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## **Complexity, Complicity, and Liability up the Securitization Food Chain: Investor and Arranger Exposure to Consumer Claims**

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# **Complexity, Complicity, and Liability up the Securitization Food Chain:**

## **Investor and Arranger Exposure to Consumer Claims<sup>1</sup>**

by Kathleen C. Engel\* and Thomas J. Fitzpatrick IV\*\*

### **I. Introduction**

The financial crisis has revealed the complexity of mortgage financing. In a matter of a few years, a multitude of actors have replaced loan officers at local banks. Now, brokers, lenders and Wall Street arrangers<sup>2</sup> mediate between borrowers and investors. Most home loans are owned by securitization trusts and investors receive a stream of income from loan payments. The law, which was designed for more deliberative and less complex transactions, did not change with the new structures. Old

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\*\* Economist, Federal Reserve Bank of Cleveland. The views expressed here are the authors' and not necessarily those of the Federal Reserve Bank of Cleveland, the Board of Governors, or other Banks in the Federal Reserve System.

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<sup>2</sup> Due to the complexity of the securitization process, there are no universally accepted labels for the entities that control the flow of loans from originators to securitization trusts. In this article "arranger" refers to the entities that put securitization deals together. Arrangers may be the sponsors or depositors in the issue's pooling and servicing agreement, or may be a parent or affiliate of the sponsor or depositor. Arrangers of subprime securitizations were most often commercial banks or investment banks. The government sponsored enterprises, Fannie Mae and Freddie Mac are arrangers

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

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

This paper is the first to assess consumer claims against arrangers and investment trusts in light of the evolution of financial institutions as securitization of home loans

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

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

## II. Securitization

For over a decade, the securitization of home loans was considered a low-cost method to expand the availability of credit, lower the cost of credit and make otherwise illiquid assets liquid. From investors' perspective, securitization created attractive bonds that provided direct exposure to housing markets with good returns that appeared to be

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<sup>3</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.

highly liquid and low risk.<sup>4</sup> From its infancy, securitization promised to insulate investors and the arrangers that structured securitization deals from the risk that they could be found liable for the unlawful acts of mortgage loan originators.<sup>5</sup> This protection was important because some lenders—particularly in the subprime market-- were known to make loans that violated consumer protection and other laws.

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

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

Two decades ago, borrowers applied for loans at local banks. The loan officers who processed borrowers' applications and underwrote the loans were employees of the

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<sup>4</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>5</sup> There are several 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 lawsuits based upon unlawful acts that brokers or lenders engaged in at origination.

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

This system was not perfect. Banks were always limited in the amount of loans they could make, and there was a constant queue of qualified borrowers who could not obtain credit. Securitization rapidly changed this market.<sup>6</sup> Instead of lenders running the entire show, an atomized<sup>7</sup> financing system emerged, involving mortgage brokers, lenders, banks, credit raters, trusts, servicers, and investors. Lenders made loans to borrowers and an arranger purchased and pooled the loans, and then sold them to a trust used to convert them into residential mortgage-backed securities (RMBS or MBS) for

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<sup>6</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>7</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, *Mortgage Banking Unbundling: Structure, Automation and Profit*, MORTGAGE BANKING (Jan. 1, 2001).

sale to investors.<sup>8</sup> Although loans had to be made before they were securitized, securitization really began with arrangers, who told originators what loans they would buy before originators even made them.

Arrangers of subprime securitizations had multiple tasks. They often funded originators that were not vertically integrated by extending lines of credit paid back through loans the originators sold to the arranger. They conducted relationship-based due diligence on originators and transaction-based due diligence on loan pools. They guided pools of loans into securitization trusts and divided the income stream from the loans into tranches (French for “slices”), each of which had different risk-return characteristics.<sup>9</sup> Arrangers also had responsibility for obtaining credit ratings for the tranches and for complying with rules governing securities disclosures.<sup>10</sup>

As part of their due diligence, arrangers were responsible for reviewing loan files for compliance with originators’ representations and warranties (“reps and warranties”) that the loans complied with the law and met specific underwriting criteria. They often contracted with independent due diligence firms to review files, track lenders’ practices and financial condition, and monitor pending litigation against originators. Through

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<sup>8</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).

<sup>9</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 by subordinating loss-positions and other credit enhancements. Adam B. Ashcraft, UNDERSTANDING THE SECURITIZATION OF SUBPRIME MORTGAGE CREDIT 29-30 (Federal Reserve Bank of New York Staff Report no. 318, 2008).

<sup>10</sup> Kathleen Engel and Patricia McCoy, THE SUBPRIME VIRUS: RECKLESS CREDIT, REGULATORY FAILURE AND NEXT STEPS 47 (Oxford University Press 2011).

these processes, arrangers had access to detailed information that was not available to the public, about subprime lenders and the performance of their loans. 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 of lender wrongdoing.

Once a deal was put together, arrangers set up bankruptcy-remote special purpose entities, usually trusts, to hold the home loans and issue the securities. The trusts purchased the loans from the arrangers, either by paying the arrangers in securities issued by the trust, or by financing the acquisition through the sale of such securities to a broker-dealer, who was often an affiliate of the arranger.<sup>11</sup> Up until the time the loans were transferred to the trust, the arranger owned them, either directly or indirectly. The investors who purchased 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 organizers with some level of command over almost every step from loan origination to selling securities. Exercising control was natural, given arrangers' role as market makers. Many had buy-side and sell-side operations; they dealt with in-house investors that were interested in buying securities (buy-side) and they also created and issued securities to external investors (sell-side). They created markets by generating investor interest in particular products and then procuring the products to satisfy the demand they had created. They provided liquidity for lenders by giving them

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<sup>11</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).



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 capital markets.<sup>12</sup>

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

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

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<sup>12</sup> See e.g. Goldman Sachs: Risk Management and the Residential Mortgage Market 3 (April 27, 2010) (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).

To ensure a steady flow of loans, many arrangers acquired ownership interests in lenders that could supply them with loans.<sup>13</sup> At the same time, arrangers knew they had to manage their relationships 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 of the originators’ misdeeds.

Knowing that arrangers could and did influence lending is essential for 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 are liable because the loans contain unlawful terms or were the result of others’ unlawful practices, the owners’ liability is derivative. Derivative liability requires no direct involvement of the current loan owner, and can be raised by borrowers defensively or affirmatively. If, for example, a trust brings a collection action against a borrower who has defaulted on a loan, the borrower may be able to defend on the grounds that during the loan origination there was unlawful activity that relieves the borrower of the obligation to repay the debt in whole or part. In addition, there are 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.<sup>14</sup>

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<sup>13</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.

<sup>14</sup> Borrowers can also bring claims for recoupment. These claims must arise out of the same transaction that formed the basis of the creditor’s claim against the borrower.

In this section of the article, we describe how owners of loans and investors in RMBS 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 of a securitization, loans can be owned by the arrangers or securitization trusts. Arrangers may become owners when they hold loans pending completion of securitization deals, before loans are transferred to a trust. The trust then becomes the legal owner of the loans, although securities holders who own the stream of income from the loans stand to lose if a trust has derivative liability.<sup>15</sup>

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Such claims are equitable in nature and are not barred by statutes of limitation. If borrowers are successful in recoupment claims against assignees, their debt is reduced, but they have no right to any affirmative relief.

For a discussion of recoupment in response to a complaint to foreclose, *see Associates Home Equity Services, Inc. v. Troup*, 778 A.2d 529, 539-40 (N.J. Super. Ct. App. Div. 2001).

For a survey of laws that can give rise to derivative liability, *see* Elizabeth Renuart, *THE COST OF CREDIT*, § 12.12.

<sup>15</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, (2008). Arrangers can also end up owning loans if they are forced to buy them back from trusts because the loans do not comply with the deal terms. There are also insurers and other entities that may have to step in when trusts experience losses.

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

When a borrower defaults on a home loan, the owner of the note typically brings a collection or foreclosure action.<sup>16</sup> The borrower can attempt to defend the claim on the basis that the note arose out of an unlawful act at origination, and that the unlawful act negates, fully or partially, the borrower's obligation to repay the loan. Fraud and unconscionability are the most frequent *common law* defenses against collection or foreclosure actions brought by note owners.

The success of these defenses turns on the sufficiency of the evidence of fraud or unconscionability as well as whether the owner of the note is a holder in due course (HDC), and therefore not liable for the vast majority of illegal acts that occur at origination.<sup>17</sup>

#### 1. Fraud

Fraud is recognized in every jurisdiction in the United States and the elements of fraud are generally consistent across jurisdictions. Courts' interpretations of the elements, however, vary widely. To establish fraud in tort, the victim must prove that the party who committed fraud made a false statement of material fact<sup>18</sup> with knowledge of the falsity and intent to deceive, on which the victim justifiability relied, and which

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<sup>16</sup> In a state with a judicial foreclosure scheme, the holder of the note files a claim against the borrower. In jurisdictions that have a non-judicial procedure, borrowers must initiate judicial review by seeking an injunction to stop the foreclosure.

<sup>17</sup> Fraud and unconscionability can also be brought as affirmative claims against assignees in recoupment claims. *See* UCC 3-305(a)(3).

<sup>18</sup> 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).

caused the victim injury.<sup>19</sup> In some jurisdictions, acceptance of the fruits of a fraud with knowledge that they were fraudulently obtained will, in itself, establish fraud.<sup>20</sup>

Courts have recognized fraud claims when borrowers were misled about a loan's interest rate prior to closing,<sup>21</sup> when brokers falsely promised to obtain the best rate possible for borrowers,<sup>22</sup> and when borrowers were deceived as to the purpose of the documents they were signing.<sup>23</sup> Courts have also recognized fraud when brokers or originators hid finance charges,<sup>24</sup> falsified borrowers' employment and income,<sup>25</sup> and

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<sup>19</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 that the alleged fraudulent statement is false or must have made it with such utter disregard and recklessness as to whether it is true or false that knowledge may be inferred); *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).

<sup>20</sup> See e.g. *Pulphus v. Sullivan*, 2003 WL 1964333 (N.D. Ill. 2003).

<sup>21</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) (allowing a fraud claim where a borrower was falsely promised that if timely payments were made for a year the loan would be refinanced at a significantly lower rate); *England v. MG 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 falsely promised to refinance at a lower rate after a year of timely payments).

