D. Fla. 1990), amended 741 F.Supp. 220 (stating “The 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”); *York v. InTrust Bank*, 299, 926 P.2d 405, 426 (1998) (holding “In light of the fact that only a small action on InTrust’s part would have revealed the material facts so that the Yorks would not have been injured, this factor should weigh heavily against InTrust”).

<sup>188</sup> *Neilson v. Union Bank of California, N.A.*, 290 F.Supp.2d 1101, 1135 (C.D. Cal. 2003) (stating “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”).

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) the duration of [the defendant's] assistance.<sup>189</sup>

The first factor will depend on the underlying cause of action, discussed in previous sections. The amount and duration of assistance arrangers provided, the second and sixth factors, will likely depend on the financing arrangements between originators and arrangers. When arrangers provided warehouse lines of credit to be paid down with the originator's loans for a substantial period, these two factors would likely cut against arrangers. The fourth factor is arrangers' relationship to originators. As we mentioned, it was not unusual for arrangers and originators to be part of the same corporate family. In addition, arrangers influenced originators in a number of ways. Regarding arrangers' state of mind-- the fifth factor, some arrangers knew of, or at least recklessly disregarded, originators' potentially unlawful practices through due diligence reports from firms like Clayton Holdings.

The only factor that appears to favor arrangers that satisfy the other requirements is the fact that they were not present at the time of originator's unlawful actions. It is unknown whether this factor will play a significant role in determining an arranger's liability because the nature of the actions and the assistance provided by arrangers does not require physical presence at the time of the tort, and the issue has not been extensively litigated.

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<sup>189</sup> RESTATEMENT (SECOND) OF TORTS § 876(b).

Aiding and abetting was the theory borrowers pursued in the case against Lehman Brothers.<sup>190</sup> 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, fees, and the principal amount of loans from borrowers who were targeted because they had equity in their homes. Lehman conducted due diligence before agreeing to establish a business relationship with FAMCO, which uncovered FAMCO's unlawful tactics and numerous consumer complaints against FAMCO. There was also evidence that Lehman officers discussed FAMCO's potential liability during Lehman's due diligence review. Thus, Lehman had actual knowledge of FAMCO's unlawful originations.<sup>191</sup>

Lehman acted as FAMCO's investment bank arranger and supplied a warehouse line of credit to finance FAMCO's activities, in exchange for which FAMCO granted Lehman Brothers 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 FAMCO's tortious conduct.<sup>192</sup> The court agreed.<sup>193</sup>

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<sup>190</sup> *In re First Alliance Mortgage Co.*, 471 F.3d 977 (9th Cir. 2006).

<sup>191</sup> *In re First Alliance*, 298 B.R. 652, 657, 660-62, 668 (C.D. Cal. 2003); *In re First Alliance*, 471 F.3d 977, 994 (9th Cir. 2005) (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").

<sup>192</sup> *In re First Alliance*, 298 B.R. 652, 662, 664 (C.D. Cal. 2003); *In re First Alliance*, 471 F.3d 977, 994 (9th Cir. 2005).

The firm never exercised the warrants. It is also noteworthy that the former Chief Financial Officer at Shearson Lehman Mortgage Corp. was the President of FAMCO.

Aiding and abetting is also the theory that the Commonwealth of Massachusetts advanced in its investigation of Morgan Stanley and Goldman Sachs. The Commonwealth never filed complaints against either company, but in an Assurance of Discontinuance 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 to make” loans borrowers could not afford to repay.<sup>194</sup> In particular, the Attorney General cited Massachusetts’ laws that make it unlawful to refinance a loan unless the new loan is in the borrower’s best interest and that make unfair or deceptive acts or practices illegal.<sup>195</sup>

## 2. Civil Conspiracy

Civil conspiracy, like aiding and abetting, is not an independent cause of action.<sup>196</sup> Borrowers alleging civil conspiracy must show that there was some underlying unlawful conduct perpetrated by one or more of the conspirators.<sup>197</sup> A party, however,

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<sup>193</sup> *In re First Alliance*, 298 B.R. 652, 668 (C.D. Cal. 2003)

<sup>194</sup> *In re Morgan Stanley, Assurance of Discontinuance*, p. 15 par. 43 (June 24, 2010).

<sup>195</sup> *In re Morgan Stanley, Assurance of Discontinuance*, p. 6 par. 16 (June 24, 2010). M.G.L.A c. 183, sec. 28C; M.G.L.A. c. 93A, sec. 2A.

