ABROGATING THE HOLDER IN DUE COURSE DOCTRINE IN SUBPRIME MORTGAGE TRANSACTIONS TO MORE EFFECTIVELY POLICE PREDATORY LENDING

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INTRODUCTION

Predatory loans have been widely criticized for the devastating effects they have on their victims. These victims, often the elderly and people of color, frequently face financial ruin and the loss of their homes. Although there is no clear definition of what constitutes "predatory lending," it is understood that unethical lenders design predatory loans to exploit financially unsophisticated or unwary borrowers.[1] As the problems of predatory lending have increasingly penetrated the public's consciousness, legislators at the federal, state, and local levels have grappled with the appropriate way to deal with these unethical practices. Recent legislation has emerged at all levels of government in a complex, and sometimes contradictory, web of prohibitions targeted at specific predatory lending practices. While such legislative attempts are commendable, they are limited in impact because they typically focus on the predatory lender and ignore the parties with whom it does business.

This Note will argue that legislators designing solutions for the problem of predatory lending should consider giving borrowers, who are the victims of the practice, a more active role in regulating the loans. Specifically, predatory lending legislation should provide borrowers with an affirmative cause of action against the assignees of predatory loans. This would allow a borrower to bring the same legal claims against an assignee of a predatory loan that he or she could bring against the predatory lender itself under existing law. Part I will

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1. *See infra* Part I.B.

provide the background of predatory lending and describe the subprime market, the problems of predatory lending, and the role that the assignment of subprime loans plays in predatory lending. Part II will discuss the historical and modern justifications for the Holder in Due Course (HDC) doctrine, which immunizes assignees from liability to the original obligee in a lending transaction. Part III will focus on legislation at the state and federal levels designed to address predatory lending and some of the issues that have arisen in the implementation of these laws. This section will focus on the Home Ownership and Equity Protection Act (HOEPA), the centerpiece of the federal response to abusive lending practices. It will then consider legislation at the state level, using recently enacted predatory lending statutes in New York and Georgia as examples.[2] This Part will also describe the significant political opposition that exists to broadening the liability of assignees of predatory loans, and will illustrate the principal problem with the current approach to predatory lending legislation, namely its patchwork quality.

Part IV will argue for an affirmative right to recovery against assignees of predatory loans. This Part will begin with a doctrinal argument that such a rule is more efficient than the current regime, which the HDC doctrine dominates, by applying some principles from the law and economics school of legal thought. This Part will then present some practical arguments for such a rule by drawing on the experience of other lending markets. It will argue that an affirmative assignee liability rule will be a useful informational tool for assignees of predatory loans and that an affirmative assignee liability rule effectively engages borrowers in the regulatory process. Part V will conclude this Note and will present some final thoughts to consider when implementing an assignee liability rule.

I.
The Current Subprime Home Mortgage Market

A. The Subprime Market

Home mortgage lending in the United States is divided into two market segments—prime and subprime. The prime market caters to individuals with solid credit histories whereas the subprime market offers financial products to prospective homeowners with less than

2. Andrew Metz, *Target: Unscrupulous Lenders; Pataki Signs Law Protecting Elderly, Poor Homeowners*, Newsday, Oct. 4, 2002, at A16.

perfect credit histories.[3] Borrowers in the subprime market present an increased risk of default, and subprime lenders compensate for this with higher interest rates, points, and fees than would be found in prime market loans.[4] From 1994 to 1999, the subprime market witnessed an explosion of activity and, in 1999, was estimated to represent $160 billion in loan originations—approximately 13% of the total home mortgage lending market.[5]

The growth of the subprime market resulted from a confluence of factors, including federal legislation regulating home mortgage lending, government policies targeting low-to-moderate income borrowers, and rapid development of a secondary market for subprime mortgage backed securities (MBS).[6] Increased subprime lending is an important development in the economic life of many Americans; it offers borrowers with imperfect credit expanded opportunities to purchase their first homes or to improve their economic situations by capitalizing on equity built into an existing residence. These opportunities are also important from a community economic development standpoint because they allow subprime borrowers, who are often located in low-to-moderate income residential areas, to qualify for home mortgages that had previously been unattainable.[7]

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3. *See, e.g.*, Kathleen C. Engel & Patricia A. McCoy, *A Tale of Three Markets: The Law and Economics of Predatory Lending*, 80 TEX. L. REV. 1255, 1258–59 (2002).

4. *Id.*

5. DEP'T. OF HOUS. AND URBAN DEV., CURBING PREDATORY HOME MORTGAGE LENDING 29 (2000), *available at* http://www.huduser.org/publications/pdf/treasrpt.pdf (last visited Oct. 2, 2003) [hereinafter DEP'T. OF HOUS., CURBING] (on file with *The New York University Journal of Legislation and Public Policy*).

6. The growth of the market for subprime loans stems from a complex convergence of factors including FHA insurance, government-sponsored entities' initiatives, novel legislation that encouraged more flexible financial products, the action of the Community Reinvestment Act, 12 U.S.C. §§ 2901–2905 (Supp. V. 1993), and the ability of lenders to use credit scoring to distinguish between borrowers. *See, e.g.*, Engel & McCoy, *supra* note 3, at 1270–79; DEP'T. OF HOUS. AND URBAN DEV., SUBPRIME MARKETS, THE ROLE OF GSES, AND RISK-BASED PRICING 7–10 (2002), *available at* http://www.huduser.org/Publications/pdf/subprime.pdf (last visited Sept. 22, 2003) [hereinafter DEP'T. OF HOUS., SUBPRIME MARKETS] (on file with *The New York University Journal of Legislation and Public Policy*).

7. Commentators increasingly view the ability to leverage the equity in one's home as a basic financial right. *See, e.g.*, Press Release, Dept. of the Treasury, Remarks of Treasury Secretary Lawrence H. Summers to the Consumer Bankers Association (May 8, 2000), *at* http://www.treasury.gov/press/releases/ls609.htm (last visited Sept. 22, 2003) ("Working together, we should ensure that all low-income Americans have access to the types of financial products that the rest of us take for granted . . . . And individuals should have access to services that enable them to leverage their equity so that they can purchase their own home.") (on file with *The New York University Journal of Legislation and Public Policy*).

However, with these increased opportunities for home ownership come increased opportunities for abusive practices by unscrupulous lenders. These abusive or predatory lenders use a variety of deceptive selling practices to trap unwary borrowers in mortgages containing terms that are unreasonable, given the actual risk of default represented by the borrower's credit history.[8] Lenders often issue these loans without regard for the borrower's ability to repay them, often resulting in stripping borrowers of the equity they have built into their home, foreclosure, or worse.

B. The Problem of Predatory Lending

> Seven years ago Theresa Duren, a retired vocational counselor living in Washington, had a nice nest egg wrapped up in the value of her home. Like many retirees her income was not high, but her house was worth around $220,000 with a remaining mortgage of only $35,000.
>
> Then she sought a $10,000 personal loan—feeling she could easily repay it out of income—to pay owed taxes.
>
> But the lender persuaded her instead to refinance her existing mortgage and fold into it her daughter's car loan and other debts, thus raising the loan to $92,500. She signed, not realizing that it included lenders' fees of $9,000 and that the interest rate—on the fees as well as the loan—was more than 20 percent.
>
> Duren quickly found she could not afford the new mortgage payments. Soon she got phone calls from other lenders, each offering to reduce her payments with new refinancing loans. Within two years she had refinanced five times, but the burden only got worse.
>
> Her monthly payments rose from the $200 she had paid for her original mortgage to $1,665. Her mortgage debt climbed to $175,000. And because she had to pay a total of $44,000 in fees and closing costs, the equity in her home vanished.
>
> At the time of closing on the fifth loan, Duren was in the hospital. Against her wishes, she says, the lenders came to her bedside and insisted she sign the papers immediately, less than two hours before she had surgery.[9]

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8. No single definition has satisfactorily defined predatory lending. The term "predatory lending" usually denotes some set of lending practices that is exploitative. *See Report of the Staff to Chairman Gramm, Committee on Banking, Housing and Urban Affairs—Predatory Lending Practices: Staff Analysis of Regulators' Responses*, 54 CONSUMER FIN. L. Q. REP. 228, 228–29 (2000).

9. Patricia Berry, *Beware: Predatory Lenders at Work*, AARP BULLETIN ONLINE (Wash., D.C.), Feb. 1999, *available at* http://www.aarp.org/bulletin/consumer/Articles/a2003-06-20-bewarepredatory.html (last visited Sept. 23, 2003) (on file with *The New York University Journal of Legislation and Public Policy*).

The example above tells the all-too-common story of an unsuspecting borrower victimized by a predatory lender. Predatory loans, through a combination of fraud, deception, and unethical sales practices, are designed to exploit financially unsophisticated parties. They disproportionately target low-to-moderate income African-American, Latino, and elderly homeowners.[10] The media and community groups have documented thoroughly the disastrous results of these loans.[11] The successful growth of the secondary market for subprime loans has fueled a laudable expansion of subprime lending opportunities across the country. But this expansion also brings a concomitant increase in abusive lending opportunities for unethical lenders who can obtain lines of credit from securities underwriters with relative ease.[12]

While the consequences of predatory loans for borrowers are well documented, what actually constitutes a predatory loan is less clear. Predatory lending is a general term that encompasses a wide range of abusive practices. These practices have evolved over time as predatory lenders work to stay ahead of statutory regulations.[13] Some of these practices include:[14]

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10. Several studies have shown that race and age are significant factors contributing to disparities that currently exist in the demographics of the subprime borrowing market. *See generally, e.g.*, CTR. FOR CMTY. CHANGE, RISK OR RACE? RACIAL DISPARITIES AND THE SUBPRIME REFINANCE MARKET, 5–9 (2002), *at* http://www.communitychange.org/housing/Risk%20or%20Race%20-%20Exec%20Summ.pdf (last visited Sept. 22, 2003) (finding that subprime mortgages are disproportionately issued to minority borrowers, particularly in metropolitan areas) (on file with *The New York University Journal of Legislation and Public Policy*); ASS'N. OF CMTY. ORGS. FOR REFORM NOW, SEPARATE AND UNEQUAL: PREDATORY LENDING IN AMERICA, 2, 7–8 (2002) *at* http://www.acorn.org/acorn10/predatorylending/plreports/SU2002/main.pdf (last visited Sept. 22, 2003) [hereinafter ASS'N. OF CMTY. ORGS., SEPARATE AND UNEQUAL] (finding that subprime loans are disproportionately targeted at lower income minority borrowers) (on file with *The New York University Journal of Legislation and Public Policy*); Jeanne Finberg, *Financial Abuse of the Elderly in California*, 36 LOY. L.A. L. REV. 667, 687–88 (2003) (finding that subprime loans are often issued to elderly); DEP'T. OF HOUS., SUBPRIME MARKETS, *supra* note 6, at 5–6 (finding that low-to-moderate income borrowers, especially African-Americans, are disproportionately represented in subprime market).

11. *See, e.g.*, ASS'N. OF CMTY. ORGS. FOR REFORM NOW, A FORECLOSURE EPIDEMIC: THE EXPLOSION IN FORECLOSURES FROM PREDATORY LENDING IN ALBUQUERQUE (2002), *at* http://www.acorn.org/acorn10/predatorylending/plreports/foreclose.htm (last visited Sept. 22, 2003) (on file with *The New York University Journal of Legislation and Public Policy*).

12. *See, e.g.*, *id.*

13. *See, e.g.*, *Report of the Staff to Chairman Gramm*, *supra* note 8, at 228–30.

14. The following list is not exhaustive—it cannot be, given the continuing efforts of unethical lenders to stay within the bounds of a rapidly changing regulatory framework. It is intended to show some of the general characteristics associated with predatory loans.

High Annual Percentage Rates (APRs)—Loans with extraordinarily high APRs are the crudest abusive lending practice and quickly are becoming the target of federal, state, and local regulation.[15] To circumvent such legislation, predatory lenders now originate loans with APRs that are as high as legally possible and contain other predatory terms.[16]

Packing—Predatory lenders often include substantial charges to the borrower in the form of points and fees that are financed as part of, or packed into, the loan. Points and fees are intended to recompense a lender for good faith costs incurred as part of the origination process. Such charges may be higher for subprime borrowers because their spotty work and credit histories warrant higher investigation and processing costs than prime borrowers. However, these charges also provide fertile ground for abuse in the hands of an unethical lender.[17]

Flipping—Predatory lenders will often induce several rapid loan refinances that provide no benefit to the borrower. Flipping practices exacerbate the problem of high points and fees because an abusive lender can assess additional points and fees with each new round of financing.[18]

Single Premium Financing of Credit Insurance—Many predatory loans include charges for a lump sum payment toward credit insurance. This insurance, which is rarely included in prime loans, is designed to operate in the event of a borrower's sickness, death, unemployment, or other contingency. By structuring the mortgage to include the credit insurance in the principal, predatory lenders can extract a large premium for the insurance (charging many times the amount the insurance would cost if paid month-to-month), which forces the borrower to pay interest on the insurance payment.[19] Such credit insurance packing is a common practice and is the target of numerous predatory lending statutes.[20]

Negative Amortization of Loans—Many subprime lenders will issue loans whose monthly payments are too low to retire the interest on

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15. Many statutes addressing predatory lending place caps on the APR of high-cost loans, which are tied to the Federal Treasury bill rate. *See, e.g.*, 15 U.S.C. § 1602(aa) (2000); N.Y. BANKING LAW § 6-*l*(1)(g)(i) (Consol. 2003).

16. *See, e.g.*, DEP'T. OF HOUS., CURBING, *supra* note 5, at 18–20.

