Held Up in Due Course: Predatory Lending, Securitization, and the Holder in Due Course Doctrine

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When Margaret Newton, a 76 year old house-bound stroke victim who had difficulty speaking, seeing, or concentrating, was approached by a home improver, she agreed to purchase siding for $9,990. The home improver arranged financing for Ms. Newton with United Companies Financial Corp., a company that had grown rapidly by securitizing its loans, pooling them and selling them on Wall Street. When the financing closed, Ms. Newton owed not $9,990 but $15,500, which included $3,050 in points and fees, plus settlement charges. Her monthly payment was over $240, even though her monthly income was only $898. The siding installed on her house was worthless, because it had been installed without insulation, and so had to be stripped off and thrown away in order to install the necessary insulation. Understandably, Ms. Newton fell behind on her loan payments. United Companies tried to foreclose.

A predatory lender's criteria for making a loan: "If you could fog up a mirror, if you had red blood running through your veins, they would lend you money." [Fn2]

When George and Marjorie Mox signed loan documents for a $31,000 loan from the Diamond Mortgage Corporation, they probably did not realize that they were dealing with a dishonest lender engaging in a massive campaign of theft and fraud. Diamond never paid off any of the Moxes' senior loans as it had promised nor did it give the Moxes the balance of the proceeds. Instead, Diamond sold the Moxes' loan and then went bankrupt, leaving thousands of victims who lost an estimated seventy-five million dollars. The Moxes were likely shocked to discover that they would still have to pay back the loan or face foreclosure, even though they did not receive a dime. A Michigan appellate court held that, because of the holder in due course doctrine, the Moxes had to pay back $31,000 that they had never received. [Fn3]

"I've heard of sticking people up with guns, not with pens." [Fn4]
I. INTRODUCTION

Predatory lending is a scourge of the modern American financial system. A recent analysis of this problem estimated that it costs U.S. borrowers $9.1 billion annually, even excluding what may be the greatest damage caused, residential foreclosures. [Fn5] Worse yet, mortgage fraud and unscrupulous lending appears to be increasing. [Fn6] Predatory lending is the process of engaging in unfair and deceptive lending practices and sales techniques that rely on misrepresentation, threats, unfair pressure, and borrower ignorance. The goal of predatory lending is to coerce or trick homeowners into obtaining loans with interest rates or fees higher than the borrowers’ credit profiles and the market would justify or loans larger than or different from what the borrowers need, want or can afford.

This article is the second of a two part series and is an attempt to understand how predatory lending has become so rampant in the American lending industry. I argue that the assignment of risk of the harm caused by predatory lending is at the heart of the problem, in that the secondary markets that have financed predatory lenders and profited by them have been too able to avoid the risk of harm created by those lenders. Investors in the secondary market have been able to assign almost all such risk, first contractually to the originators of the loans and, where that fails, through the holder in due course doctrine to the homeowners who are the victims of the predatory lenders’ sharp practices. In this way, the investors have been able to purchase predatory loans with too little concern about their fairness, and so have financed the unscrupulous lenders who originate those loans.

The specific tools predatory lenders use against borrowers are discussed in Part II, including the use by lenders of the same high pressure and misleading techniques that previously had been the tools in trade of unscrupulous used car dealers and shady home improvers. Part II also includes case histories of several predatory lenders, and a description of the boom and bust cycle of predatory lenders as they grow quickly, take advantage of many customers, sell their loans on the secondary market, then disappear.

The first article in this series was an examination of the development in negotiable instrument law and specifically the holder in due course doctrine. [Fn7] In that article, I argued that negotiability and its primary effects had once largely been understood by the makers of those instruments, and that they by and large intended to create negotiable instruments. The intent of the maker once had an integral role in the development of negotiable instrument law, as the law developed to track the growing usage of negotiable instruments and the intent of those making them. Negotiability was crucial, to provide liquidity to bills of exchange and so that they could carry on the role of currency in an otherwise cash-starved economy. When this currency role of bills of exchange was taken over by bank notes and by legal tender, however, the common use of negotiable instruments faded and with that use disappeared much of the knowledge of negotiable instrument law. When negotiable instrument law was codified, the role of intent was stripped out of the law and its place was taken over by the mere formal requirements of the various negotiable instruments acts. No longer were the words of negotiability, such as "order or bearer" viewed as signs from which the intent of the maker of an instrument could be inferred, since fewer and fewer understood that these specific words would be viewed as evidence of such intent. Instead, the words of negotiability were, pursuant to the codification of negotiable instrument law, considered sufficient in and of themselves to confer negotiability despite the unlikelihood that the maker of the instrument knew of their power or intended that the instruments be negotiable.

At the center of negotiable instrument law is the holder in due course doctrine, which cuts off most
defenses that a maker of a note might have to the note once it is assigned to a holder who takes it without notice of those defenses. This doctrine is designed to increase the liquidity of notes and other negotiable instruments, since purchasers need not worry for the most part that the maker of the note has many defenses thereto. The doctrine is used to assign the risk of many forms of fraud, forcing the borrower/mortgagor rather than the purchaser of the note to bear that risk when the original lender is no longer available to be sued. By allowing those who sign notes unwittingly to be bound by the holder in due course doctrine, that doctrine has, throughout most of the twentieth century, been abused by disreputable merchants. These merchants would provide defective goods or services, obtain a negotiable instrument as payment, then assign the negotiable instrument to a third party who could claim holder in due course status, leaving the buyer liable for the purchase price despite dishonesty of the merchant. Action by a federal regulatory agency finally ended the use of the holder in due course doctrine in these forms of consumer contracts during the 1970s. However, the holder in due course doctrine has again come to be broadly applied against unwitting makers of negotiable instruments, now against consumers not of goods or services but of credit itself.

This new use of the holder in due course doctrine has regained prominence through the development of securitization, discussed in Part III, which is the process of transforming non-liquid assets, such as notes secured by real property, into a very liquid form, securities. Securitization allows interest in residential mortgages to be sold on Wall Street as securities and has sped the growth of lending secured by the homes of borrowers and the rapid assignment of those loans to holders in due course. Part III also includes a discussion of the harm that securitization has caused to residential borrowers, particularly the atomization of the lending industry, so that borrowers deal primarily with under-regulated and often undercapitalized mortgage brokers rather than with traditional finance companies. Securitization also limits the discretion of the holders of notes and their agents in dealing with financially troubled borrowers to work out new payment plans. By providing an ease of transferability and liquidity previously undreamt of, securitization has taken over what had been the primary purpose of the holder in due course doctrine. And so, securitization has rendered the holder in due course doctrine unnecessary.

Part IV discusses the rapid and troubling rise of subprime lending, higher priced loans that are designed for borrowers with less than prime credit records. Subprime lending, aggressively marketed and too little regulated, has grown rapidly, and with it has come an explosive growth in the number of residential foreclosures. Too much of the subprime market is a product of predatory lending, a growing and widespread problem. Upon the lenders' quick assignment of the predatory loans, often in the secondary market and as part of the securitization process, borrowers lose, as to the new assignees of the loan, most claims or defenses they may have had to prevent the full collection of the loans. They find themselves defenseless and burdened by loans with harsh terms, high interest rates, and high fees. Many of these borrowers lose their homes to foreclosure, others refinance, paying out additional fees to secure a fairer loan, and still others continue making payments, saddled for up to thirty years with an overpriced loan.

Part V then concludes with a description of the so-far inadequate federal, state, and local attempts to halt predatory lending. Rather than address the problem head-on and uniformly prevent homeowners and consumers from unintentionally making negotiable instruments, the legal and legislative systems have for the most part merely tried to ameliorate the effects of this fundamental problem with a series of judicial, legislative, and administrative patches, some more effective than others. These recent patches have thus far been ineffective, and thousands upon thousands of homeowners, many of them elderly, are losing their homes or are threatened with foreclosure because they are victims of fraud, undue pressure, deception, and sharp dealings.

I argue for the abolition of the holder in due course in any transaction where it may be used against a
consumer in Part VI. An economic analysis of the effects of the holder in due course doctrine demonstrates that it encourages fraud against borrowers and magnifies its harmful effects by assigning the risk of fraud to borrowers, the parties least able to prevent or to insure against that fraud in any sort of meaningful way, as well as the parties most likely to suffer from significant secondary effects, such as foreclosure, as a result of the loss. Conversely, the holder in due course doctrine protects from risk the securitizers and investors who purchase predatory loans, even though they are the very parties best able to close down unscrupulous lenders.

Parts VII and VIII conclude this article with a discussion of potential methods for eliminating the holder in due course doctrine as well as the probable effects of that elimination. I examine the various governmental bodies that could best accomplish the abolition of the doctrine for residential borrowers, finding that none are ideal, given the vigorous fight likely to be waged by the lending industry, but that many would suffice. A traditional law and economics analysis contends that abolishing the holder in due course doctrine would increase interest rates and fees to borrowers because it would make collection from borrowers less certain and more expensive. Instead, I believe that abolishing the doctrine would lead to lower interest rates and fees, as lenders currently use the holder in due course doctrine to protect the purchasers of their loans from claims of misrepresentation and unfair practices, practices that are used to obtain above market fees and interest rates for loans. Were lenders forced to compete without the holder in due course doctrine to protect their sharp practices, they would have to use lower interest rates, rather than misrepresentation and undue pressure, to gain new customers.

II. PREDATORY LENDING AND ITS VICTIMS

A. Defining and Measuring Predatory Lending

Predatory lending is easier to discuss than it is to define. [Fn8] Daniel S. Ehrenberg provided a rough definition of predatory lending, calling it a mismatch between the needs and capacity of the borrower . . . . In essence, the loan does not fit the borrower, either because the borrower's underlying needs for the loan are not being met or the terms of the loan are so disadvantageous to that particular borrower that there is little likelihood that the borrower has the capability to repay the loan. [Fn9]

While this definition has been cited by at least one court in a predatory lending case, the exact definition seems difficult to pin down in a precise formulation. [Fn10] Even in the course of drafting a more than 100 page report on predatory lending, two governmental agencies working together could only cobble together the following definition of predatory lending:

Predatory lending--whether undertaken by creditors, brokers, or even home improvement contractors--involves engaging in deception or fraud, manipulating the borrower through aggressive sales tactics, or taking unfair advantage of a borrower's lack of understanding about loan terms. These practices are often combined with loan terms that, alone or in combination, are abusive or make the borrower more vulnerable to abusive practices. [Fn11]

Some have gone so far as to argue that, not only is defining "predatory lending" difficult, but it is a task that should not even be undertaken, perhaps from fear of providing too limited a definition. [Fn12]
defining "predatory lending" to advocate against new steps to stop such lending. [Fn13]

Just as there is no commonly agreed upon definition of predatory lending, there is also no broad consensus on how widespread a problem predatory lending is, and how much damage it inflicts on American borrowers. [Fn14] Perhaps the first studied effort to determine the amount lost by borrowers in the U.S. due to predatory lending is a report from the Coalition for Responsible Lending entitled Quantifying the Economic Cost of Predatory Lending. [Fn15] This analysis attempts to quantify the amount of harm caused by predatory lending in the United States by totaling estimates of the costs of the following putatively unfair terms: financed credit insurance, excessive up-front fees, prepayment penalties on subprime loans, and interest rates higher than the borrowers' credit risk would justify. [Fn16] These numbers, which will be discussed in more detail infra, are difficult to measure exactly, since they require a determination of exactly how high a given loan's fees or interest rate can be before they are abusive. More importantly, the analysis explicitly and intentionally excludes the costs to homeowners and the community of any foreclosures caused by predatory lending. Neither the direct financial loss nor the secondary costs, such as the homeowners' emotional distress and the effects on the community, are included. The report does note that the total costs of foreclosures, while difficult to calculate, "may well dwarf other estimates made in this report." [Fn17] The cost of such foreclosures is hinted at by the fact that, at the end of 1999, possibly more than 72,000 families were in or near foreclosure just for the loans of sixteen large subprime***Page513 lenders, making up less than one half of the subprime market. [Fn18] The analysis concludes that, even excluding foreclosures, predatory lending is costing American families $9.1 billion a year. [Fn19] This estimate, rough as it is, is a good first step toward determining the scope of the problem, even though it admittedly leaves out the costs of one of the primary losses caused by predatory lending, foreclosure.

B. The Tools of Predatory Lenders

Defining "Predatory lending" is difficult because it encompasses many actions that seem, on their face, to be indistinguishable from legitimate lending activities. Predatory lending can be divided into two sets of activities. The first set consists of those activities that are either clearly illegal or unconscionable by their very nature. These per se improper activities include such actions as misrepresenting the terms of the loans and forging the signatures of borrowers on loan documents. [Fn20]

The second set of activities that make up predatory lending are those that bedevil the regulators of the lending industry: activities that are legal but, when misused by unprincipled lenders, cause borrowers to pay interest rates and fees higher than the market and the borrowers' credit rating would justify. Practices such as balloon payments, adjustable rate mortgages, rapid refinancing of existing loans, and even high interest rates and fees could be used in non-predatory loans. [Fn21] For example, a borrower might choose to pay a higher interest rate in order to pay lower fees, or choose an adjustable rate loan to pay an initially lower interest rate. As long as these terms that benefit lenders to the detriment of borrowers are understood by borrowers and negotiated by them, borrowers can either receive something in return for the loans or decide to forgo the loan. These terms become the tools of predatory lenders when, as is common in the subprime market, they are neither negotiated over nor understood by the borrowers, ***Page514 and when borrowers receive little in return for agreeing to them. [Fn22] In the context of predatory lending, these same practices are often used to strip the equity from the homeowner's property. Though there is no agreement on how to define predatory lending, there is broad consensus on what tools and tactics are used by predatory lenders, which include the following:
1. Fees and Interest Rates Far Greater than Necessary to Provide a Reasonable, Market-Driven Return Given the Risk of Lending to the Particular Borrower

At the heart of predatory lending is the lender charging fees and interest rates far greater than necessary to provide a reasonable, market-driven rate of return to the lender given the risk of lending to the particular borrower. [Fn23] This disparity between the interest rate charged a borrower and the market interest rate given the borrower's risk characteristics is widespread among specific classes of borrowers, though uncommon in others, and has been estimated to cost U.S. borrowers $2.9 billion a year. [Fn24] In addition to excessive interest rates, predatory lenders often force borrowers to pay excessive fees, which have been estimated to cost 750,000 families a total of $1.8 billion annually. [Fn25] Many subprime lenders charge fees totaling eight percent of the loan amount or more. These high fees and interest rates seem based more on the costs of aggressive advertising by subprime lenders than on the credit profiles of the borrowers. [Fn26] One subprime lender, which charged interest rates of "only" 15%-18%, included fees of 25% to 40%, leaving the loans with true annual percentage rates of 28%-29%. [Fn27]

2. Loans Made with No Reasonable Expectation That the Borrowers Can Repay Them

An especially damaging form of predatory lending is the origination of loans by a lender who has no reasonable expectation that the borrowers can repay them. [Fn28] Lending to borrowers who cannot repay the loans is known as "equity stripping," as the nearly inevitable foreclosure strips the borrower of whatever equity remains in her house. [Fn29] Mortgage brokers who make loans that the borrower cannot repay are able to sell those loans by falsifying the borrower's income or asset documentation to show a higher income or asset level than the borrower actually has. Purchasers of notes need to have measures in place to protect themselves from these gambits of dishonest brokers. Otherwise, the purchasers may discover too late that the borrowers have almost no way of making the mortgage payment, learning this only when the borrowers stop making payments or contest the loan. [Fn30]

3. "Flipping"

"Flipping" is the early or frequent refinancing of a loan, normally with each new set of loan fees financed by the loan, so that the loan amount continually rises, even while the homeowner makes her payments. [Fn31] "Flipping," a common practice in the subprime industry, allows subprime lenders to charge customers both prepayment penalties for the refinanced loans as well as points and fees based on the new loans. A lender may flip its own loans or multiple lenders might flip each other's loans for the same borrowers. Some lenders accomplish flipping by requiring their borrowers whose loans become delinquent to refinance the loans in order to bring them current, rather than working out some other plan. [Fn32] Subprime lenders have targeted both blue-collar workers and customers who are delinquent on their loans for early refinancing. [Fn33]

4. High Pressure and Misleading Sales and Marketing Techniques

Predatory lenders succeed to a great degree because of their aggressive and misleading marketing techniques, especially directed at those least able to withstand them, such as the elderly, minorities who have been traditionally excluded from mainstream financial services, and the uneducated. One assistant manager at a major lender's subsidiary described "blitz nights" at her office, in which the sales staff would
blanket the city with misleading phone calls and mail regarding their lending programs. [Fn34] Brokers and lenders can obtain databases of homeowners, sorted by age, race, or gender, to allow the brokers and lenders to target specific types of potential borrowers. [Fn35] Once they have found customers, the brokers and lenders may blatantly misrepresent the terms of the loan, claiming the interest rate or payments will be lower than the rates actually turn out to be. Or, a broker or lender may attempt to gain an edge over a borrower by advising the borrower to stop making her loan payments, so that the loan goes into default and the borrower becomes desperate, and must accept the loan proposed by the broker or lender. If the borrower refuses to enter into a loan with the high interest rate proposed by the lender or broker, the lender or broker may promise that the rates will go down somehow or that the lender will refinance the loan at better terms in the near future. Lenders and brokers have been known to attempt to pressure borrowers to sign documents without reading them, covering up crucial terms in the documents so that the borrower does not see them, or even forge the borrower's signature. [Fn36]

5. "Packing"

"Packing" is the practice of forcing or inducing borrowers to use some of their loans' proceeds to pay for unnecessary or undesired products, such as single premium credit life insurance. [Fn37] Single premium credit life insurance, perhaps the product most widely and egregiously packed with loans, is a form of insurance where all of the premiums for the life of the policy are paid up front, normally from the proceeds of the loan. Predatory lenders try to include as many such products as they can, such as insurance to pay off credit card debt or to service home appliances, both to increase the amount of the loan (and the lenders' fees that are based on a percentage of the loan amount) and also to obtain profits from selling these overpriced products. [Fn38] The lender may include these unnecessary products in the loan without giving the borrower prior notice they will be included and without giving the borrower time at the closing of the loan to notice the extra costs or to object to them. [Fn39] Or the lender may deceive the borrower regarding the added products by, for example, asserting that they are included in the loan, leaving the borrower to understand that they are free. [Fn40] The same assistant manager described above explained, "If someone appeared uneducated, inarticulate, was a minority, or was particularly old or young, I would try to include all the coverages [her company] offered. . . . The more gullible the customer appeared, the more [insurance] coverages I would try to include in the loan." [Fn41] Credit insurance packed with loans can be painfully expensive, with credit premiums costing over 10% of the loan amount and over $10,000 reportedly not uncommon. [Fn42] One estimate concludes that packing of credit insurance alone costs American borrowers $2.1 billion annually. [Fn43] Because many large subprime lenders sell credit insurance issued by their own subsidiaries and because the insurance proceeds go to the lender if the borrower ever does make a successful claim against the credit insurance, the lenders profit enormously on all sides of the transaction. [Fn44]

6. Excessive Prepayment Penalties

Predatory lenders include large prepayment penalties, fees that are added to the amount the borrower must pay to retire a loan before it reaches full term. These penalties are designed to reduce prepayments, which reduce the amount of interest that lenders receive on a particular loan and which are more common after interest rates have dropped, so that the lender often cannot lend the money returned to it at an interest rate as high as the prepaying borrower had been paying. Lenders argue that including prepayment penalties reduces their risks in lending so they can charge borrowers lower interest rates, [Fn45] and prepayment charges have been standard clauses in residential mortgages since the 1930s. [Fn46] In practice, when employed by predatory lenders, prepayment penalties are designed either to trap the borrower, forcing her
to remain in an inequitable loan, or to reward the lender with an unreasonable payoff when an unwitting borrower refinance the loan. [Fn47] A typical prepayment penalty might be $5,000, more than enough to compensate the lender for any costs of early payment of the loan. [Fn48] The use of prepayment penalties has escalated dramatically in the subprime market since 1997, [Fn49] and prepayment penalties in the subprime market are estimated to cost American borrowers $2.3 billion annually and to affect 850,000 families. [Fn50]

7. Balloon Payments

Balloon payments are in a way the opposite of prepayment penalties. Rather than attempting to lock a borrower into remaining in a loan for the long term, balloon payments force a borrower at a set time to repay all of the remaining balance on a loan rather than continuing to make monthly payments until the entire loan has been repaid. For example, a borrower might have a loan, the monthly payments of which would not retire the loan for thirty years, but that has a balloon payment due at ten years, at which time the borrower would have to pay off all of the remaining balance of the loan. While balloon payments can be a useful way for some borrowers to lock in a low interest rate, since the lender does not need to worry about a longer term rise in interest rates, loans with balloon payments can also be disastrous for borrowers, especially elderly borrowers on a fixed income. Such borrowers are highly unlikely to be able to pay off a sizeable balloon payment without refinancing the loan, thus incurring a new round of points and fees. [Fn51] Often, these borrowers were either unaware of the balloon or were given misleading oral assurances that the balloon payments could be easily refinanced. [Fn52] Loans with balloon payments can appear deceptively attractive to borrowers, since the balloon payment allows the lender to offer low monthly payments.

What turns these sometimes benign lending practices into elements of predatory lending are sharp lending practices that would give a borrower a defense to the collection of the loan if the original lender still held the loan. If a mortgage broker made misrepresentations to induce the borrower to obtain a loan with a balloon payment or a high interest rate, for example by falsely claiming that the lender would refinance the loan after a year at a much lower rate, those misrepresentations would constitute a personal defense to the loan. Similarly, the borrower would have a defense to a loan where the lender misrepresented the effective interest rate to induce the borrower to refinance a loan that the borrower had obtained only months earlier. Once a bona fide holder holds the note representing the loan, however, those personal defenses are cut off by the holder in due course doctrine. [Fn53] The holder in due course doctrine, therefore, prevents effective legal distinction between fair and voluntary balloon payments, rapid refinancing, or insurance products, on the one hand, and on the other hand those that are unfair, the products of fraud, and foisted on an unwitting borrower. Similarly, the holder in due course doctrine eliminates, as to the purchasers of loans, any distinction between high rates and fees that result from the market accurately pricing the borrowers' risk versus high rates and fees that mortgage brokers obtained by misrepresentations and deceit. [Fn54]

The predatory aspect of these lending terms also results from information asymmetry, the fact that lenders have a much greater awareness, and the consumers a grossly inadequate awareness, of the terms of the lenders' loan products and the legal effect of those terms. [Fn55] Therefore, lenders can use lending terms such as prepayment penalties to extract much greater fees from borrowers than borrowers realize they are paying. Lenders realize, though many borrowers do not, that borrowers typically repay loans much before the full term of their loans, and that lenders will obtain a significant income stream on prepayment penalties alone. [Fn56]
This information asymmetry persists despite the disclosures designed to inform consumers about the exact terms of their loans before they enter into them. [Fn57] The federal Truth in Lending Act ("TILA") requires information regarding loans to be disclosed in a way that can be misunderstood by consumers. A less than honest broker can mix the TILA disclosures in the formidable stack of paperwork that makes up the loan package and easily convince a borrower not to pay any attention to the very information that could save the homeowner from entering into an improvident loan. [Fn58] Some information asymmetry has been caused by the fact that lenders know consumers' credit "scores," which determine what loan rate the borrowers should receive, while consumers have largely been in the dark about their own scores. Lenders, then, have known whether consumers could qualify for prime loans, while the individual consumer could only guess. This asymmetry may dissipate if, as planned, a leading credit scoring company begins to provide credit scores to potential borrowers. [Fn59] Better still would be a rule requiring lenders to provide to borrowers the credit score used by the lenders, as well as an explanation of that score.

A large portion of the information asymmetry, however, is inevitable given the complexity of the lending process and the multiplicity of options that many borrowers have. [Fn60] A borrower faced with various adjustable rate mortgages with different packages of potential prepayment penalties and balloon rates would need a sophisticated understanding of interest rate fluctuation and prepayment rates to make a well-informed decision. [Fn61] An unscrupulous lender can take advantage of its knowledge and the consumer's ignorance by misrepresenting the effects of these different packages and trap the borrower into a loan that costs much more than the borrower's credit rating would justify.

C. The Boom, Bust, and Bankruptcy Cycle of Predatory Lenders

Many predatory lenders have gone through a similar cycle: sudden growth, fueled by the predatory loans themselves and stoked by the quick influx of cash provided by the securitization process, followed in a few years by growing allegations of improprieties, allegations which the lenders furiously deny. These allegations are followed, but often slowly, by investigations conducted by regulatory agencies, though that investigation often produces few timely results other than to publicize the lenders' methods. Only after several profitable years of predatory lending does the entire structure come crashing down. The crash typically happens when publicity regarding the lender's methods so frightens the lender's financial backers and loan purchasers that the lender suddenly finds itself without the ability to fund or sell its loans. [Fn62] At that point, the predatory lender goes out of business, perhaps after declaring bankruptcy, leaving its borrowers to contend with the purchasers of their loans over the validity of those loans. [Fn63] The purchasers typically claim to be holders in due course, and thus immune to any defenses the borrowers might have as a result of the predatory lenders' illegal or dishonest behavior. [Fn64]

D. The Diamond Mortgage/A.J. Obie Story: Defrauding Borrowers and Investors Alike

An early example of this boom, bust and bankruptcy cycle, as well as an acid test for the holder in due course doctrine's utility in assigning risk of fraud, is that of perhaps the first significant predatory lender to turn to securitization, the infamous Diamond Mortgage Corp. and A.J. Obie & Associates mortgage-backed securities fraud. [Fn65] Diamond, formed in 1973, was a mortgage broker that somehow gained control of Obie, a securities dealer, in about 1980. Beginning in the middle or late 1970s, Diamond embarked on a pattern of fraud and, joined by Obie, succeeded in defrauding homeowner borrowers and investors alike. Diamond/Obie engaged in an extended Ponzi scheme that came to include many of the elements that have since been the hallmarks of securitized predatory lending: high pressure sales, celebrity spokespersons, delayed regulatory response, bankruptcy, victimized homeowners fighting a pitched battle.
with defrauded investors, and the con artist at the center of the scheme resurfacing in a new company and a different guise to defraud anew.

The Diamond/Obie scheme was the following: Diamond would solicit borrowers to obtain loans secured by their principal residence, engaging in high pressure sales practices to trick the borrowers into entering into the loans, despite their high interest rates and excessive brokerage fees. Often, Diamond/Obie would never give the borrowers a dime, though it would record a lien purportedly securing a sizeable loan. The loans would name Diamond as the lender, though often Diamond was only engaging in a table funded loan, whereby the loans were actually funded by investors. At the same time Diamond was seeking borrowers, Obie was searching for investors, either to purchase whole individual loans or to buy securities backed by loans. Obie would promise the investors either a whole loan secured by residential property in return for their investment, or promise them securities backed by loans secured by such property.