<sup>22</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).

<sup>23</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 documents signed related to a weatherization program amounted to fraud).

made loans for home repairs with knowledge that the people making them were unlikely to finish their work.<sup>26</sup>

In a recent spate of decisions, California courts allowed borrowers with pay-option loans to proceed with fraudulent omission claims against their lenders.<sup>27</sup> Pay-option loans permitted borrowers to choose from several payment options. The options included paying principal and interest (the fully amortizing payment amount), only the monthly interest charge, or an amount less than the monthly interest due, in which case the unpaid interest was tacked onto the principal up to a set maximum; this option resulted in negative amortization. The legally mandated loan disclosures included a payment schedule based on a 30-day teaser rate, and stated that negative amortization might occur. However, because the payment schedule was based on a teaser rate that

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<sup>24</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>25</sup> See *Matthews v. New Century Mortgage Corp.*, 185 F.Supp.2d 874 (S.D. Ohio 2002) (denying motion to dismiss fraud claim where allegations were that brokers defrauded borrowers by falsifying the borrowers’ income and employment status on their loan applications); *Carroll v. Fremont Investment & Loan*, 636 F.Supp.2d 41, 52 (D.D.C. 2009) (holding that a lender falsifying a borrower’s income and assets on a loan application so that they would qualify for a loan they could not afford amounts to a fraud on the borrowers).

<sup>26</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>27</sup> *Peel v. Brooksamerica Mortgage Corp.*, 2011 WL 2174373 (C.D.Cal. 2011); *Jordan v. Paul Financial LLC*, 745 F.Supp.2d 1084 (N.D.Cal. 2010); *Ralston v. Mortgage Investors Group*, 2010 WL 3211931 (N.D.Cal. 2010).

increased after 30 days, negative amortization was certain to occur if borrowers adhered to the payment schedule. Based on this evidence, the Courts denied lenders' motions for summary judgment and allowed the plaintiffs to go forward with their claims of fraud by omission.

## 2. Unconscionability

Unconscionability is another defense that borrowers can raise when note owners bring collection actions. Contracts can be unconscionable if borrowers had no meaningful choice about the terms and the terms unreasonably favored the lender.<sup>28</sup> Most courts require that borrowers prove both procedural and substantive unconscionability,<sup>29</sup> although the analysis is not rigid.<sup>30</sup> When a contract – or one or more of its clauses – is unconscionable, courts can reform or refuse to enforce the contract.<sup>31</sup>

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<sup>28</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 omitted).

<sup>29</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>30</sup> *See e.g. Matter of Friedman*, 64 AD 2d 70, 85 (NY App. Div. 1978) (stating in dicta that “[t]he concept of unconscionability must necessarily be applied in a flexible manner depending upon all the facts and circumstances of a particular case.”).

Procedural unconscionability is marked by oppression and unfair surprise.<sup>32</sup> An oppressive transaction denies the borrower meaningful choice through a gross inequality of bargaining power.<sup>33</sup> In the lending context, surprise occurs most frequently when supposedly agreed-upon terms are hidden from the borrower in clauses that are lengthy, complex, or otherwise confusing, or when the terms of the note at closing differ from those that had been negotiated previously.<sup>34</sup> The procedural prong of unconscionability will often be satisfied in abusive lending situations.<sup>35</sup>

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<sup>31</sup> See generally Restatement 2d., Contracts; U.C.C. § 2-302.

<sup>32</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>33</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, 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>34</sup> *A&M Produce v. FMC Corp.*, 135 Cal. App. 3d 473, 486 (1982) (holding that “[s]urprise involves the extent to which the supposedly agreed-upon terms of the bargain are hidden in a prolix printed form drafted by the party seeking to enforce the disputed terms”). Courts have found that borrowers can be surprised even when they signed and initialed disclosure documents. *Moore v. Mortgagestar, Inc.*, 2002 U.S. Dist. LEXIS 27457 (S.D. W.V.) (holding that the borrowers’ initials and signatures on disclosure



Substantive unconscionability is not well-defined, but courts have found common terms to be substantively unconscionable. For example, some courts have found mandatory arbitration clauses unconscionable.<sup>36</sup> Others have held that when lenders, without the borrower's knowledge, inflate the borrower's income in order to qualify the borrower for a loan, the inflation can introduce an element of unconscionability.<sup>37</sup> When individual contract terms are not by themselves substantively unconscionable, some courts have held that a combination of unfair terms can amount to substantive unconscionability.<sup>38</sup>

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documents was not evidence of a lack of surprise); *Green v. Gibraltar Mortgage*, 488 F. Supp. 177, 180 (D.C.D.C. 1980) (holding that a borrower taking out a second mortgage to avoid imminent foreclosure lacked any meaningful choice).

<sup>35</sup> See, e.g., *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).

<sup>36</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); see also *Luna v. Household Fin. Corp.*, 236 F.Supp.2d 1166 (W.D. Wash. 2002) (same); 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); *In re Firstmerit Bank, N.A.*, 52 S.W.3d 749, 44 Tex. Sup. Ct. J. 900 (2001) (same).

<sup>37</sup> *City Fin. Services v. Smith*, 2000 WL 288469 (Cuyahoga County Mun. Ct. Ohio) (holding that the lender's enhancement of borrower's income to reflect a 25% income tax deduction level, which never existed, created an element of unconscionability in the contract when it was made).

<sup>38</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).

Although loan prices can theoretically be unconscionable,<sup>39</sup> courts have been reluctant to deem them so.<sup>40</sup> In several cases, however, courts have found that a loan was unconscionable if the borrower's monthly payment was unaffordable.<sup>41</sup>

Unconscionability claims are not easy to prove, especially when borrowers have recently engaged in similar transactions, e.g. previously financing a home, and were given adequate disclosure of the terms of their loans and the associated risk.<sup>42</sup> Consistent with this approach, courts have denied unconscionability claims when borrowers underwent loan counseling before signing their loan documents, had an opportunity to

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<sup>39</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”); *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).

<sup>40</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>41</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) (denying motion to dismiss unconscionability claim where, among other factors, the borrower's financial situation made it “apparent that [the borrower] could not reasonably expect to repay the second mortgage”); *City Fin. 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).

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

<sup>42</sup> See e.g. *In re Strong*, 356 B.R. 121, 131 (Bankr. E.D. Pa. 2004) (denying a borrower's unconscionability claim where the borrower reviewed disclosure documents, consciously opted not to rescind, had entered a similar refinance agreement the prior year to the refinancing at issue, and the court found the loan terms reasonable given the borrower's financial situation).

ask questions about the loans, and believed they were able to make their monthly mortgage payments.<sup>43</sup>

### 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 successfully defend against foreclosure or collection actions. This is because the holder in due course (HDC) rule can shield note owners.<sup>44</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>45</sup> The rule applies to

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<sup>43</sup> See e.g. *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 loan terms explained at closing and had undergone loan counseling prior to the original home purchase).

<sup>44</sup> For a general discussion of the impact of the holder in due course rule on borrower claims, see Mark B. Greenlee and 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 Whitman, *supra* note \_\_\_\_ at 756-57.

<sup>45</sup> See generally Mark B. Greenlee and Thomas J. Fitzpatrick IV, *Reconsidering the Application of the Holder in Due Course Rule to Home Mortgage Notes* 41 UCC L. J. 225 (2009); Michael Sinclair, *Codification of Negotiable instruments Law: A Tale of Reiterated Anachronism*, 21 U. TOLEDO L. REV. 625, 634-635 (1989).

loans secured by real property and impedes almost all defenses to payment on a note, including unconscionability and most fraud.<sup>46</sup>

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

To satisfy the requirements of the HDC rule, purchasers must prove that they are the holders of a negotiable instrument, purchased in the ordinary course of business, for value, in good faith, and without notice that the note was overdue, had been dishonored or was subject to any defenses.<sup>47</sup> If a note owner is not a holder in due course, consumers can defend nonpayment.

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<sup>46</sup> U.C.C. §§ 3-305(a), (b). There is a small set of defenses that can be raised even against an HDC. These defenses include: (1) infancy of the obligor to the extent it is a defense to a simple contract; (2) duress, lack of legal capacity or illegality of the transaction, which completely nullify the obligation; (3) fraud that induced the note to be signed without knowledge or reasonable opportunity to learn the terms of the instrument or that the document was a negotiable instrument; and (4) the discharge of the note maker in insolvency proceedings. These defenses are limited to the most extreme violations of law.

<sup>47</sup> U.C.C. §§ 3-302; 3-308(b) and comment 2. 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.

a. Negotiable Instrument

In order for a holder to qualify as a holder in due course of a home mortgage note, the note must be a negotiable instrument. Because of the powerful protections that holders of negotiable instruments receive, courts limit the types of paper that qualify as such, as we discuss below.<sup>48</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>49</sup> A promise or order is conditional if it contains an express condition to payment, a statement that the loan incorporates another writing, or a

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

<sup>48</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>49</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). Arguably, loans with negative amortization could be for uncertain sums because the principal balance can increase over time, albeit to a set limit of usually between 110 to 115 percent of the original loan amount. But see *Goss v. Trinity Sav. & Loan Ass’n.*, 813 P.2d 492 (Okla. Ct. App. 1991) (rejecting borrowers’ claim that negatively amortizing loan was not a negotiable instrument).

statement that the rights or obligations with respect to the promise are stated in other writings.<sup>50</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>51</sup>

Although standard-form home loans do not employ express conditions because of the risk that they will undermine an assignee’s status as an HDC, there is a standard term, referred to as a “usury savings clause” that may destroy negotiability.<sup>52</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. In other words, the borrowers’ duty to pay is expressly condition on the rate being non-usurious. To the extent that courts hold that usury savings clauses create conditions to payment, notes containing such clauses are not

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<sup>50</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, 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>51</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>52</sup> Ronald J. Mann, *Searching for Negotiability in Payment and Credit Systems*, 44 UCLA L. Rev. 951, 976-77 (1997).

negotiable instruments and claims of assignees of such notes that they are holders in due course will fail.

ii. Additional Undertakings

Negotiable instruments must not require “any other undertaking or instruction by the person promising or ordering payment to do any act in addition to the payment of money.”<sup>53</sup> A standard provision that could defeat the negotiability of mortgage notes requires borrowers to notify lenders, in writing, if they plan to prepay their loans.<sup>54</sup> Whether the prepayment notice requirement is an additional undertaking has yet to be tested in courts.

b. Holders of Notes

If the party seeking to enforce a note passes the negotiability hurdle, it must still prove it is a “holder” of the note.<sup>55</sup> To be a holder, one must have possession of the note and the right to enforce it. A person in possession may enforce notes that are either payable to the person in possession or are “bearer paper,” which, in the case of home loans, usually does not specify a payee.<sup>56</sup> Thus, to be a holder a person must possess

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<sup>53</sup> UCC §§ 3-104(a).