17. *See, e.g.*, ASS'N OF CMTY. ORGS. FOR REFORM NOW, PREDATORY LENDING: PREDATORY LENDING PRACTICES, *at* http://www.acorn.org/acorn10/predatorylending/practices.htm (last visited Sept. 22, 2003) [hereinafter ASS'N OF CMTY. ORGS., PREDATORY LENDING] (on file with *The New York University Journal of Legislation and Public Policy*).

18. *See, e.g.*, *id.*

19. *See, e.g.*, *id.*

20. *See infra* Part III.

the loan. Negatively amortized loans are a fair and useful lending term in certain situations.[21] They are only a predatory lending practice when used deceptively on unsuspecting borrowers. In the predatory lending context, a borrower can find himself faced with a single monthly payment equal to the principal or greater at the end of a loan repayment period. Such practices encourage default, and ultimately, foreclosure.[22]

Balloon Payments—Balloon payments leave borrowers with a single payment far greater than the average of all other payments at some point during the life of their loans. This is not to say that all balloon payments are bad—a borrower may find balloon payments beneficial in certain situations. However, balloon payments in subprime loans often are designed to catch borrowers unaware, leaving them with a monthly payment they have no hope of repaying.[23]

Loans Issued Without Reference to the Borrower's Ability to Repay—Predatory lenders will originate loans collateralized against equity built in the home of a borrower without taking into account the actual monthly income of that borrower. Reports of this practice are legion[24] and are especially reprehensible in the case of elderly borrowers who have spent an entire career building equity in their homes. Despite the substantial after-retirement drop in the monthly income of such borrowers, predatory lenders issue loans based instead on the equity in the house.[25]

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21. *See, e.g.*, Ginnie Mae, *Your Path to Homeownership: A Guide to Owning Your Own Home: Buydown vs. GPM*, *at* http://www.ginniemae.gov/ypth/info_center/1_learn/buydown_vs_GPM.htm (last visited Nov. 6, 2003) (on file with *The New York University Journal of Legislation and Public Policy*).

22. *See, e.g.*, ASS'N OF CMTY. ORGS., PREDATORY LENDING, *supra* note 17.

23. *See, e.g.*, *id.*

24. *See, e.g.*, Press Release, Federal Trade Commission, FTC, DOJ and HUD Announce Action to Combat Abusive Lending Practices (Mar. 30, 2000) ("Delta's practice of approving loans without regard to borrowers' ability to repay exposed borrowers to unwarranted risk of default and foreclosure."), *at* http://www.ftc.gov/opa/2000/03/deltafunding.htm (last visited Nov. 9, 2003) (on file with *The New York University Journal of Legislation and Public Policy*).

25. *See infra* Part III. Some statutes have attempted to target this problem by increasing the documentary requirements a borrower must furnish to receive a mortgage. *See, e.g.*, N.Y. BANKING LAW § 6-*l*(1)(k) (Consol. 2003); 15 U.S.C. § 1639(c)(2)(A) (2000). One should not confuse the equity stripping character of predatory loans with equity reduction, which occurs during reverse mortgages (i.e., non-recourse loans issued against the equity in a borrower's house). Reverse mortgages are different from "forward" mortgages (including predatory loans) in that they require no monthly payments. This insures that the borrower retains his or her monthly income. And, because these loans are non-recourse, the borrower will never owe more than the equity in his or her house. *See, e.g.*, AM. ASS'N OF RET. PERS., EXPLORING REVERSE MORTGAGES: A CONSUMER'S GUIDE, (2002) *at* http://www.

Yield spread premiums and steering—Many predatory lenders deceive good-faith borrowers by taking advantage of the segmentation inherent in the subprime market. Predatory lenders often issue a kick-back, known as a yield spread premium, to mortgage brokers who direct, or steer, unsuspecting borrowers to that lender for loan origination. Borrowers pay for this yield spread premium as a financing fee on their loans. The practice takes advantage of the borrower's assumption that a mortgage broker acts as an agent working to secure the best mortgage deal possible.[26]

C. The Subprime Lending Pipeline and the Role of the Bond Market in Home Mortgage Lending

Shifts in the mortgage banking industry and specialization by market players have led to an increase in market segmentation.[27] The processing of lending transactions can involve up to six independent parties who transform a subprime mortgage into a securitized asset for investors in the securities market.[28] The first of these entities is, of course, the borrower. The borrower in a subprime mortgage transaction is an individual homeowner or prospective homeowner whose credit does not qualify him or her for lower interest prime mortgages. Given the increased risk associated with subprime loans, borrowers in this market tend to be less well-educated and have lower incomes than borrowers who qualify for prime loans.[29] Furthermore, demographic studies have shown that a disproportionate number of subprime borrowers are African-Americans or people over the age of fifty-five.[30]

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aarp.org/comsumerprotect-homeloans/Articles/a2002-09-30-HomeLondsReverseMortgages.html (last visited Sept. 22, 2003) [hereinafter AM. ASS'N OF RET. PERS., EXPLORING REVERSE MORTGAGES] (on file with *The New York University Journal of Legislation and Public Policy*).

26. *See, e.g.*, AM. ASS'N OF RET. PERS., EXPLORING REVERSE MORTGAGES, *supra* note 25.

27. *See* Michael G. Jacobides, *Mortgage Banking Unbundling: Structure, Automation and Profit*, MORTGAGE BANKING, Jan. 2001, at 30–40; s*ee also* DEP'T. OF HOUS., CURBING, *supra* note 5, at 38–46 (documenting how specialization in home mortgage lending has led to explosion in subprime mortgage originations).

28. While the specialized lending pipeline model (with different agents for each of the roles described, predominates) some large financial entities perform all of the functions described in this section. *See* Jacobides, *supra* note 27, at 31 ("Today in the housing finance industry, both types of value chain structures coexist. The disintegrated model has dominated . . . . However, a small number of S&Ls or other financial intermediaries still operate the traditional way—taking loans, keeping them in portfolio and servicing them until they pay off.").

29. *See* DEP'T. OF HOUS., CURBING, *supra* note 5, at 35, 38.

30. Copious studies have described the disparate impact of predatory lending on low-to-moderate income African-Americans, Hispanics, and people over age 55. *See, e.g.*, DEP'T. OF HOUS., CURBING, *supra* note 5, at 35–37; ASS'N. OF CMTY. ORGS.,

When shopping for a refinanced mortgage or home equity loan, borrowers in the secondary market typically will interact with mortgage lenders through mortgage brokers. Many mortgage brokers engage in table funding—they focus on the steps required to design and originate a loan package tailored to the individual borrower's needs, with a large financial institution underwriting the actual mortgage.[31] At the end of this process, the broker will bring in the mortgage bank that actually extends the line of credit to the borrower. Such integrated brokers are not involved with the mortgage transaction once their work in origination is completed, operating on lines of credit issued from one or more wholesale mortgage lenders, rather than paying for mortgage notes out of their own pockets.[32] While brokers often counsel borrowers on appropriate loan packages and receive compensation from the borrower in the form of points or fees on the final loan amount, they rarely act as agent or fiduciary for the borrower in the lending process.[33]

After assessing the needs of a particular borrower, the broker will refer him or her to a mortgage lender. Mortgage lenders come in a variety of forms in the modern subprime market. Prior to the 1990s, funding for subprime loans came from established finance companies that relied on a variety of capital and reliable debt financing options—including commercial paper, bonds, and lines of credit from commercial banks[34]—to provide capital for loans that would be included in the institution's financial portfolio. In recent years, the expanded use of asset-backed securitization to fund subprime mortgages has drastically changed the characteristics of subprime lenders. The increased securitization of subprime mortgage obligations has made it substantially easier for lenders to raise capital to issue loans.[35] Consequently, as the capital requirements for a lender become less of a barrier to entry, the subprime lending market has become very fragmented; traditional diversified financial institutions issue loans alongside less

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SEPARATE AND UNEQUAL, *supra* note 10, 8–12; AM. ASS'N OF RET. PERS., SUBPRIME MORTGAGE LENDING AND OLDER BORROWERS (2001), *at* http://research.aarp.org/consume/dd57_lending.html (last visited Sept. 22, 2003) (on file with *The New York University Journal of Legislation and Public Policy*).

31. Jacobides, *supra* note 27, at 32 ("Brokers could use another mortgage bank's warehouse credit line and through the practice known as table funding bring the wholesale lender in at the closing of the deal.").

32. *Id.*

33. As a result, some brokers will steer certain borrowers to predatory lenders in exchange for compensation.

34. DEP'T. OF HOUS., CURBING, *supra* note 5, at 40–41.

35. *Id.* at 41.

financially stable new entrants who specialize in these mortgages and are capitalized by the securities markets.

The securitization entity is a financial organization that purchases and holds bundles of loan obligations originated by home mortgage lenders.[36] In exchange for receiving these bundles from the lenders, the securitization entity provides capital to the lender, fueling its ongoing operations.[37] These loan obligations are assets used to back MBS and other securities offerings and are packaged in a way that ensures a stream of regular payments to investors.[38] Because the securitization entity is typically a large financial institution with an excellent reputation, it can provide lower interest rate lines of credit to the subprime lender than the lender could procure for itself. Since the lender passes part of this lower interest rate on to the consumer, securitization has had the effect of lowering home mortgage interest rates for the consumer.[39]

The perceived riskiness of the assets backing a MBS determines investor demand for it. The major rating agencies provide the most commonly used gauges of bond riskiness. These agencies evaluate a portfolio of assets backing a given security offering and provide a rating for investors on the quality of that investment.[40] The rating agencies are a key source of information on the characteristics of subprime loans and lenders, as they evaluate loan-level data in determining the investment grade to give.[41] Thus, rating agencies have significant in-

36. The term "securitization entity" refers to the assignee in the subprime lending market that purchases subprime loans from mortgage lenders. A securitization entity is actually an abstraction for several parties that serve as the intermediaries between a pool of mortgages and investors. Typically, a passive special purpose vehicle is charged with holding the loan bundles and a credit enhancer is charged with ensuring the cashflows from mortgage bundles meet the bond requirements. An underwriter is required for bond offerings to the public capital markets. *See* Comm. on Bankr. and Corporate Reorganization of the Ass'n of the Bar of the City of N.Y., *Structured Financing Techniques*, 50 BUS. LAW. 527, 529–35 (1995) [hereinafter Comm. on Bankr.].

37. Engel & McCoy, *supra* note 3, at 1274.

38. Ensuring that the cashflow from the assets is regular enough for investment purposes is the credit enhancer's primary responsibility. Comm. on Bankr., *supra* note 36, at 533–34.

39. George P. Miller, *Regulatory Developments in Securitization*, *in* NEW DEVELOPMENTS IN SECURITIZATION 2002, at 733, 761 (PLI Commercial Law & Practice Course, Handbook Series No. 843, 2002).

40. Comm. on Bankr., *supra* note 36, at 535.

41. For example, the Fitch rating agency, one of the major rating agencies relied on by investors, considers individual mortgage loan-to-value ratios, creditor FICO scores, and other loan-specific indices to determine risk of foreclosure. *See generally* KENNETH HIGGINS & GLORIA AVIOTTI, FITCH RESIDENTIAL MORTGAGE-BACKED SECURITIES CRITERIA 2–3, 10–12 (1998) (discussing Fitch criteria for analyzing risk in

fluence over the actions of securitization entities, as investment ratings are an important piece of data for investors. These agencies expend much effort to develop reputations for reliability.[42]

Because many securitization entities are specialized financial institutions that operate solely in the bond market, they have increasingly found it cost efficient to outsource the handling of the payment and collection details associated with home mortgages.[43] As a result, they hire loan servicers, who handle payment collections from the borrowers and disbursements to the securitization entity. This maintains the cashflow of the subprime MBS. These servicers specialize in collecting delinquent loan payments and are often the agents who bring foreclosure actions against borrowers who are seriously delinquent on their mortgage payments. Since servicers are employed by securitization entities, they have little interest in working out alternative payment schedules with delinquent borrowers and often pursue collection and foreclosure actions aggressively.[44]

Segmentation in the subprime market has been a major factor in the recent explosion in subprime loan origination activity.[45] This explosion correlates with growth in the secondary market for subprime MBS, which grew from an $11 billion market in 1994 to a peak of $83 billion in the late 1990s.[46] At the same time, subprime loan originations registered a five-fold increase.[47] This increase vastly improved access to opportunities for individuals to capitalize on homeownership, and thus the growth of good-faith subprime lending has been an important development for low-to-moderate income borrowers with limited or damaged credit histories. The federal government has recognized the importance of a vital secondary market for subprime MBS

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mortgage-backed securities) (on file with *The New York University Journal of Legislation and Public Policy*).

42. *See* Steven L. Schwarcz, *Private Ordering of Public Markets: The Rating Agency Paradox*, 2002 U. ILL. L. REV. 1, 6–9 (2002). Indeed, many large institutional investors simply will not purchase unrated bonds. Arthur E. Wilmarth, Jr., *The Transformation of the U.S. Financial Services Industry, 1975-2000: Competition, Consolidation, and Increased Risks*, 2002 U. ILL. L. REV. 215, 469 (2002).

43. Jacobides, *supra* note 27, at 30.

44. The role of servicers is largely beyond the scope of this Note. The securitization entity is the holder of the legal obligation and thus is the focus of this Note's assignee liability discussion. *See* Kurt Eggert, *Held Up in Due Course: Predatory Lending, Securitization, and the Holder in Due Course Doctrine*, 35 CREIGHTON L. REV. 503, 544–45 (2002); *see also* Comm. on Bankr., *supra* note 36, at 528–29 (describing numerous financial entities that are party to any securities offering).

45. The interaction between securitization entities and lenders has fueled this development. *See, e.g.*, DEP'T. OF HOUS., CURBING, *supra* note 5, at 43.

46. *Id.* at 42.

47. *Id.*

and has taken several affirmative steps to facilitate the growth of securitization in this context.[48] Policymakers cannot ignore the importance of a robust secondary market for subprime mortgages and must carefully tailor any changes that affect this market, including an affirmative rule of recovery against assignees, to leave the market unharmed.