Both Diamond and Obie used celebrity endorsers and high pressure and dishonest sales tactics in soliciting, respectively, borrowers and investors. Diamond, for example, would allegedly impose a brokerage or prepaid finance fee at the time of closing, then increase the amount of the loan to cover the fee, and use documents in the loan transaction that were inconsistent and confusing as to what amount the borrower would receive, what amount was financed, what the annual percentage rate and finance charges were, and whether Diamond was acting as a lender or a broker. [Fn66] Loan rates were fifteen percent annually or more, with an initial fee of twenty points. [Fn67] Obie employed the actor Lloyd Bridges to solicit investors, while Diamond employed actor George Hamilton to entice borrowers. [Fn68] Obie's sales agents employed tactics such as requesting a power of attorney from elderly investors so the sales agents could withdraw money directly from the elderly investors' bank accounts, and driving investors to banks to withdraw money to invest with Obie. [Fn69] Although the Obie sales agents targeted many elderly and unsophisticated investors, seeking their retirement funds, they also snared professionals, such as doctors, lawyers, and judges. [Fn70]

Once Diamond had obtained the signed note and mortgage deed for an individual loan, it would immediately sell them to Commerce Mortgage Investments, Ltd., ("CMI"), a real estate investment trust so closely connected with Diamond that they were located in the same building. Barton Greenberg, the chairman of Diamond's Board of Directors, was also the director of CMI. [Fn71] Greenberg, a high school drop-out and former bartender and seller of home-improvement programs, was the owner and mastermind behind Diamond/Obie. [Fn72] After purchasing the note and mortgage deed, CMI issued shares denominated "common stock." [Fn73] Then, Obie marketed to investors both the CMI shares and the mortgage notes, which were labeled "securities" by Diamond's offering circular. [Fn74]

Diamond/Obie reached a new level of predation by veering from misrepresentation and sharp practices into outright theft. In about 625 cases, Diamond/Obie obtained signed notes and mortgage deeds and sometimes brokerage fees [Fn75] from potential borrowers at the time they applied for mortgages and then recorded a lien against the homeowner's property without ever giving the borrower any loan proceeds, paying off senior liens as promised. [Fn76] Diamond represented to the borrowers that they would receive the proceeds of the loans if their applications were approved, but if they did not receive any money, the mortgages would be discharged, without any obligation by the borrowers to pay anything. [Fn77] Rather than discharging the mortgages, Diamond/Obie sold and assigned them to investors, leaving the borrowers' property encumbered by a mortgage despite never receiving any proceeds from the loan. [Fn78] Even if Diamond/Obie received a timely cancellation from the borrower under TILA, it would record the mortgage and assign the note and mortgage. [Fn79]

Diamond/Obie also defrauded investors by taking their money, then either never assigning any note and
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mortgage deed to them, or assigning the same note to multiple investors. Diamond/Obie used the money provided by new investors to placate old investors in an immense Ponzi scheme. [Fn80] Diamond/Obie ended up owing about 2,700 often elderly creditors an estimated $75,000,000. [Fn81] Diamond/Obie's lending and investment arms had been so profitable, though, that despite Greenberg's actions of skimming millions of dollars, and despite the nature of the Ponzi scheme, Diamond still had a sizeable mortgage portfolio when it collapsed, though not enough to cover the investors' losses. [Fn82] Searching for deep pockets, the investors filed suit against Lloyd Bridges, [Fn83] George Hamilton, [Fn84] Diamond's attorneys, and the state regulatory officials. [Fn85]

The inability of regulators in two states to react to the fraud of Obie and Diamond is staggering, given the amount of notice they had. Diamond began committing fraud sometime in the mid to late 1970s. [Fn86] Michigan's attorney general, alleging usury and violations of Michigan's consumer protection laws, had sued Diamond in 1979 in ***Page526 quo warranto and under the Michigan Consumer Protection Act. [Fn87] Diamond signed a consent decree with the Michigan Corporation and Securities Bureau in 1981, requiring it to return $7,000,000 to investors and assign mortgages to investors more promptly. [Fn88] By 1982, bureau investigators noted that Diamond appeared to be in grave financial straits, holding fewer than thirty percent of the mortgages Diamond claimed it held, and that investors were "sacking" the company. [Fn89] One internal bureau memo stated that, if the bureau allowed Diamond to remain in business, "we may very well be subject to a suit which contends that we are a willing participant if not an aider and abettor of a fraud." [Fn90] Bureau investigators noted that the mortgages Diamond supposedly held for investors had a delinquency rate of twenty-six percent and were being used as collateral for bank loans, and recommended that Diamond be shut down. Instead, the state waived its right to audit Diamond, citing the difficulty for and cost to Diamond of producing financial statements. In 1983, the Michigan Attorney General also entered into a consent judgment with Diamond, whereby Diamond agreed to abide by state and federal loan disclosure requirements. [Fn91]

For their part, Illinois securities officials attempted to force Obie to return $15 million in investors' money for its delays in assigning mortgages to investors, but then failed to take any further action or question why the last annual report Obie filed, in 1984, violated state requirements by being unaudited. [Fn92]

Finally, in August 1986, the Michigan Attorney General closed Diamond/Obie and charged its principals with fraud. [Fn93] For his role in the Diamond/Obie fraud, Barton Greenberg was sentenced to only six years and eight months to ten years in prison for embezzling $44 million from the investors in Obie and Diamond. [Fn94] Greenberg demonstrated the ease of entry into the mortgage business and the damage that such easy entry causes when, in August 1994, within weeks of being released from prison, he again worked as a mortgage broker. Despite his conviction and widespread fame as a dishonest lender, ***Page527 Greenberg joined a firm called First Fidelity Mortgage. Instead of closing loans and selling them to one or multiple investors as he had done previously, Greenberg allegedly obtained his illegal profits by demanding thousands of dollars, in one case $23,000, in up front fees from borrowers as "retainer's fees" or "returnable deposits." [Fn95] After his company received the fees, it sat on the loans, refusing to close the loan or return the fees (or pay its "bird dogs" their prizes or its loan officers any commissions), according to published reports. [Fn96] Despite his Diamond/Obie conviction, Greenberg worked with Fidelity Mortgage Co. for about two years before the regulators caught up with him and ordered First Fidelity Mortgage to cease its mortgage lending, finally revoking First Fidelity's license. [Fn97]

E. The Assignment of Risk of Harm Caused by Predatory Lending

The Diamond/Obie fraud caused an agonizing dilemma for the courts because it posed two sets of victims
against each other in a desperate attempt by each to save or recover vital property or money. On the one hand, homeowners were faced with liens encumbering their homes even though they had never received any proceeds from the underlying loans. On the other hand, the often elderly investors had paid good money to purchase those mortgages, often their life savings or their retirement funds. In this way, the Diamond/Obie cases present the most stark test of the method by which the laws governing loans secured by the residences of the borrowers assigns the risk that the homeowner will be the victim of predatory lending. There are two primary methods by which such risk is assigned to the various participants in a loan transaction. First of all, as will be discussed in the context of securitization, the purchasers of notes secured by residences can contract with the originators of such notes to give the purchasers recourse against the originators for any problem loans. [Fn98] For example, the originators may be contractually obligated to buy back any notes that do not meet the underwriting standards of the purchaser. In this way, if a borrower could convince the purchaser of a note that it is the product of fraud or deceptive practices, the purchaser ***Page528 could force the originator to buy back the loan, and then leave the borrower and the originator to resolve the borrower's claims. [Fn99]

The second primary method of assigning risk in the mortgage context is through the holder in due course doctrine, discussed extensively in the first article in this series. [Fn100] This doctrine is currently contained in U.C.C. § 3-302, which defines a holder in due course as the holder of an instrument if:

1. the instrument when issued or negotiated to the holder does not bear such apparent evidence of forgery or alteration or is not otherwise so irregular or incomplete as to call into question its authenticity;
and
2. the holder took the instrument (i) for value, (ii) in good faith, (iii) without notice that the instrument is overdue or has been dishonored or that there is an uncured default with respect to payment of another instrument issued as part of the same series, (iv) without notice that the instrument contains an unauthorized signature or has been altered, (v) without notice of any claim to the instrument described in § 3-306, and (vi) without notice that any party has a defense or claim in recoupment described in § 3-305(a). [Fn101]

A holder in due course takes a negotiable instrument free of many of the defenses that a borrower would have against the original lender. Pursuant to U.C.C. § 3-305, a holder in due course takes the instrument subject to the so-called real defenses, which include infancy, duress, lack of legal capacity, illegality of the transaction if it nullifies the obligation, fraud that caused the obligor to sign the instrument having neither the knowledge of nor a reasonable opportunity to discover of its "character or its essential terms," or the obligor's discharge in insolvency proceedings. [Fn102] Other defenses that the maker of a note might have against the original beneficiary, such as fraud or misrepresentation that did not prevent the maker of the note from learning its essential terms, less than complete incompetence, or undue influence, cannot be asserted against a holder in due course. [Fn103]

The Obie/Diamond debacle is the acid test for the holder in due course doctrine's ability to assign risk of loss in a fair, orderly way, since it presents the difficulty of choosing whether the borrowers or purchasers of loans should bear the ultimate loss in the most stark ***Page529 terms. The holder in due course doctrine failed miserably at one of the most important requirements for a rule of loss, which is predictability. At least six published opinions addressed the issue of whether the borrowers or the investors would bear the risk for Diamond/Obie's fraud where the borrowers did not receive the proceeds of the loans purportedly secured by their homes and the loans were sold to the investors. The cases were decided utterly inconsistently, with some courts finding that the investors were holders in due course and so entitled to collect on the notes, despite the lack of consideration for them. In other cases, the courts found for the borrowers, straining to find some means of preventing them from having to pay back their loans.

In Thomas v. Leja, [Fn104] where an investor had purchased a note even though the homeowner had
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never received the loan proceeds, the trial court found the homeowner's mortgage and promissory note "null and void for lack of consideration." The appellate court affirmed, though for completely different reasons, finding that because the homeowner never received the proceeds of the loan, the loan was never consummated, and so plaintiff retained his right to rescind under TILA. [Fn105]

In Stone v. Mehlberg, [Fn106] the court held that the holder in due course doctrine did not apply to the mortgage securing the note that had been sold to an investor, because the mortgage was not payable to order or bearer and so was not a negotiable instrument. [Fn107] The court further found that because Diamond had not delivered a disclosure of the borrowers' right to rescind the transaction, the borrowers' right to rescind continued. After the borrowers rescinded, based on not receiving the proceeds of the loan, the borrowers were not obligated under the loan, even though the loan had been assigned to a holder in due course, since the TILA rights to rescission were not cut off by assignment to a holder in due course. The court also concluded that the investor had never become a holder in due course because of irregularities in the documentation delivered by Diamond and Diamond's dishonest and unprofessional actions toward the investor. [Fn108]

In Thomas v. State Mortgage, [Fn109] after the trial court quieted title to the borrowers' property and voided the mortgage held by the investor, based on Diamond's fraud and lack of consideration, the court of appeal reversed, finding that the investor was a holder in due course ***Page530 of the mortgage despite facts calling the loan into question. [Fn110] The investor had stopped receiving interest on her investment, had complained to Diamond/Obie, and had learned of Diamond/Obie's financial difficulties and impending bankruptcy before she was assigned the note and mortgage. [Fn111]

In Mox v. Jordan, [Fn112] the trial court granted, and the court of appeal affirmed, the investors' motion for summary judgment against the borrowers' claims of lack of consideration, finding that the investors were holders in due course, despite their knowledge that the senior loans that were to have been paid off by the loan at issue were not paid off by Diamond. [Fn113] The court in Mox distinguished Stone as being based on lack of TILA disclosures, while asserting that it would not have to follow the federal court's discussion regarding the holder in due course doctrine in Stone. The court in Mox also noted that the mortgage instrument is not negotiable, but did not use that as a means of freeing the borrowers from the mortgage, as the court had done in Stone. Instead, the court in Mox appears to assert that the mortgage's non-negotiability is a reason to conclude that the investors were holders in due course despite their knowledge that the property secured by the loan was still subject to a previous encumbrance. [Fn114]

In Franck v. Bedenfield, [Fn115] the trial court held that, although Diamond had never disbursed the loan proceeds to the borrowers, the debt was still valid because the investors were holders in due course. The trial court held, though, that the mortgage was invalid, since the plaintiff was not a bona fide purchaser for value. [Fn116] Unsurprisingly, given the self-contradictory decision, both parties appealed. The appellate court held that even though the borrowers had never pled TILA rescission as an affirmative defense, the loan had never been consummated because the borrowers had never received the proceeds of the loan, preserving their rescission rights under TILA. While the rescission sent by the borrowers to Diamond was invalid due to Diamond's bankruptcy, once Diamond had assigned the loan to the investors, the borrowers were free to rescind. The court concluded that the borrowers' motion for summary disposition, because it alleged the borrowers had a right to rescind under TILA, constituted a notice of rescission, ***Page531 which was valid despite the investor's status as a holder in due course. [Fn117]

In Elsner v. Albrecht, [Fn118] the court found that where the borrowers had each received one, but only one, notice of their right to cancel, the borrowers retained their right to cancel because each had not received two such notices. The court held that even though the borrowers were husband and wife, because
they both had an ownership interest in the property, they each had to receive two copies of the notice of right to cancel to begin the three day cooling off period. [Fn119]

These cases demonstrate that the holder in due course doctrine, when applied to notes secured by residential property and combined with TILA, has been a hopelessly ineffective and almost irrational method to allocate the risk of loss. Faced with nearly identical circumstances, the courts ruled for either the borrowers or investors, with little or no way for any party to the transaction to predict the outcome. Some courts strained to find the slightest reason to prevent the borrowers from losing their homes, searching for any justification for allowing the borrowers to rescind. Other courts, in order to protect the investors, ignored damaging evidence that the investors knew or should have known Diamond and the loans that were assigned to them were suspect, and so should have been denied holder in due course status. Worse yet, the holder in due course doctrine seems so difficult to understand that even the courts themselves, on both the trial and appellate level, misunderstand or misapply the doctrine on a regular basis, making it even harder for any party to plan its decisions based on this rule.

Article 3 of the U.C.C., which contains the holder in due course doctrine, was revised in 1990, in a drafting process dominated by representatives of banks, clearing houses and the Federal Reserve Board. [Fn120] The only significant change made in the course of revising Article 3 was one that aided lenders, making variable rate notes potentially ***Page532 negotiable. [Fn121] In the course of revising Article 3, the drafters made a substantive change in the holder in due course doctrine, in that they altered the definition of good faith required for one to be a holder in due course. The previous standard had been one of "honesty in fact," also known as the "pure heart and empty head" defense. [Fn122] In revising Article 3, the drafters expanded the good faith standard to require not only "honesty in fact," but also "observance of reasonable commercial standards of fair dealing." [Fn123] This change, made apparently so that Article 3 and Article 4 would be more harmonious, is "concerned with the fairness of conduct rather than the care with which an act is performed." [Fn124] While the drafters no doubt thought this change might have a noticeable effect on the holder in due course doctrine, it seems unlikely to be significant in the current home loan industry.

First of all, while the U.C.C. had a subjective standard regarding good faith for the holder in due course, it also maintained a somewhat more objective standard toward notice. [Fn125] A person was held to have notice of a defect in the note that would deny her holder in due course status when from all of the facts and circumstances known to her, she had reason to know the fact. [Fn126] This relatively objective standard toward notice dampened the effect of the subjective standard toward good faith, since a holder cannot claim a "pure heart and empty head" if she had reason to know of the facts that would prevent holder in due course status. [Fn127]

***Page533 Jordan and Warren note that, because of this objective nature of notice, the distinction between the subjective and objective standards of good faith is rarely significant. "Most cases probably involve situations in which the facts relevant to the issue of good faith are the same facts giving rise to the notice of a defense or claim. In those cases, the issue of whether good faith is subjective or objective seems academic." [Fn128] Hawkland and Lawrence are even more emphatic, stating, "In the vast majority of cases, a holder will lack good faith because he has notice of a claim or defense." [Fn129]

Furthermore, the new standard is not a pure objective standard but requires only "observance of reasonable commercial standards of fair dealing," a lesser standard. Two sets of the most noted commentators on the UCC agree that this is not a move from a subjective standard to a fully objective standard, but rather a much smaller change from a subjective standard to a somewhat less subjective but not fully objective standard. White and Summers state:
So beware, good faith does not require general conformity to "reasonable commercial standards," but only to "reasonable commercial standards of fair dealing." The issue is one of "unfairness" not of "negligence." If the Code is tilting back toward an objective standard, it is going only so far. [Fn130]

Hart and Willier are more emphatic:

It appears clear that the drafters did not intend to impose any duty to act carefully in taking the instrument. Thus, the test remains a subjective one. The extent to which the new good faith standard will affect the outcome of cases is difficult to determine. Clearly, jury instructions will have to be somewhat different. But if a court instructs the jury using the words of the statute, it is doubtful that the jury members will see any distinction between the prior standard and the new one. [Fn131]

This distinction is even more often purely academic given the widespread sale of mortgages in the secondary market and their sale to investors through the process of securitization, which will be discussed in the next section. In such instances, notes are typically held by passive, special business entities designed to hold loan pools and highly unlikely to have any information regarding the underlying loan or the originating lender other than that contained in the disclosures and documents accompanying the note. Therefore, the facts giving rise to the issue of good faith and the facts giving rise to notice of a claim or defense will be almost universally identical and so, in Jordon, Warren and Walt's formulation, the change in the good faith standard was "academic" and with little real world effect in securitized mortgages. Because the holders of securitized notes are passive entities, the creation of which is normally supervised by a team of underwriters and credit-rating agencies, it would be difficult to prove that the holders of the notes violated reasonable commercial standards of fair dealing even when the passive entities do inadvertently acquire loans that are the fruit of fraud and deception. At the same time that it is vastly increasing the numbers of holders in due course of notes secured by the borrowers residences, securitization has made it far easier for the purchasers of predatory loans to claim holder in due course status despite the revision of Article 3's definition of good faith.

III. SECURITIZATION AND THE LAW OF NEGOTIABLE INSTRUMENTS

While some have claimed that the FTC Holder in Due Course Rule and other changes have effectively eliminated the importance or effects of negotiability, [Fn132] instead, the detrimental effects of negotiability, driven from their traditional home in consumer purchase contracts, have alighted in the area of home equity loans secured by residential property. Where loans once sat mostly undisturbed in the portfolios of their lenders, preventing the holder in due course doctrine from causing harm by ensuring that few new holders ever received the loans, now new secondary markets for loans cause the near instantaneous creation of a multitude of new holders of loans claiming status as bona fide purchasers. Chief among the changes in these secondary markets is the process of securitization of loans that has come to dominate the residential mortgage industry. Through securitization, investors have been able to channel huge sums of money into the lending industry, purchasing the beneficial interest in the loans produced. While they have often benefited from the high interest loans produced by predatory lenders, these investors have been too protected from bearing the risk of loss caused by the predatory nature of those loans.

A. The Basics of Securitization: Life in the Tranches

The effect of the holder in due course doctrine on homeowner borrowers and the assignment of risk of deceptive loan practices has been fundamentally changed by the process of securitization, the method of
aggregating a large number of illiquid assets, such as notes secured by deeds of trust, in one large pool, then selling securities that are backed by those assets. These securities, because they trade on an open market and do not require the paperwork used to transfer the underlying illiquid asset, are themselves highly liquid and easy to trade. Securitization has been defined, by an author who noted that there was no uniform definition for the term, as "the transformation of an illiquid asset into tradeable security with a secondary market." [Fn133] Others have defined it as "the substitution of more efficient public capital markets for less efficient, higher cost, financial intermediaries in the funding of debt instruments." [Fn134] In terms of the residential mortgage industry, securitization is the process of aggregating a large number of notes secured by deeds of trust in what is called a mortgage pool, and then selling security interests in that pool of mortgages. Through securitization, the source of capital for mortgage funding has been transferred from the savings industry, which used deposits to fund loans, to the capital markets and the portfolios of institutional investors. [Fn135] As we shall see, this emphasis on the investment by capital markets is important because it drives much of the argument about why securitization is efficient and provides access to less expensive sources of capital. Others have defined securitization even more broadly to include the substitution of securities for loans and loan participations. [Fn136]

At the center of the process of securitization is the isolation of a specific group of assets from the organization that owned them, so that the assets are legally completely independent from their former owner and free of any bankruptcy or liability risks of the former owner. [Fn137] By limiting the risk facing investors in the asset pools to those inherent in the assets themselves, and by creating standardized, ratable, and easily tradeable securities from the assets, the securitization process maximizes the liquidity of the assets. [Fn138] By providing great liquidity to notes, securitization has taken over what had been the central purpose of the holder in due course doctrine, facilitating the sale and transfer of notes. [Fn139] As noted by Joseph C. Shenker and Anthony J. Colletta, a process that increases the liquidity of an asset increases the value of the asset to its current holder. [Fn140] This increase in value to the purchaser potentially allows the seller of the securities to offer a lower yield to sell the security. [Fn141]

While the history of mortgage-backed bonds stretches back into the nineteenth century, and private title and mortgage insurance companies sold certificates secured by mortgage pools in the 1920s, [Fn142] the modern use of securitization began with the issuance in 1970 of the first publicly traded mortgage backed security by the Government National Mortgage Association (commonly called Ginnie Mae). [Fn143] Government sponsored entities (GSEs), such as Ginnie Mae, which securitizes mortgages guaranteed by the Veterans Administration, the Farm Home Administration, or the Federal Housing Administration, and Fannie Mae (the Federal National Mortgage Association) and Freddie Mac (the Federal Home Loan Mortgage Corporation), which securitize high quality residential mortgages, blazed the trail for securitization, since their implicit guarantee of financial security made some of the securities they issued seem almost risk-free. [Fn144] These GSEs have since been joined by the Student Loan Marketing Association (Sallie Mae), which securitizes student loans. [Fn145] The private sector's ability to securitize separately from GSEs increased dramatically after 1975, when rating organizations began rating the securities produced by securitization, giving investors confidence in the pricing of securities not backed by the government or a government-sponsored enterprise. [Fn146] The growing importance of securitization can be seen in the expansion of Article 9 of the U.C.C. to include sales transactions that had not previously been governed by it, to aid in their securitization. [Fn147]

Securitization of residential loans has grown at a staggering pace. In 1984, only twenty-three percent of the loans secured by mortgages on one-to- four family homes were securitized. [Fn148] By the end of 1998's first quarter, fifty-two percent of the total outstanding balance of such loans was securitized. [Fn149] The dramatic increase in securitization has been fueled in part by the support that the federal government and the GSEs have provided, by the development of new products caused by the
competitive jousting of such players as banks, thrifts, and Wall Street firms, and by the openness shown to
securitization by the banking industry and securities regulators. [Fn150]

A typical securitization of a loan secured by a residence might proceed as follows. The borrower
negotiates with a mortgage broker for the terms of the loan. Mortgage brokers may originate the loans in
their own names in three ways: (1) by using "table funding" provided by the pre-arranged buyer of the loan;
[Fn151] (2) by access to a warehouse line of credit; or (3) by supplying the broker's own funds. [Fn152]
Alternatively, the mortgage broker may close the loan in the name of the lender providing the money.
Whether the broker closes the loan in his or her own name or in the name of the lender, the broker typically
almost immediately transfers the loan to a lender. This lender quickly sells the loan to a different financial
entity, which pools the loan together with a host of other loans in a mortgage pool. [Fn153] The loans in
the pool may all come from one lender, from a multitude of lenders, or any number in between. [Fn154]

The assignee of the loans then transfers them to another entity, typically a limited liability
company or wholly owned corporate subsidiary. [Fn155] This entity (known as the "seller" because it will
sell the securities that result from the securitization process) then transfers the loans to a special purpose
vehicle (an "SPV"), a business entity that has the sole purpose of holding the pool of mortgages, and in
return the seller receives the securities issued by the SPV. [Fn156] SPVs can be trusts, corporations,
limited partnerships, or more specialized business entities, though a trust is considered the most common.
[Fn157] In fact, "[a]sset securitization has become one of the most important commercial uses of the
trust," [Fn158] even though the set of fiduciary duties that trust law would normally impose are by and
large replaced by the trust agreement's minutely detailed provisions. [Fn159]

The securities that the SPV transfers to the seller are carefully packaged to maximize their appeal to
purchasers. There are a multitude ***Page540 of ways in which these securities can be packaged, as
different aspects, or "strips," of the loans are divided up and sold separately as securities. A relatively
simple, straightforward (as straightforward, perhaps, as anything is in the new world of securitization)
revision of ownership rights in the pooled loans is for one group of securities to represent the interest that
will be paid on the loans (interest-only strips), and a second group to represent the repayment of principal
on those same loans (principal-only strips). [Fn160] If interest rates drop, the prepayment rate of the loans
in the pool normally increases, shrinking the income of the holders of interest-only strips, since there will be
fewer loans to pay interest, while swelling the returns of the principal- only strips, as they receive the
payments on principal years before the payments might have been expected. [Fn161] The pool of
mortgages can be cut into much more complex strips of mortgages, depending on what the creator of the
SPV thinks may be most easily sold. [Fn162] The strips, or classes of securities, are called "tranches,"
which is French for "strips." [Fn163]

To convince potential investors of the value of the securities, the securities are typically rated by a
national, independent credit-rating agency, unless the home mortgages are backed either by the U.S.
government or by a government-sponsored entity, which effectively, at least in the eyes of the market,
guarantee their value. [Fn164] Because the rating need only be done once for all investors rather than
separately and redundantly by each investor, the rating process efficiently allows the market to determine
the value of the investment and hence the return the investors will demand for purchasing securities backed
by the assets to be securitized. [Fn165]

The credit quality of the different tranches of securities can be improved by various techniques of credit
enhancement that reduce the ***Page541 risk of loss to the purchasers of the securities. Credit
enhancements can be either internal, meaning they depend on the assets or credit of the originator, such as
providing additional assets to the securitization pool, or external, involving the credit or assets of a third
party, such as an insurer or a bank issuing a letter of credit. [Fn166] One common credit enhancement is mortgage insurance, with each loan in the mortgage pool insured up to a certain percentage of its value. [Fn167] Or, as a credit enhancement, the originator can retain an interest in the tranche that will first absorb any defaults in the mortgage pool, forcing the originator to act as a shock absorber for the rest of the investors. [Fn168] Credit enhancements can be so effective that they allow even delinquent and foreclosed loans to be securitized. [Fn169]

Working with the seller to package the loan pool and its resulting securities is an underwriter, which, together with the rating agency, examines the loans assembled in the pool, sets specific requirements of loss probability for the loans, and discards loans that do not meet the risk standards set for the pool, returning them to the originator. [Fn170] The intermediaries who pool mortgages, however, have been reluctant to undertake any significant diligence in their own examination of the loans or the borrowers and instead rely, for the most part, on detailed representations by the originators of the loans. [Fn171] Most pooling agreements give the intermediaries the right to force an originator to take back any loan that did not actually qualify for the loan pool, the inclusion of which would cause a breach of the originator's representations. [Fn172] Therefore, the originator of the loans may be forced to take back a loan if the borrower defaults. [Fn173]

Once the securities are rated, they can be sold to investors by the seller. [Fn174] This sale is typically accomplished by private placements or by public offerings, and an underwriter is involved in all public offerings and most private placements. [Fn175] The buyers may include mutual and pension funds, insurance companies, other institutional investors, and private individuals. [Fn176]

The transfer to the special purpose trust must constitute a true sale, so that the party transferring the assets reduces its potential liability on the loans and exchanges the fairly illiquid loans for much more liquid cash. [Fn177] The true sale also acts to separate the assets from any potential bankruptcy (to confer, in the poetic language of the securitization literature, "bankruptcy remoteness") or other risk associated with the original lender or pooler of the loans. [Fn178] The trust is considered the business form most likely to preserve bankruptcy remoteness. [Fn179] This bankruptcy remoteness is becoming increasingly controversial, however, given the effect it may have on the creditors of the originators. [Fn180]

The investors typically are completely passive once they have had the opportunity to review and approve the offering documents, the loan pool's ratings, and any third party guarantees and have purchased the securities. Nor do the investors take an active hand in monitoring the SPV. Instead, the offering materials set out the method of servicing the mortgages and distributing payments to the investors. [Fn181] The SPV itself does not directly collect payments from the homeowners whose notes and deeds of trust are held by the SPV. The collection and distribution of the payments of principal and interest are made by servicers, companies who specialize in this collection and distribution of income and principal from pools of loans. [Fn182] Originally, the servicer was often the same financial institution that either originated the loans in the pool or that obtained them from the originator and pooled the loans. The servicing of loans provided, in this way, a separate income stream for the originators or poolers of loans. [Fn183] Now, servicing rights are often sold to firms that specialize in servicing. [Fn184] Servicing specialization has increased so much that there are now servicers that specialize in subprime servicing or in servicing distressed loans, with rating agencies beginning to recognize their expertise and to provide ratings for servicers. [Fn185] The servicer is employed by the SPV and, since most SPVs are trusts, the trustee is legally at the helm, directing the activities of the SPV. [Fn186] However, the servicer typically is in charge of collection efforts. [Fn187]
As the homeowners gradually pay down their notes by making their monthly payments, the value of the mortgage pool declines. A more rapid change occurs when a homeowner either pays off the loan, normally through refinancing it, or stops making payments, forcing the servicer to begin foreclosure proceedings. Whether or not a foreclosure results in a net cost to the SPV depends on the amount of equity securing the loan being foreclosed. If the loan had a high loan-to-value ratio (LTV), a large loan given the value of the property securing the loan, perhaps because of a decline in the value of the property, then the costs of the foreclosure process, which can be sizeable, can consume the remaining equity and even cause a loss to the SPV and thus to the investors.