<sup>196</sup> *In re Methyl Tertiary Butyl Ether Prods. Liab. Litigation*, 175 F. Supp. 2d 593, 633 (S.D.N.Y. 2001) (stating California, Florida, Illinois, and New York law). All but one jurisdiction, Wyoming, recognizes civil conspiracy as a cause of action. Elizabeth Renuart, *THE COST OF CREDIT*, 595.

<sup>197</sup> See, e.g. *Urbanek v. All State Home Mortgage Co.*, 898 N.E.2d 1015, 1020 (Ct. App. Ohio 2008) (ruling that “having found that [plaintiff] offered no evidence to create

can be liable as a co-conspirator even when it did not engage in the underlying illegal act.<sup>198</sup> If appraisers inflate property appraisals as part of a scheme to defraud homebuyers, for example, they can be liable for damages even if the appraisers' actions did not satisfy the elements of fraud.<sup>199</sup>

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 a person or property.<sup>200</sup> The requirement of proof of an agreement distinguishes civil conspiracy from aiding and abetting.<sup>201</sup>

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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”).

<sup>198</sup> *Hoffman v. Stamper*, 843 A.2d 153 (Md. Spec. App. 2004); *see also Halberstam v. Welch*, 705 F.2d 472, 481 (D.C. Cir. 1983) (holding “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. He need not even have planned or known about the injurious action”).

<sup>199</sup> *See e.g. Hoffman v. Stamper*, 843 A.2d 153 (Md. Spec. App. 2004).

<sup>200</sup> *See, e.g. Matthews v. New Century Mortgage Corp.*, 185 F.Supp.2d 874, 889 (S.D. Ohio 2002) (listing the elements); *York v. InTrust Bank*, 962 P.2d 405, 422 (1998) (same); *Halberstam v. Welch* 705 F.2d 472, 477 (D.C. Cir. 1983) (same).

<sup>201</sup> *Halberstam v. Welch*, 705 F.2d 472, 478 (D.C. Cir. 1983) (“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 Neilson v. Union Bank of California, N.A.*, 290 F.Supp.2d 1101, 1133 (C.D. Cal. 2003).

There is little guidance on whether arrangers can be held liable for originators' fraudulent acts as civil conspirators.<sup>202</sup> At least one court has 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."<sup>203</sup> 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*<sup>204</sup> the lender, New Century, was held liable for the tortious conduct of independent brokers when New Century had ties to the brokerage and approved fraudulent loan applications.<sup>205</sup> As more information about specific arrangers' working

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<sup>202</sup> 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.* 2009 WL 2137393 (N.D. Cal.); *Hafiz v. Aurora Loan Services*, 2009 WL 2029800 (N.D. Cal.); *Cruz v. HSBC Bank, N.A.*, 2008 WL 5191428 (N.Y. Sup.); *Singh v. Wells Fargo Bank, N.A.*, 2009 WL 2365881 (N.D. Cal.); *Fortaleza v. PNC Financial Services Group, Inc.*, 2009 WL 2246212 (N.D. Cal.). Some have survived defendants' motions to dismiss, but are not instructive. *See e.g. Minvielle v. Smile Seattle Investments, LLC*, 2008 WL 4962694 (W.D. Wash).

<sup>203</sup> *See Hays v. Bankers Trust Company of California*, 46 F.Supp.2d 490, 498 (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. In denying summary judgment to the assignee, the court stated that "one who, with knowledge of the facts, assists another in the perpetration of a fraud is equally guilty." *Id.* at 498; *see also Knapp v. Americredit Financial Services*, 245 F.Supp.2d 841, 852-53 (S.D.W.V. 2003) (denying defendant's motion for summary judgment on 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").

<sup>204</sup> 185 F.Supp.2d 874 (S.D. Ohio 2002).

<sup>205</sup> In *Matthews*, plaintiffs alleged that they told brokers their monthly incomes, but without the borrowers' knowledge, the brokers falsified the borrowers' loan applications so they would qualify for loans. New Century's agents approving the loans had close

relationships with originators comes to light, there may be additional evidence to support conspiracy claims.