<sup>54</sup> Mann, *supra* note \_\_\_\_ at 971-72; Whitman, *supra* note \_\_\_\_ at 749-50.

<sup>55</sup> U.C.C. § 3-302(a).

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

bearer paper or be the person to whom the loan is payable. Notes that are payable to an identified person or entity can be transferred through endorsement and delivery; with bearer paper delivery alone qualifies as a transfer.<sup>57</sup>

The private securitization market did not always ensure that note owners had actual possession of notes or that the notes had the required endorsements.<sup>58</sup> There are numerous instances in which sellers of notes did not endorse them 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 legal authority to do so. Courts have held that such infirmities in endorsements can preclude owners of notes from establishing holder status.<sup>59</sup>

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<sup>56</sup> U.C.C. §§ 1-201(20), 3-109(b); U.C.C. § 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).

<sup>57</sup> U.C.C. § 3-203. This speaks only to the requirements under the U.C.C. There may be additional requirements at the state level to transfer an interest in property. *See, e.g. In re Grioux*, 2009 WL 1458173 (Bankr. D. Mass. 2009) *aff'd, cert. denied MERS v. Agin*, 2009 WL 3834002 (D. Mass. 2010); *U.S. Bank Nat'l Ass'n v. Ibanez*, 458 Mass. 637, 941 N.E.2d 40 (2011).

<sup>58</sup> Whitman, *supra* note \_\_\_\_ at 757-58; *see also* Ariana Eunjung Cha, *B of A official: Countrywide mortgage documents were not transferred properly to trust*, THE WASHINGTON POST (11/24/10) (documenting the failure of Countrywide Mortgage to transfer possession of notes to assignees).

<sup>59</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 could not be an HDC); *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)



c. Taking in Good Faith and without Notice

In order to achieve HDC status, holders of negotiable instruments must also prove that they took the notes in good faith, and without notice that the borrowers were behind on payments or that the notes were subject to any defenses. The U.C.C. defines good faith as honesty in fact and the observance of reasonable commercial standards of fair dealing.<sup>60</sup> Lack of good faith can be difficult to prove, particularly in states that apply a subjective good faith standard, rather than the U.C.C.'s objective standard.

Notice is defined as actual knowledge, receipt of notice or notification, or that all the facts and circumstances known to the owners at the time in question provided reason to know the fact.<sup>61</sup> As we discuss below, a borrower's loan file, a close connection

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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); *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 of a note and mortgage were made by the same person, who claimed to be acting as an agent of two mortgage companies on the same day without any proof of an agency relationship).

<sup>60</sup> U.C.C. § 3-101(a)(4). Although U.C.C. § 1-201(20) defines good faith as honesty in fact in the conduct or transaction concerned, the comments state that this is a floor, not a ceiling. *Id.* at cmt. 19. The 2001 revisions to the UCC redefined of good faith to mean honesty in fact and observance of reasonable commercial standards of fair dealing, but most states use the pre-2001 definition.

<sup>61</sup> UCC § 1-201(25)-(27). 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

between the parties involved in the mortgage and financing, or agency relationships can put an assignee on notice and imply the close connectedness doctrine, discussed below.

i. Loan files and notice

Loan files can contain information that will put assignees on notice that a note is defective. As we discussed earlier, in the flurry of securitizations, loan originators did not always deliver borrowers' notes to the new owners and did not always endorse the loans.<sup>62</sup> Oftentimes, owners have corrected the deficiencies *after* borrowers defaulted or sued the note holder.<sup>63</sup> This means that when the owners became holders they had notice that the notes were defective, which could preclude them from being HDCs. This, in turn, could enable borrowers to raise defenses to foreclosure or collection actions brought by assignees. This was the case in *Fairbanks Capital Corp. v. Summerall*,<sup>64</sup> where an assignee brought a collection action against a borrower in default. Before the assignee

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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.

<sup>62</sup> The issue whether an assignee is a HDC is different from the question of standing that has arisen when owners of notes have attempted to foreclose based on notes that lacked valid endorsements. Whitman, *supra* note \_\_\_\_ at 762-63; 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). Without possession of the notes and the endorsements necessary to establish a valid chain of ownership, owners of notes may not have the right to foreclose

<sup>63</sup> *Carroll v. Fremont Investment & Loan*, 636 F.Supp.2d 41, 55-56 (D.D.C. 2009) (holding that borrower's lawsuit prior to the note owner becoming a holder put the holder on notice of the borrower's defenses to non-payment). Becoming a holder after legal proceedings have been initiated was standard in some cases. Ariana Eunjung Cha, *B of A official: Countrywide mortgage documents were not transferred properly to trust*, THE WASHINGTON POST (11/24/10).

<sup>64</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>65</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 conclusions when purchasers of loans have notice that a note is overdue or otherwise defective.<sup>66</sup>

ii. Close connectedness doctrine and agency relationships

Courts have also imputed knowledge when there is a close connection between an assignee and the seller of the loan.<sup>67</sup> In *England, et al. v. MG Investments, et al.*,<sup>68</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>65</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>66</sup> See e.g., *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.) (noting that Wells Fargo had purchased a 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 that "the court requires an explanation from an officer of plaintiff U.S. Bank why... plaintiff U.S. Bank [would] purchase...a nonperforming loan").

<sup>67</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>68</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>69</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. Even where there is no corporate familial relationship, courts have denied HDC status to note owners that purchased loans immediately after origination, at a substantial discount, and without investigating the credit quality of borrowers.<sup>70</sup> Courts have similarly denied HDC status when note owners exercised extensive control over the originator’s operations and acted as the sole purchaser of the originator’s notes.<sup>71</sup>

At times, courts have imputed notice of defects to assignees because of agency relationships between assignors and assignees. For example, courts impute this

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<sup>69</sup> 93 F. Supp. 2d 718, 723 (S.D. W.V. 2000); *see also 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 that where “a seller of goods executes a loan contract with the customer, and then immediately assigns the contract to a finance company” the assignee could be found liable for TILA violations on the grounds that the originator was acting as a conduit for the assignee).

<sup>70</sup> *Greene v. Gibraltar*, 488 F. Supp 177, 180-81 (D.D.C. 1980).

<sup>71</sup> *Unico v. Owen*, 232 A2d 405, 412-13 (N.J. Sup. Ct. 1967); *see also Bishop v. Quicken Loans, Inc.* 2010 WL 3522128 (S.D.W.V.) at \*4 (denying assignee’s motion to dismiss on the grounds that allegations that the assignee had “a continuing business relationship” with the loan originator could defeat the status of the assignee as a holder in due course).

knowledge when a single signatory acted for both the assignor and assignee (a practice that was not uncommon).<sup>72</sup> Similarly, in *First Union Nat. Bank v. Curtis*,<sup>73</sup> the Court denied HDC status to an assignee because the originator and assignee utilized the same third-party loan servicer, who had notice that the loan was delinquent at the time of its sale. The Court reasoned that the servicer acted as a common agent for the assignor and assignee; thus, the assignee had actual or constructive knowledge of the delinquency.<sup>74</sup> Although the Supreme Judicial Court of Maine vacated the trial court's judgment on other grounds, the Court noted that First Union had purchased an overdue note with knowledge that it was overdue.<sup>75</sup>

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<sup>72</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>73</sup> 2004 WL 2153521, *vacated on other grounds in* 2005 ME 108 (2005).

<sup>74</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]”).

<sup>75</sup> *First Union Nat’l Bank v. Curtis*, 2004 WL 2153521 at \*4, n.6.

d. Takes in the Ordinary Course of Business

In order for a holder of a negotiable instrument taken in good faith and without notice to acquire rights as a 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>76</sup> This 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 seeks to liquidate a substantial portion of loans that it would hold during its normal course of business, HDC status might not attach.<sup>77</sup> Likewise, in most circumstances, the merger of two lending institutions is a transaction

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<sup>76</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. Diversified attempted to enforce the note as a HDC, but the Court refused to accord it HDC status, stating “It is quite clear under the Uniform Commercial Code, [U.C.C. § 3-302(c)], that one cannot become a holder in due course of an instrument by purchase of it at a judicial sale or by taking under legal process.” *Id.* at 323.

<sup>77</sup> UCC § 3-302 cmt. 5.

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

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

occurring outside the ordinary course of business and the transfer of loans from one entity to another would not make the transferee an HDC.<sup>78</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 purchasers do not have time to investigate the quality of the assets that the FDIC sold them. To mitigate this information friction, the FDIC acts as an insurer, granting the purchasing institution a put (back to the FDIC) for low-quality assets.<sup>79</sup> In 1982, the 11th Circuit held that the FDIC cannot become a holder in due course when the low-quality asset put is exercised, because the FDIC has made bulk purchases not in the ordinary course of business. Nonetheless, the Court extended complete protection from

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<sup>78</sup> See *Rosa v. Colonial Bank*, 542 A.2d 1112, 1115 (1988). (stating “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 that a bank acquiring notes through a merger could still exercise the rights of an HDC by virtue of the shelter rule).

<sup>79</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 HDC 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 HDC status is appropriate when the FDIC is a receiver); *Firstsouth, F.A. v. Aqua Const., Inc.*, 858 F.2d 441, 443 (8th Cir. 1988) (holding that HDC status is appropriate when the Federal Savings and Loan Insurance Corporation acts as a receiver).

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>80</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 not qualify as an HDC on their own. The “shelter rule”<sup>81</sup> provides that an assignee has the rights of a holder in due course so long as an earlier owner was an HDC and the 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 an HDC, a subsequent assignee would have the rights of an HDC, so long as the assignee did not actively participate in creating them.

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<sup>80</sup> See *Gunter v. Hutcheson*, 674 F.2d 862, 872-73 (11th Cir. 1982).