On the other hand, if the amount of the loan is far less than the value of the property securing it, the investors could actually make money on the foreclosure process, since the holder of the loan is often the sole bidder during the foreclosure sale and typically bids only the amount of the outstanding balance on the loan. In some states, the lender could foreclose on the property, purchase the property at an unreasonably low price that does not even pay off the lender's loan, and then seek a deficiency judgment against the borrower for the amount remaining on the loan. Therefore, if the remaining balance of the loan is $60,000, the loan is secured by a house worth $120,000, and the costs of foreclosure are $10,000, the investors would make $50,000 by foreclosing on the loan and buying the house for the amount of the loan. Despite this possibility of profits from foreclosures, early repayment and, to a lesser extent, foreclosure are the two greatest risks facing investors in securities backed by pools of mortgages, assuming that the securitization process has succeeded in divorcing the pools of mortgages from all risks caused by or associated with the originators or poolers of the loan.

B. The Advantages of Securitization, Primarily to Investors and Lenders

The advantages of the securitization process to loan originators have been widely discussed. The primary advantage of securitization is the access securitization gives to public markets and private institutional funding, with the cost of capital available in these markets lower than that of traditional sources, such as bank loans. As Steven Schwarcz has noted, "Securitization is most valuable when the cost of funds, reflected in the interest rate that is necessary to entice investors to purchase the SPV's securities, is less than the cost of the originator's other, direct sources of funding." Through the securitization process, companies with severe financial problems and abysmal credit ratings can still create bonds carrying investment grade ratings, the highest rating, by transferring valuable assets to an SPV that is effectively remote from the originator. Because investors in the securities created should not need to monitor the bankruptcy risk of the originator, they save the monitoring costs they would have had to spend in the absence of securitization.

An advantage of securitization to the originator of loans is its extreme usefulness as a leveraging tool. By almost immediately securitizing its loans, a lending institution can receive payment for those loans quickly rather than waiting up to thirty years for repayment. The lender can use this infusion of capital to make a new round of loans. This quick churning of loan principal allows even an institution without a great amount of fixed capital to make a huge amount of loans, lending in a year much more money than it has. As discussed in section III(B) infra, this ability to leverage is particularly useful to smaller, disreputable companies that otherwise would have difficulty funding a large number of loans.

Lenders employ securitization to diversify risk. For example, a local lender may sell many of the loans it originates in order to keep itself from being too greatly endangered by a local slowdown of the economy. Securitization also has certain accounting advantages, permitting an originator to raise funds...
without borrowing and having to report a liability on its balance sheet, \[\text{Fn199}\] as well as allowing banks to reduce the amount of capital they need to hold by reducing the amount of their outstanding loans. \[\text{Fn200}\]

Securitization has also benefited investors by giving them a rich banquet of new and varied investment possibilities, structured by the poolers of the assets to appeal to the different risk, diversification and income tastes of the investors. \[\text{Fn201}\] The anonymity of mortgage-backed securities may appeal to some investors, such as those engaging in tax evasion and money laundering. \[\text{Fn202}\] As previously noted, securitization allows investors to reduce their information costs by pooling the acquisition of information in the form of a single rating regarding the security of the pool. \[\text{Fn203}\] However, this ability to rely on a single rating may be overshadowed by the increased complexity that securitization adds ***Page548 to the investors' financial decisions; pools can be structured in so many different ways that, even apart from unstable economic conditions, past performance of other pools may be no indication of the likely profit to be obtained by investing in a new securitization. \[\text{Fn204}\] Investors forced to rely on rating agencies, trustees, originators, or underwriters may suffer if those third parties' abilities to estimate the likely returns of the securities were also overwhelmed by the complexity of the securitization structure. \[\text{Fn205}\] Rating organizations have regularly upgraded or downgraded the ratings they have assigned to mortgage pools as the repayment and default rates have differed from expected. \[\text{Fn206}\] Investors in mortgage backed securities should also be wary of the potential for securities fraud, which may, at a stroke, cause them to lose their entire investment. \[\text{Fn207}\]

Securitization has also benefited investors by allowing them to purchase an interest in the high interest rate loans that have been associated with predatory lending, while avoiding much of the risk of defaults and delinquencies that is associated with those loans. Investors are protected from much of this risk by two methods. The first method is the use of various contractual forms of recourse between the originator or seller of the loan and the entity that purchases them in the securitization process designed to protect the buyers of the loan at the expense of the sellers. Recourse can take several forms. As noted in section II(E), the seller of the loans may make representations or warranties that, if violated, require the seller to repurchase the loan. Other contractual forms of recourse are those explicitly requiring the seller of loans to make cash payments to buyers or to repurchase the loans in the event of borrower default, those that set up reserve accounts that fund losses, and more complicated schemes involving subordinated***Page549 interests or excess servicing fees. \[\text{Fn208}\] These forms of recourse for the most part require the continued existence of a relatively solvent seller, of course. Where the originator of the loan has gone bankrupt or otherwise disappeared, then the loan buyers must depend on their second line of defense, the holder in due course doctrine. A buyer may choose to rely on the holder in due course doctrine even where the loan seller is still in existence, where, for example, a single loan pool contains a large number of loans from one originator, so that forcing the originator to buy back all of the problematic loans could force the originator into insolvency. Or the buyer may conclude that it would be easier to foreclose against the borrower and rely on the holder in due course doctrine than it would be to force the seller to take back a problematic loan.

Even those articles that sing the praises of securitization rarely mention in any great detail the effect of securitization on the homeowners whose loans have been securitized. At most, they have argued that, by obtaining access to lower cost capital markets, lenders will be able to offer loans at lower interest rates or with otherwise better terms to borrowers. \[\text{Fn209}\] Securitization by government sponsored entities does seem to be positively correlated with lower interest rates for the borrowers with the best credit whose loans are sold to GSEs. \[\text{Fn210}\] While the GSEs claim that their securitization has led to lower interest rates, a recent study by the Federal Reserve Board suggests that securitization may not decrease interest rates. Instead, falling interest rates may lead to increased securitization, rather than the other way around. \[\text{Fn211}\]
C. The Downside and Dangers of Securitization, Primarily to Borrowers

Mostly ignored in the literature on the wonders of securitization are the ways it can cause significant harm to borrowers. First of all, securitization has encouraged the decline of stringent underwriting. Careful underwriting reduces foreclosure against borrowers by deterring lenders from making loans to borrowers unable to repay the loan. As originators immediately sell their loans and face less risk of loss even if a borrower defaults, the originators naturally will spend less time and effort screening potential loans for default, thus increasing the risk of lending money to borrowers with a high level of default risk. Securitization reduces the amount of individual, lender-driven underwriting and instead depends on systemic controls that can be objectively verified, such as automated underwriting systems. Ninety-eight percent of mortgage companies now use some form of automated underwriting, according to a 2001 survey. In this way, banks step away from their great strength, which was the effectiveness and efficiency of their information gathering and regulation systems, in both selecting which loans to make and controlling those loans once made, and in using their long-term relationships with borrowers. With less lender supervision, borrowers are more likely to default on their loans and risk foreclosure, though the default and foreclosure would likely occur long after the original lender has assigned the loan. As discussed in section IV(C) infra, foreclosure rates, especially among borrowers with poor credit, are increasing dramatically. In the world of securitization, with its ever churning markets, there are few long term relationships, but only the financial equivalents of one night stands.

Securitization has forced the static standardization of loan documents, as GSEs such as Fannie Mae and Freddie Mac have mandated that specific, standardized forms be used in any loan that they purchase. The market dominance of these GSEs is so great that the forms they have promulgated have become the industry standard, even for loans not slated for GSE purchase, and this standardization has removed the power of consumers, acting en masse, to improve the terms of those loan documents. Posner assumes that the dangers of form contracts are alleviated by the ability of consumers to choose sellers based on the terms of their form contracts, effectively bargaining over the terms of the form contracts even among sellers who refuse, on an individual basis, to alter the terms of their form contracts. The seller with the best terms will find more customers, forcing the other sellers to offer better terms. Securitization, however, requires lenders to use form loan contracts that are standardized across the lending industry, so that loans from different lenders can be pooled together and rated in a uniform manner. Therefore, borrowers have lost what little power they formerly had to alter the terms of the lending contracts they sign.

D. The "Unbundling" and "Atomization" of the Residential Mortgage Industry

Securitization has accomplished what is known as the unbundling of the loan industry, disassembling the lending process into its constituent elements, and allowing a separate entity to undertake each element. Traditionally, lenders performed all of the functions of a loan, finding the borrowers, preparing the documentation for the loan, funding the loan, holding the mortgage during the course of the loan, and servicing the loan throughout its life. Securitization has, in the words of Michael G. Jacobides, "atomized" this process, so that one distinct entity, more often than not a mortgage broker, originates the loan, while another, perhaps a mortgage banker, funds the loan, and another may securitize the loan and sell it to investors. These investors, through their ownership of securities issued by the SPV holding the mortgage in trust with a pool of other mortgages, claim the capital represented by the mortgage, while a separate set of entities, such as a master servicer under the trustee's direction, services the loan, accepting the mortgage payments and foreclosing if necessary.
This separation of the mortgage process confers on each entity in the chain a plausible deniability of the actions of the others. The securitizer can claim to be unconnected to the broker and unaware of any of his activities, however improper. The SPV and the owners of its securities can claim to be holders in due course and protected from any accountability for the fraud of the mortgage broker, through their ignorance of any such fraudulent behavior. The mortgage broker can accurately claim, once the loan is out of his hands, that he can no longer help the borrower if the servicer attempts to foreclose.

E. Mortgage Brokers: Too Often Under-Regulated, Under-Capitalized, and on the Front Line of Residential Lending

Before the rise of securitization, borrowers typically dealt with large finance companies, which funded their own loans and held the loans in their own portfolios. Because these lenders continued to hold the borrowers' paper, were closely regulated, and were required by regulators to hold sizeable assets, the finance companies had diminished incentive to commit outright fraud against the borrowers, as borrowers retained any defenses they had to the loans and the borrowers could also seek damages against the finance companies. With the rise of securitization, the origination of mortgages has largely been turned over to mortgage brokers, who now originate over sixty percent of all residential loans in the United States. Mortgage brokers are less regulated than finance companies and less constrained, since they may have few assets, either in their company or individually and rarely continue to hold the loans they originate.

While mortgage brokers themselves directly interact with the secondary market very little, the brokers often originate loans for the wholesale lenders, who then sell them onto the secondary market. A wholesale lender might purchase loans from a thousand different independent brokers and bankers from around the country. This use of brokers may lead to higher fees charged to borrowers, as brokers could be tempted to seek out the lenders that provide the greatest payments to brokers rather than the best rates to borrowers. Also, because brokers' fees are commonly a percentage of the total loan, brokers have an incentive to encourage the borrowers to take out as large a loan as possible, to maximize the brokers' commissions, even if a smaller loan would be more appropriate for the borrowers. The use of brokers has hastened the growth of subprime lending, given that brokers have placed some borrowers who would qualify for conventional loans into subprime loans, because of the greater broker fees from subprime loans.

The amount of regulation of mortgage brokers varies dramatically by state. Some states require a bond or a minimum net worth, but rarely enough of either to protect borrowers in an era when many homeowners are borrowing hundreds of thousands of dollars at a time. Some states have virtually no regulation. According to the vice president of the National Mortgage Bankers Association, as of mid-2001, "A lot of states have no licensing and no bonding requirements. I live in Michigan, a state where you can talk about becoming a mortgage broker over breakfast and open an office in the afternoon--no license, no bonding . . . ." A president of a state mortgage bankers association said, "It's too easy to get into this business . . . It's not good that you could be selling paint at Sears one week and originate loans the next." Even in the majority of states that regulate mortgage brokers, the scope and intensiveness of that regulation is often modest compared to that directed at other lending institutions. As a sign of how weak the regulation has been, not until 2001 did Ohio take steps to prevent someone already convicted of theft or forgery, hardly appropriate credentials for the financial services industry, from holding a broker's license. Not until 1998 did California, which has been at the epicenter of mortgage
fraud, take steps to prevent mortgage brokers who had a license revoked by one of its departments from seeking a license from a separate department. Until then, if a broker was faced with having his license revoked by the California Department of Real Estate for fraudulent activity, the broker could easily seek a license from the California Department of Corporations, or vice versa, as the two departments did not share information about disciplinary action or consumer complaints. [Fn237] While California and Ohio are finally moving to increase their regulation of mortgage brokers, that movement is not universal. Hawaii, in 2001, "streamlined" its mortgage broker licensing law by reducing the bond requirement for licensed mortgage brokers who engage in loan servicing, trimming the bond from $50,000 to $15,000. [Fn238]

The paltry existing regulation of mortgage brokers may be easily circumvented by a tactic called "rent-a-broker" in which those barred from obtaining licenses or otherwise unable or unwilling to become brokers themselves rent the use of a broker's license, paying up to several hundred dollars per week. [Fn239] The licensed broker likely engages in little or no supervision of the renter's use of her license, though the broker does risk losing her license if fraud is committed under the auspices of her license and that fraud is discovered. [Fn240] Often, stripping the rent-a-broker's license is all that a state's licensing officials can do to target the license renter, leaving him to rent a different broker's license and restart the process.

The securitization process allows even someone with almost no capital or financial services to exploit this lack of regulation and become a lender or otherwise originate loans. Leland C. Brendsel, the Chairman and Chief Executive Officer of Freddie Mac, almost bragged about the ease of entry into the lending business, stating, ***Page556

Although it is a stretch to suggest that anyone with a modem and a fax machine can be a lender today, relatively little capital is required to start a mortgage banking operation in the 1990s, and even less to become a mortgage broker. Lenders lacking the necessary net worth can still originate loans for lenders qualified to sell into the secondary market. [Fn241]

A mortgage broker could easily be judgment-proof in the states that do not require them to be bonded or to maintain a minimum capital. Such mortgage brokers are free to disappear if they are sued. [Fn242] Disreputable brokers have been known to declare bankruptcy, move to another state, and begin business anew under assumed names. [Fn243] Furthermore, since mortgage brokers rarely hold a borrower's notes in their own portfolios, they have too little reason to be concerned about any defenses the borrower might have to the note, especially if those defenses are immediately cut off as to assignees by the holder in due course doctrine.

The borrower who has been defrauded by a mortgage broker or originator of the loan is victimized by the combination of the effect of the holder in due course doctrine, the unbundling of the loan origination and securitization process, and by the small capital required to broker or originate loans. Except for the real defenses, as between the borrower and the investors who purchased a securitized interest in the note of the borrower, the homeowner/borrower bears the risk of fraud or misrepresentation by the mortgage broker or originator of the loan, though she would retain an action for damages against the broker or originator who defrauded her. However, because securitization allows individuals with little or no capital of their own to originate or broker loans, it dramatically reduces the likelihood that the borrower can obtain any sort of repayment for her damages from the broker or originator, who can easily avoid paying any sizeable damages judgment by declaring bankruptcy or merely disappearing. [Fn244]

***Page557 Simultaneously, securitization encourages the most rapid creation of an assignee with holder in due course status by causing the originator of the loan to sell the loan almost immediately. Gone are the days when a lender would normally hold the loan for its full term. Instead, lenders might hold the loan for a
few weeks, assigning it almost immediately either to a GSE or to another securitizer.  For example, Old Kent Mortgage Co., in 1998, the eighteenth biggest mortgage banker in the nation, generating over $11 billion in mortgages, would sell the loans it generated in less than sixty days, and often much less.  

"When we buy from Old Kent," said a supervisor at a securitizer, "they typically have held it for at least 24 hours.  This way we can ensure they actually own the loan."  [Fn246]  Often, the loan will be sold before the first payment is even due, so that if the homeowner/borrower learns that her payments are much larger than had been represented to her, that defense has already been cut off as to the current holder of the note by the holder in due course doctrine. This combination (initial loan made by a thinly capitalized, poorly regulated lender who immediately negotiates the loan to a securitizer, so that the investors in the securities can claim holder in due course status) is a recipe for irresponsible and unethical lending, if not outright fraud. [Fn247]

An example of such sharp practices can be found in the case James v. Nationsbank Trust Co., [Fn248] in which the borrower/homeowners were fighting to prevent foreclosure by the holder of the loan, a trustee of a mortgage pool.  The borrowers had purchased a home from General Development Corp. (GDC) and financed the purchase through GDC's subsidiary, GDV Financial Corp. (GDV). Unfortunately for the borrowers, GDC, in the course of building 10,000 homes between 1983 to 1989 and originating the loans to pay for those houses, engaged in what appears to be a scheme to fleece naive home buyers.  GDC brought primarily out of state potential buyers to Florida, plied them with roast beef suppers cooked by a local Holiday Inn and attended by GDC employees, and gave them wildly inflated appraisals for the value of GDC's homes.  [Fn249] When the buyers committed to purchase, the mortgages they obtained based on these inflated appraisals often reportedly far exceeded the true market value of the houses that secured the mortgages.  Thus, GDC victimized not only the home buyers by obtaining their down payment, but also the buyers of the mortgages, by selling them under-secured loans.  [Fn250]  GDC financed its predatory activity by selling loans to institutional investors, [Fn251] some of which were securitized by those institutional lenders, [Fn252] and by selling registered subordinated debentures.  [Fn253]  GDC was so successful that at one time it held a reported $1 billion in assets and employed 5,000 people.  [Fn254]

On April 6, 1990, GDC filed a Chapter 11 bankruptcy petition, [Fn255] and left unbuilt thousands of platted lots and homes without any water or sewer access, and towns so poorly constructed and designed that as one city official explained it, "Basically, what we have to do is retrofit the city."  [Fn256]  In November 1990, GDC agreed to a plea bargain on a conspiracy charge, offering up to $160 million in restitution, though the special master administering the deal noted there "may not be enough money to cover all such claims."  [Fn257]  Although a federal judge initially sentenced four of GDC's officers to prison terms ranging from five to ten years, [Fn258] those fraud convictions were overturned in 1996 when the court of appeal declared that the home buyers could not have been defrauded by the GDC executives because buyers had been free at any time to investigate the prices of other Florida homes.  [Fn259]  The court found that, because GDC's scheme could not deceive buyers with ordinary prudence and comprehension, it did not constitute mail fraud.  [Fn260]  Apparently, it is permissible to deceive anyone with below average prudence and comprehension.

Various victims of GDC's sharp practices spent most of the rest of the 1990's attempting to recover some of their damages. [Fn261]  Two such victims of those sharp practices were Cedric and Elizabeth James, who purchased a home from GDC in 1986.  After GDC was indicted, the Jameses ceased their mortgage payments.  Nationsbank Trust Company ("Nationsbank"), the trustee under a loan pooling agreement for the pool containing the Jameses' loan, brought a foreclosure action against the Jameses.  The trial court dismissed the Jameses' counterclaims and defenses to that foreclosure action and entered a summary judgment of foreclosure, after Nationsbank claimed it was a holder in due course.  The appellate court
reversed and remanded only as to the Jameses' allegation that Nationsbank was not a holder in due course, based on the Jameses' allegations that Nationsbank had purchased the pool of mortgages with actual knowledge of GDC's use of fraudulent appraisals that misrepresented the value of the homes. [Fn262] However, it appears that unless the Jameses could somehow show that the trustee had such knowledge of the originator's fraud at the time the trustee acquired the mortgages for the pool, then the borrowers' defenses based on the fraud conducted by the originator of the note would be cut off due to the trustee's holder in due course status. [Fn263]

The holder in due course doctrine and securitization provided support for GDC in its schemes, both by providing financing for GDC's efforts and by giving protection to the investors in the loans originated by GDC, making them far more willing to buy those loans because they were protected from most claims by the homeowner/borrowers.

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F. "Tranche Warfare" and How Securitization Reduces Lenders' Discretion in Resolving Borrowers' Difficulties

Securitization hurts borrowers by making it more difficult for a borrower with financial difficulties to arrange alternative payment terms that involve any change in the borrower's payment stream. [Fn264] Before the advent of securitization, homeowners typically borrowed from their neighborhood banks, which normally held the loans for their entire terms. Because of those long-term, local relationships, lenders were often aware of their borrowers' troubles even before the borrower missed a payment, because the lender might know of a factory closing or of a borrower's severe illness. [Fn265] This relationship allowed lenders to step in early and encouraged resolution of borrower difficulties without the need for formal collection efforts. [Fn266] While a borrower whose loan is held by a traditional bank might have some success in convincing the bank to restructure the loan, too much of this flexibility vanishes once the loan has been securitized. [Fn267] The originator has often washed its hands of the loan and has neither the ability to nor the interest in helping the borrower change the terms of the loan. [Fn268] The trustee and servicer of the loan, even if either is the original lender, must follow the documented procedures that are normally included in the initial documentation of the securitization. That documentation often limits the discretion to alter the terms of the loans because the securities backed by the loan pool are based on the loans' original terms. [Fn269] The trustee and servicer do have some discretion to create a loan repayment plan, a loan modification, or arrange a short sale, a discretion that can aid investors given the ***Page561*** expense of the foreclosure process, especially in states which do not allow non-judicial foreclosure. [Fn270] However, the willingness of servicers to work with borrowers is subject to the servicers' conflicting interests, as the servicer may be rewarded either for preventing foreclosures by instituting quick and successful repayment plans or, alternatively, for negotiating short sales by the borrowers or foreclosing as quickly and efficiently as possible. [Fn271]

The borrower cannot turn for succor to the investors who own the securities that are backed by the borrower's loan, since the investors are passive, beneficial owners, who depend on the trustee and servicer to control the assets. [Fn272] It would be practically impossible for a borrower even to learn the identities of the investor, let alone communicate with them. [Fn273] The investors are not even notified of the default of an individual borrower. [Fn274] Even if investors wanted to overrule a trustee's order to foreclose on a homeowner, the trustee is forbidden from accepting instructions that conflict with the terms of the securitization agreement. [Fn275] Once the deeds of trust are securitized, they enter into what Tamar Frankel has called "a kind of suspended animation," noting that "the sellers of the financial assets are no longer the owners. The buyers are only beneficial owners, and the trustee controls the assets but does not benefit from them (except by fees)." [Fn276]
Reducing the amount of discretion any party has to alter the terms of the borrower's loans or payment requirements may aid investors and improve the liquidity of the loan pool, but it can also force a trustee to foreclose where a traditional lender might merely have restructured the loan, possibly even to the traditional lender's benefit. In effect, the securitization process erects a wall between the borrowers and the beneficial owners of the note, preventing them from working out mutually advantageous changes to the terms of the note. This dramatic increase in the transaction costs between borrower and beneficial note holder leads to great inefficiencies. The weight of these inefficiencies falls primarily, if not exclusively, on the party that neither approved of nor likely even knew about the possibility of securitization, the borrower. Securitization itself has made the borrower's life more difficult by removing the personal discretion of the holder of the note to make exceptions for a borrower who, perhaps through no fault of his own, is forced to miss one or more payments on his note. \[Fn277\]

Even in cases where the foreclosure criteria contained in the initial offering of the securities backed by mortgages give the trustee some discretion regarding when and whether to foreclose, and even where the trustee and servicer would want to help out a financially troubled borrower, the underlying structure of the securities throw roadblocks in front of the exercise of that discretion. Imagine an elderly homeowner who has been the victim of fraud by a mortgage broker in the origination of the refinance of his home loan. A common way for the holder of the note, when discovering this fraud, to resolve the dispute with the homeowner would be to restructure the loan, either by reducing the amount of the principal, reducing the interest rate, or forbearing on requiring repayment of either principal or interest while the homeowner is alive and instead collecting some or all of the loan after the elderly homeowner dies. In this way, the homeowner can live out her remaining years in peace, and the lender can receive a fair return, delayed by an uncertain number of years.