II.
THE ORIGINS OF AND CONTINUING JUSTIFICATION FOR THE RULE IMMUNIZING ASSIGNEES OF SUBPRIME LOANS

The rule governing assignee liability for the transfer of negotiated instruments under modern contract law is codified in § 3-302 of the Uniform Commercial Code. This rule, known as the Holder in Due Course (HDC) doctrine, protects a third-party holder of a note from claims and defenses that could have been raised against the original holder of the note as long as the third party had no actual or constructive knowledge of these claims and defenses at the time of transfer.[49] The HDC doctrine has a limited exception for defenses at common law including infancy, duress, incapacity, illegality, fraud, or a discharge in bankruptcy.[50] More simply, in the context of predatory lending, the HDC doctrine shields securitization entities from claims brought by homeowners on account of abusive loans issued by a predatory lender.[51] The HDC doctrine leaves a borrower who is the victim of a predatory loan held in the secondary market without a party to sue for relief: the original lender is no longer a party to the transaction, and the securitization entity is shielded from lawsuit by the HDC doctrine.

The HDC doctrine is a contract law gap filler term, and thus operates as the default rule in the absence of an overriding law or contractual provision. The HDC doctrine operates in contexts where other assignee liability provisions exist, such as HOEPA or the New York predatory lending law.[52] In the case of HOEPA, the HDC doctrine operates when an assignee practicing ordinary due diligence fails

48. Engel & McCoy, *supra* note 3, 1273–79.

49. For an assignee to claim HDC status, he or she must comply with eight prerequisites of the doctrine, including a requirement that he or she exchange something of value for the negotiable instrument and a requirement that he or she act in good faith. *See* Gregory E. Maggs, *The Holder in Due Course Doctrine as a Default Rule*, 32 GA. L. REV. 783, 788–91 (1998).

50. U.C.C. §§ 3-305(2)(a)–(e) (1999).

51. Eggert, *supra* note 44, at 375–78.

52. *Id.* at 590–91.

to find a HOEPA infraction in loans it purchases.[53] Similarly, the assignee liability provision of the New York law overrides the HDC doctrine only in collection or foreclosure actions.[54] At all other times the assignee is almost certainly free from liability under the HDC doctrine. The interplay between these assignee liability rules has been criticized for its complexity and adds to the confusion regarding the proper treatment of assignees.[55]

At common law, the HDC doctrine evolved to protect good-faith purchasers of negotiated instruments and to promote the liquidity of these instruments in the general economy. As originally developed, the HDC doctrine abrogated common law notions that legal rights ran with the property transacted.[56] The doctrine was an attempt by nineteenth century legislatures, first in England and then in the United States, to control fraudulent practices by agents operating between buyer and seller in rapidly expanding regional and national markets.[57] As a historical matter, the common law HDC doctrine originally applied to commercial transactions in physical goods; these were transactions in which the assignee, often a large bank, would take a shipment of goods passed from a middleman as security for a loan.[58] The doctrine developed to immunize banks from claims challenging the adequacy of the middleman's negotiations with the bank on the buyer's behalf.[59] It took some time for judges and legislators to extend this concept to negotiable instruments, particularly when the agreements in those instruments pertained to real property.[60] Only after use of the HDC doctrine became prevalent in the commercial paper

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53. 15 U.S.C. § 1641(d)(1) (2000).

54. N.Y. BANKING LAW § 6-*l*(13).

55. *Id.* at 591.

56. Grant Gilmore, *The Commercial Doctrine of Good Faith Purchase*, 63 YALE L.J. 1057, 1057 (1954) ("The initial common law position was that equities of ownership are protected at all costs: an owner may never be deprived of his property rights without his consent.").

57. *Id.* at 1057–60. The doctrine relied on the development of the concept of voidable title—a good-faith holder would have to respect a buyer's real defenses (which would lead to void title), but could disregard defenses that made title to property voidable. *Id.* 1059–60; *see also* Maggs, *supra* note 49, at 787 ("The sole exception [to the protections of the HDC doctrine] provides that the maker of an instrument may assert so-called real defenses, such as infancy, duress, incapacity, illegality, fraud in the factum, or a discharge in bankruptcy.").

58. Gilmore, *supra* note 56, at 1058.

59. *Id.*

60. *Id.* at 1081 ("Against this background it is not hard to understand why the courts seized upon what may have been inadvertencies in the drafting of the [Negotiated Instruments Law] as an occasion for waging still another rear-guard action in the struggle against security rights.").

context did the judiciary feel comfortable applying the doctrine to negotiable instruments securing mortgage property.[61]

The conventional reasoning underlying the use of the HDC doctrine in transactions of negotiable instruments rests on two assumptions: 1) granting the assignee immunity encourages transactions in negotiable instruments and 2) this liquidity is beneficial to society.[62] The first assumption arises from the straightforward observation that immunizing an assignee from legal risk will lead to reduction in the assignee's transaction costs.[63] The expansion in subprime lending resulting from the increased assignment of subprime mortgages to the secondary mortgage market validates the second assumption.[64] Proponents of the continued use of the HDC doctrine in the subprime mortgage context have argued vigorously that abrogating the doctrine will increase transaction costs for prospective securitization entities, and consequently drive these entities out of the subprime MBS market.[65] Such a shift in the secondary market would lead to a reduction in the credit available to subprime lenders, reducing the number of loans they could originate. Ultimately, such a provision would reverse the commendable improvements in access to mainstream financial products that individuals with subprime credit have enjoyed during the last decade.

Fear of liability without actual culpability is only one concern. Even a diligent securitization entity that closely analyzes every mortgage asset backing a particular security offering may find itself subjected to a consumer lawsuit under an affirmative rule of recovery. This is because predatory lending is not currently defined, and prohibited lending practices change over time as abusive lenders adapt to stay within the boundaries of changing laws. These concerns are not unfounded—the current statutory framework governing subprime

61. *Id.* at 1088 ("Furthermore, the whole question of the negotiability of note and mortgage lost its early importance as changes in business and banking practice made it much less common than it had been for mortgages to move from the hands of the original mortgagee into those of a purchaser for value.").

62. Maggs, *supra* note 49, at 792.

63. *Id.* at 792–94.

64. *See supra* Part I.B; *see also* Maggs, *supra* note 49, at 794–97 (discussing theoretical justifications for assumption that liquidity in negotiable instruments bestows benefit on society).

65. *See, e.g.*, Mortgage Bankers Ass'n of Am., *The Bond Market Association Warns of Pending NY Legislation; In Letter to New York Assembly Speaker Says Bill Would Dramatically Curtail Mortgage Credit to Low and Moderate Income Borrowers*, *at* http://www.mbaa.org/industry/news/02/0626b.html (Sept. 22, 2003) [hereinafter Mortgage Bankers Ass'n of Am.] (on file with *The New York University Journal of Legislation and Public Policy*).

high-cost loans is a complex pastiche of federal, state, and municipal ordinances.[66] These regulations offer different, and occasionally conflicting, accounts of which lending practices are prohibited and thus subject to enforcement.[67] This complicated system fails effectively to put a securitization entity on notice as to which loans are merely high-cost and which are predatory.

Other commentators have argued that an expanded rule of assignee liability could dampen the innovation of products.[68] In its strongest form, this argument envisions a bond industry, already uncertain of which loans actually subject it to liability, unwilling to securitize *any* product that fits the established "safe" profile.[69] This reluctance will lead to a dampening of innovation by subprime lenders—they will not create products to meet the varied needs of subprime borrowers for lack of a market to securitize such novel products.[70] According to this argument, subprime borrowers will suffer in the long term because product innovation ultimately leads to benefits for the consumers of these products.

Another concern focuses on the importance of rating agencies in the securitization process. Rating agencies evaluate MBS offerings using established evaluation procedures. These procedures review the assets backing a given security offering to determine an appropriate rating based on the perceived risk/return characteristics.[71] Introducing an affirmative assignee liability rule could upset the rating agencies' established risk evaluation techniques, thus hampering their ability to provide a properly informed rating for investors. Such a dramatic shift in liability is exacerbated in the case of predatory lending, where

66. *See infra* Part III.

67. *See* Mortgage Bankers Ass'n of Am. (discussing differing treatment of assignee liability at federal level and in New York under amended law). Statutory definitions of prohibited practices often differ across states. *See infra* Part III.C.

68. *See* Eggert, *supra* note 44, at 430.

69. This argument, that abrogation of the HDC doctrine will lead to risk-averse banks that fail to innovate in their financial offerings, has been offered in the consumer financing context and is easily applied to the home lending context. *See generally* William H. Lawrence & John H. Minan, *The Effect of Abrogating the Holder-in-Due-Course Doctrine on the Commercialization of Innovative Consumer Products*, 64 B.U. L. REV. 325, 340, 354–59 (1984) (discussing unintended consequences of FTC Rule).

70. This is an important concern given the importance of innovation in the home mortgage lending area. *See* Engel & McCoy, *supra* note 3, at 1275 (discussing development of broader set of mortgage products that facilitated growth of subprime market). The Alternative Mortgage Transaction Parity Act (AMTPA) is a real world example of federal support for financial innovation in the mortgage lending context. *See, e.g.*, Scott D. Samlin, *AMTPA—The Federal Alternative Mortgage Transaction Parity Act (Parity or Parody?)*, 54 CONSUMER FIN. L. Q. REP. 129, 129–31 (2000).

71. *See infra* Part III.D.

patchwork regulations and evolving abusive practices complicate the standard for actual liability. Securities investors rely heavily on rating agencies, which cultivate this reliance by maintaining a reputation for accuracy in their bond evaluations.[72] The importance of this reputation could result in a rating agency unwilling to evaluate the riskiness of MBS securities under a rule of assignee liability. Conservative estimates of MBS ratings would affect significantly investor demand, and could result in disincentives for the bond industry to securitize subprime mortgage assets.

Finally, as predatory lending becomes increasingly part of the national consciousness, the specter of bad public relations is a growing concern for securitization entities.[73] As predatory lenders continue to garner bad press for their actions, they create disincentives for securitization entities, which are typically large, well-recognized financial institutions,[74] to deal with subprime lenders. These factors could trigger a withdrawal from the subprime lending market by securitization entities. This would be disastrous, particularly in light of recent financial market turbulence among subprime lenders. The late 1990s already witnessed a decline in subprime MBS offering activity, as small specialized subprime lenders tended toward consolidation or acquisition by larger, more stable lenders.[75]

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72. *See* Schwarcz, *supra* note 42, at 8–9 ("To a large extent, the almost universal demand by investors for ratings makes rating agencies gatekeepers of the types of securities that investors will purchase. That, however, can slow down experimentation with inventive transaction structures, especially in the innovative fields of structured finance and securitization.").

73. *See, e.g.*, Acting Superintendent Elizabeth McCaul, Remarks at the Interagency Bank Supervision Conference (Oct. 18, 1999), *at* http://www.banking.state.ny.us/sp991018.htm (last visited Oct. 1, 2003)

> Predatory practices can cause irreparable harm to an institution's good name and undermine customers' confidence in its ability of the institution to deliver financial services and safeguard assets. As you all well know, there is no greater threat to the future business development capabilities of a bank, or for that matter, its future viability, than the loss of public trust and confidence.

(on file with *The New York University Journal of Legislation and Public Policy*).

74. DEP'T. OF HOUS., CURBING, *supra* note 5, at 43 ("The top eight Wall Street underwriters of subprime securities accounted for three-fourths of all subprime issues during 1999. Two affiliates of prime mortgage lenders were ranked in the top ten underwriters of subprime securities in 1999.").

75. *Id.* at 44.

III.
CURRENT REGULATIONS AIMED AT CURBING PREDATORY LENDING

A. *Overview of the Federal Response to Predatory Lending*

Ignoring the costs of foreclosures (the most damaging hallmark of seriously abusive loans),[76] the financial damage due to predatory lending practices may cost Americans $9.1 billion.[77] Predatory lending is widely recognized as a problem of national scope that primarily affects people living in low-to-moderate income residential areas. Community groups throughout the country have issued studies of communities struck by the blight of predatory home mortgage lending. The recent growth in subprime originations has been tied to increased high-cost loan ownership and foreclosures, particularly among minority and elderly borrowers.[78]

Homeowners and advocacy groups are not alone in recognizing this problem. In June 2000, the Department of Housing and Urban Development (HUD) issued a lengthy study documenting the growth of predatory lending and discussing practices that constitute abuse in lending.[79] HUD issued a comprehensive set of policy proposals including increased consumer education, increased disclosure and reporting requirements for loan originators, increased power for federal administrative agencies to prosecute predatory lending claims, and stricter prohibitions on currently regulated lending practices.[80]

The extensive documentation of predatory home mortgage lending has resulted in attempts to craft appropriate regulatory response. Federal legislation addressing the issue has progressed in an incremental fashion, weighing the concerns of affected homeowners against public policy favoring a robust subprime lending market. The federal government first addressed the problem directly with the passage of

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76. *Id.*

77. ERIC STEIN, QUANTIFYING THE ECONOMIC COST OF PREDATORY LENDING 2–3 (2001), *at* http://www.predatorylending.org/pdfs/Quant10-01.pdf (last visited Oct. 1, 2003) (on file with *The New York University Journal of Legislation and Public Policy*).

78. *See* AMALIA NIETOGOMEZ, JASON KIELY & SHANA KOTELCHUCK, PREYING ON NEIGHBORHOODS: SUBPRIME MORTGAGE LENDING AND CHICAGOLAND FORECLOSURES 12–24 (1999), *at* http://www.ntic-us.org/preying/preying.html (last visited Oct. 1, 2003) (on file with *The New York University Journal of Legislation and Public Policy*).