### 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 joint venturers that may be express or implied, written or oral. Generally, there are five elements to a joint venture:<sup>206</sup> (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 in furtherance of the venture.<sup>207</sup> Unlike aiding and abetting and civil conspiracy, however, a

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personal ties with at least one mortgage broker who had engaged in this type of fraud. 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. A number of cases have followed Matthew's. *See Smith v. ABN AMRO*, 2007 U.S. Dist. LEXIS 26585, \*36 (W.D. Ohio); *M&T Mortgage Corp v. White*, 2010 U.S. Dist. LEXIS 89008, \*81-83 (E.D.N.Y.); *Automotive Fin. Corp. v. WW Auto*, 2005 U.S. Dist. LEXIS 9038 (S.D. Ohio), *but see Williams v. 2000 Homes*, 2009 U.S. Dist. LEXIS 65433, \*18-19 (E.D.N.Y.) (dismissing borrower's conspiracy to defraud claim where there was no evidence the lenders had any knowledge of illegally inflated appraisals).

<sup>206</sup> *See, e.g. Short v. Wells Fargo Bank Minnesota, N.A.*, 401 F.Supp.2d 549, 563 (S.D.W.V. 2005) (listing elements).

<sup>207</sup> *See id.* (holding "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 joint venturers"); *Jackson v. East Bay Hospital*, 246 F.3d 1248 (9th Cir. 2001) (holding venturers are liable for the negligence of their joint venturers).

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 asset a joint venture in the context of fraudulent loan origination practices, *Short v. Wells Fargo Bank*<sup>208</sup> 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 *Short* court reasoned that the PSA contractually defined the relationships among the parties to a securitization.<sup>209</sup> The court held that the PSA could satisfy the elements of a joint venture as it was a contract that controlled the operations of the securitization and contained provisions through which the parties shared profits and losses.<sup>210</sup> The parties eventually settled the case without any appellate ruling.

#### V. Policy Implications of Assignee and Arranger Liability

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<sup>208</sup> 401 F. Supp.2d 549 (S.D.W.V. 2005).

<sup>209</sup> A PSA is a contract that defines the roles of the parties in a securitization and their duties to the trustee of the trust that issues the mortgage backed securities, which is created by the PSA. The parties to a PSA are the entity selling the loans to the trust (typically the arranger), the servicers, and the trustee. Different parts of the PSA cover numerous aspects of a securitization, including the contribution of mortgages to the trust, administration of the loans, subservicing loans, the classes of securities that will be created by the trust, underwriting the securities, and distributions from the trust to investors. Typically, the PSA and related documents discuss the payments each party will receive, who controls what aspects of the deal, and loan repurchase provisions.

<sup>210</sup> *Short v. Wells Fargo Bank Minnesota, N.A.*, 401 F. Supp. 2d 549, 565 (S.D.W.V. 2005); see also *Herrod v. First Republic Mortgage Corporation*, 218 W.Va. 611, 625 S.E.2d 373 (2005) (recognizing a joint venture to originate loans between brokers and lenders when brokers used lender rate sheets and were compensated through yield spread premiums).

Securitization gave creators of and investors in RMBS false security that they were protected against liability from borrower litigation. Although claims by aggrieved borrowers against assignees and arrangers have been sparse, increasing numbers of litigants are testing the theories of liability we have spelled out in this article. To the extent that aggrieved borrowers are successful in their actions-- either affirmatively or defensively—against assignees and arrangers, they may be able to obtain relief even though the brokers and lenders involved with their loans may be bankrupt. Their success will pose a financial burden on investors in RMBS and arrangers and could result in further downgrades of subprime RMBS and related derivatives.

Asset backed securitization is an incredibly powerful innovation that can be an excellent medium for channeling investment capital to borrowers in need of credit and for giving institutional investors direct, and relatively more liquid, exposure to credit markets. Subprime mortgage-backed securitizations did not work as well in practice as they did in theory. One goal of securitization was to provide a legal firewall between the actions of subprime loan originators and arrangers and investors. As we have described in this article, arrangers may have breached this firewall through the way they structured deals, by vertically integrating their companies, exerting control over originators, and by financing loans that violated the law.

As more information on securitization of home mortgages has come to light, it has become clear that the securitization of subprime loans was more costly than anyone anticipated. It was costly to borrowers, some of whom have had their claims cut off by the holder in due course rule, and others who have valid claims but cannot obtain relief because their lenders have folded. It has been costly to investors who purchased RMBS

assuming that the trusts that owned the loans and issued the securities could not be liable for loan originators' misdeeds. Arrangers, as holders of loans slated for securitization, investors in RMBS and dealmakers, are facing unexpected legal exposure from many angles.