Once the loan has been securitized, this flexibility to restructure the loan repayment is dramatically reduced, since the loan is no longer held as a unitary asset by one owner, but rather has been split into a number of tranches, each tranche representing different interests held by different sets of investors. One tranche might hold the right to any principal repayments made during the first year, another to interest payments during that year, yet another to interest payments the second year, and so on. \[Fn278\]

Restructuring the loan poses a substantial fiduciary dilemma to the trustee, because it would almost inevitably involve removing some part of a stream of income from one tranche and adding income to another tranche, "tranche warfare," so to speak. \[Fn279\] A bank could forego mortgage payments for the life of a borrower with little financial detriment, so long as there is sufficient collateral to secure the loan and the interest rate is competitive to the then current market rate of interest. If the loan has been securitized into tranches divided by principal and interest and by the year principal or interest is received, the same agreement to forego payments would strip the tranches receiving early payments of principal or interest of all benefit from this particular loan, and would instead cause other tranches receiving later payments to receive a much greater sum than they would have obtained if the loan had not been restructured. \[Fn280\] Restructuring loans, therefore, would force trustees to choose which of the tranches would receive extra money and which would receive none, leaving the trustee open to claims of favoritism and breach of fiduciary duty by the owners of securities in the tranches that bear the brunt of the restructuring. \[Fn281\]

As loan pools are split into increasingly complex tranches, trustees will find it virtually impossible to restructure loans without harming securities owners in some tranches more than others, and so might well react, whenever possible, by refusing to restructure loans voluntarily, so as not to risk breaching their fiduciary duty. This could force homeowners to resolve their disputes through litigation. The trustees' fiduciary dilemma does not disappear even when the homeowners sue, however, making the process of
settling litigation more difficult. As a ***Page564 result, homeowners might be driven to take their cases to trial, so that the judge can force the trustee to rescind or restructure the loan.

Similarly, securitization removes one sometimes potent weapon in the hands of a borrower who needs to have her loan restructured. When loans were held by regional or local banks, those banks were susceptible to bad publicity and might be loath to foreclose on the home of, for example, an elderly borrower, especially one who was the victim of fraud. Banks have locally recognizable brand names, so that borrowers can threaten to picket a bank or bring discredit to the brand name unless the bank acts reasonably in helping borrowers resolve their problems. Banks also might have some interest in keeping their customers satisfied, with an eye to obtaining repeat business from the customer or new business from referrals.

Securitization, on the other hand, has allowed the markets to be unbundled, atomizing the mortgage origination and collection process. [Fn282] When a mortgage broker solicits the borrower, an SPV holds the loan, and a servicer collects the payments, whom would a defrauded borrower picket in order to obtain a loan forbearance? [Fn283] The originator may be long gone, as many subprime lenders have in recent years declared bankruptcy and gone out of business. The SPV is a business entity whose sole purpose is to hold a mortgage pool, and is completely immune from any threats to its good name, which is often something like "Security Pool #351." The servicer is similarly immune to threats or pleading, as it serves solely at the direction of the trustee. The servicer little depends on the happiness or good will of the homeowners who make payments to it, since the homeowners have no choice whatsoever regarding which servicer collects the payments on their loans. The trustee also does not need to keep the good will of the borrowing public, since it gets its business from originators, not the borrowers. A reputation as a particularly ruthless collector of debts ***Page565 might well aid the trustee or servicer in gaining new originator clients. [Fn284] Furthermore, the trustee and servicer can always claim, correctly, to be bound by the foreclosure criteria contained in the initial offering of the securities and absolve themselves of any responsibility to exercise discretion in dealing with a desperate homeowner.

The parties to the securitization who may most be affected by bad publicity are the underwriters, large Wall Street firms, like Lehman Brothers and Prudential Securities, who would want to avoid tying their firms' valuable reputation to predatory lending. While Wall Street firms might avoid individual firms linked to predatory lending (though their continued support of finance companies like First Alliance, discussed below, throws even that supposition into doubt), they did continue to participate in the securitization of residential loans without attempting to root out fraudulent lenders despite widely publicized hearings in 1994 and 1998 that documented how many lenders were taking advantage of unsophisticated borrowers and that the problem was growing dramatically. [Fn285]

Securitization almost completely depersonalizes the lending process and deprives the borrower of the advantages of a personal relationship with her lender. [Fn286] There is an odd echo here of the underlying purpose behind the ancient prohibition against assigning a chose in action, which was that since a creditor could have his debtor thrown in jail for non-payment of the debt, a debtor should be able to pick who his creditor would be and to avoid borrowing from anyone brutal enough to demand that his debtor be imprisoned. [Fn287] Now that a borrower risks losing her house should she fall behind on her payments, she might want to pick as the holder of her note a company with a reputation for being reasonable with borrowers in distress. Securitization eliminates the ability of a borrower to pick his creditor. ***Page566 or even the type of creditor, such as a small bank instead of a large bank or an individual investor, as it sweeps up the vast majority of American mortgages into faceless, almost nameless, unknowable business entities.
G. The Survival of the Holder In Due Course Doctrine in the Age of Securitization

Some have argued that the advent of securitization has effectively eliminated the holder in due course doctrine, stating that the process of indorsing each of the hundreds or thousands of notes that make up a mortgage pool would be so time consuming as to be impractical. [Fn288] Tamar Frankel stated, "Usually the servicer of the SPV's portfolio is the loan's originator and the payee under the notes. Therefore, in practice, notes are not endorsed, and the originator remains the holder of the notes." [Fn289] While originators were formally the usual servicers of the loans they originated, this is no longer universally, or even generally, the case. Now, the servicing rights to loans are easily and widely bought and sold, with originators discovering that they can avoid the volatility associated with servicing, such as varying prepayment rates by borrowers, by transferring the servicing rights to a company that, because it specializes in servicing, can derive greater profit from those rights. [Fn290] Small lenders in particular often sell their loans "servicing released," meaning that the buyer of the loans also obtains the servicing rights to them. [Fn291]

Steven Levine and Anthony Gray assert that "[o]riginators typically endorse and deliver notes to issuers," noting that "in the absence of such endorsement and delivery, the transferee would be the owner of the note but not the holder and, therefore, not a holder in due course." [Fn292] The Kravatt treatise on securitization describes in detail the efforts that a securitizer of residential mortgages should take to become a holder in due course and further notes, "If a note is negotiable, the simplest way to transfer an ownership interest in the note is to negotiate it to the pool entity if the note constitutes bearer paper, or endorsing it and delivering it, if the note constitutes order paper." [Fn293]

While there may well be securitizers who do not ensure that each note is indorsed to a new holder, the GSEs that have been the driving engines of securitization, by and large, require that the notes be endorsed before they can be securitized. For example, Freddie Mac's Single-Family Seller/Servicer Guide requires a seller to endorse notes delivered to Freddie Mac without recourse and states "If the Seller is not the original payee on the Note, the chain of endorsements must be proper and complete from the original payee on the Note to the Seller." [Fn294] The document custodian handling this volume of documentation is required by Freddie Mac to "verify that the chain of endorsements is proper and complete from the original payee on the Note to the Seller." The Kravatt treatise on securitization describes in detail the efforts that a securitizer of residential mortgages should take to become a holder in due course and further notes, "If a note is negotiable, the simplest way to transfer an ownership interest in the note is to negotiate it to the pool entity if the note constitutes bearer paper, or endorsing it and delivering it, if the note constitutes order paper." [Fn293]

The new rules for endorsement under the revised U.C.C. make it easier to endorse a large number of notes. For example, it is simpler to staple an indorsed allonge to each of a large number of notes than to inscribe an endorsement on the backs of each of them. Previous law arguably allowed the use of an allonge only when there was insufficient space on the back of the negotiable instrument for a new indorsement, presumably to preserve the record of previous endorsers in an orderly fashion. [Fn298] Under the new revision of U.C.C. Article 3, allonges are allowed even when there is space for more indorsements on the instrument. [Fn299] Similarly, previous law required an allonge to be so firmly affixed as to be part of the original document, denying a loan purchaser status as a holder in due course where, for example, it failed to staple its allonges to the back of its notes. [Fn300] The new U.C.C. omits this requirement, requiring only a "paper affixed to the instrument" and leaving open the possibility that allonges could merely be paper-clipped or otherwise loosely attached. [Fn301]
Evidence that securitizers do in fact indorse their notes can be found in the case Bankers Trust (Delaware) v. 236 Beltway Investment. [Fn302] in which two general partners of a limited partnership sought to reform a note to avoid personal liability on it, claiming that the loan should have been non-recourse. [Fn303] The trustee of the securitization asserted that it was a holder in due course, and so he took the loan free of any personal defenses such as reformation. The partners furiously challenged the trustee's holder in due course status, claiming that the trustee was not a bona fide holder because (a) the trustee did not have physical possession of the note; (b) the trustee did not acquire the note for value (arguing that the investors paid for the note, not the trustee); (c) the trustee received the note as part of a bulk transfer of 141 mortgages; and (d) since the pooling agreement stated that all of the loans in the pool were non-recourse, the trustee had knowledge of the partners' defense when it acquired the loan. [Fn304]

The court beat back each of these objections to holder in due course status, finding that the trustee did not need to have personal physical custody of the note so long as the note was held by its agent; that the trustee had delivered value for the note by delivering the securities in exchange for the mortgages; that the bulk assignment exception, which denies holder in due course status to a bulk buyer of mortgages, did not apply because the trustee did not receive the note as part of a bulk sale of a portion of the seller's entire assets; and that the information contained in the pooling agreement did not constitute proof of actual knowledge required to disprove the good faith of the holder. [Fn305] In the end, though, the court found that the adjustable rate feature of the mortgage prevented the trustee from being a holder in due course under then-existing Virginia law. [Fn306]

Similarly, in C.W. Haynes v. Midfirst Bank, SSB, [Fn307] the original holder of twenty-one mortgages indorsed them to another mortgage corporation that, after returning four of the loans, indorsed the remaining mortgage notes in blank. The second corporation delivered the mortgages to one of Ginnie Mae's document custodians for pooling in a Ginnie Mae mortgage pool, but never paid the original holder of the mortgages. When the original holder sought to invalidate the transfer to the second mortgage corporation and to Ginnie Mae, Ginnie Mae asserted its status as a holder in due course as a defense. The trial and appellate courts agreed, finding that Ginnie Mae became a holder when its agent received the notes indorsed in blank and that Ginnie Mae gave value for the notes by delivering a security to the other mortgage company. The trial court directly refuted the assertion by many modern academics that the holder in due course doctrine no longer plays a role in the modern mortgage system, stating:

Haynes argues that UCC Article Three should not apply in this case because the rationale underlying the good faith purchaser for value concept (embodied in Article Three as holder in due course) no longer applies in modern day transactions. Haynes contends that this protection is unnecessary in modern day transactions because a merchant can "require the strictest accounting from the person whom he is receiving the instrument." However, Article Three of the U.C.C. controls transfers of negotiable instruments, and the mortgage notes are clearly negotiable. If U.C.C. should not apply in this case and the holder in due course doctrine no longer warrants, then any abolishment of that body of law should come from the legislature, not the court. [Fn308]

In Dupuis v. Federal Home Loan Mortgage Corp., [Fn309] the court also found the holder in due course doctrine to be relevant to securitized loans. There, a homeowner brought suit against Federal Home Loan Mortgage Corp. ("FHCMC"), alleging that the servicer of a pool of loans was an undisclosed agent for FHCMC and had defrauded her by failing to disburse to her the full amount of her loan or to credit her with payments she made to the servicer. The court found that while FHCMC was an undisclosed principal and normally would be bound by the actions of its agent, because FHCMC was a government sponsored entity, an agent could not bind FHCMC beyond the agent's authority. [Fn310] The court also found FHCMC to be a holder in due course, despite the fact that it purchased so many loans from the servicer and made the servicer its agent. Because the servicer was not FHCMC's agent for the purpose of obtaining or closing loans, but just for servicing them, FHCMC held the loan free of any defenses the borrower may
have had against the originator of the loan. [Fn311] These cases illustrate that the holder in due course doctrine still plays an important role in the assignment of risk in the modern mortgage industry. "The holder in due course doctrine is often asserted in consumer transactions, particularly direct loans secured by mortgages," according to a state consumer affairs official. [Fn312]

IV. THE RAPID AND TROUBLING GROWTH OF SUBPRIME LENDING

A. Subprime Lending and Subprime Borrowers

A second major change affecting borrowers recently, in addition to securitization, has been the enormous growth in subprime lending, which has been defined by federal banking agencies as "extending credit to borrowers who exhibit characteristics indicating a significantly higher risk of default than traditional bank lending customers." [Fn313] Any analysis of predatory lending must include a discussion of subprime lending because most predatory lending occurs in the subprime market, which has been called a "fertile ground for predatory lending practices." [Fn314] By comparison, the prime market normally deters predatory lending because it is conducted by such regulated entities as banks and credit unions, as well as through robust competition among lenders, more informed borrowers and simpler, more homogenous loan terms. [Fn315] The number of subprime home equity loans increased thirteen-fold in just six years, from 66,000 in 1993 to 856,000 in 1999, [Fn316] a growth fueled by securitization. [Fn317] Subprime loans are made typically to borrowers with limited or impaired credit histories, or who have a large amount of debt given their income. [Fn318] Some subprime lenders specialize in serving customers who are unable or unwilling to provide credit documentation, such as employment history. [Fn319] Many of the consumers who obtain subprime loans either have fewer credit options than other borrowers or perceive incorrectly (a misperception often created or fostered by a subprime lender) that they have fewer such options. [Fn320] Also, subprime loans include those too small for most prime lenders. [Fn321] Subprime lending is also referred to as "B/C" or "nonconforming" credit, [Fn322] and serves communities that have in the past been under-served by more traditional lenders. [Fn323]

Unlike the prime market, which is typically entered by borrowers seeking either to purchase a home or to refinance an existing loan at more favorable rates, the subprime market is used far more often by borrowers seeking either to consolidate debt or to purchase home improvements or consumer goods. [Fn324] According to a Treasury report, over seventy-five percent of the growth between 1993 and 1998 in subprime lending to low to moderate income borrowers and areas can be attributed to refinancing of existing loans rather than to new loans for the purchase of a home. [Fn325] More than one half of first lien subprime mortgages and up to seventy-five percent of second lien subprime mortgages are used for debt consolidation as well as other consumer credit purpose, and not to purchase the home, for home improvements, or to refinance an existing loan. [Fn326]

Subprime loans are significantly more expensive than prime loans to borrowers, both in terms of interest rates and points and fees. For example, Professor Lesser Mansfield reports that when she reviewed SEC filings for the interest rates of the subprime loans that had been placed in securitized pools, those filings showed an interest rate range of 3% to 19.99% in 1999, with a median interest rate between 11% and 11.99%, much higher than the annualized rate for conventional thirty year mortgages, which averaged 7.43%. [Fn327] Subprime loans also include much higher points and fees than prime loans, averaging ten to fifteen points in fees, or three to five times as much as the three or four points typically charged for
conventional borrowers. [Fn328] The excessive interest rates paid by many subprime borrowers have been documented in a recent study by Freddie Mac researchers, who compared interest rates on loans rated A-minus and originated by subprime lenders with loans rated A-minus by a Freddie Mac underwriting model and purchased as prime loans by Freddie Mac. Despite the identical A-minus rating, the subprime loans averaged 215 basis points higher, 100 basis points of which could not be explained. [Fn329]

Lenders argue that they charge higher interest rates and fees for subprime loans because of the increased risk characteristics of subprime borrowers. [Fn330] Subprime borrowers are more likely than prime borrowers, on average, to be delinquent on their payments, though this increased delinquency is due in part to the higher interest rates and fees charged to subprime borrowers. [Fn331] Market researcher Mortgage Information Corp. reports that at last year's end, the level of subprime loans delinquent by ninety days or more was ten times that of conventional loans, though still only 2.73%. [Fn332] Lenders further argue that subprime loans require increased due diligence costs and that servicing subprime loans is more expensive, both of which drive up the costs that lenders must charge subprime borrowers. [Fn333]

Subprime lending is disproportionately prevalent in low income and minority neighborhoods, being three times more likely in low-income than high-income neighborhoods, and with subprime refinancing five times more likely in predominantly black neighborhoods than in predominantly white neighborhoods. [Fn334] Worse yet, the disparity between the use of subprime lending in black and white neighborhoods is so great that borrowers in high income black neighborhoods relied on subprime refinancing twice as much as borrowers in low income white neighborhoods, with thirty-nine percent of high income homeowners in black neighborhoods using subprime financing compared to only eighteen percent of low income homeowners in white neighborhoods. [Fn335]

This targeting of minority neighborhoods can partially be attributed to the fact that these neighborhoods have been traditionally under-served by prime lenders. [Fn336] By comparison, GSEs such as Freddie Mac and Fannie Mae have the same market share in upper-income black households as they do in the very low-income white market. [Fn337] Historically, the refusal of lenders to provide credit in low income or minority neighborhoods could be explained by the increased cost of obtaining accurate information regarding potential creditworthy borrowers in neighborhoods where they are less likely to be found. [Fn338] However, with the increased ability to obtain inexpensive credit information about borrowers in low income neighborhoods through commercially available and nearly instantaneous credit scoring, combined with the computer enhanced ease of manipulating this flood of data, lenders should be able to find creditworthy borrowers wherever the borrowers live and whatever their race or ethnicity. [Fn339] While the question is contested, current research indicates that credit discrimination against minority borrowers persists. [Fn340]

Subprime lending is also aimed at elder homeowners, many of whom have significant equity in their homes and need funds either for home repairs or for retirement. [Fn341] The ideal customer for a subprime loan has been described as "an uneducated widow who is on a fixed income... who has her house paid off, is living off of credit cards, but having a difficult time keeping up her payments, and who must make a car payment in addition to her credit card payments." [Fn342]

Subprime borrowers are typically less educated than prime borrowers. For example, only thirty-eight percent of subprime loans are taken out by college graduates, while sixty percent of prime loans involve college graduates. [Fn343]

The subprime market has until recently been increasing at a rapid rate, much more rapidly than the remainder of the lending market. [Fn344] Between 1993 and 1998, subprime mortgage refinancing grew
from fewer than 100,000 loans to more than 800,000, while refinancing from prime lenders barely increased. [Fn345] The subprime market has increased its share of all mortgage originations from five percent of all originations in 1994 to almost thirteen percent of all originations in 1999. [Fn346] It is estimated that loan originations in the subprime market have increased from $35 billion as of 1994 to $160 billion five years ***Page577 later, with total outstanding subprime loans of $426 billion at the end of 1998. [Fn347] Half would be categorized as A-, and the other half as B, C and D paper. [Fn348] Most subprime loans are made by mortgage brokers, then purchased by banks. [Fn349]

B. The Causes of Subprime Lending's Increase

This increase in subprime lending can be explained by a number of factors. A primary one is that the existence of ready capital available to lenders through the securitization of subprime loans has dramatically increased their ability to make those loans. Before the 1990s, most subprime loans were not securitized and instead "were sold as whole loans to individual investors" looking for high investment returns and not frightened by substantial risk. [Fn350] After a few successful securitizations of subprime loans, Wall Street quickly grew interested in securitizing subprime loans, initially simply handling the securitization and finding investors, but gradually taking a larger role. Wall Street firms began "making short-term loans to subprime lenders," giving subprime lenders capital to make more loans. [Fn351] In return, the Wall Street firms not only received interest on the short term loans, but also additional fees from the increased subprime securitization. [Fn352]

By 2000, of the roughly $240 billion worth of subprime mortgage loans that were outstanding, about $100 billion, or over one third, had ***Page578 been securitized. [Fn353] Lenders have been able to expand rapidly by making loans and quickly selling them to a securitizer or securitizing the loans themselves, receiving back the principal on the loan while retaining as an immediate profit the lenders' fees and often a portion of the securitized tranches. [Fn354] "These independents, starting out, were doing $50 million in underwriting the first year, $100 million the next, $1 billion the third," said Cary Thomson, CEO of Aames Financial Corporation, a major subprime lender. [Fn355] In this way, a subprime lender can lend far more money during the course of the year than its balance sheet would otherwise make possible. The reliance of subprime lenders on the secondary mortgage market can be seen in the reaction of the subprime market to the 1999 liquidity crisis, which occurred when investors, shaken by Russia's default on its foreign debt, withdrew capital from the subprime market. A number of subprime lenders went out of business, ready to start again at a moment's notice if the market changed. [Fn356]

Another reason for the increase in the subprime market has been the preemption of state usury laws by Congress, primarily by the Depository Institutions Deregulation and Monetary Control Act of 1980 (DIDMCA). [Fn357] In her excellent article, The Road to Subprime "HEL" Was Paved with Good Congressional Intentions: Usury Deregulation and the Subprime Home Equity Market, [Fn358] Cathy Lesser Mansfield traces the enactment of DIDMCA, which its supporters hoped would increase the availability of mortgage funds by buttressing the viability of savings and loans and by allowing mortgage interest rates to be market-driven. [Fn359] DIDMCA preempts state usury ceilings on first ***Page579 mortgage loans that are made by most lenders, such as banks, mortgage bankers, and HUD-approved lenders under the National Housing Act. [Fn360] DIDMCA further preempts state laws by allowing a state-chartered financial institution to export the law of its own state into any other state where it does business. [Fn361] Naturally, this exportation and preemption encourages lenders to be based in states with little or no usury regulation. Although it is not clear that Congress intended to preempt usury laws for non-purchase money loans, the courts have, somewhat grudgingly, concluded that DIDMCA applies to all first position liens, whether or not the loan involved was used to purchase the property securing the loan.
The subprime lending industry’s rapid increase is also due to aggressive advertising by subprime lenders. Mortgage brokers around the country obtain borrowers by bombarding homeowners with loan offers, using telephone calls, door-to-door marketing, or fliers. One homeowner made a common complaint, "I get calls and letters every week. One company contacted me twice in the same day." This aggressive marketing is so effective that it has captured a significant number of borrowers who could have obtained prime loans at much lower interest rates. The exact number of subprime customers who could have obtained prime rate loans is difficult to determine, but the estimates range from a low of ten percent to thirty-five percent to a high of up to fifty percent. Subprime lenders are able to snare prime, creditworthy borrowers in part by contacting homeowners who are not seeking a loan, and then convincing the homeowners to borrow. Once they convince the homeowner to borrow, the broker or lender often labors to increase the amount of the loan, so as to maximize the profit of both the lender and the broker.

Other reasons for the rapid expansion of the subprime market noted by a recent HUD report on predatory lending include: the Tax Reform Act of 1986, which left mortgage interest as one of the few forms of consumer interest that is still tax deductible; the rise in consumer bankruptcy and credit card debt, leaving more potential buyers with troubled credit history; and the increase in subprime first mortgages, instead of the smaller second subprime mortgages that had dominated the market. Since 1999, with the outcry against abusive lending practices, the subprime market has seen a retrenchment, perhaps temporary, with many subprime lenders in bankruptcy and the amount of securitization of subprime loans decreasing.

C. The Links Between the Rise of Subprime Lending and the Increase in Residential Foreclosures

The number of residential foreclosures is increasing at a frightening rate, especially among subprime borrowers. The report "Unequal Burden: Income and Racial Disparities in Subprime Lending" notes that "completed foreclosures in the Chicago area doubled over the five-year period from 2,074 in 1993 to 3,906 in 1998. The increase in foreclosures corresponded to the increase in originations by subprime lenders, which rose from 3,137 in 1991 to 50,953 in 1997." Foreclosures are occurring among subprime loans not only in greater numbers than their prime equivalents, but also much sooner in the life of the loan. For example, recent studies indicate that in Baltimore, foreclosures of loans by subprime lenders occurred on average when the loan was 1.8 years old, as opposed to 3.2 years for prime and Federal Housing Administration ("FHA") loans, a ratio comparable to Atlanta's two years for subprime versus four years for other lenders and Boston's three years for subprime versus seven years for other lenders. Subprime loans account for a vastly disproportionate share of foreclosures compared to their share of loan originations, with the share of subprime foreclosures as much as double the share of the subprime origination. A subprime loan, therefore, is not only foreclosed sooner, but is also much more likely to be foreclosed than a prime or FHA loan. This explosion in foreclosure rates among subprime loans is a national phenomenon, even where the overall foreclosure rate is declining.

Foreclosures cause intense damage to borrower/homeowners completely distinct from the financial effect of losing a house. Homeowners often place a value on their home that is incommensurate with the strict financial value thereof. Their home may be where they raised their family or lived with their
now-deceased spouse. Their house may be the great repository of many of their life experiences and may be the Proust's madeleine to stir their most cherished memories. The loss of the home often creates psychological and emotional havoc in homeowners, especially elderly homeowners who typically have no way of earning enough money to purchase another home. Foreclosure can lead to "sadness, depression, psychological distress, sleep loss, anger, and idealization of the lost home." Someone who loses her house because she foolishly (or through fraud) entered into a loan she could not pay may feel great shame, forever blaming herself for the loss of her home. The shame itself, often felt by elderly victims of fraud, can have a punishing effect. It combines humiliation with a fear by the elderly victim that she has not only lost her home, but could also lose her independence if she is forced to move into a nursing home. Worse yet, foreclosure can lead to homelessness, which, hard as it is on the young, is much more difficult for the elderly.

The secondary loss of foreclosure is not limited to that suffered by the borrowers themselves, but also spreads out in a rippling fashion, affecting the entire community. Chicago's Mayor, Richard M. Daley, described the systemic effects of the foreclosure: We are seeing a pattern in the city and in the suburbs. . . . It's the same story: A family has suddenly abandoned their home. In many cases, it is elderly people who have lived there for many years . . . . Once abandoned, these homes have been taken over by gangs and drug people, and they become breeding places for crime.

Foreclosed homes often stay vacant longer than other homes, with less maintenance, becoming wrecked hulks that are breeding grounds for crime, depressing property values and economic development. Foreclosures on subprime loans have, like the subprime loans themselves, been concentrated in low income and minority neighborhoods.

One cause of the excessive foreclosures associated with subprime lending is that the true cost of foreclosures is not adequately factored into the price of the subprime loan. The borrower typically is ill-equipped to calculate the costs of the foreclosure and so decides whether to enter into the loan transaction without adequate knowledge of the risks of foreclosure and the cost to the borrower of that risk. Borrowers regularly discount risks, such as foreclosure, that they have never experienced, or that are too frightening to contemplate. The lender, on the other hand, is typically fully informed about the risks of foreclosure, especially where those risks are high. Lenders often seek protection from risks by charging higher interest rates or larger fees, which has the ironic effect of increasing the risk of default and making foreclosure more likely by making it more difficult for a borrower to make his mortgage payments. Or, the lender may agree to riskier loans only where the loan to value ratio for the loan is low enough that the lender can recover the full amount of its loan through the foreclosure process. This strategy tends to maximize the borrower's financial loss in cases of foreclosure because the borrower will have more equity in the house to lose, with little chance of recovering any of that equity through the foreclosure process.

These foreclosure statistics do not prove that none of the subprime market is conducted ethically. Given the traditional reluctance of conventional lenders to make loans in lower-income and minority communities, subprime lenders have arguably filled a glaring need, and perhaps have contributed to the recent increase in home-purchase lending in these communities. Even this contribution is disputed, however, as at least one prominent association contends that this increase in minority and low-income home

...
ownership is due more to lending by prime banks covered by the Community Reinvestment Act than to subprime lending, arguing that most of such increase occurred between 1990 and 1995, while subprime surged after 1995. Whatever its other effects, the price paid for this increase in subprime lending so far has been the corresponding increase in foreclosures and the predatory lending that constitutes too large a portion of the subprime market.