79. DEP'T. OF HOUS., CURBING, *supra* note 5.

80. *See* DEP'T. OF HOUS., CURBING, *supra* note 5, at 57–71, 94–96.

HOEPA, in 1994.[81] Since then, various states, in response to pressure from local community groups, have passed legislation that expands on the homeowner protection policies contained in HOEPA. Currently, more than 30 states have passed, or are reviewing, legislation that expressly targets predatory lending.[82] The Federal Reserve Board has also acted by passing an amendment to Regulation Z, the HOEPA implementing regulation.[83]

Government agencies have also begun to target individual abusive lenders in an increased effort to combat predatory lending practices. The most notable recent example of federal enforcement in this area is the $215 million settlement payment from Citigroup to the Federal Trade Commission following abusive sales tactics and excessive packing of credit insurance fees by its Associates subdivision.[84] The settlement compensated two million borrowers for losses caused by Associates, which "manipulated people into buying overpriced mortgages and credit insurance."[85] Similarly, a nationwide settlement with all 50 states and the District of Columbia could result in up to $484 million in settlement costs for Household International for excessive packing and other predatory lending abuses.[86]

The combined settlements of these two lawsuits total approximately $700 million. Each one required substantial government resources and occurred as a result of overwhelming consumer demand for litigation.[87] These lawsuits have recompensed victims of predatory lending some money damages and have resulted in changed lending practices for Citigroup and Household.[88] They also indicate that

81. 15 U.S.C. § 1602(aa) (2000). This statement is a simplification of the current federal legislative framework. This framework includes regulations of kickbacks to brokers in the Real Estate Settlement Procedures Act (RESPA), 12 U.S.C. § 2601 (2000), the general disclosure requirements of the Truth in Lending Act (TILA), 15 U.S.C. 1601 (2000), and various legislation that has generally encouraged subprime lending. *See Report of the Staff to Chairman Gramm*, *supra* note 8, at 228–30.

82. *See* Law Offices of Herman Thordsen, *Predatory Lending Law & Pending Legislation Updates*, *at* http://www.lendinglaw.com/predlendlaw.htm (last modified Sept. 26, 2003) [hereinafter Thordsen, *Predatory Lending Law*] (on file with *The New York University Journal of Legislation and Public Policy*).

83. 12 C.F.R. §§ 226.31–.35 (2003).

84. David Ho, *Citigroup Will Settle Case for $215 Million*, PHILA. INQUIRER, Sept. 20, 2002, at C2.

85. *Id.*

86. *See* E. Scott Reckard, *Lender to Refund Up to $484 Million in Settlement*, L.A. TIMES, Oct. 12, 2002, at C2.

87. The Household settlement, for example, required the cooperation of attorneys general in every state and the District of Columbia and will result in payouts from Household to 15,000 borrowers in the state of Florida alone. Michele Chandler, *Lender to Pay Up for Overcharging Borrowers*, MIAMI HERALD, Oct. 12, 2002, at A1.

88. *See, e.g.*, *id.*

leaving future enforcement of predatory lending claims to government administrative agencies can be problematic.

Household and Associates Financial are large financial institutions with national visibility. Their monolithic natures made it feasible for government administrative resources to investigate their practices and mobilize effectively against them. Such government mobilization may not be possible against smaller predatory lenders, which are often less established than institutions operating in the prime lending marketplace.[89] Litigating these cases required a major allocation of the resources available to the Federal Trade Commission (FTC) and various state attorneys general offices.[90] It remains unclear whether continued enforcement by government administrative and legal entities is feasible or desirable.

B. Home Ownership Equity Protection Act

The Home Ownership Equity Protection Act (HOEPA) provisions of the Truth in Lending Act are the primary federal regulations that target abusive mortgage lending practices. HOEPA operates by designating certain mortgages as high-cost through the use of an APR trigger and a fee trigger.[91] High-cost loans are defined as loans with an APR greater than the HOEPA APR trigger *or* with points and fees greater than the HOEPA fees trigger.[92] Such loans are subject to HOEPA's mandatory disclosures and prohibitions.[93] The HOEPA disclosures notify a consumer that he or she is entering into a high-cost loan and that default on the loan could lead to foreclosure. HOEPA prohibits certain characteristics of high-cost loans including balloon payments, negative amortization, call provisions, and flipping.[94] Loans that violate HOEPA are subject to limited statutory damages and equitable remedies.[95]

HOEPA contains a limited assignee liability provision that preserves consumer claims and defenses only if the assignee could ascer-

89. *See* DEP'T. OF HOUS., CURBING, *supra* note 5, at 38–40 (explaining that increased segmentation of subprime market has led to smaller specialized market entities, which allows for increased abuses in subprime market).
90. *See supra* note 87 and accompanying text.
91. 15 U.S.C. § 1602(aa) (2000). The Federal Reserve Board can modify these triggers through its implementing statute, Regulation Z, and has set the fees trigger at 8% (or $400, whichever is more) and the APR trigger at 8% for first-lien loans and 10% for all subordinate loans. 12 C.F.R. §§ 226.32(a)(1)(i)–(ii) (2003).
92. 15 U.S.C. § 1602(aa)(1).
93. 15 U.S.C. §§ 1639(a), (d)–(h) (2000).
94. *Id.*
95. 15 U.S.C. § 1640 (2000).

tain that the loan contained a HOEPA violation through the practice of ordinary due diligence.[96] Some have criticized this provision for inadequately dealing with dishonest predatory lenders who fail to divulge their HOEPA violations.[97] Critics also complain that ordinary due diligence is not precisely defined.[98] This is not to say that HOEPA's assignee liability provision offers consumers as few protections as the common law HDC doctrine.[99] Several cases have recognized that "Congress intended to place the increased burden [beyond the common law HDC requirements] of inquiring into the legitimacy of the lending practices engaged in by the original lender upon the assignees of HOEPA loans."[100] In this case, the court seemed to be interpreting HOEPA's assignee liability provision as a partial abrogation of the HDC doctrine, though the extent of this abrogation is still uncertain.

C. State Legislation

i. New York's Response to Predatory Lending

Various states and municipalities have worked to expand consumer protections against predatory loans.[101] On October 3, 2002, New York's Governor George Pataki signed Assembly Bill 11856 into law.[102] This legislation,[103] the product of two years of intensive lobbying by almost 100 community and advocacy groups, attempts to curb the proliferation of abusive home mortgage loans made in the subprime home mortgage lending market.[104]

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96. *Id.*
97. Eggert, *supra* note 44, at 589–90.
98. *Id.* at 590–91.
99. *See supra* Part II.
100. Bryant v. Mortgage Capital Res. Corp., 197 F. Supp. 2d 1357, 1365 (N.D. Ga. 2002) (rejecting defendant securitization entity's motion to dismiss on grounds that it was immunized under HOEPA from plaintiff's claim that it was liable for allegedly predatory loans it had been assigned). *See also* Cooper v. First Gov't Mortgage and Investors Corp., 238 F. Supp. 2d. 50, 57 (D.D.C. 2002) (rejecting assignee's motion for summary judgment because it failed to "demonstrate with undisputed facts that a person with knowledge of the HOEPA requirements evaluated and analyzed the loan documents and disbursements" to meet the ordinary due diligence standard of HOEPA); *In re* Rodrigues, 278 B.R. 683, 688–90 (Bankr. D.R.I. 2002) (finding that assignee that did not provide any showing of ordinary due diligence could not assert Federal Truth in Lending Laws as defense to plaintiff's claims of predatory and fraudulent lending practices).
101. *See* Thordsen, *Predatory Lending Law*, *supra* note 82.
102. *See, e.g.*, Dennis Hevesi, *New Curbs on Predatory Loans*, N.Y. TIMES, Nov. 10, 2002, at 11.1.
103. N.Y. BANKING LAW § 6-*l* (Consol. Supp. 2003), N.Y. GEN. BUS. LAW § 771-a (Consol. Supp. 2003), N.Y. REAL PROP. ACTS § 1302 (Consol. Supp. 2003). These statutes took effect April 1, 2003.
104. Metz, *supra* note 2, at A16.

State predatory lending statutes can take a variety of forms, but most supplement the protections in HOEPA; they expand the definition of a high-cost loan and add stricter prohibitions and enhanced disclosure requirements.[105] New York's recently amended predatory lending law is a paradigmatic example of this kind of state legislation. It applies lower APR and fee triggers than HOEPA, and therefore applies to a greater percentage of loans.[106] Furthermore, the law prohibits a wider range of abusive lending practices than HOEPA, including additional restrictions on loan refinancing, stricter restrictions on the use of balloon payments, and new prohibitions on the financing of credit and life insurance with loan proceeds.[107] The amended law also preserves equitable remedies and applies a different set of statutory damages than HOEPA.[108]

The assignee liability provision of the New York law allows a borrower to raise claims and defenses authorized by the law against an assignee only when the borrower faces a foreclosure or collection action.[109] This provision is structured differently from the HOEPA assignee liability provision: HOEPA preserves a borrower's claims and

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105. Broadly speaking, two types of statutes exist. The first (and predominant) type are statutes such as New York's, which lower trigger thresholds to encompass a broader set of loans and prohibit a wider array of practices. *See, e.g.*, FLA. STAT. ANN. §§ 494.0078–.00797 (West Supp. 2003); N.Y. BANKING LAW § 6-*l* (Consol. 2003); GA. CODE ANN. §§ 7-6A-1 to -13 (Supp. 2003); N.C. GEN. STAT. ANN. § 24-1.1E (West Supp. 2003). The second type of approach uses the market power of the government to dissuade financial institutions from dealing with predatory lenders by forbidding local government interactions with known predatory lenders. *See* ASS'N OF CMTY. ORGS. FOR REFORM NOW, NEW YORK CITY PREDATORY LENDING BILL: FACT SHEET AND BILL SUMMARY, 1–3, *at* http://www.acorn.org/acorn10/predatorylending/plreports/nycplfactsheet.pdf (last visited Oct. 1, 2003) (on file with *The New York University Journal of Legislation and Public Policy*).

106. The current APR trigger under New York law is 8% for a first-lien mortgage and 9% for a subordinate lien mortgage; the fees trigger is 5% for loans over $50,000 and the greater of 6% or $1,500 for loans less than $50,000. N.Y. BANKING LAW § 6-*l*(1)(g).

107. N.Y. BANKING LAW § 6-*l*(2). The packing of credit insurance into a loan is a common abusive lending tactic and was one of the central abuses complained of in the Household and Citigroup settlement proceedings. *See* Ho, *supra* note 84, at C2; Reckard, *supra* note 86, at C2.

108. *Compare* N.Y. BANKING LAW § 6-*l*(7)–(12) (stating that remedies for violations of banking law include actual damages, statutory damages equal to interest paid and closing charges, attorney fees, and various equitable remedies) *with* 15 U.S.C. § 1640 (2000) (stating that remedies for violations brought by individual creditor include actual damages, two times amount of any finance charge with statutory minimum of $200 and maximum of $2000).

109. N.Y. BANKING LAW § 6-*l*(13)

> In any action by an assignee to enforce a loan against a borrower in default more than sixty days or in foreclosure, a borrower may assert any claims in recoupment and defenses to payment under the provisions of

defenses only in those instances in which the borrower can prove that the assignee failed in its duty to practice ordinary due diligence in reviewing the loan at the time of assignment.[110] While New York's assignee liability provision appears to operate less restrictively than the HOEPA provision, the law only contemplates a defensive rule of assignee liability—consumer claims against a predatory lender are only preserved against that lender's assignee in defense of collection on loan default or foreclosure.[111] In other words, a victim of an otherwise illegal loan originated in New York and held by an assignee must wait for initiation of a foreclosure or collection proceeding before raising the defenses available under the law. For some borrowers this could entail months or years of payments on an abusive loan before default and ensuing legal action. This rule also has implications for the innocent assignee, which would not be aware of predatory loans it had received from a lender until it actually attempted to foreclose on a defaulting borrower. As a result, the assignee could conceivably purchase many loans over a period of time from a predatory lender with little notice of their illegal character.

ii. Georgia—A Model for an Affirmative Right to Recovery

In October 2002, the Georgia legislature passed the Georgia Fair Lending Act (GFLA).[112] Similar in structure to New York Banking Law § 6-*l*, the GFLA defines a set of thresholds for the high-cost loans it regulates.[113] Within this set of loans, the GFLA prohibits certain lending practices including flipping[114] and packing,[115] and restricts the use of other practices such as negative amortization,[116] balloon payments,[117] and yield spread premiums.[118] Violations of these prohibitions provide an injured borrower with an affirmative claim that entitles him or her to actual damages, statutory damages equal to two times the interest already paid plus the interest owed for the remainder of the loan, and punitive damages, attorneys' fees, and

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> this section and with respect to the loan, without time limitations, that the borrower could assert against the original lender of the loan.

Id.

110. Eggert, *supra* note 44, at 590–91.
111. N.Y. BANKING LAW § 6-*l*(13).
112. GA. CODE ANN. §§ 7-6A-1 to -13 (Supp. 2003).
113. *Id.* §§ 7-6A-2(7), (17).
114. *Id.* § 7-6A-4(a).
115. *Id.* § 7-6A-3(1).
116. *Id.* § 7-6A-5(3).
117. *Id.* § 7-6A-5(2).
118. *Id.* § 7-6A-5(9).

any equitable relief ordered by a court.[119] Up to this point, the GFLA is substantially similar to New York Banking Law § 6-*l*.[120] The GFLA expands New York's liability rule in two ways. First, the statute defined creditor broadly, such that the term could encompass mortgage assignees.[121] Second, the liability provision of the statute contained the following language:

> Notwithstanding any other provision of law, where a home loan was made, arranged, or assigned by a person selling home improvements to the dwelling of a borrower, *the borrower may assert against the creditor all affirmative claims and any defenses that the borrower may have against the seller or home improvement contractor*, provided that this subsection shall not apply to loans other than high-cost home loans unless applicable law requires a certificate of occupancy, inspection, or completion to be obtained and said certificate is not obtained. [emphasis added].[122]

The apparent result of this provision is to abrogate the HDC doctrine, thus allowing borrowers private rights of action for violations of the GFLA against any party holding his or her mortgage. The financial industry responded aggressively to the passage of the GFLA by accelerating the preemption debate to avoid Georgia's high-cost loan requirements and liability provisions.[123] And, more alarmingly for proponents of the expanded liability rule, Standard & Poor's—one of the three largest securities rating agencies[124]—refused to continue rating MBS containing high-cost loans from Georgia, citing the uncertain breadth of liability under the GFLA.[125] This move irritated the financial entities in the lending pipeline as Moody's quickly followed suit.[126] This move was a major blow to the GFLA, as rating agencies play a crucial role in the securitization process, and unrated bonds

119. *Id.* § 7-6A-7.