Markets operate within state and federal regulatory frameworks. As policy-makers alter this framework to lay the foundation for the future of housing finance, particularly RMBS markets, it is critical that they take into account the hidden costs of securitization and decide whether and how to address them. One approach would be for legislators and regulators to rely on the memory of market participants to minimize arrangers' and assignees' potential liability. Already, there are new tools for arrangers and investors to investigate loan pools in a more granular fashion and to actively police originators through enhanced compliance and risk retention requirements, and stronger recourse provisions. Eventually, insurance products may emerge to provide "buyback insurance" for originators; such policies would cover recourse claims that originators might face. There are potential drawbacks to this approach; for instance pricing potential risk is a task that even the most sophisticated "quants" have not been able to accomplish. Additionally, as arranging private RMBS issues once again becomes a profitable business, there is a risk of a return to behaviors like those seen during the housing bubble: the money spent on enhanced due diligence and compliance may dwindle, and there may be overreliance on reps and warranties.

Alternatively, policymakers may attempt alter the regulatory framework to make it possible to quantify investors' and arrangers' exposure to borrower claims, which would enable more accurate pricing of RMBS. This strategy would also resolve some of

the uncertainty in the extant law and, importantly, could increase the incentives for arrangers and investors to police lenders in order to minimize their liability.<sup>211</sup> Providing incentives for more effective self-policing will encourage arrangers to identify unscrupulous originators and cut off their source of funding before they create substantial risks to borrowers, investors, and ultimately society.

Policy makers could employ a range of paradigms for assignee and arranger liability. At one extreme, they could adopt a strict liability standard making assignees and arrangers liable for all unlawful acts of originators. If there is unlimited liability for all illegal originator acts, even those that lenders or brokers successfully conceal from arrangers and assignees, there will be a powerful disincentive to purchase loans from originators. In turn, originators will be constrained in the number of loans they can make and we may well return to the time when deserving borrowers could not obtain credit.<sup>212</sup> Only originators with flawless reputations would be able to sell loans. This would create barriers to new lenders entering the market, which would reduce competitive forces. And it is likely that any costs that could not be mitigated through reputational capital would be passed on to consumers.

At the other extreme, policy-makers could pass laws immunizing assignees and arrangers for any liability based on lenders' practices or the terms of loans. If assignees and originators have no potential liability, they would have reduced incentives to police originations by cutting off capital flows to unscrupulous originators.

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<sup>211</sup> See Kathleen C. Engel and Patricia A. McCoy, *Turning a Blind Eye: Wall Street Finance of Predatory Lending*, 75 FORDHAM LAW REVIEW 2039, 2081-94 (2007).

<sup>212</sup> Kathleen Engel and Patricia McCoy, *A Tale of Three Markets: The Law and Economics of Predatory Lending*, 80 TEXAS LAW REVIEW 1255, 1271-73 (2002).

Middle ground solutions seem to be the most fertile for balancing the ability to price and market incentives for self-policing. For example, in situations where there is no claim of direct wrongdoing by arrangers and assignees, laws could place limits on the dollar amount of potential assignee liability, perhaps based upon the loan amount, which would eliminate some of the uncertainty that exists today. Another option would be to impose liability on arrangers and assignees only if the originator was insolvent. This would encourage the secondary market to purchase loans from adequately capitalized or insured originators.

There are also good reasons to consider imposing a constructive notice standard on arrangers or assignees. Under this approach, assignees and arrangers could face liability if they *should have known* of the originator's unlawful acts and any illegal loan terms. This standard would create an incentive for arrangers and assignees to investigate loans and lenders and act on the information they obtain. This contrasts with an actual knowledge standard which encourages loan purchasers to turn a blind eye to avoid having knowledge of unlawful origination activities and loan terms, or immunization from liability, which discourages arrangers and assignees from acting on the information they have. The goal of any of these rules should be to provide incentives for secondary market actors to adopt systems to avoid liability altogether and to make it easier to price for litigation risk. Crafting such rules is no easy task.

## VI. Conclusion

In the meantime, as Congress, regulators, industry 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. The

environment is ripe for lawyers and their clients to pursue claims against entities beyond brokers and lenders. Legal scholars and consumer lawyers have identified theories of liability that can increase the range of potential defendants. And, judges and juries, who in the past did not consider the possibility that Wall Street financiers could be involved with fraud on borrowers, may be more sympathetic to borrowers now that they have learned about the inner-workings of financial firms and have bailed them out. Although it will be years before anyone can calculate the cost of subprime securitizations, we are confident in our conclusion that Wall Street's belief that it had insulated itself and investors from borrower claims was a false sense of security.