V. LEGISLATIVE AND REGULATORY RESPONSES TO PREDATORY LENDING

A. HOEPA and Its Flaws

After the growth of subprime and predatory lending in the 1980s, the outcry led to the passage by Congress of HOEPA: the Home Ownership and Equity Protection Act of 1994. HOEPA is an attempt to regulate high cost mortgages, which are defined in the act as those which meet one of two loan cost triggers, either (a) the annual percentage rate of the loan is more than a certain percentage greater than the yield on Treasury securities with maturities comparable to the loan (the "rate trigger") or (b) the total of all the loan's points and fees payable at or before closing exceed the greater of either $400, annually adjusted for inflation, or eight percent of the total loan amount (the "fee trigger"). HOEPA does not cap fees or interest rates, however, or limit lenders' ability to make any form of equity-based loan. Instead, it is designed primarily as a method of providing additional protections and disclosures to borrowers obtaining high cost loans. The HOEPA provisions cover any lender that originates two or more high cost loans in any twelve month period or that makes one or more such loans through a mortgage broker.

Once the HOEPA triggers have been satisfied, HOEPA mandates disclosures to be given the borrower three business days before the loan is closed, and creates a mandatory three day cooling off period before the consumer can commit to the loan, in order to give the consumer time to seek advice or, perhaps, an alternative loan. The new disclosures are in addition to, and abbreviated from the regular Truth in Lending disclosures and, when combined with the TILA's three day right of rescission, provide the consumer with at least six days to reflect on whether the loan is appropriate. Among the HOEPA disclosures are the annual percentage rate and the monthly payment amounts, as well as a statement in adjustable rate mortgages that the monthly payments and interest rate may increase, and the amount of the maximum monthly payment, in order to prevent the lender from misleading the borrower regarding these amounts through misleading oral representations. The lender must also warn the borrower that if the borrower enters into the loan, the borrower could lose the house securing the loan, and also that the borrower is not obligated to enter into the loan. If the lender fails to provide these disclosures, the borrower has an extended right to rescind, and if the lender fails to honor such a rescission, the borrower may seek remedies that have been described as severe and multifaceted, especially if the borrower is in bankruptcy.

In addition to these additional disclosures and cooling off period, HOEPA prohibits certain lending terms that have been identified to be aspects of predatory lending. For example, HOEPA bars balloon payments in notes with a term less than five years; negative amortization, which would allow the balance owed on the loan to increase rather than decrease; and an increase in interest rates in the event of default by the borrower. HOEPA also bars prepayment penalties unless all of the following conditions apply: (a) the consumer's total monthly debt payments are less than fifty percent of the consumer's monthly gross income; (b) the pre-payment penalty does not apply to refinancing by the creditor.
or its affiliates; (c) the prepayment penalty ***Page586 no longer applies five years after the loan is consummated; and (d) the penalty is not otherwise prohibited. [Fn404]

Creditors are also prohibited from engaging in a "pattern or practice of extending credit" through HOEPA loans "based on the consumers' collateral without regard to the consumers' repayment ability, including the consumers' current and expected income, current obligations, and employment." [Fn405] This last prohibition is designed to prevent equity-based loans that seem designed to cause default by the borrower and lead to foreclosure by the lender.

Should the lender violate HOEPA by inserting the barred provisions described above, such a violation would trigger the extended right to rescind the transaction provided by general Truth-In-Lending law. [Fn406] HOEPA provides that adding a prohibited provision to a mortgage constitutes failing to deliver the material disclosures required by Truth-In-Lending, and therefore, allows a borrower to rescind anytime within three years of the close of the mortgage or before the sale of the property, whichever comes first. [Fn407]

In addition to the new disclosures and cooling off period, HOEPA provides a limited recovery of damages for violating HOEPA's requirements in excess of normal TILA damages, namely damages in an amount equal to all of the finance charges and fees paid by the borrower, unless the creditor is able to prove that its failure to comply was not material. [Fn408]

Most significant, for the purposes of this article, is the attempt in HOEPA to eliminate the holder in due course doctrine in high cost loans. Under HOEPA, any assignee of a high cost loan is subject to all of the claims and defenses the borrower could assert against the original creditor, unless the assignee demonstrates that a reasonable person using ordinary due diligence is unable to determine, based on the required documentation, that the mortgage was a high cost loan. [Fn409] Furthermore, anyone who assigns a high cost mortgage must include a prominent notice of the assignee's potential liability based on the consumer's retention of her claims and defenses under HOEPA, [Fn410] stating "Notice: This is a mortgage subject to special rules under the federal Truth in Lending Act. Purchasers or assignees of this mortgage could be liable for all claims and defenses with respect to the ***Page587 mortgage that the borrower could assert against the creditor." [Fn411] Because HOEPA merely preserves claims rather than creates them, it alone is not the basis of federal question jurisdiction where it is merely preserving state claims. [Fn412] The liability of assignees is limited, however, as "§§ 1641(d)(c) and (3) limit the assignee's liability to, essentially, the greater of (1) the applicable TILA damages or (2) elimination of loan and recovery of all payments made." [Fn413]

Before HOEPA was enacted, mortgage industry critics claimed that it would hurt borrowers by drying up the supply of credit to borrowers with checkered credit histories, and would drive up interest rates to them. [Fn414] Even the Federal Reserve Board criticized the proposed bill, arguing that it would deprive borrowers of needed credit, and that the interest and fee triggers were set too low. [Fn415] Given the dramatic growth in the subprime market since the passage of HOEPA, this early criticism seems wildly off the mark.

Since enacted, HOEPA has been criticized for its ineffectiveness in protecting borrowers. First of all, it has seemed too easy to evade, especially if lenders are willing, as they appear to be, to charge interest rates and fees only slightly below the rate and fee triggers provided by HOEPA. [Fn416] Because the HOEPA triggers are set so high, few subprime customers have received any benefit from HOEPA's provisions. [Fn417] Anecdotal evidence indicates that the types of unscrupulous lending practices that HOEPA was designed to prevent now often occur in loans slightly under the HOEPA triggers, possibly as a result of less
scrupulous lenders shifting to the highest cost non-HOEPA loans. [Fn418] If they do, HOEPA obviously provides the borrower no protection whatsoever, since it does not apply to the loan.

***Page588 Secondly, lenders have been tempted to obtain additional profits outside of the interest rates or fees that would trigger HOEPA. Thus, some are allegedly shifting some of their fees into such forms as credit or loss of income insurance, which have not been included in any HOEPA trigger. [Fn419] Even yield spread premiums, funds paid to brokers to encourage the broker to induce the borrower to obtain a loan at above-market interest rates, may be excluded from the fee trigger. [Fn420] The limitations on points and fees could also be easily circumvented by more rapid flipping of the loan, since the fees on the earlier loan do not apply to the determination of whether the second loan is a high cost mortgage. [Fn421] Therefore, a lender could charge a 7.5% fee three separate times in rapid succession for three different loans, collecting fees totaling well over 20%, without exceeding the 8% fee trigger.

It has been very difficult for individual borrowers to show that lenders have engaged in a "pattern and practice" of making loans based solely on equity while ignoring the borrowers' ability to pay. One court to address the level of proof needed to show a pattern and practice of equity-based lending has concluded that such proof would require "a representative sample of [the lender's] loans analyzed empirically and cannot be inferred from the examples selected by plaintiffs," calling this proof requirement an "admittedly heavy burden on consumers." [Fn422]

To alleviate these problems, the Federal Reserve Board has adopted amendments to the provisions of Regulation Z, which implements HOEPA. These amendments, effective December 20, 2001 with compliance mandatory October 1, 2002, seek to tighten up HOEPA by doing the following: The APR trigger for first-lien mortgage loans is reduced from ten percentage points to eight percentage points, though the APR trigger for subordinate lien loans remains at its original ten percentage points. [Fn423] The fee trigger is changed to include optional insurance, such as credit life, health, accident, or loss of income insurance, as well as other debt-protection products financed by the loan. [Fn424] These changes should make more loans subject to HOEPA protections, especially first lien mortgages packed with insurance products. The amendments to Regulation Z also are intended to reduce "flipping" by prohibiting an originating lender, a servicer, or an assignee from refinancing a HOEPA loan into another HOEPA loan within twelve months of the first loan's origination, unless it is in the best interest of the borrower. [Fn425]

While these provisions should make HOEPA more effective by including more loans under its ambit and reducing some pernicious practices, HOEPA still has significant shortcomings. Lenders can avoid the effect of the limitation on short term balloon payments by writing loans with longer balloon terms, then contacting their borrowers after a year and suggesting that the borrower refinance the loan and obtain a new loan without a balloon payment. Thus, the lender obtains the primary advantage of a balloon payment, which is the points and fees of the refinance, without even having to wait for the term for the balloon payment to come due. [Fn426]

An even less scrupulous lender can purport to abide by the HOEPA disclosure process by backdating the required disclosures, while having them signed at the time the loan closes. [Fn427] One court noted that the failure to provide HOEPA mandated pre-closing disclosures "appears to be a prevalent practice in the industry." [Fn428]

The very complexity of HOEPA, daunting as it may be for lenders, provides them with a defense against its enforcement. [Fn429] It is often difficult to determine whether a particular loan is or is not a HOEPA loan, as that identity may turn on whether a particular cost or charge associated with a loan should be included in the fee trigger. For example, whether a particular charge such as an appraisal fee should be
included in the fee trigger depends on whether the charge is "reasonable," which may be difficult to pin down; whether the charge is paid to a third party unaffiliated to the creditor; and whether the creditor receives ***Page590 any direct or indirect compensation for the charge. [Fn430] All of these are factual questions that would be difficult for anyone but the lender to answer. Similarly, whether a particular prepayment fee is barred or not depends on the potentially difficult calculation involving determining the exact amount of the consumer's total monthly debt payments and monthly gross income to determine the ratio thereof. [Fn431] The complexity of these issues and the difficulty of determining whether a loan is even covered and whether certain practices are allowed or barred by HOEPA dramatically decrease the likelihood that HOEPA will be understood or used by private practitioners representing individual borrowers. [Fn432] Furthermore, the complexity makes it difficult for judges or arbitrators to understand and apply HOEPA and to enforce the protections that it is supposed to apply. [Fn433]

This complexity also limits the ability of purchasers of loans to determine whether they are purchasing HOEPA loans, leaving purchasers more likely to buy HOEPA loans inadvertently. This inadvertence harms borrowers more than the purchasers, however. The assignees of the loan can claim that, because they could not determine whether the loan was covered by HOEPA, the provisions of HOEPA that would normally preserve borrower defenses do not apply to the assignees, since the assignees of the loan could not have determined, using ordinary due diligence and based on the required documentation, that the mortgage was a high cost loan. [Fn434] The very complexity of HOEPA and the difficulty of determining whether a loan is covered ***Page591 by HOEPA therefore protects the purchasers of loans at the expense of the borrowers.

Most damning, perhaps, is the fact that HOEPA's effect on purchasers of a high cost loan depends on the honesty of the originator of the loan, since HOEPA does not provide liability to assignees unless they reasonably and using ordinary due diligence could have determined that the loan was in fact a HOEPA loan. The lender's determination of HOEPA status should be based on the documentation supplied by the originator and required by TILA and HOEPA, the itemization of the amount financed, and the disclosed disbursements. [Fn435] In other words, if the originator of a high cost mortgage fails to include in the mortgage a notice of potential liability to assignees and also falsifies the disclosures and disbursements so as to conceal the points, fees, or interest rate that would trigger HOEPA, then an assignee takes the mortgage free from any claims and defenses that HOEPA may have provided the borrower.

HOEPA provides no protection if the disclosures hide the high cost of the loan even if, for example, the loan broker does not disburse any of the loan proceeds to the client, keeping it all for himself, as was done in the Diamond/Obie case and in the more recent Tri-Star/Polo Financial fraud. [Fn436] In the Tri-Star/Polo case, the mortgage broker, operating through a rent-a-broker, was accused of stealing the proceeds of its customers' loans and even stealing title to its customers' homes, forging documents where it would further the fraud. [Fn437] Tri-Star/Polo was accused of failing to disclose to purchasers of numerous of its loans all of the initiation, escrow, and closing fees that it charged its borrowers, thus preventing the purchasers of the loan from being able to calculate the total fees, a calculation necessary to determine whether the loans are above HOEPA's fee trigger. [Fn438] One purchaser alone may have found itself holding over $20 million in fraudulent loans generated by Tri-Star/Polo. [Fn439] Thus, the HOEPA protections are least effective where they are most needed, when a borrower is faced with an intentionally dishonest and deceitful broker and lender, ***Page592 rather than merely one who honestly charges high interest or fees. [Fn440] HOEPA primarily deters the honest predatory lender. [Fn441]

B. The Growth, Success, and Bankruptcy of First Alliance: a Post-HOEPA Predatory Lender
Held Up in Due Course: Predatory Lending, Securitization, and the Holder in Due Course Doctrine, 35 Creighton L. Rev. 503 (2002)

HOEPA's failure, at least until the Federal Reserve Board's recent amendments to Regulation Z become mandatory, can be documented by the continuing cases of predatory lending that have occurred despite its passage. The most notable example, what has been called a "central symbol of predatory lending practices," is the rapid rise, great profitability, and unexpected bankruptcy of First Alliance Mortgage Corp., based in Irvine, California. [Fn442] First Alliance began its life as a small consumer finance lender, founded in 1971 by Brian Chisick and his wife, Sarah. [Fn443] It began growing after Congress preempted usury limits. In 1987, the financial world was alerted to First Alliance's unseemly lending practices. That year, a jury awarded over a million dollars to an elderly couple who stated that they had been deceived into entering into three sequential loans, each demanding balloon payments, with the final loan requiring monthly payments of $400 even though the lender knew the couple's entire monthly income was $500 in Social Security payments. [Fn444] By 1988, First Alliance had become one of the five largest consumer finance lenders and had lent more than $65 million, according to a California deputy attorney general.

In 1988, California attempted to revoke First Alliance's licenses based on allegations that it discriminated against minorities both in aggressive direct mail and radio advertisements, according to the suit, and the state regulators sought to have that advertising stopped. [Fn446] The state also alleged that the balloon payments First Alliance used were designed to force borrowers to incur new origination fees of up to twenty-one percent to refinance when the balloon payment became due. [Fn447] The judge in the action enjoined First Alliance from engaging in discrimination, but refused either to shut First Alliance down or to force it into a receivership, as requested by the state. [Fn448] First Alliance settled the case, agreeing to pay $436,000 and to send its employees to "sensitivity training classes." [Fn449]

First Alliance Mortgage had been selling all of its loans as whole loans, but in 1989 began exploring whether it could securitize its loans to increase its profits over selling the loans individually. [Fn450] First Alliance securitized its first loan in March 1992, privately placing a $10.5 million securitization. [Fn451] In August 1993, it consummated its first public home equity loan asset-backed securitization, a $56 million dollar pool of home equity loans. [Fn452] With the access to capital markets provided by the securitization conduit, First Alliance grew rapidly and, in less than a year, expanded from originating $100 million to originating $400 million in loans. [Fn453]

Even as First Alliance was expanding, complaints regarding its lending practices continued. In 1994, a class action suit alleging that First Alliance fraudulently concealed its excessive and unwarranted fees from borrowers was reportedly confidentially settled, without acknowledgment of liability, for an amount greater than $6.8 million. [Fn454] The state of Washington investigated consumer complaints against First Alliance, including the complaint of one borrower that her loan fee was seventeen percent of her loan amount, and of another borrower that she discovered that her $59,238 loan carried an $11,632.49 fee. [Fn455] These complaints did not deter the husband and wife founders and owners of First Alliance, as they designed a public offering for First Alliance that apparently included plans to pay them between $43 million and $47 million of the proceeds from the offering. [Fn456] The public offering netted $59.5 million [Fn457] and the founders received a reported $45 million. [Fn458] First Alliance's retail loan origination continued growing at a scorching pace of thirty-one percent annually and, by 1997, it had twenty-five branches in places as far from its California base as Boston, Pennsylvania, and the United Kingdom. [Fn459] As of 1997, First Alliance had originated over $1 billion in home equity loans, made possible through securitization. [Fn460]

Part of First Alliance's growth was due to its sales agents and their specialized training. According to an ex-sales agent, First Alliance hired crack used car salesmen, who were comfortable with high pressure sales...
tactics but tired of the long weekend and evening hours spent on used car lots, [Fn461] then put them through a three month training regimen, requiring the memorization and constant practice of a 134-step sales pitch, which was constantly rehearsed in front of peers and on videotape. [Fn462] The sales agents were reportedly taught to extract as much personal information as possible from potential customers, then use that information to manipulate the customer into agreeing to the loan, all the while attempting to hide First Alliance's high fees by such tactics as claiming that the disclosure of the fees was just "loan jargon" that the customer need not be concerned with. [Fn463] First Alliance targeted customers with significant equity in their homes, but who seemed likely, because of prior credit problems or lack of significant credit history, to have limited access to credit from conventional lenders. [Fn464] After they identified these potential borrowers, the agents hounded them with a fury, mailing over 1.5 million solicitation ads monthly, and using computerized dialers to solicit targeted homeowners, often the same ones over and over, as well as the company's existing borrowers. [Fn465]

Worse yet, First Alliance has been widely accused of engaging in outright deception and openly lying to its customers about the amount of fees it would charge them and the amount of the loan that would encumber their homes. In one case, a homeowner reportedly recorded a First Alliance sales agent who expressly lied to her, and when she asked him if there would be $13,000 in fees added to her loan of about $46,000, the loan agent replied, "No, no, no" even though "the answer should have been 'yes, yes, yes.'" [Fn466] The sales agent, when interviewed, said he was merely following the script First Alliance taught him to follow, according to published reports. [Fn467]

Using high pressure, allegedly deceptive sales tactics allowed First Alliance to charge sales fees of reportedly up to twenty-three percent of the loan amount, even though the industry wide standard was about five percent. [Fn468] First Alliance was said to have had charged the same high fees whether the borrower had good or bad credit, demonstrating that its sales tactics had succeeded in allowing First Alliance to ignore the market rate for the credit it was supplying. [Fn469] First Alliance's fees were "just so excessively high that it's hard for me to conceive of any way a consumer would agree to that kind of loan if all the facts have been put before them," asserted a Florida assistant attorney general. [Fn470]

In 1997, First Alliance was sued for allegedly defrauding several elderly (and some less elderly) homeowners through trickery, including a suit by a seventy-six year old woman who alleged that she wanted only a $5,000 loan for plumbing repairs, only to find herself saddled with two loans totaling more than $61,000 with $16,000 in fees after the loan broker covered up parts of the documents and failed to make proper disclosures to her. [Fn471] At about the same time First Alliance was being sued and receiving increasingly widespread newspaper reports of its disreputable lending practices, [Fn472] First Alliance reported that its net income for the first six months of 1997 was $15.6 million, a 54% increase over the year before. [Fn473] Despite the bad press and lawsuits, First Alliance was able to sell its mortgages through repeated securitizations [Fn474] and, in early 1998, it was touted by stock analysts as a "tightly run ship" and praised for its conservative approach and sound fundamentals. [Fn475]

When criticized for charging its customers excessive, unconscionable rates, First Alliance defended itself by claiming that the low credit ratings of its borrowers made loans to them risky, and that it had to charge them high rates to cover that risk. At the same time, however, in documents that it prepared for investors in its securitized loans, First Alliance reportedly averred that over three-fourths of its loans are made to borrowers with relatively good credit records. [Fn476]

The first significant chink in First Alliance's armor appeared in May 1998, when the American Association of Retired Person ("AARP") joined in a $50 million lawsuit accusing First Alliance of targeting elderly homeowners and using aggressive telemarketing and direct mail advertising, along with
concealing loan amounts to coerce borrowers into entering into loans with origination fees that averaged approximately fifteen percent of the loans, in order to strip the elderly homeowners' equity from them. [Fn477] Sharp lending practices had apparently become a family business, as two loan brokerage companies owned by three sons of founder Brian Chisick were investigated by Washington and Oregon regulators to examine allegations of deceptive lending practices. [Fn478]

First Alliance attempted to defend itself from litigation by inserting a mandatory arbitration clause into its lending contracts. [Fn479] Such arbitration clauses helped First Alliance in several ways. [Fn480] First of all, arbitration typically proceeds privately, appeals are severely limited, and the arbitration is unlikely to result in a published opinion. [Fn481] Therefore, even if First Alliance were to lose the arbitration, knowledge of that loss was much less likely to reach the investors in First Alliance's securitized loans, preserving First Alliance's access to the secondary market. [Fn482] Secondly, arbitration often limits the amount of discovery that a party can conduct, effectively preventing borrowers from proving that First Alliance had a pattern and practice of lending to borrowers without a reasonable likelihood of the borrower being able to repay the loan, and of showing that First Alliance engaged in widespread conduct similar to that alleged by the individual borrower. [Fn483] Arbitration clauses would also make it much more difficult for one homeowner to employ offensive collateral estoppel and attempt to use in one case a finding in a separate case that First Alliance's methods constituted fraud, since it would not have access to a published opinion to learn the result of the arbitration. [Fn484] Finally, arbitration clauses make class action suits much more difficult to prosecute. [Fn485]

Despite First Alliance's efforts to limit the effectiveness of borrower litigation against it, the lawsuits and publicized allegations of dishonest lending finally began to affect First Alliance. Its stock, which had traded at over $24 per share in late 1997, dropped to less than $3 in interday trading in October 1998, before First Alliance announced that the Justice Department and seven attorneys general had opened investigations of its lending practices. [Fn486] In November 1998, Minnesota sued First Alliance, charging it with deceptive practices, including intentionally trying to hide its unconscionable fees and monitoring borrowers' conversations through hidden microphones after the First Alliance agents had left the room. [Fn487] In late 1998, Massachusetts and Illinois also sued First Alliance based on allegations it intended to deceive borrowers regarding its high fees. [Fn488] These suits were followed by a nationwide class action accusing First Alliance of hiring former used car salesmen to pressure its borrowers to accept loans with hidden fees and "exploding" interest rates. [Fn489]

Despite all of its well-publicized legal problems, First Alliance continued to securitize its loans, successfully completing a securitization of $120 million in mortgage backed loans in December 1998. [Fn490] An industry publication anticipated that securities backed by First Alliance's notes would be rated AAA by two rating services long after any knowledgeable observer should have been well aware of the extensive allegations of fraud and deception by First Alliance in creating its pools of loans. [Fn491] In February 1999, a California court of appeals, in an unpublished opinion, reportedly ruled that the signatures of an elderly couple on a form waiving the right to file lawsuits had been "obtained by fraud" and said that First Alliance had "trained its employees to use various methods, including deception, to sell its services." [Fn492]

In March 1999, First Alliance's parent corporation announced that First Alliance had completed a $115 million securitization. [Fn493] In June 1999, First Alliance announced it would begin a web site to lend on-line. [Fn494] In September 1999, it announced that it had settled the action by the State of Minnesota for $50,000. [Fn495] Despite its legal problems throughout 1999, First Alliance's income for the year was still an astonishing $484 million, only $50 million less than during 1998. [Fn496] By 1999, First Alliance, including its affiliated organizations, serviced nearly $900 million in loans and had licenses in
eighteen states and the District of Columbia. [Fn497] Even in early 2000, a spokesman for Lehman Brothers defended First Alliance's lending practices, [Fn498] apparently trying to justify the more than $2 billion in loans by First Alliance that Wall Street firms had securitized, and Lehman's involvement with First Alliance. [Fn499] Lehman's spokesman claimed that Lehman officials somehow believed that First Alliance had improved its efforts during the last eighteen months to prevent lending abuses. [Fn500] In private memos, Lehman apparently had a different view of First Alliance. According to published reports, a Lehman executive writing of First Alliance, stated "It is a requirement to leave your ethics at the door." [Fn501] Lehman helped First Alliance securitize its loans even though Lehman reportedly acknowledged that it was fully aware of First Alliance's legal problems. [Fn502]

On March 23, 2000, First Alliance pierced this balloon, announcing that it had stopped making new loans and that it had filed bankruptcy under Chapter 11. [Fn503] First Alliance's founder claimed that the filing was due to the "unfair and inaccurate stories [that] have devastated the company's 30-year reputation and acutely hindered the company's relationships with businesses, consumers and regulators." [Fn504] This bankruptcy filing may have come as a shock to the investors in First Alliance's securitized loans, given First Alliance's apparent assets and the information that had been provided to them. [Fn505] Some have speculated that, rather than being a sign of current financial distress, the bankruptcy petition may have been part of a strategy by the company to stymie the litigation against First Alliance while protecting the value of the corporation to its shareholders. [Fn506]

***Page601*** After First Alliance filed bankruptcy, two more governmental actions were filed against it: the first in June 2000, by the state of Florida against First Alliance and some of its officers and employees, based on alleged fraud and violations of a Florida unfair business practices statute; the second in October 2000 by the FTC, based on alleged violations of the Federal Trade Commission Act, 15 U.S.C. §§ 45(a) and 53(b), the federal Truth in Lending Act ("TILA"), 15 U.S.C. § 1607(c), and Regulation Z, 12 C.F.R. § 226, which implements TILA. [Fn507] Both suits sought rescission of homeowners' loans and disgorgement of money, either based on borrowers' damages or First Alliance's unjust enrichment. [Fn508]

As a result of First Alliance's bankruptcy, the borrowers it victimized are unlikely to collect much for the harm they received. Because of its former great profitability, First Alliance, even in the midst of bankruptcy, has been able to hire the most expert and capable legal representation, at significant expense, to defend itself from its victims' claims. [Fn509] This legal talent for a time had significant success in defending First Alliance from class claims by borrowers. For example, in one bankruptcy ruling, at which First Alliance was represented by a nationally prominent law firm, the bankruptcy judge refused to allow class proofs of claims on behalf of certain borrowers, eliminating in a stroke hundreds of millions of dollars in claims against the bankruptcy estate of First Alliance. [Fn510] The judge also barred the prosecution of class action lawsuits against First Alliance, and threw out AARP's action against First Alliance based on California's unfair and deceptive practices law. [Fn511] Later, these rulings were overturned by a federal district judge. [Fn512] As of the time of this writing, First Alliance has reportedly settled many of the claims against it for either $60 million or $95 million without admitting any wrongdoing. [Fn513] According to published reports, as part of this settlement, the borrowers were required to waive their right to cancel their outstanding loan. [Fn514] Despite the funding they provided First Alliance, it appears that the investors in the mortgage pools will be able to retain their interest in the loans originated by First Alliance and the excessive interest rates that the loans generate. By protecting the secondary market investors from liability for purchasing First Alliance's loans, the settlement encourages further investment in loans originated by shady originators.