120. *See supra* Part III.C.i.

121. GA. CODE ANN. § 7-6A-2(6).

122. *Id.* § 7-6A-6(a).

123. *See* Letter from Malcolm Bush, President, Woodstock Institute, to Office of the Comptroller of the Currency (Mar. 28, 2003), *at* http://www.woodstockinst.org/occ preemption.html (last visited Oct. 1, 2003) (on file with *The New York University Journal of Legislation and Public Policy*).

124. The other two major rating agencies are Fitch and Moody's.

125. Press Release, Standard & Poor's, Standard & Poor's to Disallow Georgia Fair Lending Act (Jan. 16, 2003), *at* http://www.mbaa.org/industry/news/03/0116b.html (last visited Oct. 1, 2003) (on file with *The New York University Journal of Legislation and Public Policy*).

126. *Moody's: GFLA Makes Some Loans in Securitizations Too Risky*, ATLANTA BUS. CHRON., Jan. 30, 2003, *at* http://atlanta.bizjournals.com/atlanta/stories/2003/01/27/daily53.html (last visited Oct. 1, 2003) (on file with *The New York University Journal of Legislation and Public Policy*).

have a very limited market among securitization entities and bond investors.[127] At around the same time, the Federal Home Loan Mortgage Corporation (Freddie Mac), one of three government-sponsored entities that specializes in purchasing mortgages for securitization,[128] declared that it would no longer purchase mortgages from Georgia. There were rumors that the Federal National Mortgage Association (Fannie Mae) would follow suit.[129]

The Georgia legislature could not withstand this onslaught from the lending industry. The legislature modified the GFLA, substantially limiting the assignee liability provision. The changes included a narrowed definition of creditor clearly to exclude assignees of a mortgage,[130] and a refined assignee liability provision:

> Notwithstanding any other provision of law, any person who purchases, is assigned, or otherwise becomes a holder of a high-cost home loan shall be subject to all affirmative claims and any defenses with respect to the high-cost home loan that the borrower could assert against the creditor of the high-cost home loan, *unless the purchaser or holder demonstrates, by a preponderance of the evidence, that the purchaser or holder exercised reasonable due diligence at the time of purchase of the home loans*, or within a reasonable time thereafter, intended to prevent the purchaser or holder from purchasing or taking assignment of high-cost home loans.[131] [emphasis changed from original].

While it is not yet clear how courts will interpret this new clause, it is interesting to note the similarity between the reasonable due diligence standard for assignees in the revised GFLA and the ordinary due diligence language in HOEPA.[132] This example illustrates the substantial political pressures the lending market will exert on any rule that expands assignee liability. Following this and other more industry-friendly changes in the GFLA, the rating agencies resumed their practice of rating MBS covered by the GFLA.[133]

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127. *See supra* text accompanying note 42.

128. The other two government-sponsored entities are the Federal National Mortgage Association (Fannie Mae) and the Government National Mortgage Association (Ginnie Mae).

129. *See, e.g.*, *OUR OPINIONS: To the Letter, Perdue Team Misled Us on Lending Law*, ATLANTA J.-CONST., Mar. 19, 2003, at A18.

130. GA. STAT. ANN. § 7-6A-2(6) (2003).

131. *Id.* § 7-6A-6(b) (2003).

132. *See supra* Part III.B.

133. Brad Finkelstein, *How the GA Law Became More Industry Friendly*, NAT'L MORTGAGE NEWS, Mar. 24, 2003, at 7.

D. Problems with Federal Preemption of State Laws Targeting Predatory Lending Practices

Discussion of statutes including a rule preserving borrowers' claims and defenses is incomplete without considering whether state level or federal level implementation is more appropriate. Implementing a state private right of action (without the ordinary due diligence standards in HOEPA and the state laws discussed) against assignees would be easier, because the definition of predatory lending is already established. The private right of action could refer to lending prohibitions devised by the state legislature, giving this approach the advantage of simplicity; predatory lending violations would already be defined and completed and would be sensitive to local lending practices.

State level implementation of a private right of action against assignees would create two problems. First, because it would create a state-specific liability rule, such a scheme could result in high compliance costs for securitization entities with national operations. If all fifty states passed assignee liability rules using state predatory lending prohibitions, national securitization entities would incur massive costs trying to stay within the bounds of these 50 rules.[134] Given the mechanics of securitization,[135] a state level rule of assignee liability could complicate securitization entities' operations by subjecting a pool of mortgages backing a given security offering to an inconsistent set of liability rules. This would confound securitization entities' (and rating agencies') attempts to predict the risk profile for that offering.[136]

The second problem is that federal preemption of state law could confound the rules. Because individual states rarely coordinate their efforts at regulation, each new statutory scheme targeting predatory lending adds new liability rules with which interstate subprime lenders must comply. As statutory requirements have multiplied, lenders have called on Congress and national bank-regulating bodies, such as the Office of the Comptroller of the Currency, to enact rules at the federal level to preempt local and state regulation.[137] In response, advocacy groups and state governing bodies have called on federal rule makers

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134. *See* Donald C. Lampe, *Predatory Lending Initiatives, Legislation and Litigation: Federal Regulation, State Law and Preemption*, 56 CONSUMER FIN. L. Q. REP. 78, 84 (2002).

135. *See supra* Part I.C.

136. *See* Lampe, *supra* note 134, at 84.

137. *See, e.g.*, Letter from Malcolm Bush, President, Woodstock Institute, to Office of the Comptroller of the Currency, *supra* note 123.

to abstain from preemption out of fear that federal standards for abusive lending will be less stringent than state standards and less sensitive to local lending practices.[138] This issue has reached the courts in terms of state loans that contravene the federal Alternative Mortgage Transactions Parity Act (AMTPA), a federal statute that applies to certain classes of mortgages and allows lenders the flexibility to structure their mortgage offering pursuant to federal standards.[139] The risk of preemption is a real one, as several courts have held that where state lending statutes contravene the federal standards laid out in AMTPA, the federal standard trumps the state standard.[140]

A federal private right of action would have the advantage of circumventing the issue of preemption, but would have other implementation issues. A federal private right of action that incorporated a unitary federal standard for a fair subprime loan would not be sensitive to every particular mix of abusive lending practices employed by predatory lenders nationwide, because there is no clear consensus about what defines a predatory loan and because abusive lending practices vary from state to state.[141] One solution would be the creation of a federal private right of action against the issuer and all assignees of a predatory loan, for which the definition of a predatory loan could be found by reference to state law. While federal laws are presumed to have a unitary definition in order to have uniform application,[142] Congress can override this presumption and condition a federal right on a state law definition.[143] While this approach would be more sensitive to local lending practices, its relative novelty would likely make it controversial. Moreover, financial entities in the subprime market would continue to face state-specific standards, because this approach would define predatory lending according to state law.

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138. *See, e.g.*, Letter from Center for Responsible Lending, to Office of the Comptroller of the Currency (Mar. 28, 2003), *at* http://www.responsiblelending.org/pdfs/comments_toOCC_on_Georgia_preemption_040303.pdf (last visited Oct. 1, 2003) (on file with *The New York University Journal of Legislation and Public Policy*).

139. 12 U.S.C. §§ 3801–3805 (2000).

140. *See* Robert M. Jaworski & Henry H. Cronk, *Mortgage Lenders' New Regulator: The Plaintiff's Bar*, 57 BUS. LAW. 1275, 1275–76 (2002).

141. *Compare supra* Part III.C (discussing regulatory provisions of HOEPA), *with supra* Part III.D (discussing provisions in New York and Georgia banking laws that regulate high-cost loans).

142. *See* RICHARD H. FALLON, ET AL., HART AND WECHSLER'S THE FEDERAL COURTS AND THE FEDERAL SYSTEM 768–70 (4th ed. 1996).

143. For example, in De Sylva v. Ballentine, 351 U.S. 570 (1956), the Supreme Court held that where a federal copyright statute referenced "illegitimates," the definition of "illegitimates" would be determined by state law. Similarly, in Mississippi Band of Choctaw Indians v. Holyfield, 490 U.S. 30 (1989), the definition of "domicile" in the Indian Child Welfare Act was determined by state law.

IV.
The Outdated Rule Immunizing Assignees Should Be Abrogated

Several fundamental shifts have influenced the environment surrounding negotiable instrument transactions. First, negotiable instrument use has declined, as consumers have turned to bank lines of credit to supplement their cash reserves when making purchases. The importance of negotiated instruments as an alternative to cash was once a major justification for preserving liquidity in the market of negotiated notes.[144] The declining use of negotiated transactions has made this rationale less compelling. Furthermore, despite the fact that secured transactions applied to commercial parties, which are presumably better able to evaluate the risks pursuant to a transaction secured by real property, the judiciary was still reluctant to extend the HDC doctrine to mortgage transactions.[145] This reluctance rested on judicial recognition of the importance of an individual's retention of his or her property rights. It was overcome, in part, because assignment of secured transactions involving property was relatively rare at the time the HDC doctrine expanded to this area.[146] The modern subprime lending market, however, has witnessed an explosion in the use of assignees, undermining this justification for using the HDC doctrine. The judiciary's concerns regarding the importance of property rights have additional force in the context of personal mortgage transactions. These concerns have become weightier because a lender and a homeowner are less likely to be on equal footing than two commercial parties to a secured transaction; an individual is less likely to be on guard against the consequences of losing his or her property rights through assignment. Also, mortgage transactions have become increasingly complex as lawyers gradually expand the agreements to account for newly discovered contingencies.[147] Finally, modern judicial philosophy has evolved and now contemplates a broader range of circumstances that justify mitigating circumstances for failure to execute

144. *See* Kurt Eggert, *supra* note 44, at 399–401.

145. *See* Gilmore, *supra* note 56, at 1081.

146. *Id.* at 1088 ("Furthermore the whole question of the negotiability of note and mortgage lost its early importance as changes in business and banking practice made it much less common than it had been for mortgages to move from the hands of the original mortgagee into those of a purchaser for value.").

147. *See* Eggert, *supra* note 144, at 423–26 (2002) (describing efforts of lenders and banks to develop most favorable negotiable instruments laws to their position at expense of consumer).

contract provisions.[148] As modern courts take a more activist role in transactions between parties, the foundation of the HDC doctrine, premised on the primacy of the bargain over issues of public policy, has become increasingly suspect. Changes in the use of negotiable instruments secured by mortgaged property in the subprime market provide a powerful case for rethinking the application of the HDC doctrine.

A. The Holder in Due Course Doctrine is a Less Efficient Delegation of Risk Than a Rule Permitting Claims Against an Assignee

When a predatory lender assigns a loan, it leaves the borrower and the securitization entity with an unfair loan that was the product of their respective good-faith bargaining. There is no question of moral culpability, because of the assumption that the two parties are operating in good faith; therefore, this analysis will examine what risk sharing regime between borrower and assignee will maximize social wealth.[149] This analysis will necessarily implicate notions of utilitarianism (e.g., the relative value of a home to a borrower versus the value of extra-secure transactions for the securitization entity) and autonomy (e.g., tensions between contract certainty and the importance of fair bargaining). It is not meant to be a rigorous economic analysis of the costs involved, but rather, a discussion of some broad principles from the law and economics school of thought and application to the relationship between borrower and securitization entity.

Mortgage transactions implicate rights existing in both contract and property law. The relationship between borrower and assignee could be viewed as a property transaction, which would implicate property rights and entitlements,[150] or alternatively as a contractual agreement secured by the borrower's home, which would involve contract concepts such as reciprocity and reliance.[151] Ultimately, how-

148. This is evidenced by the broader variety of defenses that now exist such as the doctrines of impracticability and stricter judicial review of adhesion contracts. *See generally* Charles L. Knapp, et al., Problems in Contract Law Cases and Materials ch. 8 (Richard A. Epstein et al. eds., Aspen Law & Business 4th ed. 1999) (discussing the various doctrines for avoiding contract enforcement entertained by modern courts).

149. *See generally* Richard A. Posner, *Wealth Maximization Revisited*, 2 NOTRE DAME J.L. ETHICS & PUB. POL'Y 85 (1985) (evaluating wealth maximization in variety of contexts).

150. *See generally* Guido Calabresi & A. Douglas Melamed, *Property Rules, Liability Rules, and Inalienability: One View of the Cathedral*, 85 HARV. L. REV. 1089 (1972) (discussing background of property rights theory).

151. *See generally* Charles J. Goetz & Robert E. Scott, *Enforcing Promises: An Examination of the Basis of Contract*, 89 YALE L.J. 1261 (1980) (discussing basic concepts in contract law).

ever, concepts from law and economics models applied to both areas are illustrative. The relationship between the borrower and assignee defies traditional economic models because the two parties never directly contract with one another. The subprime lender's role of intermediary complicates the analysis but does not invalidate the broad concepts applicable from the law and economics school of thought.