Over time, federal courts developed a federal HDC rule that applied to the FDIC, See, e.g. *FDIC v. Wood*, 758 F.2d 156, 161 (6th 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). 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 that “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).

<sup>81</sup> U.C.C. § 3-203(b).



## B. Statutory Claims

Thus far, we have focused on derivative common law claims that borrowers might be able to pursue against the owners of their notes. We now turn to derivative statutory liability. Under 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 preserves assignee liability for loans used to pay for consumer goods or services. Other laws, like the federal Truth in Lending Act (TILA), allow borrowers to exercise rights of rescission against the owners of their notes. States have adopted analogues to some or all of these laws. In this section of the article, we describe these various laws, their complex interactions with each other and other laws, and their implications for owners of whole loans as well as RMBS investors.

### 1. Truth in Lending Act

The Truth in Lending Act<sup>82</sup> requires specific disclosures to borrowers in consumer credit transactions. TILA and the rules written pursuant to it mandate that creditors “provide a good faith estimate of the loan costs, including a schedule of

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<sup>82</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. Elizabeth Renuart and Kathleen Keest, *TRUTH IN LENDING* 13-14 (6th ed. 2007).

The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, Publ. L. No. 111-203, 124 Stat. 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 to a more expensive loan product.

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>83</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>84</sup> TILA contains a complex remedial scheme. For violations of TILA’s disclosure rules, consumers can recover statutory damages of twice the finance charge.<sup>85</sup> Actual damages are available for any TILA violation, but only if borrowers can prove that they relied to their detriment on the

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<sup>83</sup> 15 U.S.C. § 1638(b)(1)and(2); 12 C.F.R. §§ 226.17(c)(2), 226.19(a)(1).

<sup>84</sup> For a full treatment of TILA, including the rules governing open-ended credit, *see* Elizabeth Renuart and 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 be “conspicuously separated from other terms, data or information provided in connection with the transaction.” 15 U.S.C. § 1632(a).

For ARMs, before paying an application fee, consumers must also receive a brochure 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 and Kathleen Keest, *TRUTH IN LENDING* 91 (6th ed. 2007).

<sup>85</sup> 15 U.S.C. § 1640(a)(2)(i).

erroneous disclosure.<sup>86</sup> Borrowers, whether they seek statutory or actual damages, are entitled to attorney's fees and costs.<sup>87</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>88</sup> Successful plaintiffs can have their debt reduced by the amount of their TILA damages.<sup>89</sup>

TILA also provides a right of rescission. With some restrictions,<sup>90</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 means that borrowers who did not receive TILA disclosures at origination have up to three years to exercise their rescission rights.<sup>91</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>92</sup> Second, if the TILA

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<sup>86</sup> Elizabeth Renuart and Kathleen Keest, TRUTH IN LENDING 577-78 (6th ed. 2007).

<sup>87</sup> Elizabeth Renuart, STOP PREDATORY LENDING 97 (2002).

<sup>88</sup> 15 U.S.C. §1640(e).

<sup>89</sup> Elizabeth Renuart and Kathleen Keest, TRUTH IN LENDING 489 (6th ed. 2007).

<sup>90</sup> For example, rescission rights do not apply to purchase money mortgages. Elizabeth Renuart, STOP PREDATORY LENDING 100 (2002).

<sup>91</sup> *Id.*

<sup>92</sup> 15 U.S.C. § 1641(a).

disclosures were incomplete or contained errors the borrower can rescind the loan within three years after it was consummated, even when such violations were not apparent on the face of the loan documents. These rescission rights act against whoever owns the notes.<sup>93</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 security interest is lost or held in abeyance by courts until the borrower tenders the proceeds of the loan less any damages.<sup>94</sup>

## 2. Home Ownership and Equity Protection Act

The Home Ownership and Equity Protection Act (HOEPA)<sup>95</sup> amended TILA to require special disclosures three days before closing and to prohibit various terms in high-cost loans.<sup>96</sup> HOEPA only applies to closed-end consumer credit transactions

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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 there was no evidence of irregularities apparent on the face of the documents).

<sup>93</sup> 15 U.S.C. § 1641(c).

<sup>94</sup> 15 U.S.C. § 1635(a) – (i).

<sup>95</sup> 15 U.S.C. § 1639(a) – (l).

<sup>96</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 []

secured by the borrowers' principal residence.<sup>97</sup> The statute does not apply to purchase money or construction loans.<sup>98</sup> In addition, only loans that meet specific interest rate and points and fees "triggers" are subject to HOEPA.<sup>99</sup>

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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 the value of any improvements they made to 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>97</sup> 15 U.S.C. § 1602(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>98</sup> 15 U.S.C. § 1602(w).

<sup>99</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 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 which 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 HOEPA requirement that borrowers prove a "pattern and practice" of equity-based lending.

Borrowers can bring affirmative HOEPA claims and raise HOEPA as a defense to collection efforts by the holders of their notes. There is a one-year statute of limitations on affirmative claims, but no limit on defensive claims.<sup>100</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>101</sup> Unlike TILA claims, borrowers do not have to prove that HOEPA violations are apparent on the face of the documents.<sup>102</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

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Assignees are not liable for damages for violations of provisions governing higher-priced loans although failure to comply with prepayment penalty restrictions on such loans can trigger rescission. 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>100</sup> 15 U.S.C. § 1640(e).

<sup>101</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 a loan is governed by HOEPA, an assignee “can rely on the documentation it receives from its assignor and has no obligation to investigate its accuracy”).

<sup>102</sup> *In re Murray*, 239 B.R. 728, 733 (Bankr. E.D. Penns. 1999).

creditor's violations are "material."<sup>103</sup> Any violations of HOEPA are deemed material for the purpose of triggering the right of rescission under TILA.<sup>104</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>105</sup> This has been interpreted to mean 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 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>106</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 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>107</sup> Several courts have implicitly adopted this

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<sup>103</sup> 15 U.S.C. § 1640(a) (2008) and 15 U.S.C. § 1641(d)(2)(A) (1994). These remedies are not available in claims against involuntary assignees. 15 U.S.C. § 1641(a).

<sup>104</sup> 15 U.S.C. §§ 1602(u) (2008), 1639(j) (2009).

<sup>105</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>106</sup> 15 U.S.C. § 1641(d)(2), (3).

<sup>107</sup> Barbara S. Mishkin and Kevin M. Toth, *Assignee Liability: How Far Does It Extend?* 5 CONSUMER FIN. SERVS. REP. 19 (April 10, 2002).

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>108</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>109</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>110</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 prohibits unfair and deceptive acts in the “conduct of . . . trade or commerce.”<sup>111</sup>

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<sup>108</sup> 197 F. Supp. 2d 1357, 1364-5 (N.D. Ga. 2002); *see also Pulphus 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>109</sup> 197 F. Supp. 2d 1357, 1365 (N.D. Ga. 2002).

<sup>110</sup> 401 F. Supp. 2d 549 (S.D. W.V. 2005).

<sup>111</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. 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



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>112</sup> the court dismissed plaintiff’s Equal Credit Opportunity Act (ECOA) claim on the grounds that HOEPA’s general assignee liability provision had to yield to ECOA’s provision “eliminat[ing] an assignee’s liability for ECOA violations unless the assignee participated in the violation or knew or had reasonable notice of the act that constituted the violation.” 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 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

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fraud claim against the assignee of a HOEPA loan); *Schwartz v. Bann-Mar Corp.*, 197 S.W. 3d 168, 179 (2006) (allowing plaintiffs to go forward with consumer protection claims against assignees of HOEPA loans regardless of arguably contradictory state law provisions).

<sup>112</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) (stating in dicta that “HOEPA does not create a new right or claim that would not be otherwise cognizable under the law. Specifically, under North Carolina law, only the alleged perpetrator of a fraud . . . and not a subsequent assignee, can be held liable for an unfair or deceptive trade practice”); *Durham v. 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).

or nullified by a general one, regardless of the priority of enactment.’<sup>113</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>114</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>115</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>116</sup> The Heath Court also held that the debtor could

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<sup>113</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>114</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 loans because “[u]nlike ECOA, RESPA does not expressly discuss claims against assignees”).

<sup>115</sup> 2001 WL 1771825 (Ill. Cir. Ct. Oct. 26, 2001).

<sup>116</sup> *Id.* at \*3.

not maintain a claim under the state's Unfair and Deceptive Acts Practices statute because the statute only permitted recovery against perpetrators.<sup>117</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>118</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>119</sup>

When states enacted APLs, some protested that the new laws “could throw a monkey wrench into both the residential mortgage-backed securities and subprime housing markets,” by making arrangers and trusts legally liable for loans that violated the state statutes.<sup>120</sup> In fact, when Georgia passed an APL that subjected assignees to

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<sup>117</sup> *Id.* at \*2.

<sup>118</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>119</sup> *Id.* at 2091-93.

uncapped liability for originators' misdeeds, credit rating organizations refused to rate RMBS backed by loans made in Georgia because they claimed they could not shield investors from borrowers' predatory lending claims. Although there are state APLs that expose assignees to potential liability, industry protests and the response to Georgia's APL led most states to shy away from strong assignee liability provisions in their APLs. Ultimately, Georgia retreated from its broad assignee liability provision.

#### 4. FTC Holder Rule

There is yet another channel through which assignees are exposed to potential derivative liability. The Federal Trade Commission (FTC) issued a Trade Regulation ("the FTC Rule" or "the Rule")<sup>121</sup> in 1975 that effectively bans the HDC defense in consumer credit contracts for the sale of goods or services and permits both affirmative and defensive actions against owners of notes.<sup>122</sup> Because the FTC Rule applies only to the sale of goods and services, most mortgage loans are not subject to the Rule. The FTC Rule applies when the note was originated in connection with the home repairs, goods and services, or manufactured housing.

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<sup>120</sup> Bill Shepherd, *Perils and Phantasms*, 69 INVESTMENT DEALERS' DIGEST 26 (February 3, 2003).

<sup>121</sup> For a comprehensive discussion of the FTC Rule, see Carolyn L. Carter and Jonathan Sheldon, UNFAIR AND DECEPTIVE ACTS AND PRACTICES 650-76 (7th ed. 2008); Eugene J. Kelley, John L. Ropiequet, and Georgia Logothetis, *Assignee Liability: Through the Minefield*, 61 CONSUMER FINANCE LAW QUARTERLY REPORT 279 (2007).