First Alliance successfully engaged in its predatory practices despite the protections of HOEPA in two ways. First of all, it has allegedly failed to provide timely HOEPA disclosures to at least some of its
borrowers, which would deny them the additional time to investigate the loan and discover its terms before being bound by the loan. [Fn515] Secondly, the secondary markets were not as attentive as they should have been to how many HOEPA loans a particular lender was securitizing. Lenders have not been required by law to disclose to a rating agency or securitizer how many HOEPA loans are included in a particular loan pool. [Fn516] Until recently, underwriters and rating agencies have been surprisingly lax about determining how many HOEPA loans are in a pool, given that the presence of HOEPA loans is an indication of potential predatory loans and that the holders of HOEPA loans do not have holder in due course protection. Even in its November 2000 draft memorandum on "How to Avoid Purchasing or Investing in Predatory Mortgage Loans," the FDIC does not advise banks to determine how many HOEPA loans are in a mortgage pool before investing in securities related to that pool. [Fn517]

This laxity may be explained in part by the low percentage of all subprime loans HOEPA affects, including an estimated one percent falling under the APR trigger. [Fn518] Therefore, the ratings agencies and underwriters may have concluded initially that they did not need to exclude HOEPA loans from securitizations or treat them much differently than non-HOEPA loans because there were so few of them. Also, ***Page603*** some participants in the secondary market may not have realized that HOEPA actually eliminates the holder in due course doctrine in high cost loans. [Fn519] Given the huge profit that Wall Street was making on the securitization of subprime loans, the firms may have, intentionally or unwittingly, turned a blind eye to the problems potentially associated with securitizing HOEPA loans. Wall Street's attention has been captured, however, by a class action lawsuit against Lehman Brothers, alleging that it is liable for First Alliance's wrongdoing, given Lehman's participation in First Alliance's securitization of loans. [Fn520] It appears that only by holding the securitizers and purchasers of the loans generated by a predatory lender liable for the harms caused by that lender's activities can those investors and securitizers be convinced to stop dealing with unscrupulous lenders.

A lender's ability to evade liability for fraudulent or deceptive conduct through bankruptcy, when combined with the holder in due course doctrine, prevents borrowers from seeking recovery either from the predatory lender or from the purchaser of the loans. [Fn521] Like First Alliance, most of the leading subprime lenders have filed for bankruptcy since the great liquidity crisis of October 1998, leaving a vast number of subprime borrowers without any remedy for fraud or deception. [Fn522]

First Alliance is hardly alone among leading subprime lenders in its use of predatory lending tactics. Associates First Capital Corporation, as late as last year one of the nation's largest subprime lenders, was charged by the FTC in 2001 with actively misleading borrowers in order to induce them into accepting loans with high interest rates, costs and fees, and high priced credit insurance, in violation of the Federal Trade Commission Act. [Fn523] Jodie Bernstein, directory of the FTC's Bureau of Consumer Protection, claimed that "The Associates engaged in widespread deceptive practices . . . . They hid essential ***Page604*** information from consumers, misrepresented loan terms, flipped loans and packed optional fees to raise the costs of the loans." [Fn524] Associates was acquired by Citigroup in 2000 for about $31 billion. [Fn525] In September 2001, Citigroup Inc. reportedly agreed to pay up to $20-million to settle a claim brought by the North Carolina attorney general, separate from the FTC action. [Fn526] The FTC began actions against fifteen different subprime lenders from 1998 through mid-2001. [Fn527]

C. State and Local Efforts to Patch HOEPA

HOEPA is far from the only legislative or agency response to predatory lending. In fact, by the close of the 106th Congress, four separate bills designed to combat predatory lending (one introduced separately in the House and the Senate) were referred to committee. [Fn528] At least thirty-one states, as well as
numerous cities and counties, have introduced varied bills seeking to rein in predatory or improper lending. [Fn529] North Carolina became the first state to enact a statute attacking predatory lending, a statute that goes beyond HOEPA by, among other things, prohibiting flipping and limiting brokers fees. [Fn530] North Carolina has since been joined by Massachusetts, New York, and the City of Chicago, among others. [Fn531] Even Fannie Mae announced loan purchase guidelines designed to combat predatory lending. [Fn532] A full description of the numerous proposals to attack predatory lending currently in play is outside of the scope of this article, and in fact would require an easily updated web page to avoid being out of date nearly instantaneously. [Fn533]

This plethora of legislation and ordinances is obviously well-intentioned, given the obvious flaws in HOEPA. However, at least one critic has argued that too many forms of lending regulation could drive up the cost of credit and harm the very low income borrowers the regulation is intended to help. [Fn534] This critic notes that this would be especially true if the penalties for predatory lending are severe and local standards defining "predatory lending" are so vague that a lender cannot reasonably determine whether the loan it is considering funding is in fact predatory. Some lenders are claiming that local action to attack predatory lending will cause lenders to forego making subprime loans in such jurisdictions entirely, [Fn535] but this claim appears to be wildly exaggerated. [Fn536] In addition, a widely varying mosaic of laws and ordinances designed to combat predatory lending can drive up the cost of borrowing by charging the lender with the task of keeping track of not only the federal rules, but also the various rules in the many cities, counties, and states where the lender does business. [Fn537] This burden would be imposed not only on the original lender, but also on any potential assignees of the loans, and may make it more difficult to securitize even legitimate, non-predatory subprime loans.

Perhaps more importantly, the lending industry may attempt to use some anti-predatory lending law to weaken, rather than strengthen, the other rules that might prevent such lending. For example, California recently passed a bill designed to curb predatory lending. [Fn538] California's Act does have some good features, such as barring, for loans covered by the bill, prepayment penalties after three years from the loan's origination, [Fn539] negative amortization for junior loans of any duration, [Fn540] loans made with no expectation that they can be repaid, [Fn541] and loan steering, which is the directing of borrowers to loans that have higher costs than other loans the borrower would be eligible for, or the steering of borrowers by mortgage brokers to lenders who would charge the borrower more than would other lenders with whom the borrower does business. [Fn542] Among the remedies the Act supplies is the ability of a court to reform the note to remove any barred term. [Fn543] The Act's main defect is that it accomplishes too little and explicitly does not apply to holders in due course. [Fn544] No doubt, purchasers of predatory loans will claim to have taken them free of any claim based on this Act, and so would argue that a court could not order reformation of a note under the Act once the note is held by a holder in due course.

By comparison, the Oakland City Council passed a much tougher ordinance to deter predatory lending. [Fn545] This ordinance bars some practices on all loans in general, limiting the amount of prepayment penalties, even within the first three years, and barring lenders from financing credit insurance and from encouraging a borrower to miss a payment on an existing loan. [Fn546] The ordinance is even stricter regarding high-cost loans, as defined by the ordinance. Lenders may not make high cost loans without receiving a certification that the borrower received home loan counseling, may not charge any prepayment penalties on high cost mortgages, may not refinance any loan with a high cost loan unless the borrower receives a benefit, and cannot refinance a subsidized or below market rate loan with a high cost loan, unless an independent counselor has determined that the borrower would be best served by such a refinance. [Fn547] Most importantly, the ordinance specifically applies not only to the originators of the note but also to any assignees or purchasers, abrogating the holder in due course doctrine as to this
ordinance. [Fn548] In response to the Oakland ordinance, a lender trade association has sued Oakland, to prevent its ordinance from being enforced, arguing that the ordinance is preempted by state law. [Fn549] The association is attempting to use weaker state law to defeat stronger local law.

VI. THE CASE FOR ELIMINATING THE HOLDER IN DUE COURSE DOCTRINE FOR ALL NON-COMMERCIAL LOANS

With the rapid growth in subprime and predatory lending and the securitization of subprime loans, the subprime industry greatly resembles the consumer credit industry of the 1970s before the FTC eliminated the holder in due course doctrine for that industry through its regulation. There is a similar victimization of consumers by fly-by-night dealers who immediately assign their credit instruments to other business entities. Now, instead of home improvement contractors fleecing customers with shoddy siding, then selling their credit instruments to finance companies, mortgage brokers are tricking borrowers into signing overpriced and inappropriate loans, then selling those loans to securitizers. Too many mortgage brokers have adopted the sleazy techniques of used car salesmen or fly-by-night home improvers, even going so far as to hire the used car salesmen directly. Like their dishonest predecessors, they are promising goods or services that are either never delivered or are delivered in a way contrary to the representations made to the borrower. And they are employing high pressure sales tactics, misrepresentations, and outright fraud.

The FTC acted because finance companies claimed holder in due course status even though they bought retail installment contracts regularly from the same unscrupulous contractors and merchants. Now, the secondary market and the Wall Street securitizers are dealing over and over with the same particular shady originators of the credit instruments, only to claim ignorance of the originators’ fraud and to rely on the status as holder in due course as protection for their investors when the borrower objects to the deceit and unfair practices used by the originators. [Fn550]

Courts and legislatures have responded to predatory lending much as they did to predatory home improvers and retail merchants. Courts are giving individual relief to some borrowers but cannot create uniform rules that protect all borrowers. At the same time, the states and local governments have developed an increasingly complicated, patchwork response to the problem, just as states once acted independently to stop fraudulent retail credit practices before the FTC stepped in. [Fn551] These local responses, however, do not address the core problem, which is that the buyers of predatory loans bear too little risk of loss for fraud and misrepresentation committed by the originators of those mortgages.

The surest solution to the problem of predatory lending is to force the markets that fund subprime lenders to police those lenders, and the surest way to force this private policing effort is to ensure that the buyers of predatory loans bear any risk of loss associated with the sharp practices by the lender, rather than having that loss borne by the borrower. Actions by regulatory agencies or prosecutorial bodies, though helpful, are too slow, as it can take months if not years before a regulatory body even notices a mortgage broker’s deceptive practices. [Fn552] As demonstrated in the cases of First Alliance, Diamond/Obie and Polo/Tri-Star, cited supra, it takes too much time for the regulator or prosecutors to discover that a particular broker or lender is engaging in fraudulent practices, then even more time to gather the evidence and engage in the due process required to strip the lender of its licenses, enjoin the behavior, or prosecute the lender criminally. Only the purchasers of the loans have the ability, described below, to create an early warning system to detect the presence of improper loan practices and to stop the brokers responsible by cutting off the brokers’ supply of funds available to close any additional loans. [Fn553]
Because the best way to encourage the purchasers of loans to cut off the predatory lender's supply of capital is to force those purchasers to bear the risk of the fraudulent or misleading practices of that lender, the problem of predatory lending calls for the elimination of the holder in due course doctrine in all loans secured by residences of the borrowers. The effectiveness of this elimination can be seen through an economic analysis of the holder in due course doctrine, which demonstrates that this doctrine is inefficient when applied to non-commercial loans, such as residential mortgages, because it prevents borrowers from effectively determining the cost of their loans, and because it discourages the actors most able to prevent loss caused by a dishonest loan originator from engaging in the loss-prevention monitoring that is needed to prevent predatory lending.

A. The Holder in Due Course Doctrine Is Inefficient Because It Prevents Informed Decision-Making by Borrowers

The holder in due course doctrine is inefficient and harms borrowers by making it more difficult for them to determine whether a particular loan is in their best interest. Assuming that each party is acting in his or her own self-interest, neither the drawer nor the payee of the negotiable instrument would likely engage in the creation of that negotiable instrument unless each believed that the creation, including its attendant transaction costs, would benefit them, or at least not cause them any harm. If this transaction benefits each of its participants or least benefits some and does not harm the others, then the transaction would be efficient, producing a net good. Indeed, unless third parties are somehow injured by the creation of the negotiable instrument, the transaction would meet the more rigorous standard of Pareto Superiority, which is satisfied if a transaction benefits every party affected by it, or at least leaves them no worse off. If third parties are somehow harmed, the creation of the negotiable instrument could still be efficient if judged by the less rigorous standard of Kalder-Hicks efficiency, the more commonly applied standard that would require only that the benefit to the transacting parties exceeds the detriment to any third parties.

To determine whether creating the negotiable instrument would benefit them, each transacting party should have sufficient information to determine the value of the creation of the negotiable instrument to that party, which would require each party to be reasonably well informed regarding the potential benefits and costs before making the exchange.

Whether an instrument is negotiable is an important element of the value of that instrument to the maker, to determine the assignment of risk and the resulting costs of the loan to the borrower. The borrower would need to factor in the risk assigned to him, as well as the costs of additional precautionary measures the borrower would have to undertake because of the assignment of risks. Only if the borrower understands this risk and the attendant costs will the borrower know what terms he should demand, either in interest rate or other terms, in order to insure the loan will actually benefit him. Understanding the assignment of risk will also help the borrower determine to what extent he should discount any representations made to him by the originator of the loan, given that any defenses he might acquire based on those representations could be almost immediately cut off if the other party transfers the instrument. If borrowers are unable to understand how the holder in due course assigns risk, they cannot make sure that they will enter into only loan agreements that benefit them, and those agreements may cause more harm than good.

Whether the holder in due course doctrine applies to a particular loan, what its legal effect would be, and the magnitude of the risk of fraud or loss that it assigns are all essential pieces of information for any borrower, especially a subprime borrower concerned about predatory lenders. Before a borrower enters into a loan, she should know how the risk of loss would be assigned if, for example, she did not receive the
mortgage proceeds because of a dishonest broker's conversion. The holder in due course doctrine effectively prevents borrowers from obtaining this information, however, because it is so little known. As noted by Lary Lawrence, "No one except a student of Article 3 would know that the difference between a non-negotiable and a negotiable instrument is the use of a magical word like 'bearer,' 'order,' 'cash' or 'exchange.'" [Fn560]

The holder in due course doctrine is not only little known by non-commercial borrowers, it is unfairly difficult for them to learn and understand. [Fn561] The holder in due course doctrine is counter-intuitive, in that it would not occur to the average borrower that her legal rights could be affected by the lender merely assigning her loan. [Fn562] Consumers are little used to contracts that assign them the risk of loss due to the fraud of a seller, and so would not expect that the loan agreement would do so. [Fn563]

To understand the holder in due course doctrine and its potential effect, a borrower would first have to understand that a gap-filling term not in the contract but instead provided by operation of law could determine whether the borrower or the purchaser of the loan bears the risk of loss caused by a lender's dishonesty. Next, the borrower would have to realize that the holder in due course doctrine assigns such risk of loss to him, unless he can demonstrate one of the so-called "real defenses." Then, the borrower would have to understand when the holder in due course doctrine is abrogated, for example by TILA, by HOEPA, or by the FTC Holder in Due Course Rule. Next, the borrower would have to determine the amount of risk that the holder in due course doctrine is likely to assign, which would require an assessment of the likelihood of the lender engaging in sharp or dishonest practices and the potential harm that those practices could cause.

This kind of understanding, information gathering, and risk assessment, the doctrine's "cognitive load," [Fn564] is clearly beyond the capabilities of all but a minute fraction of non-commercial borrowers, but without such understanding, subprime borrowers dealing with under-regulated mortgage brokers are likely regularly to enter into loan agreements embodied by negotiable instruments that harm rather than help them. [Fn565] Non-commercial borrowers are bound by that negotiability, regardless of their ignorance of it or the harm that it might cause them.

B. The Holder in Due Course Doctrine's Assignment of Risk Encourages Fraud

Another way to consider the effect of the holder in due course doctrine is to think of it not so much as a negotiation issue, or part of the formation of the contract, but rather as a question of how to allocate certain types of loss caused by fraud, misrepresentation, or conversion. One of the primary purposes of the holder in due course doctrine is to allocate the risk of loss between the maker of a note and the buyer of the note from the original lender. A typical loss in the home mortgage market occurs when the loan is the product of fraud or forgery, such that either the homeowner does not receive the proceeds of the loan, or the loan is substantially different than it was represented to be and the homeowner is induced into entering into a loan that does not make economic sense for him to have entered. Either case causes a loss, the first the loss of the proceeds of the loan, the latter a loss of the more beneficial terms the borrower could have obtained had no fraud or misrepresentation been involved. [Fn566]

Once this loss has occurred, the primary question is who should bear the loss. Clearly, the mortgage broker or initial lender who converted the proceeds of the loan or who committed the fraud or misrepresentation that caused the loss should bear the loss, but any mortgage broker or lender who commits theft, fraud, or misrepresentation, especially on a broad scale, is all too likely to declare bankruptcy or simply disappear, leaving insufficient assets to make its victims whole. [Fn567] Therefore,
the loss must be allocated between the borrower and the purchaser of the loan or subsequent holders. In the absence of the holder in due course doctrine, the loss should be borne by the assignee of the loan since the borrower would be able to assert any defenses, including fraud or theft, against the assignee of the loan that he would against the original lender. However, under the holder in due course doctrine, the borrower loses all defenses except the so-called "real defenses." [Fn568] Therefore, for the most part the holder in due course doctrine places the risk of loss for most fraud firmly on the back of the homeowner who signed the note.

For the holder in due course doctrine to work effectively, it must be an efficient system of allocating these losses. But how can we determine whether the losses are allocated efficiently? The most effective way, perhaps, is to break "efficient" loss allocation down into its constituent parts and then test the holder in due course doctrine against each part. [Fn569] One can divide the efficiency of loss allocation into four major principles: loss reduction, loss activity assignment, *loss imposition, and loss spreading.* [Fn570] The most efficient system is one that best balances these principles. [Fn571]

C. The Failure of Effective Loss Reduction Under the Holder In Due Course Doctrine

Loss reduction is the most obvious and easily understood of these loss allocation principles. We should try to allocate the loss to the party that can most inexpensively and easily prevent or minimize the loss. This allocation of loss would give the greatest incentive to reduce the loss to the party most able to reduce the loss efficiently. Robert D. Cooter and Edward L. Rubin point out that the principle of loss reduction can itself be divided into four elements: precaution, innovation, responsiveness, and learning. [Fn572] Because loss responsiveness and learning are so closely related and affect each other, they will be addressed here together.

1. Effective Precaution: Borrowers vs. The Secondary Market

Precaution consists of the steps that parties can take to avoid or minimize the loss before the loss happens, and a rule works efficiently when it prompts each party to undertake precautions that will cost less than the costs that will occur if the party fails to take such precaution. [Fn573] To maximize effective precaution, therefore, some risk of loss should be assigned to all parties who can take precaution, with each party obtaining at least sufficient risk of loss to encourage them to take the most cost-effective amount of precaution. [Fn574] However, several factors can affect how the risk of loss should be allocated. Where one party can take more effective precaution at a lower cost, then generally *more risk of loss should be assigned to that party.* [Fn575] Similarly, where one party is much more sensitive to risk and requires a much smaller risk to induce a party to maximize its precaution, then less risk of loss should generally be assigned to that party (the risk sensitive party). [Fn576] This factor, loss responsiveness, will be discussed in section VI(C)(3) infra.

Both the borrower and the purchaser of the loan can take precautionary steps: the borrower can refuse to respond to subprime lenders' advertising, try to deal only with reputable loan brokers and to read all of the documents presented for her signature, refusing to sign those that she does not understand or agree to, or do not correspond to the oral representations she has received. [Fn577] The purchasers of loans or securities backed by residential mortgages can investigate the brokers and lenders from whom they buy loans, insisting on dealing only with reputable brokers and lenders and ones with sufficient capital to cover sizeable losses. They can also monitor the complaints and default rates of loans that they have already purchased, and refuse to deal further with brokers and lenders where there have been problems. [Fn578]
On the surface, it appears that the borrowers' precautionary measures, because they are so direct, would be more effective at less cost. If a potential borrower refuses to sign an unfair or fraudulent loan then, absent forgery, the loan would not exist to begin with. If a loan securitizer refuses to purchase an unfair loan from a dishonest originator, that securitizer's action does not prevent the originator from attempting to sell the loan elsewhere or attempting to collect on the loan itself.

On closer examination, however, it is clear that the borrowers' attempts at precaution can be feeble at best, while the buyers of loans on the secondary market, although they cannot prevent a particular predatory loan from being made, can take inexpensive yet effective measures to reduce the general incidence of unfair loans. A subprime borrower's efforts to avoid deceptive loans by dealing only with large, reputable lenders, could easily come to naught, as even the largest subprime lenders such as First Alliance have been accused of fraud. Nor are the borrower's efforts to avoid deception by reading the loan documents carefully likely to bear fruit, as the documents are so complex and confusing for the borrower that an unscrupulous lender can easily insert unfair terms in the loan agreement without the borrower's knowledge. While some blame this complexity on the mandated mortgage disclosure forms, much of the complexity of the transaction is inherent in any loan secured by real property, as the presence of a security interest necessarily complicates the transaction well beyond the understanding of most residential borrowers. While the rare borrowers so sophisticated that they understand all the terms of the loan may escape fraud, their escape will not prevent unscrupulous lenders from moving on to their next victims.

By comparison, the secondary market can take effective, long-term, precautionary measures simply by refusing to deal with originators who develop a reputation for sharp practices or deception or who regularly engage in predatory pricing of their mortgage products. The secondary market has effective tools to discover predatory practices and refuse to purchase the loans that result. Lenders and underwriters can use sophisticated databases that track fraud and other suspicious activity in residential mortgages, identifying questionable brokers by name. They can identify specific "hot zones," neighborhoods that contain an unusually high incidence of residential foreclosures and are likely breeding grounds of predatory lending. Lenders and underwriters have the help of federal regulators to advise them how to discern warning signs of predatory lending. They can conduct complex analysis of loan pools to see which loans and which lenders are likely predatory. Participants in the secondary market can review loans for signs of unscrupulous tactics, including excessive fees and interest rates, balloon payments or prepayment penalties with no corresponding decrease in interest rates for borrowers, and adjustable rate loans that only increase. Because the essence of predatory lending is charging above the market rate for loans, given the credit risk of the borrower, the secondary market participants can spot evidence of predatory lending by comparing the borrowers' credit scores with the loan costs to see if the borrower was overcharged.

If such disreputable lenders lose their access to the secondary market and are forced to keep their loans themselves and attempt to collect from their own, often angry, borrowers who retain their defenses to the loan, these unscrupulous originators would, for the most part, be driven out of business. The cost to the secondary market of such monitoring would be two-fold, first of all, the costs of acquiring information about which brokers and other originators are suspected of illegal or improper practices, and secondly the cost of foregoing the profits to be gained by buying predatory subprime loans that have interest rates above the market rate. This latter cost is not one that even Wall Street is likely to publicly decry. The former cost is not an undue one, given the size of the subprime market and that it can be spread out over the entire market. More importantly, it is a cost that is already being incurred to good effect by some members of the mortgage industry, and the fruits of that labor can be easily shared with little net cost to the entire lending industry. Therefore, the secondary market has by far the most cost effective means of
precaution at its disposal and for this reason, should be assigned more of the risk of loss than the borrower.

2. Innovation and Loss Reduction

The element of innovation asks which party, if forced to bear the risk of loss, can create new methods or mechanisms for consummating the transaction that will minimize the risk of loss. [Fn588] This concept causes the element of precaution to be viewed as a dynamic, changing system. 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. [Fn589] Investors and the other commercial players are also likely to be the only parties with the attorneys, lobbyists, financial expertise, and planning ability to make any innovation in the financial services sector. They can also create innovative systems to discover and track unscrupulous mortgage brokers. [Fn590] Finally, they can spread the costs of all of these innovations among many of them or among the entire industry.

If the borrower somehow did attempt to innovate any aspect of the lending process, that attempt would almost certainly fail as the securitization process requires standardization. [Fn591] An individual borrower, or even a group of borrowers acting en masse, would not likely be allowed to change even the wording of the note and deed of trust. Furthermore, a borrower would have great difficulty in assembling the tools to track predatory lenders, or to encourage the spreading of the cost of that enterprise to other borrowers.

3. The Unresponsiveness of Borrowers to the Loss Assigned by the Holder in Due Course Doctrine

Determining whether parties will be responsive to liability rules and to what extent is crucial in determining whom should be assigned the risk of loss. If some parties would take effective precautions and so prevent the loss, then assigning the risk to them would do more to prevent the loss than assigning the risk of loss to an unresponsive party, even if the cost of preventing the loss might be lower for the unresponsive party. [Fn592] Even if borrowers were the lowest cost reducer of mortgage fraud, if they will not change their behavior or act to reduce the risk of loss even if the risk of loss is assigned to them, then the risk of loss should be assigned to the parties that will likely change its behavior, the purchasers of the note.

A party's responsiveness to the assignment of risk depends on whether the party understands that the risk has been assigned to them and on whether the party recognizes the magnitude of the risk. [Fn593] These separate aspects of comprehension may not reside in the same party. In other words, one party might better understand the magnitude of the risk, yet not realize that the law assigns the entire risk to him. Another party may recognize who is assigned the risk by action of law, yet have no effective way of discovering the magnitude of the risk. [Fn594] If a party does not understand that the risk has been assigned to her, then she is much less likely to be responsive to it. If she does not appreciate the amount of risk, both in terms of how large the loss might be and also in terms of the chance of the loss occurring, then she will be unable to determine the appropriate precautions to take. Therefore, risk should be assigned to parties who will realize that they bear the risk, and to the parties most able efficiently to evaluate the risk and determine the probability and amount of the loss. This knowledge is not static, since the parties might well be able to
learn about the allocation of loss and the magnitude of the risk that they could bear. While people often learn about how loss is allocated in fairly simple, commonplace transactions, they are much less likely to do so in more complicated transactions that they rarely repeat. [Fn595] The holder in due course renders such learning almost impossible because it is so arcane and conceptually difficult. [Fn596]

The holder in due course doctrine should not be applied in such a way as to assign the risk of loss to people who are unlikely to understand (or be able to learn about) the holder in due course doctrine and that the rule assigns to them the risk of loss. Whenever a rule assigns risk to those who do not understand and are unlikely to learn about the rule, the rule is acting inefficiently, since those people cannot be responsive to the rule and avoid or minimize the loss allocated by the rule. [Fn597]

Clearly, lenders and investors in securitized loans are better able than borrowers to determine the assignment of risk caused by the holder in due course doctrine. Lenders have attorneys, extensive and detailed manuals regarding the law of lending, and their own experience in the lending business. Investors in securitized loans are given detailed disclosure statements that should lay out the risks inherent in their investment.

The typical borrower, especially the typical subprime borrower, on the other hand, is unlikely to be familiar with even the basics of the loan process, which may be the most complicated financial transaction the borrower will ever experience. [Fn598] The vice president of the Mortgage Bankers Association, hardly a rabidly pro-consumer group, stated,

[A] fundamental root problem leading to abusive lending is the confusion caused by the complexity of the mortgage process. [***Page621] Any consumer that has ever been through a settlement knows how confusing and cumbersome the process can be. Mortgage disclosures are voluminous and often cryptic, and consumers simply do not understand what they read nor what they sign. . . . These problems are exacerbated ten-fold in instances of uneducated or illiterate consumers. [Fn599]

Unethical brokers target the elderly and undereducated, looking for those even less likely than the average borrower to understand the effects of the loan. [Fn600] Subprime borrowers rarely have the help of an attorney in negotiating a loan secured by residential property, as such advice might cost thousands of dollars. Unethical lenders attempt to separate the borrowers from those who might provide valuable advice, and thus prevent borrowers from becoming more knowledgeable about the loan. [Fn601]

Therefore, if the holder in due course doctrine were to assign risk efficiently to the party most likely to discover that assignment of risk and act on it, clearly it should assign such risk to the secondary market.