One economic model of property law contemplates three ways to protect the entitlement interest in mortgaged property: 1) through a rule of property rights; 2) through a rule of liability; or 3) through some tacit restriction on the transfer of property.[152] The decision of which rule (or rules) to apply to a given transaction hinges on considerations of efficiency (i.e., which rule will result in the lowest transaction costs between the parties),[153] resource allocation concerns (i.e., how will the rule affect the distribution of wealth between the parties),[154] and extra-economic concerns of justice and fairness.[155] In an idealized regime with costless transactions, the parties will presumably bargain for the most efficient outcome; the decision between property and liability rules has no impact from an efficiency standpoint, but it may impact resource allocation and justice concerns.[156]

We can immediately apply this framework to the borrower-assignee relationship by conceptualizing the subprime lender as a transaction cost between these parties. Given the dependence of subprime lenders on sales of mortgages to the secondary market as well as the fact that mortgage transactions between large financial institutions and individual homeowners often take place in the prime market, this conceptualization is appropriate. Because the significant transaction costs between borrower and assignee limit the applicability of the Coase

152. The difference in the liability and property rules hinges on the method of valuation—a property rule will protect the property holder's entitlement up to his subjective valuation of the property, whereas a liability rule imposes an objective cost of the imposition on that entitlement. Within these boundaries, both the property rule and the liability rule envision freely transacting parties bargaining for control of the property in question without limitation. The third rule, the rule of restriction, goes further and imposes socially mandated regulation on the transaction of the property. Calabresi & Melamed, *supra* note 150, at 1093–1105.

153. *Id.* at 1093.

154. *Id.* at 1097.

155. *Id.* at 1102.

156. *See id.* at 1097–98 ("Economic efficiency is not, however, the sole reason which induces a society to select a set of entitlements. Wealth distribution preferences are another, and thus it is to distributional grounds for different entitlements to which we must now turn."); Harold Demsetz, *When Does the Rule of Liability Matter?*, 1 J. LEGAL STUD. 13, 22 (1972).

theorem,[157] different rules of risk-sharing will result in different net efficiencies within the mortgage transaction.[158] This Note's goal is to determine which regime—a regime governed by the HDC doctrine or by a borrower's right to recover from the assignee—is optimal within this framework.[159]

i. The Holder in Due Course Doctrine Operates Inefficiently Between Homeowners and Assignees

The question of efficiency turns on a determination of which party to the transaction is a least cost avoider for the harm in question.[160] In other words, one must ask which of the two parties can more cheaply detect and avoid a predatory loan originated by an abusive lender. Based on the current characteristics of assignee and borrower, the assignee can more cheaply avoid the harm of a predatory loan for the following reasons: 1) it is in a better position to shift costs back on a predatory lender to account for increased risk of predatory loans; 2) it has a wider variety of third-party risk reduction mechanisms; and 3) as an institutional purchaser of mortgages in bulk, it can spread the risk of loss resulting from a predatory loan among a substantially larger pool of assets than the borrower.[161]

An assignee of a subprime loan in the bond market is in a better bargaining position with abusive lenders than an individual homeowner.[162] Subprime borrowers are often financially unsophisticated parties who are unaware of alternatives that exist to a given subprime loan. This lack of sophistication makes these borrowers susceptible to

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157. The Coase theorem holds that in an idealized setting with zero transaction costs, a rule of liability will not change the behavior of parties to a transaction since they will bargain for the most efficient outcome. *See, e.g.*, Demsetz, *supra* note 156, at 14.

158. Calabresi & Melamed, *supra* note 150, at 1096–97.

159. It is noteworthy that this binary comparison is a narrower question than attempting to determine what regime satisfies the requirements of Kaldor-Hicks efficiency. A Kaldor-Hicks efficiency improvement occurs upon implementation of a change that results in a net increase in social resources from a given transaction. That analysis would require a broader examination of all the possible relationships between borrower and assignee as well as an analysis of all externalities that arise from each relationship. This Note's more narrow analysis will focus on the relative merits of the risk regime under the HDC doctrine as opposed to those of a hypothetical rule that would allow a borrower to retain all claims that he or she would have under state and federal predatory and abusive lending laws against the assignee. A rule mandating disclosure is another possible arrangement that may satisfy efficiency considerations. *See generally* Anthony T. Kronman, *Mistake, Disclosure, Information, and the Law of Contracts*, 7 J. LEGAL STUD. 1 (1978) (discussing types of information necessary to correct problem of unilateral mistake within theory of contract law).

160. Calabresi & Melamed, *supra* note 150, at 1097.

161. Eggert, *supra* note 44, at 614–18, 625–28.

162. *Id.* at 614–25.

the high pressure sales tactics that some abusive lenders employ to close a mortgage.[163] Beyond a lack of sophistication lies the ugly history of discrimination in the financial services sector.[164] It is undeniable that redlining practices have had some impact on the financial condition of low-to-moderate income minorities, particularly African-Americans. Because predatory lending disproportionately impacts these same groups,[165] it victimizes individuals who are recovering from this legacy of discrimination. As a result, an unethical lender can have considerable leverage in closing an abusive loan with a borrower who may feel constrained by his or her lack of prime credit. In contrast to this, bond market assignees are professionally managed financial organizations. Because subprime lenders rely on securitization to fund their ongoing operations, assignees have considerable leverage in bargaining with subprime lenders. These assignees have more leverage to build in contractual protections against liability than homeowners and are in a better position to cut off known predatory lenders.[166]

Unlike the average homeowner, bond institutions have a wide variety of means to mitigate the risk of a predatory loan.[167] These include the purchase of third-party liability insurance, a greater ability to contract for liability reduction with the lender, and portfolio structuring that can take the costs of assignee liability into account.[168] The

163. Use of high pressure sales tactics on unsophisticated buyers is a hallmark of predatory lenders. *See* Ho, *supra* note 84, at C2; Reckard, *supra* note 86, at C2.

164. The problem of racial discrimination in the provision of financial services has been so pervasive that the label for this practice, redlining, is almost part of the common lexicon. *See, e.g.*, David E. Runck, Note, *An Analysis of the Community Development Banking and Financial Institutions Act and the Problem of "Rational Redlining" Facing Low-Income Communities*, 15 ANN. REV. OF BANKING L. 517, 518–21 (1996).

165. *See supra* text accompanying note 10.

166. Eggert, *supra* note 44, at 618

> Repeat commercial players are far more likely to engage in innovation, including legislative reforms, than non-repeat, private players because the commercial players have an interest in improving a process in which they will engage for decades, while a neophyte, one-time player has little reason to care about the process other than its effect on the single transaction at hand.

Id.

167. *Id.* at 618.

168. The credit enhancement entity in the securitization process is a professionally managed organization with the responsibility of minimizing risk. Andrew E. Katz, *Due Diligence in Asset-Backed Securities Transactions*, *in* CONDUCTING DUE DILIGENCE 2002, at 371, 386 (PLI Corporate Law and Practice Course, Handbook Series No. 1304, 2002).

> If credit [is] enhanced by third-party action, whether by letter of credit or financial guaranty insurance policy, inquiry is necessary into the authority

individual homeowner has none of these measures and thus has little recourse beyond litigation to deal with the tactics of an abusive lender. Between the innocent homeowner and the innocent assignee, the assignee is in a better position to plan effectively for abusive loans.

Assignees can spread the losses resulting from a bad loan across the pool of loans that form their asset backed security portfolios.[169] In contrast, a predatory loan that results in a foreclosure can be a devastating event in the life of an individual subprime borrower. For most homeowners, equity in a home represents a significant bulk of the resources accumulated over a lifetime. Predatory loans endanger these resources directly, threatening a homeowner with financial insolvency and foreclosure. These occurrences result in substantial secondary costs as negative externalities spill over to society at large and homeowners struggle to regain fiscal solvency.[170] On the other hand, the securitization entity has numerous advantages as a specialist in processing financial obligations. The securitization entity typically purchases loans in bundles as part of a broader portfolio that will eventually back an MBS offering. The failure of one loan in this pool of assets represents a relatively (as compared to the borrower) minor cost of doing business.[171] A subprime mortgage represents an uncommon event in the life of an individual borrower, whereas the assignee typically purchases these loans on an ongoing basis. Assignees can spread the costs of past predatory loans across future purchases of subprime loan bundles—they can adapt their purchase offers for a given lender based on liability costs they have incurred from loans purchased in the past from that lender.

Borrowers are arguably least cost avoiders. As individuals dealing with relatively few transactions, borrowers have traditionally been viewed as the least cost avoiders because they are closer to the details of the transaction and are typically able to exercise more control over its inherent risk. Prime borrowers may be least cost avoiders in this context because they have a wide breadth of choices among mortgagees, they tend to be financially sophisticated, and they can effectively

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> of that entity to issue the credit enhancement document and its sufficiency as a document of that type. Critical for asset securitization transactions which are credit enhanced by third parties is the obligation of the credit enhancer to provide payment to the security holders in the manner described in the offering documents.

Id.

169. Eggert, *supra* note 44, at 627–28.

170. *See id.* at 625–26.

171. *Id.* at 627.

police their own self interests.[172] The numerous financial literacy programs conducted by community groups that target predatory lending are, from an economic sense, intended to decrease the costs of avoidance for subprime borrowers by providing them with the tools to evaluate properly and plan for the obligations that come with signing a mortgage.[173]

As the damage caused by redlining is gradually repaired over time and borrowers become increasingly sophisticated and wary of predatory lenders, an increased burden on borrowers could be justified. This reasoning led to the development of the HDC doctrine in the first place—the assignee in the transaction was viewed as being removed from the transaction and thus less capable of controlling the practices of a fraudulent intermediary.[174] In that context, the argument for the borrower as least cost avoider was considerably stronger and justified the risk-shifting imposed by the common law HDC doctrine.[175]

A final point worth noting is that the HDC doctrine developed as a rule restricting the rights of the obligor (the borrower in the subprime lending context) against the assignee relative to transactions not affected by the doctrine.[176] The HDC doctrine logically induces a greater degree of reliance on the bargain by the assignee than would otherwise be possible, as the borrower bears the greater legal consequences in default.[177] Typically, reciprocal enforcement of a contract

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172. This is the economic rationale for enforcing contracts between equally sophisticated parties where a unilateral mistake has occurred. Each party is considered the least cost avoider for his or her own mistakes and thus should be held liable for any errors in business judgment. Kronman, *supra* note 159, at 5. This is not to say that prime borrowers necessarily are least cost avoiders; this idea has been presented as a partial justification for some of the additional legal protections developed for subprime borrowers.

173. *See, e.g.*, Deborah Goldstein, *Protecting Consumers from Predatory Lenders: Defining the Problem and Moving Toward Workable Solutions*, 35 HARV. C.R.-C.L. L. REV. 225, 247–50 (2000).

174. *See supra* Part II.

175. At least one commentator has argued that this efficiency approach justifies the retention of the HDC doctrine in a different context, where the Federal Deposit Insurance Corporation (FDIC) works to bail out struggling banks and requires the immunity provided by the HDC doctrine to maximize depositor—and taxpayer—resources. *See* Marie T. Reilly, *The FDIC as Holder in Due Course: Some Law and Economics*, 1992 COLUM. BUS. L. REV. 165 (1992).

176. *See supra* Part II; Gilmore, *supra* note 56, at 1057.

177. *Cf.* Goetz & Scott, *supra* note 151, at 1279–80 ("In contrast, if a promise is legally enforceable, and the regret costs shift to the promisor, the promisee may engage in a greater than optimal level of reliance."). This argument was made in reference to the decision of whether or not to enforce nonreciprocal promises. The concept that a shift in the legal rules governing risk sharing among two parties to a transaction

is thought to be the most efficient regime because it induces reasonable reliance—reliance that is merited by the risks associated with a given transaction.[178] Because the assignee is partially immunized from borrower claims, the borrower faces greater legal consequences for breach than the assignee does. This shift in the risk-sharing regime can induce the assignee to rely on beyond what is reasonable. Furthermore, the extent of this over-reliance is unclear under current law. Pursuant to HOEPA's assignee liability provision (and analogous assignee liability provisions at the state level) the HDC doctrine protects assignees of subprime mortgages.[179] The scope of these assignee liability provisions is as of yet uncertain, which forces assignees to incur some transaction costs to determine the proper degree of reliance they may place on a given subprime mortgage agreement.[180] In the current context, over-reliance by the assignee is a less efficient arrangement than the paradigm of reciprocal risk-sharing. The degree of the benefit received by the assignee from this over-reliance is uncertain as the assignee must incur some transaction costs to determine what constitutes ordinary due diligence under current law.[181] An affirmative rule, in contrast, operates certainly and is closer to the efficient reciprocal enforcement arrangement contemplated by theoretical models.[182]

ii. Enforcing the HDC Doctrine is a Costly Social Policy

Economic efficiency is not the only touchstone on which to base a rule of liability.[183] One must also consider the application of society's resource allocation goals to the transaction.[184] Society's interests in furthering the benefits of homeownership outstrip the securitization entity's interests in profit. This broad principle, however, leads to tension in the current transaction. While the above resource allocation goal seems at first to mandate valuing the homeowner's interests over the assignee's, and thus abolishes the HDC doctrine, this analysis neglects the importance of the secondary

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will induce one party to rely more on the promise and the other party to take more precautions in case of breach seems equally applicable to reciprocal promises.

178. *See id.* at 1286–87 (conceptualizing beneficial and detrimental reliance in context of inter-temporal consumption).

179. *See supra* Part III.B.

180. *See* Goetz & Scott, *supra* note 151, at 1267–70.

181. *Id.*

182. The model of mutual enforcement and how it incurs reasonable reliance on the part of both parties is discussed in Kronman, *supra* note 159, at 1–6.

183. *See* Calabresi & Melamed, *supra* note 150 at 1093–1105.