<sup>122</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. Carter and Sheldon, *supra* note \_\_\_\_ at 686.

The Rule states that it is an unfair or deceptive trade practice under the Federal Trade Commission Act<sup>123</sup> to take or receive a consumer credit contract that fails to include a notice that assignees take it “subject to the consumer’s claims and defenses.”<sup>124</sup> Sellers who finance transactions must include this notice. Similarly, if a seller refers a customer to a lender or is affiliated with a lender that provides the financing, the seller must include the notice in the sales contract.<sup>125</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>126</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, “the consumer’s maximum recovery . . . is cancellation of all remaining indebtedness plus an affirmative recovery of the amount already paid in on

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<sup>123</sup> 15 U.S.C. §§ 41-58

<sup>124</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).

<sup>125</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>126</sup> 41 FED. REG. 20023-24 (May 14, 1976).

the debt.”<sup>127</sup> This cap applies to all claims under state or federal law brought pursuant to the FTC Rule.<sup>128</sup> Some courts further restrict a consumer’s remedies if the damages exceed 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 receive nothing of value in the transaction in order for a consumer to recover monies already paid.<sup>129</sup> This view is not uniform across courts and more recent FTC Staff Commentary disavows this interpretation.<sup>130</sup>

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

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<sup>127</sup> Carter and Sheldon, *supra* note \_\_\_\_ at 668.

<sup>128</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 FTC Rule. Carter and Sheldon, *supra* note \_\_\_\_ at 668.

<sup>129</sup> 40 Fed. Reg. 53524, 53527 (Nov. 18, 1975); *see, e.g., 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”); *Herrara 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>130</sup> Carter and Sheldon, *supra* note \_\_\_\_ at 661-3; *see, e.g., Beemus v. Interstate Nat’l Dealer Servs., Inc.*, 823 A.2d 979 (Pa. Super. Ct. 2003) (quoting the FTC staff commentary).

example, the law requires some level of participation that was absent.<sup>131</sup> This was the situation in *Nations Credit v. Pheanis*.<sup>132</sup> The assignee of a contract to finance the purchase of a mobile home brought suit for nonpayment against the borrower. The borrower counterclaimed, asserting that the assignee was liable for the seller's violation of the Ohio Consumer Sales Practices Act (CSPA). The alleged violation of CSPA was that the seller sold the mobile home without a permit, which prevented the borrower from obtaining a certificate of title. In upholding the borrower's claim, the Court made clear that under the FTC Rule, a holder could have derivative liability even if it would not have direct liability under the state law. In contrast, in *LaBarre v. Credit Acceptance Corp.*,<sup>133</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>134</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>131</sup> Carter and Sheldon, *supra* note \_\_\_\_ at 658.

<sup>132</sup> 656 N.E.2d 998 (Ohio App. 1995).

<sup>133</sup> 175 F.3d 640 (8th Cir. 1990).

<sup>134</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 partly because the assignee did not "participate" in making the loan as required under the Consumer Fraud Act).

Rule cannot be used to “sidestep” TILA’s limits on assignee liability.<sup>135</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 broad assignee liability in state laws that parallel the FTC Rule.<sup>136</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 Unfair and Deceptive Acts or Practices (UDAP) claim against an assignee under the FTC Rule, based on misrepresentations in the disclosures when the disclosures did not violate TILA. In a highly-controversial decision, the Illinois Supreme Court held, in *Jackson v. South Holland Dodge*,<sup>137</sup> 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

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<sup>135</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 courts’ unwillingness to hold that the FTC Rule trumps limitations on assignee liability under the Truth in Lending Act).

<sup>136</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>137</sup> 755 N.E.2d. 462, 468-70 (Ill. 2001).



TILA preemption of the FTC Rule. Few courts have addressed the complex relationship between TILA, the FTC Rule, and state law claims. Thus, the extent to which jurisdictions outside Illinois will follow *Jackson* is unknown.

Even if *Jackson* becomes the dominant paradigm, borrowers can still invoke the FTC Rule to bring deceptive trade practices claims against assignees based on sellers' misconduct that is not related to disclosures.<sup>138</sup> For example, in the *Nations Credit* case,<sup>139</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>140</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, UDAP statutes, or state anti-predatory lending laws.<sup>141</sup> To assuage these concerns about legal liability, securitization deals were structured to protect investors from the risk

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<sup>138</sup> Carter and Sheldon, *supra* note \_\_\_\_ at 665.

<sup>139</sup> 656 N.E.2d 998 (Ohio App. 1995)

<sup>140</sup> Carter and Sheldon, *supra* note \_\_\_\_ at 665-6.

<sup>141</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).

of borrower claims.<sup>142</sup> The terms of the deals typically required originators (1) to provide reps and warranties that none of the loans were governed by laws that could impose liability on the trusts; and (2) to agree to buy back any loans that were found to violate the reps and warranties or to substitute the offending loans with loans that were not covered by laws that permitted assignee liability.<sup>143</sup> The purpose of such recourse provisions was to force originators to retain the risk that borrowers might have claims for which assignees could be liable.

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<sup>142</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).

<sup>143</sup> The following excerpt from a Morgan Stanley prospectus provides an example:

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

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

Prospectus and Prospectus Supplement, *Mortgage Pass Through Certificates, Series 2007-HE7*, Morgan Stanley ABS Capital I Inc. Trust 2007-HE7 (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).

Despite the reps and warranties, originators sold loans that violated deal provisions. For example, one industry article dating back to 2000 estimated that some securitization portfolios contained as many as 30% HOEPA loans even though the reps and warranties stated that none of the loans were governed by HOEPA.<sup>144</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 major subprime originators could go bankrupt, thus precluding enforcement of recourse provisions.

This is exactly what happened in 2004, when US Bancorp settled class action suits in which borrowers asserted that the bank was liable for HOEPA violations as an assignee. US Bancorp had purchased the challenged loans from Firstplus, which was declared bankrupt in 1999. Because Firstplus was out of business, it was impossible for US Bancorp to unload the loans that violated HOEPA. The attorney for Firstplus explained that the loan purchasers were "relying on reps and warranties . . . but [they don't] protect the buyer if the seller goes bankrupt."<sup>145</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

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<sup>144</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>145</sup> Erick Bergquist, *Guess What? Loan Buyers Liable under Federal Law*, AMERICAN BANKER (May 7, 2004).

of reps and warranties. By 2007 the number of such demands had escalated further.<sup>146</sup> A former executive at a subprime lender described the subprime industry as choking “on the volume of loans put back to them.”<sup>147</sup> Lenders claimed they did not have the money to buy back loans and many sought bankruptcy protection. A startling example is New Century Financial Corp., which had over \$8 billion in repurchase demands in March 2007. The next month the firm announced it was bankrupt.<sup>148</sup>

When originators cannot honor the recourse provisions in pooling and servicing agreements (PSAs), the trusts may have to retain ownership of the loans. And, as owners, they can potentially be subject to affirmative claims and defenses to nonpayment

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<sup>146</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).

<sup>147</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>148</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).

by borrowers as described above. In other words, the assignees bear a risk that they thought they had avoided through the reps and warranties.<sup>149</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>150</sup>

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

Thus far, when describing arrangers' liability, we have focused on the possibility that arrangers as owners of notes can be derivatively liable. In this section of the paper, we consider the possibility that arrangers have direct liability to borrowers for illegal acts of originators. For these claims, liability would not depend on arrangers' status as owners of the notes, but instead would be based on their involvement in securitization activities.<sup>151</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

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<sup>149</sup> Steven Schwarcz, *Protecting Financial Markets: Lessons from the Subprime Mortgage Meltdown*, 93 MINN. L. REV. 373 at 389 (Dec. 2008).

<sup>150</sup> Gretchen Morgenson, *A Road not Taken by Lenders*, NEW YORK TIMES (April 6, 2008).

<sup>151</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).

legal claims brought against them. As it turns out, having some level of knowledge of lenders' wrongdoing and exercising control were not uncommon during the past decade.

Arrangers operated in the most information-rich environment in the securitization chain. They conducted due diligence on originators and loan pools. They interacted with RMBS investors. And, they knew what products could be sold on the secondary market. This information allowed them to steer significant amounts of capital to originators who could produce loans with the terms that arrangers requested based upon investors' demand. Theoretically, it would have allowed arrangers to shut off capital flows to subprime originators who were known to originate loans with unlawful terms or through unlawful means, but incentives were not in place to ensure that happened.

A. Arrangers' Knowledge: Evidence from Lawsuits and Investigations

Arrangers' direct liability for unlawful origination practices requires that they at least be aware of those practices. As we discuss in subsection E below, awareness could be actual knowledge of an originator's illegal actions or reckless disregard of them. Recent federal and state investigations, private lawsuits, whistle blowers, and academic analyses have all uncovered evidence that some arrangers knew or disregarded the fact that the lending operations they were financing were making loans on potentially illegal grounds.<sup>152</sup> 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

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<sup>152</sup> Additional sources of information on potential consumer protection violations could come from investigations of depository institutions by regulators. More general information on deficits in underwriting and other problems within financial firms can be found in industry publications.

securities to investors, some of this evidence be used as evidence in consumer lawsuits against arrangers.<sup>153</sup>

Through due diligence, arrangers collected an array of information on lenders' operations. This included public consumer complaints and lawsuits alleging unlawful origination practices or loan terms. Transactional due diligence included a review of loan files and underwriting practices, which many times revealed that lenders were not complying with their own underwriting standards. This did not stop arrangers from putting the loans through the securitization pipeline.<sup>154</sup>

Over time, the dominant subprime lenders became more lax in terms of adhering to their credit policies. Increasing default rates reflected their weak underwriting. As early as 2003, loans began defaulting within a few months of origination—a red flag that the loans were unaffordable from the start. This should have prompted arrangers to

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<sup>153</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>154</sup> *See, e.g. Jordan v. Paul Financial*, 745 F. Supp.2d 1048, 1097 (N.D. Cal. 2010) (stating that the master loan purchase agreement granted RBS, the arranger, the right to underwrite the loans and review the mortgage files and loan portfolios, for issues including but not limited to "...credit, documentation, litigation, default, and servicing level compliance, as well as loan-level testing").