Lenders and investors in securitized loans not only have infinitely greater understanding of the holder in due course doctrine than borrowers, they also have far more information regarding the magnitude of the risk of loss. The firms that rate loan securitizations have finely calibrated methods to determine the risk of loss in the pools of loans and disclose that risk to the investors. Servicers can build web pages that allow investors to obtain default rates and other loan performance information. [Fn602] By comparison, an individual borrower has little comparable access to information on the risk of fraud or whether an individual mortgage broker might be likely to commit fraud. Loan counseling for borrowers has been demonstrated to significantly affect the likelihood that a borrower will become delinquent on their loans. [Fn603] However, such counseling is uneven and inadequate, and [***Page622] faces further budget cuts. [Fn604] Therefore, assigning the risk of fraud to purchasers of mortgage-backed securities would do far more to deter fraud than assigning that risk to borrowers, since lenders and the underwriters and ratings agencies who analyze risk for the investors are much better equipped to determine the risk of that fraud and to minimize that risk by refusing to deal with the unscrupulous mortgage brokers and loan originators likely to engage in fraudulent activities. [Fn605]
Held Up in Due Course: Predatory Lending, Securitization, and the Holder in Due Course Doctrine, 35 Creighton L. Rev. 503 (2002)

A party's responsiveness to liability does not necessarily continue to increase as the amount of liability increases. Instead, at least for consumers, "there will be a point at which liability ceases to produce major increases in loss avoidance behavior." [Fn606] This point is most likely reached quickly for the average borrowers, especially for subprime borrowers who may have few valuable assets other than their homes. [Fn607] Borrowers would exhaust almost their complete repertoire of precautionary measures to avoid losing $3,000 in the course of a loan transaction, and might not be able to take many more steps to avoid losing $100,000. Because the loss of the $3,000 could be so financially disruptive to the borrower, increasing the amount of loss above that sum would not likely significantly increase their precaution. On the other hand, an investor in loans would take much greater precaution to avoid losing $100,000 than it would $3,000.

This differing loss responsiveness indicates that the holder in due course doctrine assigns risk of loss in the exact opposite direction than it should. If the average borrower is the victim of mortgage fraud, she will likely be forced to pay an attorney thousands of dollars to attempt to undo the loan. In other words, even without any risk of liability being assigned to her, the cost of taking legal steps to rescind the loan (especially if we add the emotional costs to homeowners of being the victims of fraud) is a sum sufficient to induce the borrower to take all ***Page623 effective precaution that she can. The risk of loss should be assigned wholly to the purchaser of the fraudulent loan, to encourage it to engage in the much more effective precaution available to it.

4. The Uncertainty of Risk Assignment by the Holder In Due Course Doctrine

For a rule assigning risk of loss to work efficiently, the rule should be "simple, clear, and decisive." [Fn608] The holder in due course doctrine fails miserably in this regard, as it is complicated, opaque, unpredictable, and often overruled by other laws. [Fn609] Though lenders and investors in mortgage-backed securities are much more likely than residential borrowers to understand the holder in due course doctrine's assignment of risk, one sign of the growing unworkability of that doctrine is the increasing difficulty that even lenders and investors, armed with a high-priced team of attorneys, have in discovering how or whether the holder in due course has assigned the risk of loss. First of all, that risk might be assigned by other laws that take precedence over the holder in due course doctrine, such as TILA or its subsidiary HOEPA. As we have seen in our discussion of HOEPA, because the law is complex, and its applicability to a loan is governed by facts likely to be in the hands only of the original lender, neither a purchaser of a loan nor the borrower may be able to determine, absent judicial intervention, whether HOEPA applies and eliminates the protection of the holder in due course doctrine. [Fn610] Even where the holder in due course doctrine might apply, the securitization process is so complicated that courts often have great difficulty in determining who is the holder of a note and if that holder is a bona fide purchaser for value.

For example, in England v. MG Investments, Inc., [Fn611] the homeowner plaintiffs were promised by a mortgage originator that the interest rate on their loan would drop by almost 400 basis points (from 11.9% to 8%) after one year. Four days after the loan closed, the note and deed of trust were assigned to defendant Bankers Trust, along with the servicing rights. [Fn612] After a year, when the interest rate was ***Page624 not lowered as promised, the plaintiff/homeowners attempted to cancel the loan and then sued to rescind it.

Both the servicer of the loan, Advanta, and the trustee, Bankers Trust, claimed to be holders in due course in their answers to the complaint, despite the mortgage originator's contractual obligation to the servicer to provide the servicer one million dollars worth of loans a month, each loan meeting the terms of a sixteen
page "Master Loan Purchase Agreement." The court found that the servicer could not be a holder in due course because it was not the holder of the loan, but that the situation was too murky to determine whether the trustee was a holder in due course, stating "the actual relations among MG/PMC, Advanta and Bankers Trust remain obscure, at best." [Fn613]

Similarly, in Hays v. Bankers Trust Company, [Fn614] both Advanta and Bankers Trust claimed to be holders in due course, where Advanta was a "Master Servicer" and Bankers Trust the trustee for a pool of loans, including the loan at issue in the case. [Fn615] The plaintiff was a single mother of three who had taken out a loan from one predatory lender, which refused to allow her to rescind, promised her that the lender would refinance her loan in a year at much lower interest rates, and then declared bankruptcy. The plaintiff was contacted by a different lender, who promised her a thirty year conventional loan, but then, on the date of closing, gave her paperwork for a fifteen year loan from a different company with a balloon payment and a different interest rate. [Fn616] On the date of closing, the loan was assigned twice, first to yet another lender and then to defendant Bankers Trust, which placed the mortgage in a pool of loans and securitized it. After she fell behind on her mortgage payments, the plaintiff allegedly attempted to bring her loan current by paying Advanta, the loan's servicer, the sum it demanded. Rather than accepting this sum, Bankers Trust apparently foreclosed on the plaintiff's house and attempted to evict her. The plaintiff sued, claiming violations of, among other law, TILA and HOEPA. Bankers Trust and Advanta responded by filing a motion for summary judgment, both claiming that their status as holders in due course barred plaintiff's claims as to them. [Fn617]

The court seemed mystified by the securitization of the loan and the relationship between the borrower, the servicer, and the trustee of the loan pool. The court examined the 134 page, single spaced "Pooling and Servicing Agreement" and stated "Advanta's status in this complicated credit transaction is less clear. . . . None of this explains how Advanta ostensibly came to control the loan." [Fn618] The court concluded that Advanta, the servicer, could not be a holder in due course because it was never assigned the loan. Next, the court attempted to determine whether Bankers Trust, the trustee of the loan pools, was a holder in due course. Even though the loan seemed to be a HOEPA loan and so was not subject to the holder in due course doctrine pursuant to HOEPA, [Fn619] and even though violations of HOEPA were evident on the loan's face, the court threw up its hands, and announced itself "unable to determine on the record now before it whether Advanta [wa]s a holder and whether Bankers Trust [wa]s an HDC [a holder in due course]." [Fn620] The court denied Advanta and Bankers Trust's motion for summary judgment, concluding that "[t]he record [wa]s simply too tangled for the Court to conclude, without more, that Bankers Trust had no knowledge of, or complicity in, the wrongs Hays asserts. . . ." [Fn621] This case and the difficulty even a federal judge had in determining how to apply the holder in due course doctrine demonstrates that, with loans subject to securitization, TILA and HOEPA, the holder in due course doctrine has become too complicated and its results too unpredictable for it effectively to notify anyone of its own assignment of risk.

D. Loss Spreading, Loss Magnification, and the Holder in Due Course Rule

Another factor determining the most efficient loss allocation is the loss spreading principle, the idea that if more people bear the risk of loss, that loss will be less onerous to them collectively. A $50,000 loss could devastate one person's life, causing a permanent and irremediable trauma if, for example, a homeowner's $50,000 fraudulent loan causes her to lose her house. Spread the same loss out among 50,000 homeowners and, at most, each homeowner experiences a minor annoyance, the sum of which would hardly equal the pain of the one large loss. In economic terms, when one person bears the entire loss, the primary loss is much more likely to cause secondary, unnecessary losses as a result of the secondary economic dislocation
caused by the ***Page626 primary loss. [Fn622] The secondary loss of a house caused by the primary loss of the mortgage proceeds is one such example.

Besides the possibility of economic dislocation, two other theories have emerged to explain why loss spreading is desirable, even when it does not decrease the amount of loss. One is the theory that people are risk averse, and so if faced with a small risk of a large loss, they would pay more than the amount at risk multiplied by the chance of it happening. If faced with one chance in ten thousand of losing $100,000, most people would pay more than $10 to avoid the risk entirely. [Fn623] Another theory is derived from the idea of the declining marginal utility of money, which holds that the more money one has, the less each incremental increase of money is worth in real terms to that person. [Fn624] A corollary to this rule would be that as a person loses more money, each additional dollar of loss is worth more to that person than the dollar before, so that a $20,000 loss causes more than twice as much pain as a $10,000 loss, since the second $10,000 loss is a loss of money that is worth more to the victim. [Fn625] If we take the diminishing marginal utility of money seriously, then in determining our distribution of risk, we should weigh the wealth of the parties as a factor to consider and attempt to distribute risk more heavily to the wealthier party in a transaction, because a wealthier party forced to pay the same amount as a poorer party will value that amount less than the poorer party and so will lose less in the process. [Fn626]

***Page627 Whatever the basis of the loss spreading principle, economically minded commentators have largely agreed on its usefulness as a principle in allocating loss, so long as the loss is not spread so widely that the loss spreading itself discourages the prevention of the loss. [Fn627] A primary method of spreading loss is through insurance, either through an insurance policy or through self-insurance. [Fn628] All other elements being equal, risk of loss should be assigned to the party that can most economically purchase or otherwise obtain insurance for that loss, and so spread the risk of it. [Fn629] Homeowners have no effective method of engaging in loss spreading. There is no common insurance policy against predatory lending, and when the borrower has the risk imposed on her, she often pays by having her house foreclosed. Instead of spreading the risk, imposing risk on the borrower magnifies it, intensifying the risk through the foreclosure process. Instead of merely losing a fixed sum of money, the borrower often loses her home, often her sole means of security in her old age.

By comparison, investors in securitized mortgage pools have insurance built into their investment. The loan pools are enormous, so large that the loss of a mortgage would barely even be noticeable to the investors. [Fn630] By investing in a small part of such a large pool of loans, investors are in effect joining together to self-insure en masse. [Fn631] Risk has been carefully balanced by the poolers of the mortgage and should have been spread across the tranches in a carefully disclosed manner. Because many of the investors are institutional investors, investing money from pensions and other large funds in an array of investment devices, even the investment in the mortgage pool ***Page628 itself is just part of a larger diversified investment; therefore, even if the pension fund somehow lost its entire investment in the mortgage pool, no individual pensioner would likely even notice the harm. Clearly, the participants in the secondary market are much better able to spread the risk of loss than borrowers, and so should bear that risk.

E. Loss Imposition

Effective loss imposition looks to the costs of imposing the loss on whichever party is to bear it. As noted by Cooter and Rubin, the least expensive loss imposition system would be to leave the loss on whichever party initially suffered it. Then, there would be no resulting expensive litigation or negotiation after the loss occurred, only the licking of wounds by whichever party suffered the loss. [Fn632] However, this
would often result in the loss being borne by a party that could neither take any precautions against the loss nor spread the loss in any way, and so may be highly inefficient in terms of preventing or minimizing the impact of the loss, however efficient it may be in avoiding loss imposition costs. [Fn633] In this case, imposing the risk of loss on the investors would not change net costs, since borrowers will be forced to litigate the issue of fraud in most cases, and lenders will still likely attempt to foreclose on the loans if they are not paid, pending a successful borrower's suit.

From this economic analysis, it is clear that the holder in due course doctrine misallocates the risk of loss due to fraud by allocating it to the party least able to prevent the fraud, understand the allocation of risk, insure against that risk or bear that loss should it occur. The rule thus encourages mortgage fraud, magnifies the harm caused by that fraud, and punishes the innocent borrower with that fraud once it occurs.

F. Holder In Due Course as a Default Rule

The holder in due course doctrine's specific role in the formation of contracts is that of a default rule, which is an off-the-shelf rule that governs a specific question if the parties do not specify their own rule. [Fn634] Parties to an instrument could explicitly specify whether it would have the characteristics of negotiability, for example, making an instrument non-negotiable simply by writing "non-negotiable" across the face of it. [Fn635] Similarly, the parties could obtain many of the benefits of a negotiable instrument by drafting language in the contract calling for the borrower to waive various defenses to the contract once the contract is assigned to a third party. [Fn636] However, even without agreeing on specific language regarding the negotiability of an instrument or inserting language specifying the extent of negotiability, the parties can obtain all of the benefits of a negotiable instrument merely by fulfilling the requirements of U.C.C. § 3-104, thus saving the costs of negotiating the specific terms regarding the waiver of defenses. [Fn637]

Analysis of the holder in due course as a default rule differs from our analysis of its efficiency as a spreader of risk of loss in the following way. In our previous analysis, we assumed that all of the parties knew of the holder in due course doctrine and expressly consented to its operation on the negotiable instrument. By comparison, default rules are designed to act whether or not the parties to a transaction are aware of them, unless the parties contract around them. In fact, one of the purposes of default rules is to provide terms of a contract that parties have omitted, sometimes because one or more of the parties have failed to consider the possibility of the circumstances that have made the default rules necessary.

Academics who have applied an economic analysis to the holder in due course doctrine have, by and large, decided that the doctrine is likely an efficient default rule or that its inefficiency cannot be demonstrated. Richard A. Posner argues that, "unfavorable though it is to consumers," the holder in due course doctrine, because it reduces the costs of collection while increasing its certainty, lowers the cost to consumers of installment-financed purchases. [Fn638] Posner concludes, "It is not obviously wiser for the consumer to decide to pay more for a product than to decide to give up one of his legal remedies against the seller."

[Fn639] This analysis implies that a consumer is the one who would make this decision. The holder in due course doctrine, because it is not in the contract and is so obscure and inherently difficult to understand, is extremely unlikely to be known, let alone understood by a consumer.

***Page630 Following in Posner's wake, Marie T. Reilly argues that the holder in due course doctrine efficiently allocates loss. Reilly argues that, unless the third party buyer of the instrument has knowledge of the maker's defenses or unless there are the so-called "real defenses" to the note, the maker of the note is probably better able to obtain information regarding the likelihood and magnitude of her own loss, and so is
the better insurer. [Fn640] Similarly, Gregory E. Maggs, in the most extensive analysis of the holder in due course doctrine as a default rule, concludes that the doctrine exists primarily to reduce the transaction costs of negotiating waiver of defense clauses that would spring up were the doctrine eliminated. [Fn641]

The work of each of these commentators is based on a fundamental unstated premise, a premise unfounded in the use of negotiable instruments in consumer contracts or loans. This premise is that either (a) both parties to the instrument understand that it is negotiable and understand the effects of the holder in due course doctrine, or (b) the efficiency of the doctrine is not affected by the fact that one of the parties does not understand the doctrine or its effect. Maggs assumes that people who use negotiable instruments want to waive their defenses to those instruments, and bases his argument for the efficiency of the holder in due course doctrine on this conscious choice of waiving defenses, stating that the notion of the holder in due course doctrine as a default rule "eliminates the need for speculating about the exact reasons parties may have for wanting to waive claims and defenses. Their particular purposes do not matter. Whatever their reasons, if competent parties choose to waive claims and defenses, the holder in due course doctrine may reduce the cost of accomplishing that result." [Fn642] Maggs goes on to note: "[M]ost parties who want to waive defenses choose negotiable instruments." [Fn643] What this analysis ignores is whether the makers of negotiable instruments either intended to waive any claims or defenses or understood the holder in due course doctrine and what its effects might be.

Similarly, Marie Reilly views the holder in due course doctrine as efficient because it provides an easy, certain method of determining whether the maker of an instrument has waived defenses if the instrument is purchased by an innocent third party. She states: "Any rule that A, B, and C [the maker, original beneficiary, and buyer, respectively, of the potentially negotiable obligation] can easily apply to determine the likelihood that an obligation will fall into the hands of an immune party enhances efficiency by reducing costs." [Fn644] She fails to discuss, however, whether the holder in due course doctrine is, in fact, easily applied, especially by consumers who are unlikely even to know of its existence, let alone whether, given HOEPA's restrictions on the holder in due course doctrine, the doctrine will apply to their loan. [Fn645]

Crucial to the efficiency of the holder in due course doctrine as a default rule is whether both parties to the original transaction know of and understand the doctrine and how it assigns risks. Ian Ayres and Robert Gertner note that it is common for one party to a transaction to know of default rules while the other party remains in the dark if the first party is a repeat player, repeatedly participating in similar transactions, while the other party is a neophyte. [Fn646] The better informed party in this situation may intentionally remain silent about the default rule to maximize its own profits, even if the overall benefit to both parties would increase if they were both informed and negotiated regarding the subject of the default rule. [Fn647] The knowledgeable party is most likely to remain silent where the default rule favors it rather than the uninformed party. [Fn648] Ayres and Gertner conclude that, especially where transaction costs are small and so parties are relatively free to negotiate regarding the terms of a contract, default terms should be set to favor the party most likely to be unaware of them. This would give the more knowledgeable party, here the lender, an incentive to bring up the subject covered by the default rules in negotiations and so inform the other party (here the borrower) of the existence of the default rule, leading the parties to contract explicitly regarding the subject and so resolving it efficiently through negotiation, rather than leaving it, perhaps inefficiently, in a manner which benefits only the knowledgeable party. [Fn649]

Applying these arguments regarding default rules to the holder in due course doctrine shows that this rule tends to work most efficiently only among parties who understand the rule and can determine the value added to or subtracted from their wealth by the operation of the rule. Somewhat less efficient would be a rule assigning the risk of loss to a knowledgeable repeat player rather than a naive novice.
If someone is making a note, one of the terms that should be the subject of negotiation is whether or not the note will be negotiable.

From this analysis, we can reach the conclusion that the holder in due course doctrine is likely to be efficient only under one of two sets of conditions: (1) when the maker of the negotiable instrument understands the rule, realizes that she will be assigned various risks as a result of the rule, and can appraise the magnitude of those risks; or (2) when the risk assigned to the maker of the negotiable instrument through the holder in due course doctrine is so negligible that it is unlikely to tip the balance of costs and benefits to the maker of the instrument. Only then can she make the kind of informed choice about whether to enter into the transaction that is required for efficient transactions. Given the near impossibility of residential borrowers understanding the holder in due course doctrine and the great risk of predatory lending in the subprime market, neither condition is satisfied for subprime loans.

If the consumer unintentionally gives up his remedies against the seller, he does not knowingly exact a better price in return. He would unwittingly pay a lower cost in return only where the market is so efficient that it forces the lenders to reduce the interest rates and fees they charge when their collection costs decline. In an honest market, where the buyer would have few defenses, the price reduction that the buyer would receive would be minimal, reflecting the value of the defenses, which is so small as to be, in Homer Kripke's words, "statistically unnecessary." [Fn651] Where the buyer most needs the protection of her defenses, in instances of fraud or other forms of sharp dealings, the seller is already attempting to extract from the buyer a price that ***Page633 is above the market price for the good delivered, either by charging an excessive price or by supplying inferior products or no products at all. In such a situation, the buyer is highly unlikely to obtain any price reduction for having given up some of his defenses, but would instead receive a price increase. In other words, in an honest market, the buyer is likely to receive very little return for giving up his defenses, and in a dishonest market, the buyer is likely to be paid back for giving up his defenses with excessive prices, shoddy merchandise, or both. [Fn652] And because the buyer unintentionally gives up his defenses, he is not even alerted that he must take extra precaution to defend himself against the shady dealer.

Even if all of the parties are equally familiar with the default rule, the rule's assignment of risk or benefit affects the ultimate distribution of gain or loss from a contract. If the initial assignment is not to the most efficient user, that user will exact a price. [Fn653] In fact, the non-efficient user is likely to increase his asking price simply because the benefit was initially assigned to him, since people tend to ask more in price to give up something than they would be willing to pay to acquire that same thing. [Fn654] This has been termed the "sticky default." [Fn655] Even if borrowers were to realize that the holder in due course doctrine assigned the risk of loss to them rather than to assignees of the loan, and even if they could effectively negotiate to transfer the risk of loss, they would have to pay for that transfer. This default rule, therefore, provides a permanent subsidy to lenders at the expense of borrowers.

G. Default Rules as Gap-fillers in Standardized Consumer Contracts: The Uniform Code's Defense Against Claims of Unconscionability

In the context of standardized consumer contracts, default rules play a far different role than they do in commercial contracts. In commercial contracts, default rules are used most often when the parties have not included a rule governing a specific situation, either intentionally or unintentionally. Parties intentionally omit a rule for a multitude of reasons: they have been unable to agree on a specific ***Page634 rule; they want to avoid the transaction costs of negotiating a specific rule; or they consider the possibility of the situation occurring too unlikely to concern them. [Fn656] Unintentionally, parties may omit a rule because
they did not conceive of the situation or expect that it could occur. Default terms are used, many commentators agree, to supply the terms that the parties would have agreed to had they been able costlessly to bargain specific terms, in order to fill out the contract. [Fn657] This use of gap filling matches the idea that economic efficiency is most likely to result from the voluntary informed agreement between the parties. [Fn658]

By comparison, in standardized consumer contracts, typically contracts of adhesion, default rules serve a very different purpose. [Fn659] The default rules do not come into play because the parties have been unable to agree on a rule, because one party has had free rein to predetermine ***Page635 all of the rules contained in the standardized, form contract. [Fn660] Nor are they omitted to avoid transaction costs, since the standardization of consumer contracts already avoids those costs. The consumer typically does not even read the form contract, let alone bargain over its terms. [Fn661] Nor are the omissions the result, typically, of any lack of awareness by the drafters of the contracts of the possibility of an event, since the same likelihood of such an event that would generate a default rule, the risk of fraud for example, would also notify the commercial party of the need to include such a term in its contract. Indeed, the holder in due course doctrine governs possibilities, such as risk of fraud or deception, with which any professional drafter of standard loan documents should be intimately familiar.

Instead, the primary purpose of a default rule in standardized contracts that harms a consumer, such as the holder in due course doctrine, is to protect the enforceability of terms that could be held unconscionable were they contained in the text of standardized, adhesive consumer contracts. The default rules allow such terms to be imported into those contracts in a way that makes it impossible for a court to declare them unconscionable. A court might well declare a contract term waiving any defenses a non-commercial borrower might have unconscionable, but if the Uniform Commercial Code, as enacted by a state, waives that same defense, the court will be hard pressed to find the waiver unenforceable. In this way, the holder in due course doctrine encourages the formation of unconscionable contracts by providing a legal cloak to cover that unconscionability.

Similarly, the use of default rules in consumer contracts that benefit sellers or lenders at the expense of borrowers and consumers allows the seller or lender to benefit from harsh terms in the sales or loan contracts without having to incorporate those terms into the contract or loan agreement itself. By omitting those terms from individual contracts and incorporating them generally through gap-filling laws, the sellers and lenders accomplish several tasks. First of all, they avoid the possibility that the consumer or borrower, in the unlikely event that she reads all of the purchase or loan documents, will note, understand, and challenge the harsh term, since that term will appear nowhere in the agreement. The seller or lender avoids the necessity of either explaining or defending the harsh term and the possible liability that may result from misrepresenting the effect of the ***Page636 harsh term. Secondly, the sellers and lenders minimize the chance that other lenders will lure away their customers by supplying better terms. If the harsh terms are nowhere to be found in the contract, a customer is much less likely to make its purchase or borrowing decisions based on the contract. [Fn662]
VII. POTENTIAL METHODS OF ELIMINATING THE HOLDER IN DUE COURSE DOCTRINE FOR NON-COMMERCIAL LOANS

The holder in due course should be abolished in any instance where it would assign the risk of loss for a loan to a non-commercial borrower. However, mere elimination of the holder in due course doctrine is not sufficient, since commercial actors quickly incorporate waiver of defense clauses to replace the holder in due course doctrine when it suits their purpose. [Fn663] The incorporation of such clauses in pre-printed contracts of adhesion would be as little bargained over as the current rule. Given the complexity of the holder in due course rule, it seems hopeless to think that this is an issue a residential borrower can bargain over meaningfully. Therefore, in the place of the holder in due course doctrine should be a non-waivable rule preserving any defenses that such a borrower would have as to any assignees, bona fide or otherwise. In effect, the holder in due course should be reversed and the risk of loss due to the originator's fraud or deceptive practices should automatically be assigned to the purchasers of loans.

One possible method of reversing the holder in due course doctrine would be through revising U.C.C.'s Article 3, which governs negotiable instruments, to reverse the holder in due course doctrine in every instance where it is applied to any non-commercial loan. The likelihood of such a change seems small, given the history of drafting and revision of the U.C.C. Article 3 was last revised in 1990, long after many legislative and judicial battles over what protection should be given to non-commercial borrowers. The revisers of Article 3 intentionally refused to alter Article 3's distribution of risk between non-commercial borrower and lender. Fred Miller notes the "exclusion, consistent with the traditional U.C.C. approach, of affirmative consumer protection provisions from revised Articles 3 and 4..." [Fn664] The drafters of the revised Article 3 were under fairly explicit orders not to alter Article 3's "balance" Article 3 establishes between consumers and bankers, if one can speak of a "balance" in such a pro-banker code. [Fn665] Even the drafters' efforts to abide by this charge were deemed too far-reaching, and instead, as noted in Section II(E), the revision was limited to minor rewoldings with little real change. [Fn666] While more consumer protection has crept into the revision of Article 9, it seems unlikely that the guardians of the U.C.C. will be ready any time soon for such a bold and necessary stroke as reversing the holder in due course doctrine in all non-commercial loans. [Fn667]

Another possible actor that does much to reverse the holder in due course doctrine in non-commercial loans would be the GSEs that acquire so many of the prime residential loans. If the GSEs, such as Fannie Mae and Freddie Mac, changed their form promissory notes to include an FTC-like disclaimer preventing the cut-off of defenses, the GSEs would soon force all of the prime market and that limited portion of the subprime market that the GSEs purchase to include such a preservation of borrower defenses. The remainder of the subprime market that is securitized could conceivably follow suit, though there would be no legal obligation to do so.

Other federal actors could claim to be hamstrung. The OTC and the Federal Reserve Board have only limited powers to regulate all of the mortgage brokers and non-federally insured or regulated lenders across the country, though they could order regulated banks to purchase only loans containing an express preservation of borrower defenses. States could individually alter their laws so as to eliminate the holder in due course doctrine from non-commercial loans and preserve borrower defenses. Such state-by-state action would create a patchwork system and vastly reduce the uniformity of the laws of negotiable instruments. However, this lack of uniformity could convince the U.C.C. drafters to change the rule uniformly to protect borrowers and, even if not, the benefit in fraud reduction would likely outweigh the costs of uniformity.
The agent best able to eliminate the holder in due course doctrine for residential loans and replace it with a preservation of borrower defenses would be Congress, which has the power to eliminate the holder in due course doctrine generally on non-commercial loans, just as it did in a more limited fashion through HOEPA. Whether it will have the political courage to do so remains to be seen.