184. *See id.* at 1098–1100 (discussing implications of resource allocation preferences on wealth distribution).

market for subprime borrowers.[185] If liability for a predatory lender's acts is extended to the securitization entity, this could have the unwanted effect of driving these entities out of the secondary market to the detriment of homeowners who benefit from increased access to subprime mortgage products. This cost would be difficult to quantify and compare with the toll abusive and predatory lending practices have on borrowers, but it cannot be ignored. The reality of such a rule is likely not this extreme, because the HDC doctrine has been abrogated in other contexts without such an extreme response, and abrogation could provide other benefits to assignee and borrower alike.

B. Precedent for Abrogating the Holder in Due Course Doctrine in Subprime Mortgage Transactions

The issues raised by the operation of the HDC doctrine in modern transactions have arisen in other lending contexts. During a twenty-year period beginning in the 1950s, the same type of interplay between borrower, lender, and third party was commonplace in the consumer retail lending market—borrowers would incur loan obligations to finance the purchase of large consumer goods.[186] Some unethical retailers, much like the predatory lenders of today, would take advantage of consumer demand by issuing abusive loans to the unwitting or unsophisticated consumer.[187] The retailers would then assign these loans to large financial institutions in exchange for cash or a bank line of credit. Under the HDC doctrine, the default rule at the time, consumers found themselves in a position similar to that of the victims of predatory loans—they held an unreasonable loan with no target for legal recourse.[188]

In response to this problem, the FTC, after raising many of the theoretical arguments for the elimination of the HDC doctrine discussed above, enacted the FTC Holder Rule in 1975.[189] The FTC Rule eliminates the inefficiencies caused by the HDC doctrine in the consumer credit lending context by placing the burden of liability on assignees of a consumer credit contract.[190] The FTC Rule is self-exe-

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185. *See supra* Part I.B.
186. Preservation of Consumers' Claims and Defenses, 40 Fed. Reg. 53,505, 53,507 (Nov. 18, 1975) (to be codified at 16 C.F.R. pt. 433).
187. *Id.* at 53,509, 53,512.
188. *Id.*
189. Preservation of Consumers' Claims and Defenses, 16 C.F.R. § 433 (2003).
190. Preservation of Consumers' Claims and Defenses, 40 Fed. Reg. at 53,523

> Our objective then, in this rule, is two fold. First we would employ our remedial authority to modify existing commercial behavior such that costs occasioned by seller misconduct in the consumer market are re-

cuting[191] and requires, in part, that assignors of a consumer credit contract include the following notice in any consumer credit contract they assign:

> NOTICE
> ANY HOLDER OF THIS CONSUMER CREDIT CONTRACT IS SUBJECT TO ALL CLAIMS AND DEFENSES WHICH THE DEBTOR COULD ASSERT AGAINST THE SELLER OF GOODS OR SERVICES OBTAINED PURSUANT HERETO OR WITH THE PROCEEDS HEREOF. RECOVERY HEREUNDER BY THE DEBTOR SHALL NOT EXCEED AMOUNTS PAID BY THE DEBTOR HEREUNDER.[192]

The FTC Rule applies to individual consumers and financial institutions that "in the ordinary course of business, lend[ ] purchase money or finance[ ] the sale of goods or services to consumers on a deferred payment basis."[193] By passing the FTC Rule, the Federal Trade Commission acted on its findings that it was "an unfair practice for a seller to employ procedures in the course of arranging the financing of a consumer sale which separate the buyer's duty to pay for goods or services from the seller's reciprocal duty to perform as promised."[194]

Unethical retailers divested consumers of their legal claims in one of two ways. First, retailers would refer a consumer to a third-party consumer finance institution for a purchase money loan and apply the proceeds to the cost of the retail item. In this way, the buyer's obligation to pay the consumer finance institution was independent of the seller's duty to perform.[195] Second, the retailer would enter into a retail installment contract with the consumer directly and then assign this loan at a discount to a third-party finance company. This divested

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> duced to the lowest possible level . . . . Second, where certain seller misconduct costs cannot be eliminated from the market we would require that such costs be internalized, so that prices paid by consumers more accurately reflect the true social costs of engaging in a credit sale transaction.

Id.

191. Michael M. Greenfield & Nina L. Ross, *Limits on a Consumer's Ability to Assert Claims and Defenses Under the FTC's Holder in Due Course Rule*, 46 BUS. LAW. 1135, 1137 (1991) ("The Rule is self-executing and enables the consumer to assert seller-related claims and defenses when the assignee seeks to enforce the consumer's obligation to pay.").

192. 16 C.F.R. § 433.2.

193. 16 C.F.R. § 433.1. This excludes credit card issuers.

194. Preservation of Consumers' Claims and Defenses, 40 Fed. Reg. at 53,522.

195. *Id.* at 53,507.

the consumer of his legal claims in the contract through the action of the HDC doctrine.[196]

The second of these practices is strikingly similar to the mechanics of assignment in the subprime market. Also similar is the appetite large financial institutions showed for consumer retail contracts at the time of the FTC Rule, which is on par with the appetite securitization entities have shown for subprime mortgages in the 1990s.[197] As a result, many consumers were caught off-guard by the action of a rule that consequently affected a multi-billion dollar industry.[198]

The FTC noted the counter-intuitive nature of the HDC doctrine and found that modern consumer credit transactions were host to a wholly different set of policy considerations than those that gave rise to the HDC doctrine in the first place.[199] It found that the HDC doctrine was designed to maintain the liquidity of negotiated instruments in the commercial paper market by protecting confidence in commercial transactions, and that the extension of the HDC doctrine to consumer lending was a "mechanical abrogation" of consumer rights.[200] The FTC went on to find that the HDC doctrine operated inefficiently in the context of consumer retail contracts. It found that between the innocent consumer and financier, the financier was in a better position to protect itself from an abusive retailer.[201] This conclusion was premised on the finding that the financier-assignee could bargain for effective recourse agreements and warranties against consumer claims.[202] The financier-assignee was in a better position to control the practices of unethical lenders because it could pick and choose between retailers and suppliers with whom it did business.[203] The FTC also noted that the HDC doctrine resulted in an unfair allocation of costs, as "[m]isconduct costs are not incorporated in the price of goods or services [rendered]."[204] Finally, the FTC found that creditors

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196. *Id.*

197. *Compare id.* ("Over the past two decades, banks and credit unions have vigorously pursued emerging opportunities in the consumer credit market. They held 54.4 billion dollars in consumer installment credit as of December 1970, or 53.8% of the market."), *with* DEP'T. OF HOUS., CURBING, *supra* note 5, at 42 (noting that in 1999 37% of all subprime originations were held in securities offerings in capital market).

198. Preservation of Consumers' Claims and Defenses, 40 Fed. Reg. at 53,507–08 ("The average consumer would hardly expect that his sales agreement will receive the same treatment as a sight draft on the Bank of England, in the event that his seller fails to perform as promised.").

199. *Id.* at 53,507.

200. *Id.* at 53,507–08.

201. *Id.* at 53,509.

202. *Id.*

203. *Id.*

204. *Id.* at 53,522.

could internalize losses from a bad loan more easily than consumers by spreading losses across their pool of financial assets.[205] Creditors were also in a better position to enforce actions against abusive lenders than the average consumer, who could ill afford the cost and time involved in litigation.[206]

Opponents to the FTC Rule presented arguments similar to those of opponents to an expanded rule of assignee liability for predatory loans. These opponents argued that the abolition of the HDC doctrine would lead to risk-averse financial institutions becoming unduly restrictive toward sellers of negotiated instruments in this sphere and possibly leaving consumer credit lending entirely.[207] Such action would drive many retailers out of business, as they would not be able to originate loans for large personal consumables that required an installment sale for the typical consumer.[208] Creditors argued that they could not police retailer practices, particularly among smaller retailers with unknown reputations. They also feared that assignees' risk-shifting costs would increase to the detriment of these smaller retailers.[209] This risk-shifting would ultimately result in higher interest rates for customers as financial institutions would seek to cover their increased risk.[210]

In response to these concerns, the FTC found that creditors already performed background checks on retailers to whom they extended credit. It also determined that establishing assignee liability in this context was the only equitable way to share risks between consumer and assignee.[211] In addition, the FTC concluded that even if there was some reduction in credit lending activity, "[a] finding that this rule may marginally reduce the aggregate amount of sales-related credit which is extended is not a persuasive argument against its adoption."[212] The FTC noted that many states had already limited the

205. *Id.* at 53,523.

206. *See id.* at 53,512.

207. *Id.* at 53,517.

208. *Id.*

209. *Id.* at 53,518 ("Industry members also asserted that they are in no position to know the status and reputation of retail merchants; that they cannot, realistically, be expected to police retail sellers.").

210. *Id.* at 53,517.

211. *Id.* at 53,520

> The record of this proceeding shows that the inequities of the present system will be eliminated if a greater responsibility is placed upon the financial institutions to police the merchants with whom they deal. The costs associated with this rule will be shared by banks, other financial institutions, sellers, and ultimately consumers.

Id.

212. *Id.* at 53,520.

HDC doctrine in various ways with little negative effect on lending activity. It concluded that interest rates would probably remain about the same under the FTC Rule, as the creditors' increased exposure to liability was balanced by decreased risk of default and unethical retailers were driven out of business by the rule.[213] Thus, while the FTC found that the rule would shift some of the risk of consumer misconduct to third-party assignees to a retail contract, it also concluded that abrogation of the HDC doctrine in favor of an affirmative rule of recovery was an efficient marketplace solution in the best interests of the consumer.[214]

The FTC Rule abrogates the HDC doctrine by preserving the claims and defenses consumers would have against an unethical retailer against the assignee of a consumer retail contract. The FTC intended for this rule to operate affirmatively and expressly rejected a defensive construction of the rule, finding that such a construction would undermine the policy considerations behind the rule.[215] Citing testimony that a defensive rule would lead to assignees damaging a consumer's credit rating to induce payment, the FTC found that adopting a defensive rule would deny consumers "a basic weapon of protection against unresponsive third parties to installment credit contracts."[216]

There are many parallels between the consumer credit marketplace at the time immediately prior to the FTC Rule and the subprime marketplace of today. Both markets are characterized by significant segmentation and regular assignment of borrower obligations by the parties to the loan.[217] The segmentation of each market serves the valuable purpose of expanding available credit for borrowers, but also allows for abuse by unethical lenders through the HDC doctrine. In each market, economic efficiency dictates that the assignee is in a better position to weather the effects of an abusive loan than the individual borrower. Considering these parallels, the FTC's decision to

213. This conclusion was based on expert testimony that the application of the rule would result in a five-to-ten percent contraction in retail lending at worst, and that abusive retailers caused considerable harm to consumers of all income brackets. *Id.* at 53,520 ("We believe that the benefits to consumers occasioned by this rule vastly outweigh predicted impact on credit supply.").

214. *Id.* at 53,526–28.

215. *Id.*

216. *Id.* at 53,527. The FTC also rejected any set-off provisions, a compromise proposed by opponents of the rule that would place a statutory cap on damages against an assignee of an abusive loan, finding that "[t]he practice [of issuing abusive loans] does not cease to be unfair simply because it involves a larger amount of money." *Id.* at 53,527.

217. *See* notes 189–191 and accompanying text.

abrogate the HDC doctrine forms a persuasive argument to adopt a similar rule for victims of predatory home mortgage loans. This argument becomes especially compelling in light of the size of the subprime lending market[218] and the devastating impact the loss of a home can have on an individual homeowner.

C. Permitting Claims Against Assignees Will Not Harm the Legitimate Subprime Lending Market

Opponents to a rule of expanded assignee liability have argued vigorously that exposing the bond industry to liability will result in its withdrawal from subprime market securitization.[219] Such dire predictions, however, were raised prior to the passage of the FTC Rule and have been raised anytime predatory lending legislation is proposed at the federal, state, or local level.[220] Despite these arguments, consumer credit lending remains a thriving industry some 27 years after the passage of the FTC Rule.[221] Additionally, the subprime market has grown dramatically following the passage of a substantial body of predatory lending legislation.[222] One estimate pegs the maximum possible liability the subprime market could face, based on the current statutory definition of a high-cost loan, at 5% of all subprime loans.[223] This figure is comparable to the risk the FTC found acceptable in light of the positive public policies that would result from passing the FTC

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218. The subprime lending market was estimated to encompass $160 billion in originations with $60 billion in MBS securities. DEP'T. OF HOUS., CURBING, *supra* note 5, at 42.

219. *See supra* text accompanying notes 108–116.

220. *See supra* text accompanying notes 210–213.

221. *Cf.* Ellen R. Dugan, *FTC Activities*, 44 BUS. LAW. 1419, 1422 (1989) ("It is doubtful that the Commission's review of the rule will generate much commentary from interested parties. Retail sellers have learned to live with the rule by including the required notice in their credit agreements. Consumers generally do not understand either the language or the effect of the notice.").

222. A study following the passage of predatory lending legislation in North Carolina has shown that the legitimate subprime market has remained healthy in the years following the legislation. *See* Center for Responsible Lending, *Impact of North Carolina Predatory Lending Law*, (2003) at http://www.responsiblelending.org/news_headlines/062503newsrelease.cfm (last visited Oct. 3, 2003) (on file with *The New York University Journal of Legislation and Public Policy*).

223. The recently amended Regulation Z has placed the current APR Trigger for a HOEPA loan at 8% over the T-bill rate. *See generally* Donald C. Lampe & Stephen F.J. Ornstein, *Federal Reserve Board Amendments to Regulation Z/HOEPA Regulations*, 55 CONSUMER FIN. L. Q. REP. 223, 223–24 (2001) (providing overview of recent changes to Regulation Z). This means that HOEPA, the primary federal abusive lending regulation, applies to roughly 5% of all subprime loans. DEP'T. OF HOUS., CURBING, *supra* note 5, at 87 ("According to recent data, an estimated five (5) percent of subprime mortgage loans have interest rates that would exceed [an APR trigger of 8%] . . . .").