In 2006, Bear Stearns overrode a due diligence firm's conclusions that 56% of the time, loans should not be purchased for securitizations. *Id.* at 10 (citing an Internal Report produced by Clayton Holdings, Inc., CLAY-AMBAC 0001770-80 at 1777). More explicit evidence comes from an internal Bear Stearns email showing that Bear Stearns was aware of the low quality of the loans it was securitizing. In the e-mail, the 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 Bear Stearns' then-vice president and deal manager to its Managing Director of Trading).

engage in deeper investigations because numerous states have laws prohibiting making loans that borrowers cannot afford to repay.<sup>155</sup> At least some arrangers had actual knowledge that they were securitizing poorly underwritten loans; yet they continued to finance originators.<sup>156</sup> As evidence of bad lending practices mounted, arrangers actually reduced the number of loans they examined as part of their due diligence review.<sup>157</sup>

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<sup>155</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).

<sup>156</sup> 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 9) (describing how Citi continued to buy and sell "defective" mortgage loans with knowledge of their defects).

For example, in 2006, Goldman Sachs and Washington Mutual (WaMu) joined forces to securitize loans generated by one of WaMu's loan originators, Long Beach Mortgage Company. The parties entered this deal even though Long Beach had experienced record rates of early payment defaults—defaults that happen within a few months after loans are originated—and whose securities were performing poorly relative to the rest of the market. See WALL STREET AND THE FINANCIAL CRISIS: THE ROLE OF INVESTMENT BANKS BEFORE THE FIN. CRISIS INQUIRY COMM'N 111th Cong. 6 (2010) (Exhibit 1a, memorandum from Senators Carl Levin and Tom Coburn to Members of the Permanent Subcommittee on Investigations), *available at* [http://hsgac.senate.gov/public/\\_files/Financial\\_Crisis/042710Exhibits.pdf](http://hsgac.senate.gov/public/_files/Financial_Crisis/042710Exhibits.pdf).

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

The Long Beach securitizations were not aberrations. In 2007, Goldman Sachs securitized more than one billion in loans originated by Fremont Investment and Loan Fremont even though Fremont was already under close scrutiny by regulators for its role in making loans that people could not afford to repay. WALL STREET AND THE FINANCIAL CRISIS: THE ROLE OF INVESTMENT BANKS BEFORE THE FIN. CRISIS INQUIRY COMM'N 111th Cong. 6-7 (2010) (Exhibit 1a, memorandum from Senators Carl Levin and Tom



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

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 a single arranger to own a subprime loan originator, a servicer, an underwriter, and a broker/ dealer arm.<sup>158</sup>

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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).

<sup>157</sup> Vikas Bajaj and 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.

Typically, arrangers contracted with due diligence firms to determine whether a lender's loans adhered to the lender's promised underwriting criteria. Loans that deviated from the criteria were called "exceptions." Clayton Holdings, which conducted due diligence reviews, reported that 28% of the loans it reviewed in 2006 and the first half of 2007 were exceptions. Of these, securitizers waived 39%. Clayton Holdings, All Clayton: Trending Reports: 1<sup>st</sup> Quarter 2006- 2<sup>nd</sup> Quarter 2007 (on file with authors). In other words, arrangers converted almost half the loans that failed Clayton's due diligence review into securities, often using the exceptions to justify reducing the price they would pay lenders for the loans. WALL STREET AND THE FINANCIAL CRISIS: THE ROLE OF INVESTMENT BANKS BEFORE THE FIN. CRISIS INQUIRY COMM'N 111th Cong. 166 (2010) There were also situations in which some arrangers agreed not to reject more than a specified percent of loans in a package. They reached these agreements before they had conducted due diligence and, thus, before they knew how many exceptions a pool of loans contained. 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>158</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).

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

A managing director at Moody's Investors Service noted that:

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. 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>159</sup>

Vertical integration also made it easier for various subsidiaries and affiliates of arrangers to share valuable proprietary information to their firms' advantage. 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

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<sup>159</sup> Todd Davenport, *What's Behind Wall Street Players' Mortgage Deals?* AMERICAN BANKER (AUG. 14, 2006).

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 later involved in selling. 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).

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).

that the pools that arrangers did not bid on ultimately performed worse than those they bid on.<sup>160</sup>

C. Arrangers' Influence on Lenders

Arrangers had powerful levers that they could use to influence the originators who were dependent on them for financing their operations and purchasing their loans.

Arrangers were market makers that often told lenders the types of products they wanted for securitization and the number of loans they needed. As an executive from Washington Mutual, a notoriously risky lender, wrote in an email, “we always need to worry a little about Goldman because we need them more than they need us.”<sup>161</sup>

There is evidence that some arrangers used their purchasing power to shape lending practices. For example, *New York Times* reporter, Vikas Bajaj, reported that Ownit Mortgage Solutions loosened its underwriting standards “reluctantly and under pressure from . . . investors, particularly Merrill Lynch”<sup>162</sup> According to documents filed

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<sup>160</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.”)

<sup>161</sup> Carrick Mollenkamp and Serena Ng, *Investors Lost, Goldman Won on WaMu Deal*, WALL STREET JOURNAL (April 26, 2010).

<sup>162</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 that otherwise it would take its business

by the Commonwealth of Massachusetts, Morgan Stanley would agree to buy loans from lender New Century according to parameters that Morgan Stanley had set before the loans had even been made—a practice known as selling forward. New Century would then make loans based on Morgan Stanley’s “order.”<sup>163</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 loans, they may have exposed themselves to direct liability.

When securitization of subprime mortgages first emerged, there was concern that arrangers could be on the hook for financing originators who were engaged in predatory lending. In 2000, a Wall Street publication reported that industry insiders 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 “[t]he legal issues are complicated ones that are just starting to wend their way through the courts.”<sup>164</sup>

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elsewhere. *In re Morgan Stanley, Assurance of Discontinuance*, p. 9-10 par. 24-6 (June 24, 2010).

<sup>163</sup> *In re Morgan Stanley, Assurance of Discontinuance*, p. 5, par. 11 (June 24, 2010).

<sup>164</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 first, and for a long time, the only case asserting a claim against an arranger was a consumer suit against the now-defunct Lehman Brothers for its involvement in the misdeeds of First Alliance Mortgage Company (FAMCO). Wall Street “warily eye[d]” the lawsuit against Lehman.<sup>165</sup> Ultimately, after protracted litigation, a jury found that Lehman was 10% responsible for FAMCO’s unlawful lending practices and ordered Lehman to pay more than \$5 million of a \$51 million damage award.<sup>166</sup> This was the first time that consumers “penetrated the asset-backed securities world.”<sup>167</sup>

Shortly after the Lehman verdict, arrangers increased vertical integration of, and lending to, subprime originators. Had Lehman been hit with a more substantial damage award, arrangers might have become averse to having close relationships with lenders. Instead, arrangers moved from buying whole loans from unaffiliated originators to buying pools of loans directly from subprime lending affiliates.<sup>168</sup>

For almost a decade, as arrangers were streamlining their securitization machines, the Lehman/ FAMCO decision stood out as the only major consumer lawsuit that extended up the securitization food chain. In 2010, the tide began to shift when the Commonwealth of Massachusetts initiated a “market wide investigation” into “the

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<sup>165</sup> Michael Gregory, *ABS World Warily Eyes New Suit against Lehman*, INVESTMENT DEALERS’ DIGEST, May 8, 2000.

<sup>166</sup> *In re First Alliance Mortgage Co.*, 471 F.3d 977, 989 (9th Cir. 2006).

<sup>167</sup> Michael Gregory, *ABS World Warily Eyes New Suit against Lehman*, INVESTMENT DEALERS’ DIGEST, May 8, 2000.

<sup>168</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); Levine, *supra* note \_\_\_\_ at 58.

finance, purchasing and securitization of allegedly unfair residential mortgages” by investment banks.<sup>169</sup> As a result of these investigations, both Goldman Sachs and Morgan Stanley settled with the Commonwealth, Goldman for \$60 million,<sup>170</sup> and Morgan Stanley for \$102 million.<sup>171</sup> Following the Goldman Sachs agreement, the Massachusetts Attorney General, Martha Coakley, stated that “there’s no dispute that Goldman Sachs and other securitizers have been involved intricately in this whole process by which loans were made to homeowners and as we have argued, in many instances, destined to fail.”<sup>172</sup> These cases, and others like them, provide guidance, which we discuss next, on different ways arrangers may be liable to borrowers for unlawful origination practices.

E. Legal Theories for Arranger Liability

There are at least three theories under which arrangers may be directly liable for the unlawful acts of originators: aiding and abetting, conspiracy, and joint venture.<sup>173</sup>

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<sup>169</sup> In re Morgan Stanley, Assurance of Discontinuance, p. 1 par. 1(June 24, 2010).

<sup>170</sup> Jenifer B. McKim, *State Reaches \$60M Subprime Deal with Goldman Sachs*, BOSTON GLOBE (May 11, 2009).

<sup>171</sup> In re Morgan Stanley, Assurance of Discontinuance (June 24, 2010).

<sup>172</sup> Kathleen M. Howley and Christine Harper, *Goldman to Pay \$60 Million in Subprime Settlement*, BLOOMBERG.COM (May 11, 2009).

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

It is also possible that arrangers could be found to have violated the Fair Housing Act (FHA), 42 U.S.C. 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 against people based on their race, color, religion, sex, handicap, familial status, or

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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 the defendant did not lend money directly to the borrowers, but it allegedly had a "connection to the financing of residential real estate" . . . [and] may have unlawfully discriminated in the context of housing in violation of the FHA").

Some state unfair and deceptive acts and practices (UDAP) laws contain broad provisions that could encompass arranger activities. Those that follow the FTC Act contain general prohibitions on unfair or deceptive acts. Others contain only specific prohibitions on clearly specified activities. Some allow private rights of action, while others mimic the FTC ACT and only permit agency enforcement. There are also acts that exclude specific entities from coverage. *See generally*, Carolyn L. Carter, CONSUMER PROTECTION IN THE STATES (February 2009). To the extent states have adopted the more general UDAP standard and arrangers do not fall under any exclusions, arrangers could be subject to UDAP claims.