Rule.[224] Dire predictions that proposed regulation will dry up liquidity in the subprime market are not new arguments from the lending industry. Such predictions preceded the passage of HOEPA,[225] and yet the subprime market and the market for subprime MBS offerings have grown dramatically since the passage of HOEPA.[226] While these observations do not necessarily disprove the lending industry's predictions of a liquidity crunch, they do indicate that these predictions are not a certainty.

D. A Rule Permitting Claims Against Assignees Will Benefit Investors by Operating as a Signaling Mechanism for the Bond Market

A rule of affirmative assignee liability will benefit the secondary market by quickly alerting securitization entities to the existence of a predatory lender. Securitization entities that purchase bundles of subprime mortgages rely on rating agencies to determine the appropriate premium to demand from the seller and how much insurance to purchase for the security bundle. Traditionally, rating agencies have been viewed as participants in the information marketplace, who rise and fall based on the quality of their bond ratings.[227] These agencies make their evaluations based on analyst reports that synthesize information about a particular group of assets for securitization. As consensus builds around what defines a predatory loan, rating agencies will be held increasingly accountable to the public for their ability to predict which bundles of subprime loans will produce steady streams of income and which bundles are composed of predatory loans.[228] A record of consumer litigation about loans issued by particular lenders could provide an extra measure of information about the character of

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224. Preservation of Consumers' Claims and Defenses, 40 Fed. Reg. 53,505, 53,520 (Nov. 18, 1975) (to be codified at 16 C.F.R. pt. 433) ("Professor Greer predicted a reduction in the amount of credit extended in connection with certain consumer sales transactions in the neighborhood of 5 to 10 percent.").

225. *See, e.g.*, Press Release, Office of the Iowa Attorney General, Miller Tells Congressional Committee of Predatory Lending Problems and Vows They Will Be a Main Priority of His Office (July 26, 2001) *available at* http://www.state.ia.us/government/ag/consumer/press_releases/2001/predatory_lending_testimony_rel_7_26_01.html ("We should also keep in mind that this prediction [that predatory lending legislation will dry up subprime credit] has been made of most consumer protection and fair lending legislation in my memory—from the original Truth in Lending up through HOEPA. And it has never happened.") (on file with *The New York University Journal of Legislation and Public Policy*).

226. *See supra* Part I.C.

227. *See* Frank Partnoy, *The Siskel and Ebert of Financial Markets?: Two Thumbs Down for the Credit Rating Agencies*, 77 WASH. U. L.Q. 619, 628–32 (1999).

228. *See id.*

the loans comprising an MBS offering. This record would also aid the rating agency in its analysis. Extending consumers' right to sue the securitization entity would fill the information void that currently exists after a loan is assigned. This would allow rating agencies to see which lender issued loans resulting in consumer litigation as well as the outcome of that litigation. Rating agencies recently came under siege for their role in getting Enron securities to market, and methods to improve accuracy are at premium in that industry.[229]

It may seem counterintuitive to argue that expanding the scope of liability of secondary market assignees will act to their economic benefit. Allowing affirmative consumer litigation, however, will provide both the information and the incentive for securitization entities to change quickly the course of their dealings with particular subprime lenders whose loans result in disproportionate legal costs. Under the current regime, securitization entities have little incentive to differentiate between legitimate subprime loans and predatory loans.[230] A securitization entity could unwittingly purchase a large bundle of loans from a predatory lender over time and would assume the aggregate of the increased risk of default that inheres in each of these loans. With the specter of $700 million in combined damages from the Household and Citigroup settlements still fresh in recent memory, fears of large financial meltdowns due to predatory loans are not unsubstantiated.[231] The unwary securitization entity faces a real risk of substantial damage to its business under the HDC doctrine. While the short term potential for increased litigation costs for assignees may militate against a rule of affirmative recovery, the long term effects of timelier signaling, an increase in predictive accuracy by rating agencies, and a shakeout of predatory loans in the secondary market easily counterbalance these costs.

E. Permitting Claims Against Assignees Will Aid in General Policing of Abusive Loans

Extending consumers' right to bring claims and defenses against the assignee of a predatory loan will further public policy by improving enforcement of abusive lending legislation. Relying on private rights of action has long been an accepted means of enforcement in

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229. The methods of credit rating agencies have come into question since the Enron financial disaster, which resulted from the agencies' failure to predict Enron's true financial health. *See, e.g.*, Jonathan D. Glater, *Top Debt Rating Agencies Take a Look at Accounting*, N.Y. Times, Jan. 11, 2003, at C1.

230. *See supra* Part III.C.

231. *See supra* text accompanying notes 74–77.

other domains, such as tort law, and has certain benefits over public enforcement by state-sponsored agencies. Private enforcement schemes have greater flexibility than their public enforcement counterparts. Public enforcement schemes are limited by their legislative mandate, and the agencies empowered to enforce these schemes bring claims to deter behavior contrary to a given statutory scheme.[232] In contrast, a private enforcement scheme is designed to redress individual harms that arise out of irresponsible behavior. As private enforcement occurs on a case-by-case basis, the private party bringing a suit has a wider array of settlement options than a state agency bringing a suit on behalf of many constituents.[233] In addition, common law remedies for private claims are more individualized than remedies under a statutory scheme, which are typically damages capped at some amount for each instance of a statutory infraction.[234] A private right of action also contemplates a more flexible inquiry into the nature of the infraction. This is particularly important for predatory lending, which is defined by practices that shift and change, often more quickly than a statutory scheme can keep up with.[235] Furthermore, citizen suits provide incentives for government enforcement bodies to investigate the practices of particular lenders.[236]

Public enforcement schemes are not without their advantages. Generally speaking, public enforcement schemes are preferable when the probability of detection is low and the regulated activity constitutes a real crime that exposes the public to ongoing harm.[237] Predatory lending encompasses both of these characteristics, which justifies the use of a public enforcement scheme. Predatory lenders often rely on a combination of several practices that may be difficult for an individual homeowner to evaluate, especially since the average homeowner is likely unaware of the statutory prohibitions for subprime lending. Regulating a subprime lender directly, rather than on a per-loan basis, removes predatory lenders from operation faster than a private enforcement regime could.[238] Because predatory loans touch the

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232. *See* Keith N. Hylton, *When Should We Prefer Tort Law to Environmental Regulation?*, 41 WASHBURN L.J. 515, 515 (2002).

233. *See id.* at 516–17.

234. 15 U.S.C. § 1640(a)(2)(A) (2000).

235. This has been termed a detection advantage. *See* Valerie Sarris, THE EFFICIENCY OF PRIVATE ANTITRUST ENFORCEMENT: THE "ILLINOIS BRICK" DECISION 54–58 (1984).

236. *Id.* at 59–63 (discussing incentives and spillover benefits of private regulatory schemes in antitrust context).

237. Hylton, *supra* note 232, at 518–19.

238. Both Household International and Citigroup are large financial institutions whose practices span many states. *See supra* Part III.A.

lives of so many parties—the homeowner and his or her family, the secondary market parties who securitize the loan, and the bond investors who purchase a security backed by the loan—public policy should focus on putting known predatory lenders out of business as quickly as possible. To promote this goal, a system of public enforcement should operate concurrently with a more flexible private enforcement scheme.[239]

V.
Practical Considerations for Instituting a Rule Abrogating the Holder in Due Course Doctrine

Proposing a rule that extends a borrower's right to sue over a predatory loan ignores numerous issues of practical significance.[240] While the GFLA provides a model for structuring an affirmative assignee liability right for a borrower, an alternative possibility would be a regulation like the FTC Rule, which requires subprime lenders to add a notice preserving a borrower's claims and defenses against an assignee of a loan. In practice, however, the FTC Rule has not resulted in an unqualified right for consumers to pursue legal action against third-party assignees. Some courts have interpreted the FTC Rule narrowly by placing limits on when affirmative legal action can be pursued and the extent of recovery (statutory and actual) against an assignee.[241] Because it does not create new rights of action between the consumer and the assignee, the FTC Rule invites judicial interpretation. The rule merely preserves claims the consumer would have had against the original seller in the transaction. Some courts have interpreted claims to mean underlying substantive rights rather than specific statutory damages.[242] These courts have limited damages against an assignee to actual damages up to amounts already paid by a consumer, rather than actual and punitive or treble damages that

239. The principal problem with operating private enforcement schemes in conjunction with public enforcement schemes is overenforcement. Over-enforcement would lead to excessive deterrence, driving lenders and assignees out of the subprime market. While there is no plausible argument, in the current context, that subprime lending is over-enforced, this is a valid concern anytime a regulatory scheme is expanded. *See* Sarris, *supra* note 235, at 45–53.

240. *See supra* Parts III.C, III.D (providing examples of extreme industry opposition to affirmative rule and problems of preemption).

241. Greenfield & Ross, *supra* note 191, at 1138–48 (describing the outcomes in Ford Motor Credit Co. v. Morgan, 536 N.E.2d 587 (1989); Shelter America Corp. v. Edwards, No. 01-87-00073-CV slip op. (Tex. Ct. App. July 30, 1987); Hardeman v. Wheels, Inc., 565 N.E.2d 849 (Ohio Ct. App. 1988)).

242. *Id.* at 1144–45 (citing *Hardeman*, 565 N.E.2d 849).

would be recoverable against the actual party to the transaction.[243] Some commentators have argued for the retention of punitive damages to heighten assignees' incentive to police unethical lenders,[244] but a lack of knowledge on the part of a good-faith assignee complicates this suggestion.[245]

Other courts have limited the affirmative use of the FTC Rule in cases where state law limits affirmative recovery against an assignee. Under the theory that the FTC Rule merely provides the consumer with rights he or she would have under state law, a Minnesota Court found that a consumer could not raise an affirmative suit for recovery against a creditor where Minnesota law prohibited such affirmative claims.[246] Other courts have reached a contrary conclusion, finding that the policy discussion in the FTC Rule's Statement of Basis and Purpose expressly mandates its use as an affirmative rule of recovery.[247] These types of contrary interpretations will occur irrespective of the form an affirmative rule of recovery takes. They reinforce the need for clarity in enacting any such rule.

VI.
Conclusion

Predatory lending is a scourge on homeowners throughout the United States. As the visibility of the problem has grown, legislation has developed across the country to prohibit the worst predatory practices and to provide homeowners with some measure of relief. Although they have begun to address predatory lending, these laws would be improved by providing victims of predatory loans with an unqualified right to recovery against assignees.

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243. This was done on the theory that an unwitting assignee had no punishable intent and thus should not be punishable by punitive damages. *Id.* at 1145.

244. Gene A. Marsh, *Lender Liability for Consumer Fraud Practices of Retail Dealers and Home Improvement Contractors*, 45 Ala. L. Rev. 1, 51 (1993) ("If the two principal reasons for the FTC Rule are to reduce seller misconduct and to internalize the costs of any seller misconduct that remains, the punitive damages awards in *Union Mortgage* and *Hobdy* reach the same end, but through different theoretical means.").

245. *See id.*

246. Ellen Carey, Note, *Affirmative Recovery Under the FTC Holder Rule*, 13 Loy. Consumer L. Rev. 129, 129–30 (2001) (citing LaBarre v. Credit Acceptance Corporation, 175 F.3d 640, 644 (8th Cir. 1999)).

247. *Id.* at 134–40 (citing Mayberry v. Said, 911 F. Supp. 1393, 1401 (D. Kan. 1995); Ford Motor Credit Co. v. Morgan, 536 N.E.2d 587 (Mass. 1989); Felde v. Chrysler Credit Corp., 580 N.E.2d 191 (Ill. App. Ct. 1991); Oxford Finance Co. v. Velez, 807 S.W.2d 460, 463 (Tex. App. 1991); Simpson v. Anthony Auto Sales, Inc., 32 F. Supp. 2d 405, 409 n.10 (W.D. La. 1998)).

The HDC doctrine that currently protects assignees is an anachronism grounded in public policy that is not relevant to the subprime mortgage industry. While it is true that the ordinary due diligence standard of HOEPA has already partially abrogated this doctrine, this standard is not yet solidified in this context, and still favors assignees.[248] Allowing an affirmative rule of recovery is an economically efficient approach to treat predatory loans, as the innocent assignee is in a better position to weather the damages of an abusive loan than the innocent homeowner. An affirmative rule will provide incentives for the secondary market to shift risks back on subprime lenders, driving unethical lenders out of business.[249] The FTC accepted these efficiency arguments in its promulgation of a rule that abolished the HDC protections of consumer credit assignees.[250] Many of the same problems that currently exist in the subprime lending market plague the consumer credit industry.[251] Additionally, an affirmative rule of recovery will alert the secondary market to unethical lenders faster than is currently possible, and will prevent major market dislocations.[252]

Political opposition from financial entities in the subprime market to a rule of assignee liability is considerable. In Georgia, for example, secondary market entities withdrew from the subprime MBS market in response to the GFLA, which armed borrowers against predatory lenders and their assignees.[253] This was a political response, and pressure from the industry came within the first few months after the passage of GFLA. Because a loss of profit did not cause the response, the Georgia experience only demonstrates the contentious political environment that exists around this issue. While an empirical analysis of the specific effects an affirmative rule would have on the profitability of the secondary market is beyond the scope of this Note, the liquidity arguments that proved so forceful in Georgia have been made several times in the past and have yet to be realized.[254] An affirmative rule of recovery will expand effectively the regulatory framework of high-cost loans in a flexible and efficient way, taking legislatures one step closer to addressing adequately this unacceptable problem.

248. *See supra* text accompanying notes 83–86.
249. *See supra* Part IV.A.
250. *See supra* Part IV.B.
251. *See supra* Part IV.B.
252. *See supra* Part IV.D.
253. *See supra* Part III.C.ii.
254. *See supra* Part IV.C.