The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 also prohibits unfair, deceptive, or abusive acts or practices. Publ. L. No. 111-203, 124 Stat. 1031(a). The Act does not create a private right of action for consumers; however, state AGs and the CFPB have enforcement authority. Arthur E. Wilmarth, *The Dodd-Frank Act's Expansion of State Authority to Protect Consumers of Financial Services*, 36 J. CORP. L. 893, 924 (2011).

In addition, arrangers could find themselves defendants in claims brought under the Racketeering Influenced and Corrupt Practices Act. RICO prohibits anyone from (a) using income received from a pattern of racketeering activity or from the collection of an unlawful debt to acquire an interest in an enterprise affecting interstate commerce; (b) acquiring or maintaining through a pattern of racketeering activity or through collection of an unlawful debt an interest in an enterprise affecting interstate commerce; (c) conducting or participating in the conduct of the affairs of an enterprise affecting interstate commerce through a pattern of racketeering activity or through collection of an unlawful debt; and (d) conspiring to participate in any of these activities. 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 that 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

These theories are not independent causes of action. Rather, they allow plaintiffs to bring claims against defendants who did not directly engage in the unlawful conduct leading to the plaintiffs' injuries, but enabled the wrongful conduct to occur.

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

#### 1. Aiding and Abetting Originators' Unlawful Originations

When an arranger enables an originator's unlawful conduct, borrowers harmed by that conduct can claim that the arranger aided and abetted the originator. The elements necessary to hold a party liable as an aider and abettor vary across jurisdictions, but generally they require that a party not directly engaged in an unlawful act must knowingly and substantially assist another in the commission of the act. To establish knowledge, some jurisdictions require actual knowledge of the illegal act, while others allow claims to go forward if there are allegations that the defendant recklessly ignored facts that suggested the illegal act.<sup>174</sup> The substantial assistance element can be satisfied

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(S.D. Miss. 2007) (dismissing a RICO claim against the lender based on abusive lending by broker).

<sup>174</sup> See, e.g., *Hashimoto v. Clark*, 264 B.R. 585, 598 (D. Ariz. 2001) (stating that California law requires an aider and abettor to have actual knowledge); *Tew v. Chase Manhattan Bank N.A.*, 728 F. Supp. 1551, 1569, *amended* 741 F.Supp. 220 (S.D. Fla.



by either affirmative acts or failures to act, depending on the facts of the case.<sup>175</sup> The assistance must have a substantial causal connection to the harm suffered by the plaintiff.<sup>176</sup>

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>177</sup>

The practices we have identified-- e.g. the information sharing and control that comes with vertical integration, the financing arrangements between arrangers and originators, and knowledge of poor underwriting-- would all be material given these factors. It is possible to argue that plaintiffs could not prove that arrangers were present at the time of originators' unlawful actions; however, the nature of arrangers' actions does not require their physical presence at the time of the illegal act.

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1990) (holding that recklessness satisfies the aiding and abetting knowledge requirement under Florida law).

<sup>175</sup> *Tew v. Chase Manhattan Bank N.A.*, 728 F. Supp. 1551, 1569 (S.D. Fla. 1990), *amended* 741 F.Supp. 220 (explaining "[t]he jury must also find that the failure to speak and the alleged affirmative misrepresentations represented substantial assistance to [the defendant's] officers and directors in concealing the fraud").

<sup>176</sup> *Neilson v. Union Bank of California, N.A.*, 290 F.Supp.2d 1101, 1135 (C.D. Cal. 2003) (stating that "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").

<sup>177</sup> Restatement (Second) of Torts § 876(b).

Aiding and abetting was the theory borrowers pursued in the case against Lehman Brothers.<sup>178</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. Before establishing a business relationship with FAMCO, Lehman conducted due diligence that uncovered FAMCO's unlawful tactics and numerous consumer complaints against the company. There was also evidence that Lehman's officers discussed FAMCO's potential liability during Lehman's due diligence review. Thus, Lehman had actual knowledge of FAMCO's unlawful originations.<sup>179</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 Lehman received stock warrants. The credit was repaid with proceeds from the securitization of FAMCO's mortgages, which were underwritten by Lehman. Because Lehman satisfied all of FAMCO's financing needs, the plaintiffs alleged that Lehman substantially assisted the company's tortuous conduct.<sup>180</sup> The Court agreed.<sup>181</sup> Recently California courts have

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<sup>178</sup> *In re First Alliance Mortgage Co.*, 471 F.3d 977 (9th Cir. 2006).

<sup>179</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>180</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).

followed the FAMCO decision, holding that when arrangers help design disclosures containing fraudulent omissions, provide lines of credit, and commit to purchase the originator's loans, they could be found liable for the fraudulent omissions as aiders and abettors.<sup>182</sup>

Aiding and abetting is also the theory advanced by the Commonwealth of Massachusetts in its investigation of Morgan Stanley and Goldman Sachs. The Commonwealth never filed complaints against either company, but in an Assurance of Discontinuation with Morgan Stanley, the Commonwealth stated that "Morgan Stanley aided and financed the business of originating unfair loans to Massachusetts borrowers in violation of Massachusetts law" by providing "substantial assistance to New Century, through its warehouse funding, forward purchasing, and other activities that enabled New Century to make" loans borrowers could not afford to repay in violation of the Massachusetts UDAP statute.<sup>183</sup>

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Lehman never exercised the warrants. It is also noteworthy that the former chief financial officer at Shearson Lehman Mortgage Corp. was the President of FAMCO.

<sup>181</sup> *In re First Alliance*, 298 B.R. 652, 668 (C.D. Cal. 2003).

<sup>182</sup> *Peel v. Brooksamerica Mortgage Corp.*, 2011 WL 2174373 at \*7 (C.D. Cal. 2011) (refusing to dismiss claim based on allegations that the assignee drafted loan documents for the lender to use to make the loans that the assignee would then purchase); *Jordan v. Paul Financial LLC*, 745 F.Supp.2d 1084 (N.D. Cal. 2010) (refusing to dismiss claim based on allegations that a purchasing and servicing agreement "specified an ongoing business enterprise" between the lender and assignee, that the assignee participated in crafting loan documents and loan terms, and that assignee reviewed loan portfolios) *Ralston v. Mortgage Investors Group*, 2010 WL 3211931 at \*5 (N.D. Cal. 2010) (refusing to dismiss claim based on allegations that assignee was involved in the scheme to market loans, was involved in designing and approving loan documents, provided financing to the lender, and agreed to purchase loans the lender originated).

## 2. Civil Conspiracy

Civil conspiracy, like aiding and abetting, is not an independent cause of action.<sup>184</sup> Borrowers alleging civil conspiracy must show that one or more conspirators perpetrated some underlying unlawful conduct.<sup>185</sup> A party, however, can be liable as a co-conspirator even if it did not engage in the underlying illegal act.<sup>186</sup> If appraisers inflate property appraisals as part of a scheme to defraud homebuyers, for example, they can be liable for damages even if their actions did not satisfy the elements of fraud.<sup>187</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

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<sup>183</sup> *In re Morgan Stanley*, Assurance of Discontinuance, p. 15 par. 43 (June 24, 2010).

The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 prohibits unfair, deceptive, or abusive acts or practices and makes it unlawful for “any person to *knowingly or recklessly provide substantial assistance* to a covered person or service provider in violation” of this provision. Publ. L. No. 111-203, 124 Stat. 1031(a); 1036(a)(3)(2010) (emphasis added). The substantial assistance language appears to codify the common law on aiding and abetting.

<sup>184</sup> *In re Methyl Tertiary Butyl Ether Prods. Liab. Litigation*, 175 F. Supp. 2d 593, 633 (S.D.N.Y. 2001) (citing California, Florida, Illinois, and New York law). All but one jurisdiction, Wyoming, recognizes civil conspiracy as a cause of action. Elizabeth Renuart, THE COST OF CREDIT, 595.

<sup>185</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 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>186</sup> *Halberstam v. Welch*, 705 F.2d 472, 481 (D.C. Cir. 1983) (holding that “once the conspiracy has been formed, all its members are liable for injuries caused by acts pursuant to or in furtherance of the conspiracy. A conspirator need not participate actively in or benefit from the wrongful action in order to be found liable.”).

<sup>187</sup> *See e.g. Hoffman v. Stamper*, 843 A.2d 153 (Md. Spec. App. 2004).

agreement; (2) by two or more persons; (3) to accomplish an unlawful act or a lawful act in an unlawful manner; (4) an overt act performed in furtherance of the scheme; and (5) injury to a person or property.<sup>188</sup> The requirement of proof of an agreement distinguishes civil conspiracy from aiding and abetting.<sup>189</sup>

There is little guidance on whether arrangers can be held liable, as civil conspirators, for originators' fraudulent acts.<sup>190</sup> To the extent courts have addressed the issue, they have held that a question of material fact exists as to whether an assignee is a civil conspirator when the tortuous conduct of the originator was "apparent on the face of the loan."<sup>191</sup> In other cases, borrowers have survived motions for summary judgment with evidence that the assignee was working closely with lenders to falsify documents

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<sup>188</sup> See, e.g., *Matthews v. New Century Mortgage Corp.*, 185 F.Supp.2d 874, 889 (S.D. Ohio 2002) (listing the elements).

<sup>189</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).

<sup>190</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.).

<sup>191</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.

and inflate fees.<sup>192</sup> In 2011, a federal district court decision in the Western District of Washington signaled that deal terms may be important factors in determining the existence of a conspiracy.<sup>193</sup> The court was ruling, in part, on a motion to dismiss filed by an arranger. At issue was whether the plaintiff had adequately stated a claim that the arranger had conspired with the originating lender to make unlawful loans. The court denied the motion, relying in part on allegations that:

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

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<sup>192</sup> *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 a conspiracy claim where plaintiff produced evidence that the assignee “worked with [the lender] to carry out creation of false paystubs, false down payments and charging an acquisition fee in addition to interest of twenty-one percent”).

Most of the civil conspiracy cases involving subprime lending have involved claims that lenders conspired with brokers to defraud borrowers. For example, in *Matthews v. New Century Mortgage* the court denied a lender’s motion to dismiss where the plaintiffs alleged that the lender’s agents had close personal ties with at least one mortgage broker who had falsified the borrowers’ loan applications. The Matthews’ Court held that the plaintiffs had set forth facts tending to show that New Century conspired with the mortgage brokers and caused injury to the borrowers. 185 F.Supp.2d 874 (S.D. Ohio 2002); *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>193</sup> *Villalobos v. Deutsche Bank*, Case No. C09-1450-JCC (W.D.Wash 2011). The plaintiffs also brought aiding and abetting and joint venture claims against the arranger and trust. *Id.*

- the lender and arranger were parties to a pooling and servicing agreement giving the lender responsibility for originating the loans, out of which the arranger created securities
- disclosure violations were apparent on the loan documents<sup>194</sup>

### 3. Joint Venture

Joint venture, like civil conspiracy and aiding and abetting, is not an independent cause of action. A joint venture arises out of a contractual relationship between the parties that may be express or implied, written or oral. Generally, there are five elements to a joint venture:<sup>195</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>196</sup> Unlike aiding and abetting and civil conspiracy, however, a lack of knowledge of wrongdoing, in and of itself, does not absolve a joint venturer of liability.

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<sup>194</sup> *Id.*

<sup>195</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>196</sup> *See id.* (holding that “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”).

Of the cases where a borrower has tried to assert a joint venture in the context of fraudulent loan origination practices, *Short v. Wells Fargo Bank*<sup>197</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 Court in *Short* reasoned that the PSA contractually defined the relationships among the parties to a securitization. The Court held that the PSA could satisfy the elements of a joint venture because it was a contract that controlled the operations of the securitization and contained provisions through which the parties shared profits and losses.<sup>198</sup> The parties eventually settled the case without any appellate ruling. The recent California decisions discussed in the aiding and abetting section followed *Short* in recognizing that PSAs and similar loan purchase and servicing agreements in combination with underwriting guidance such as rate sheets are sufficient evidence for a joint venture claim to survive summary judgment.<sup>199</sup>

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<sup>197</sup> 401 F. Supp.2d 549 (S.D.W.V. 2005).

<sup>198</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) (holding that evidence that brokers used lenders' rate sheets and were compensated through yield spread premiums was sufficient to defeat motion for summary judgment of joint venture claim against lender).

<sup>199</sup> *See, e.g., Jordan v. Paul Financial LLC*, 745 F.Supp.2d 1084, 1097 (N.D.Cal 2010) (holding a master loan purchase agreement between the arranger and originator could be sufficient to establish a joint venture); *Peel v. Brooksamerica Mortgage Corp.*, 2011 WL 2174373 at \*8 (C.D.Cal 2011) (holding that allegations that arrangers pre-approved the disclosures at issue in the case, provided underwriting guidelines and rate sheets, and committed to purchase the loans originated by the lenders was sufficient to overcome the arranger's motion to dismiss a joint venture claim).



## V. A Critical Moment for Policy-Making

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

Policymakers should address the tangle of liability under consumer protection laws while housing finance is still in a state of flux. Fannie Mae and Freddie Mac, the two largest loan arrangers in the United States, are in conservatorship. Private sector securitization of subprime mortgages has stopped completely and even securitization of prime loans is rare. As a result, Fannie and Freddie now own or guarantee almost all new residential mortgage loans.<sup>200</sup> In February 2011, the Obama Administration released a proposal outlining three plans for the future of housing finance. In all three plans, Freddie and Fannie would be phased out over a period of years and replaced with a private securitization market that may be backed, in whole or in part, by a government guarantee.<sup>201</sup> At the same time, the new Consumer Financial Protection Bureau has

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<sup>200</sup> This has been the case for the past few years. *See, e.g.,* 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>201</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*

inherited a hodgepodge of federal lending laws and has been charged with writing rules governing mortgages.

Going forward, the goal should be to establish a clear liability scheme that allows accurate pricing of risk, enables bank regulators to effectively exercise their oversight responsibilities, and creates an incentive structure that encourages market participants to police the home financing market. At the same time, the law should not cripple the mortgage-backed securitization market, which is an incredibly powerful innovation that channels investment capital to borrowers in need of credit and gives institutional investors direct, and relatively liquid, exposure to credit markets.

The designers of securitization sought to insulate investors and arrangers by erecting legal structures that would shield them from liability arising from the actions of loan originators. As this article demonstrates, those structures are not as solid as investors and arrangers expected. Instead, what we have is a complicated system of laws that makes liability for all loan purchasers uncertain. We contend that the solution is clear rules imposing assignee liability. There are several rationales for our approach. First, there is a precedent for allowing consumers to bring claims against the owners of their notes. The FTC preserved assignee liability in consumer goods and services transactions to incentivize loan purchasers to better police originators. Second, protecting loan purchasers from consumer claims may have made sense when transactions were truly arms-length and purchasers could not assess the credit quality of borrowers, but arrangers' knowledge of and influence over the origination process makes

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<http://www.treasury.gov/initiatives/Documents/Reforming%20America%27s%20Housing%20Finance%20Market.pdf> (last visited Feb. 2011)

it difficult to apply the same justifications today. Third, the complexity of the law coupled with securitization has been costly in ways that were largely unforeseen ex-ante. When mortgage credit was readily available and housing prices were rising, the probability of borrowers bringing claims based on wrongdoing at origination was low. It was easy for borrowers to refinance, and legal complexity made consumer claims expensive to litigate. In today's environment the opposite is true: there is little mortgage credit and a growing bar of consumer attorneys who have become experts in securitization has led to an increase in consumer claims.

These rationales speak to the need to change the current liability system to make it easier to predict and price liability and to incentivize self-policing in the consumer credit market. The goal of the proposals we describe below is not to create new liabilities; as we have argued, the liability is already present. The goal is to simplify the legal environment and also create a coherent incentive system that encourages secondary market actors to adopt practices to effectively police lenders and loans. Crafting such rules is no easy task.

### 1. Assignee Liability

Preserving consumer claims would require imposing liability on the owners of loans for lender violations of consumer protection laws. For owners of notes, liability would not be based on whether they were holders in due course or whether a law was state or federal. Rather, liability for affirmative and defensive claims would arise simply from holding the note, just as the law currently stands under the FTC Act and HOEPA.<sup>202</sup>

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<sup>202</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).

Alternatively, the law could allow consumers to raise defenses to collection claims or foreclosures brought by owners of notes, but only allow affirmative claims against the owners of notes if the originator was insolvent. This would encourage secondary market entities to purchase loans from adequately capitalized or insured originators. Both paths would clarify assignee liability by eliminating the complexity in extant laws, while at the same time encouraging entities that finance lending to identify and cut off funding to unscrupulous originators.<sup>203</sup>

Liability of note purchasers should be limited, or else there may be no secondary market for loans. Policymakers would have to implement a system that would enable owners of notes to quantify their exposure to borrower claims. Examples of limits include liquidated penalties per violation, damages caps based on the amount of finance charges, loan amounts, multipliers of either one, or some combination thereof.

## 2. Arranger Liability

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

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<sup>203</sup> See Kathleen C. Engel and Patricia A. McCoy, *Turning a Blind Eye: Wall Street Finance of Predatory Lending*, 75 FORDHAM LAW REVIEW 2039, 2098-99 (2007).

In response to market pressures, the securitization industry is already developing new standards and tools that allow arrangers and investors to investigate loan pools in a granular fashion. AMERICAN SECURITIZATION FORUM, ASF RMBS DISCLOSURE AND REPORTING PACKAGES (July 15, 2009), *available at* [http://www.americansecuritization.com/uploadedFiles/ASF\\_Project\\_RESTART\\_Final\\_Release\\_7\\_15\\_09.pdf](http://www.americansecuritization.com/uploadedFiles/ASF_Project_RESTART_Final_Release_7_15_09.pdf).

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

#### A. Prudential Supervision

Not all reform requires changing the law. There are practices that prudential supervisors can adopt that will reduce firms' and investors' exposure to litigation and protect consumers at the same time. Financial institutions' potential liability to consumers is akin to hidden leverage: it was not readily apparent during the boom times and is amplifying losses in the current crisis. Liability was opaque because of both the complexity of the law and the complexity of housing finance. The management structure of arrangers and their affiliates was conducted along functional business lines, rather than according to legal structures.<sup>204</sup> However, supervision of financial institutions is based primarily upon a firm's legal boundaries. This approach makes it difficult to fully appreciate the risks of arranging securitizations.

Robust compliance testing to identify risks associated with securitization requires testing along functional business lines. Regulators can accomplish this through

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<sup>204</sup> Thomas J. Fitzpatrick IV, Mark B. Greenlee, and James B. Thomson, "*Resolving Large, Complex Financial Firms*" Federal Reserve Bank of Cleveland Economic Commentary no. 2011-16 (2011).

consolidated corporate risk management reviews. Consolidated risk management provides the opportunity to design compliance systems along business lines, rather than according to the way parents, subsidiaries, and affiliates are legally organized. Under this supervision scheme, firms may be required to expand their due diligence when acquiring and securitizing loans, adopt plans to address issues identified in due diligence, conduct audits to ensure the necessary legal formalities are observed, and promptly correct problems as they are identified. With consolidated risk management, regulators can eliminate some of the uncertainty about liability and, in turn, be more certain about firms' balance sheets.

#### VI. Conclusion

As Congress, regulators, Wall Street, and consumer advocates hammer out the details of financial reform, investors in RMBS and arrangers should expect more borrower litigation and the potential for large damage awards.<sup>205</sup>

The environment is ripe for consumers, state attorneys general, and federal agencies to pursue claims against entities further up the securitization food chain, especially given increasing evidence that Wall Street failed to observe the formalities that might have insulated arrangers and investors from most consumer claims. Judges and

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<sup>205</sup> As we discussed in the aiding and abetting section, *supra* note \_\_ a group of California courts have allowed cases of fraud to go forward against arrangers based on option ARM disclosures. To the extent other courts render similar rulings on California and other option ARM loans, of which there are about \$160 billion outstanding, arranger liability has the potential to substantially increase. American Securitization Forum, Non-Agency MBS Market Review August 2011 Remittance, Part II: Option Arm Report (Aug. 2011) available at <http://1010data.com/downloads/asf/Aug/ASF-Non-Agency-Review-August-2011-Remittance-Mid-Month-Update.pdf>.

juries, who, in the past, may not have considered the possibility that Wall Street financiers could be involved with fraud on borrowers, appear to be increasingly sympathetic to such claims. It will be years before the liability dust settles, but we are confident of two things: investment trusts and arrangers should be worried about litigation risk, and the failure of the law to keep pace with securitization has created costly uncertainty.