VIII. THE EFFECT OF ELIMINATING THE HOLDER IN DUE COURSE DOCTRINE

The traditional view is that the holder in due course doctrine allows lenders to charge somewhat lower interest rates, since they bear less risk of loss and would, the argument goes, spend less money to defend suits by disgruntled borrowers. Instead, for the prime market, the effect on interest rates would likely be so negligible as to be unnoticeable. There is so little fraud in the prime market in proportion to the size of the prime market that the transference of risk of fraud from one party to another will have almost no effect on the price of credit. \[\text{Fn668}\]

Eliminating the holder in due course doctrine in the subprime market could well affect the price of credit to subprime borrowers, rather than increasing the cost of subprime credit, it would almost certainly lower it. As demonstrated by the fact that so many subprime borrowers could have received prime rate mortgages at a significantly lower cost and by how much more the subprime market charges A-borrowers than the prime market does, the subprime market is not an efficient one. \[\text{Fn669}\] In other words, subprime borrowers are not sufficiently effective price shoppers, and often purchase more expensive credit when less expensive credit is available to them. \[\text{Fn670}\] Subprime lenders have too often competed with each other not by offering lower ***Page639 rates, but by relying on more aggressive or misleading sales techniques than their competitors, not by offering better services, but by flipping more borrowers into new, higher cost loans. Competition among predatory subprime lenders has been to see which company could reach the elderly, the undereducated, or naive or easily confused first and obtain a high cost loan well above the market rate given the risk characteristics of the borrower. \[\text{Fn671}\] Many borrowers have been induced to purchase credit at above market rates through the aggressive marketing and dubious and deceptive sales techniques that have been the hallmark of predatory lenders and all too often practiced even by more mainstream subprime lenders.

One of the reasons that subprime lenders have been free to engage in this aggressive marketing and that the financial markets have been willing to securitize the resulting loans, is the understanding that, because of the holder in due course doctrine, the buyers of these loans are virtually immune from the borrowers' suits alleging many of these forms of fraud. So long as the lender follows TILA and skirts the triggers for HOEPA, the holder in due course doctrine reduces the possibility that the purchaser of the loans will lose any money based on those predatory practices. If enough borrowers sue the initial lender, then that lender can declare bankruptcy, leaving the borrowers with little recourse for the fraud committed on them.

If the holder in due course doctrine is eliminated, then the purchasers of subprime loans will be much less likely to deal with an unscrupulous lender and will go to much greater lengths to avoid those lenders whose aggressive marketing tactics verge on predatory lending. As a result, fewer borrowers will obtain loans because of the marketing blitz that predatory lenders use. Fewer will be tricked into entering into loans based on oral misrepresentations regarding future loan reductions, or the nature and effect of credit products packed into the loan. As the predatory lenders are starved by the financial markets, and the more legitimate subprime lenders find a clearer path to the borrowers, the interest rate charged subprime borrowers should, on average, decline significantly. The extent of the likely decline can be estimated based
on the amount that the subprime market currently appears to be overcharging its borrowers. Thus, based on various studies, interest rates to subprime borrowers would likely decline by an amount commensurate with the 100 basis point excess that subprime lenders currently charge subprime A-borrowers over prime A-borrowers. [Fn672]

IX. CONCLUSION

The time has come to end the holder in due course doctrine in the last area where it is damaging the innocent, non-commercial makers of negotiable instruments who have no way of knowing of its existence, let alone its effect. The history of the negotiable instrument at first was the story of the intent of the makers of negotiable instruments driving the legal development of those instruments. Since the codification of negotiable instruments law, however, and its takeover by bankers and their attorneys, the history of negotiable instruments has been that of the victimization of makers of negotiable instruments who neither intended nor understood they were making negotiable instruments, with no clear idea of negotiability or its effects. The holder in due course doctrine is no longer necessary in non-commercial loans. It is no longer needed to provide an effective currency substitute. Its purpose of providing liquidity to those loans has been taken over by securitization, which has provided more ease in the transfer of notes than the holder in due course doctrine ever could have done.

The banking and lending industry has too long reaped the benefit of seizing control over the codification of negotiable instruments law. It is time to return the proper role of intent to that law by preventing those who are unlikely to understand the holder in due course doctrine or to intend they be bound by it from creating negotiable instruments. We must finally end the pernicious effects of widespread, unintentional negotiability.

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[Fn4]. Jeff Glasser, Sometimes a Deal Is Too Good to Be True Big-bank Lending and Inner-city Evictions, U.S. News & World Rep., March 5, 2001, at 40, 2001 WL 6319836 (quoting seventy-two year old Goldie Johnson, who suffers from glaucoma and was induced to sign a loan with monthly payments of about eighty percent of her fixed income and a balloon payment that comes due the same year she turns eighty-six).


[Fn7]. See generally Kurt Eggert, Held Up in Due Course: Codification and the Victory of Form Over Intent in Negotiable Instrument Law, 35 Creighton L. Rev. 363 (2002).

[Fn8]. Federal Reserve Board Governor Edward M. Gramlich noted, "The term 'predatory lending,' much like the terms 'safety and soundness' or 'unfair and deceptive practices,' is far-reaching and covers a potentially broad range of behavior. As such, it does not lend itself to a concise or a comprehensive definition." Edward M. Gramlich, Remarks at the Federal Reserve Bank of Philadelphia, Community and Consumer Affairs Department Conference on Predatory Lending (Dec. 6, 2000), at http://www.federalreserve.gov/boarddocs/speeches/2000/20001206.htm (last visited Feb. 26, 2002).


[Fn13]. In its report on predatory lending, the staff of Senator Phil Gramm argued that, unless and until they can agree on a definition of predatory lending, regulators should not take further regulatory action to stop such practices, stating "Providing a clear definition is the beginning step and cannot be skipped. That step has not yet been taken by the regulators." Staff of Senate Comm. On Banking, Housing and Urban Affairs, 106th Cong, Predatory Lending Practices: Staff Analysis of Regulators' Responses, (August 23, 2000) (reporting to Chairman Gramm), available at http://www.senate.gov/<tilde>banking/docs/reports/predlend/predlend.htm (last visited Feb. 25, 2002). This report is also available at 54 Consumer Fin. L.Q. Rep. 228, 228-32 (Summer 2000).

[Fn14]. Indeed, it would seem impossible to find common agreement on exactly how widespread predatory lending is among those who cannot even agree on the definition of predatory lending. It would be impossible to measure the exact amount of predatory lending without first selecting a specific definition to determine which loans are predatory.


[Fn16]. Id. at 2-3.

[Fn17]. Id. at 12-13.

[Fn18]. Allen Fishbein & Harold L. Bunce, Subprime Market Growth and Predatory Lending, at http://


[Fn22]. See Comments of the National Consumer Law Center and Consumer Federation of America to the FDIC on Predatory Mortgages, at http://www.nclc.org/predatory_lending/fdic.html (last visited Mar. 26, 2002). This analysis was suggested to me by Elizabeth Renuart, of the National Consumer Law Center.


[Fn25]. Id. at 7.

[Fn26]. Cathy Lesser Mansfield, The Road to Subprime "HEL" Was Paved With Good Congressional Intentions: Usury Deregulation and the Subprime Home Equity Market, 51 S.C. L. Rev. 473, 546-47, 547 n.453 (2000). A recent Freddie Mac study concluded that 100 basis points of subprime loan pricing was not explicable by the borrower's credit risk. Eric Stein, Quantifying the Economic Cost of Predatory Lending, A Report from the Coalition for Responsible Lending 2, at http://www.responsiblelending.org (citing Peter Zorn, Subprime Lending: An Investigation of Economic Efficiency (Freddie Mac, Dec. 21, 2000)).


[Fn28]. James T. Berger, Subprime Lending Produces Dangerous Side-Effects, Chi. Sun-Times, June 9, 2000, at 16N, 2000 WL 6681282 (quoting William Apgar, assistant secretary for housing at HUD, as saying "In many of these [subprime] loans, from Day One people can't repay them. We are just setting people up for failure.").

[Fn29]. Alvin C. Harrell, Subprime Lending Developments With Implications for Creditors and Consumers, 52 Consumer Fin. L.Q. Rep. 238, 242 n.45 (1998). "Equity stripping" is also used more broadly to refer to payment of excessive fees of all types, since a borrower, even if she does not lose her home to foreclosure, has a significant amount of the home's equity stripped from her when she pays excessive fees or prepayment penalties. See Eric Stein, Quantifying the Economic Cost of Predatory Lending, A Report from the Coalition for Responsible Lending 2, at http://www.responsiblelending.org (last visited Feb. 27, 2002).


[Fn40]. Id.


[Fn45]. For a scholarly argument that prepayment penalties lower the interest rates charged borrowers, see Frank S. Alexander, Mortgage Prepayment: The Trial of Common Sense, 72 Cornell L. Rev. 288, 330-31 (1987). See also Dale A. Whitman, Mortgage Prepayment Clauses: An Economic and Legal Analysis, 40 UCLA L. Rev. 851, 860 (1993) for a discussion of the windfall a lender can receive from prepayment penalties, especially where a borrower prepays the loan when market interest rates have increased.

[Fn46]. Before 1938, if the loan agreement was silent as to prepayment, the borrower had no right to prepay a loan and could only pay it out over the entire term of the loan. Alexander, 72 Cornell L. Rev. at 289. After the Home Loan Bank Board reversed this default rule, making all borrowers eligible to prepay their loans without penalty absent a contrary provision in their loans, lenders began inserting prepayment provisions in loan agreements. Id. at 289, 326.


[Fn49]. A Standard and Poor's survey found that approximately eighty percent of subprime mortgages contained a prepayment penalty in mid-2000, a sizeable increase from 1997, when fifty percent had such penalties. See citation to study in Home Bound: Nasty Surprise Haunts Some Folks' Mortgage: A Prepayment Penalty, Wall St. J., Aug. 1, 2001, at A1, 2001 WL-WSJ 2871388. See also Prevalence of Prepayment Penalties, Coalition for Responsible Lending, (Mar. 27, 2001) (citing the director of Mortgage Information Corporation as reporting that about two-thirds of the subprime mortgages the organization tracks contain prepayment penalties), at http://www.responsiblelending.org/CoalitionStudies/Prevalence%20of%CC20Prepayment%20Penalties.htm (last visited Feb. 25, 2002).


[Fn52]. Id.

[Fn53]. See discussion of holder in due course doctrine in section II(E), infra.

[Fn54]. The holder in due course doctrine preserves this distinction between fair, high cost loans and those based on fraud only where the fraud prevented the borrower from understanding the essential nature of the loan agreement. See discussion of the real defenses infra note 102 and the accompanying text.

[Fn55]. For the argument that predatory lending is primarily the result of information asymmetry between lenders and borrowers, see Edward M. Gramlich, Member, Board of Governors of the Federal Reserve System, Remarks at the Fair Housing Council of New York (April 14, 2000), available at 2000 WL 378316.


Apart from outright fraud, these are the fundamental characteristics of predatory lending. Mortgage provisions that are generally desirable, but complicated, are abused. For these generally desirable provisions to work properly, both lenders and borrowers must fully understand them. Presumably lenders do, but often borrowers do not. As a consequence, provisions that work well most of the time end up being abused and hurting vulnerable people enormously some of the time.

Id.

[Fn61]. To compare various adjustable rate mortgages, for example, a homeowner would need to know the initial (qualifying) rate and how long that rate will remain; the index used to adjust the rate or monthly payment in response to index changes; the loan-to-value ratio and mortgage insurance costs; the number of points and any caps on how much rates or payments can go up each year or over the life of the loan; prepayment penalties; delinquency and default charges; and property, life, or health insurance requirements. Eskridge, 70 Va. L. Rev. at 1133.


[Fn63]. For one of many examples, see John B. O'Donnell, Fast Downtown for Md. Lender Crash, Balt. Sun, Jan. 9, 2001, at 1A, 2001 WL 6147846.

The rise of American Skycorp was stunning. So was its flameout. In less than three years, the Timonium firm soared to the heights as one of the nation's top lenders of Federal Housing Administration - backed mortgages. Then it crashed under the weight of defaulted borrowers, severe criticism of its business practices and multiple inquiries, including at least one fraud investigation.

Documents emerging from the investigations paint a picture of a company that skirted the law and government regulations as it aggressively collected high fees on questionable loans in pursuing its goal of being the No. 1 mortgage lender in the nation.

Id.

[Fn64]. See Diamond/Obie cases cited in Section II(D).


[Fn70]. Id.


[Fn77]. Greenberg, 439 N.W.2d at 338.


[Fn82]. In re Diamond Mortgage Corp., 135 B.R. at 84.


[Fn86]. Stone, 728 F. Supp. at 1345.


[Fn89]. Id.

[Fn90]. Id.

[Fn91]. Stone, 728 F. Supp. at 1345.


[Fn93]. Id.
[Fn94]. Greenberg, 439 N.W.2d at 339.


[Fn96]. Id.


[Fn98]. See discussion of recourse in Section III(B).

[Fn99]. Pursuant to U.C.C. § 3-203(b), the originator could not claim holder in due course status even though it received an instrument back from a holder in due course if the originator had engaged in "fraud or illegality affecting the instrument."

[Fn100]. See generally Kurt Eggert, Held Up in Due Course: Codification and the Victory of Form Over Intent in Negotiable Instrument Law, 35 Creighton L. Rev. 363 (2002).


[Fn102]. U.C.C. § 3-305(a) (2000).

[Fn103]. U.C.C. § 3-305.


[Fn108]. Stone, 728 F. Supp. at 1347-49.


[Fn111]. Thomas, 439 N.W. at 299-300.


[Fn114]. Mox, 463 N.W.2d at 115.


[Fn117]. Franck, 494 N.W.2d at 841-42.


[Fn121]. Some courts had refused to consider adjustable rate notes negotiable because they did not have a "sum certain." James J. White & Robert S. Summers, Uniform Commercial Code 504 (4th ed. 1995). In discussing the changes to Article 3, other than making adjustable potentially negotiable, White and Summers stated "While we hesitate to label these changes as insignificant, we suspect that would be a fair characterization. Except for the change in the sum certain requirement that makes variable rates potentially negotiable, we believe that the changes are not significant." Id.


[Fn125]. Under U.C.C. § 3-302, notice of certain defects in, or defenses to, a note denies the holder status as a holder in due course.


[Fn127]. Various commentators have differed as to how fully objective this test is, with some calling it objective and others, referring to the split in courts as to how to apply the test, noting that it has a subjective element. For example, Brian Blum, in his article Notice to Holders in Due Course and Other Bona Fide Purchasers Under the Uniform Commercial Code, 22 B.C. L. Rev. 203, 220 (1981), states

[T]he test contains both an objective and subjective element. In the first instance it requires a subjective inquiry in order to establish that the person had actual knowledge of certain secondary facts ... [O]nce the subjective baseline is established either directly or circumstantially, the court is able to apply an objective test and to inquire how a reasonable person would have responded to the secondary facts.

Id.


Hathorn v. Loftus, 726 A.2d 1278, 1281 (N.H. 1999), refers to an "objective element," which seems an attempt to find a middle ground. For a similar analysis, see Me. Family Fed. Credit Union v. Sun Life Assur. Co. of Can., 727 A.2d 335, 342 (Me. 1999).

[Fn131] 2 Frederick M. Hart & William F. Willier, Negotiable Instruments Under the Uniform Commercial Code, § 11.04[2] (1997) (emphasis added). In Maine Family Federal Credit Union, the court underscored the difficulty of applying this change, stating, "Unfortunately, the ease with which the distinction between 'fair dealing' and 'careful dealing' was set forth in the comments to the U.C.C. revisions belies the difficulty in applying these concepts to the facts of any particular case, or in conveying them to a jury." Me. Family Fed. Credit Union, 727 A.2d at 342.


[Fn133] Joseph C. Shenker & Anthony J. Colletta, Asset Securitization: Evolution, Current Issues and New Frontiers, 69 Tex. L. Rev. 1369, 1373 (1991) (citations omitted). The authors note that the definition is limited because it describes the final product of the process of securitization, but not the process as distinct from its product. As a result, they give as their definition of securitization "the sale of equity or debt instruments, representing ownership interests in, or secured by, a segregated, income producing asset or pool of assets, in a transaction structured to reduce or reallocate certain risks inherent in owning or lending against the underlying assets and to ensure that such interests are more readily marketable and, thus, more liquid than ownership interests in and loans against the underlying assets." Id.

[Fn134] Leon T. Kendall, Securitization: A New Era in American Finance, in A Primer on Securitization 2 (Leon T. Kendall & Michael J. Fishman eds., 1996) (quoting John Reed, Chairman of Citicorp, Address at the Kellogg Graduate School of Management). Lewis Ranieri claims to have coined the term "securitization" when asked by a Wall Street Journal reporter what to call the process for creating a new type of mortgage-backed security. See Lewis S. Ranieri, The Origins of Securitization, Sources of Its Growth, and Its Future Potential, in A Primer on Securitization 31 (Leon T. Kendall & Michael J. Fishman eds., 1996). Ranieri reports that the Wall Street Journal used the word under protest, noting it was a term concocted by Wall Street. The newspaper treated Wall Street's coinage of the new word with the same lack of respect Judge Holt had shown Lombard Street's creation of a new form of negotiable instruments. See Kurt Eggert, Held Up In Due Course: Codification and the Victory of Form Over Intent in Negotiable Instrument Law, 35 Creighton L. Rev. 363, 387-88 (2002).


[Fn139] See discussion of the central purposes of the holder in due course rule in section IV of Eggert, 35 Creighton L. Rev. at 375.

[Fn140] Shenker & Colletta, 69 Tex. L. Rev. at 1380.

[Fn141] Id.
Held Up in Due Course: Predatory Lending, Securitization, and the Holder in Due Course Doctrine, 35 Creighton L. Rev. 503 (2002)

[Fn142] Id. at 1380-81.


[Fn144] Claire A. Hill, Securitization: A Low-cost Sweetener for Lemons, 74 Wash. U. L.Q. 1061, 1106 (1996). For a discussion of the extent of government ownership and regulatory scrutiny of these GSEs, see Robin Paul Malloy, The Secondary Mortgage Market a Catalyst for Change in Real Estate Transactions, 39 Sw. L.J. 991, 1001-02 (1986). See A. Michael Froomkin, Reinventing the Government Corporation, 1995 U. Ill. L. Rev. 543, 583 (1995) (observing that the strategies and purposes of Fannie Mae and Freddie Mac have so converged that they have essentially become competitors, if not entirely redundant). Securities issued by GSEs are perceived as relatively risk-free, as the market assumes that the securities are implicitly guaranteed by the federal government or at least, at worst, that GSEs are safe because either they are too large to fail or the United States government would not allow them to fail. Id. These GSEs were created by Congress largely to support the secondary market for residential mortgages, with the hope that this support would reduce interest rates. Roberta Romano, A Thumbnail Sketch of Derivative Securities and Their Regulation, 55 Md. L. Rev. 1, 69 (1996). Even mortgage backed securities issued by the most risk free GSE are not themselves risk free. While they may be free of the risk of default by the originator, they still can contain sizable risk that interest rate or other economic changes will substantially alter the prepayment rate, affecting the securities depending on how sensitive they are to prepayment rates. Id. at 71.


[Fn151] "Table funding" is the process whereby a loan is closed in the name of an originator, typically a mortgage broker, though the funds for closing the loan are provided by a different lender and the loan is usually assigned to that different lender almost immediately. Table funding is very confusing for borrowers. See Dominick A. Mazzagetti, Dealing with Mortgage Loan Brokers: Legal and Practical Issues, 114 Banking L.J. 923, 936 (1997). See also Joint U.S. Dept' of Housing and Urban Dev.--U.S. Dept' of the Treasury Task Force on Predatory Lending, Curbing Predatory Home Mortgage Lending 39 (June 2000), at http://www.hud.gov/library/bookshelf18/pressrel/treasrpt.pdf (last visited Mar. 9, 2002).

[Fn152] Id.


Held Up in Due Course: Predatory Lending, Securitization, and the Holder in Due Course Doctrine, 35 Creighton L. Rev. 503 (2002)

(1994) (discussing "one-off" securitizations, those where all of the assets come from one originator, as compared to multi-seller securitization conduits, where a number of originators use a common business entity to hold the assets to be securitized). The multi-seller securitization conduits have the benefit of economies of scale, and the decreased risk that a single originator's bankruptcy might affect the business entity holding the assets, while the "one-off" securitizations have the advantage of allowing the originator to tailor the securitization to the originator's particular needs. Id.


[Fn156]. Katz, 1247 PLI/Corp at 534. See also Thomas J. Gordon, Securitization of Executory Future Flows as Bankruptcy-Remote True Sales, 67 U. Chi. L. Rev. 1317, 1321-23 (2000). The above description is a simplification of the complicated world of securitization, in that exactly what the SPV transfers to the seller may depend on the form of the SPV and how it is set up. For example, if the SPV is a corporation, the investors may purchase debt obligations rather than securities. See Kenneth G. Lore & Cameron L. Cowan, Mortgage-Backed Securities: Developments and Trends in the Secondary Mortgage Market 6-34 to -35 (2000).

[Fn157]. The purpose of the SPV is three-fold: First, it provides a means for the illiquid assets to be pooled and transformed into liquid securities. Second, it protects the investors in the SPV from bankruptcy by being an entity highly unlikely to become bankrupt, since it serves mostly as a conduit for an income stream. Third, it protects the investors from claims of the originator's creditors or other third parties. Gordon, 67 U. Chi. L. Rev. at 1322-23 (2000).


[Fn159]. Henry Hansmann & Ugo Mattei, The Functions of Trust Law: A Comparative Legal and Economic Analysis, 73 N.Y.U. L. Rev. 434, 469 (1998). For a contractarian view of the law of trusts, discussing the development of the trust from a means of conveyance to a structure for management, see John H. Langbein, The Contractarian Basis of the Law of Trusts, 105 Yale L.J. 625 (1995). SPVs are dual in nature. On the one hand, they typically are in the form of a business entity defined under state law, such as a trust, a corporation, a partnership or a limited liability company. On the other hand, they may also have an identity under the federal tax code that provides favorable federal income tax status. SPVs can be REMICs ("Real Estate Mortgage Investment Contracts") or FASITS ("Financial Asset Securitization Trusts"), which are different forms of entities under the tax code. See Robert Dean Ellis, Securitization Vehicles, Fiduciary Duties, and Bondholders' Rights, 24 J. Corp. L. 295, 301 n.32 (1999); Kenneth G. Lore & Cameron L. Cowan, Mortgage-Backed Securities: Developments and Trends in the Secondary Mortgage Market 6-32 to -35, 6-115 to -117 (2000).


[Fn161]. It is important to note, however, that borrowers do not always refinance when interest rates have dropped sufficiently to make it economically reasonable to refinance. Brian A. Maris & Tyler T. Yang, Interest-Only and Principal-Only Mortgage Strips as Interest-Rate Contingent Claims, 13 J. Real Est. Fin. & Econ. 187, 187-88 (1996).

[Fn162]. Borod describes a "continuous flood of innovations in the structuring of mortgage securities," including stripped mortgage-backed securities, which separate the interest and principle payments into separate strips, and a multitude of other forms. Securitization: Asset-Backed and Mortgage-Backed Securities §1.05(A)(1) (Ronald S. Borod ed., 1999).

[Fn163]. Hill, 74 Wash. U. L.Q. at 1069 n.33.

[Fn164]. Leon T. Kendall, Securitization: A New Era in American Finance, in A Primer on Securitization 4 (Leon
Held Up in Due Course: Predatory Lending, Securitization, and the Holder in Due Course Doctrine, 35 Creighton L. Rev. 503 (2002)

T. Kendall & Michael J. Fishman eds., 1996). See also Trust Co. of La. v. N.N.P. Inc., 104 F.3d 1478, 1482 (5th Cir. 1997), regarding the value of the guarantee provided by Ginnie Mae.


[Fn168]. Such participation by the originator not only forces the originator to take the first loss, but also gives the originator an increased and extended incentive to monitor the assets and their performance. See Alan P. Murray, Has Securitization Increased Risk to the Financial System?, Bus. Econ., Jan. 1, 2001, at 6367, 2001 WL 15747038.

[Fn169]. See, e.g., Steinhardt Group Inc. v. Citicorp, 126 F.3d 144, 146-47 (3d Cir. 1997), in which the promise was made that an investor in such a securitization of delinquent and foreclosed loans could receive annual returns of eighteen percent or more annually, though in this case, the investor claimed that these were fraudulent promises, and depended on inflated valuations of the underlying properties.


[Fn172]. McDaniel, SF11 ALI-ABA at 69. See also SMFC Funding Corp. v. United Fin. Mortgage Corp., No. 97 C 3257, 1997 WL 798780, at *1 (N.D. Ill. Dec. 22, 1997), in which the Seller/Servicer Guide adopted by the securitizer of mortgage loans requires an originator to buy back any loans where any person involved in the loan transaction made any misrepresentations or pertinent omissions in connection with the loan transaction. In that case, the court refused to dismiss a claim for implied indemnification where SMFC had also pled a claim for express indemnification.

[Fn173]. See United Cos. Lending Corp. v. Sargeant, 20 F. Supp. 2d 192 (D. Mass. 1998), in which the subprime lender, United Companies, apparently attempted to justify its high interest rates by arguing that it had to buy back defaulted loans.

[Fn174]. See Trust Co. of La. v. N.N.P. Inc, 104 F.3d 1478 (5th Cir. 1997), for the record keeping used to track the sales of Ginnie Mae-issued securities to the ultimate investors, as well as a method of perpetrating fraud in such an issuance.

[Fn175]. Andrew E. Katz, Due Diligence in Asset-backed Securities Transactions, 1247 PLI/Corp 529, 534-35 (2001). Some private placements are sold directly to investors without the involvement of an underwriter. Id.

[Fn176]. Claire A. Hill, Securitization: A Low-Cost Sweetener for Lemons, 74 Wash. U. L. Q. 1061, 1067-68 (1996). Hill notes that securitization differs from factoring, though the lines between securitization and factoring can blur when the buyer actively negotiates the transaction terms. Id. at 1068 n.29 (citing Steven L. Schwarcz, The Alchemy of Asset Securitization, 1 Stan. J.L. Bus. & Fin. 133, 144 (1994)). Tamar Frankel discusses an interesting issue in securitization, namely who is in fact the issuer of the securities that result from the process: the SPV that is formed, the sponsors of the securitization process, the trustees or servicers of the SPV, or some combination of them? She concludes that this question may determine whether the securities need be registered...

[Fn177] To determine whether the transfer of the assets to the SPV constitutes a true sale, the most important factor the courts will look to is whether the transferee has any recourse against the transferor should there be problems with the assets, such as in the quality or collectibility of a loan. Steven L. Schwarcz, The Parts Are Greater Than the Whole: How Securitization of Divisible Interests Can Revolutionize Structured Finance and Open the Capital Markets to Middle-Market Companies, 1993 Colum. Bus. L. Rev. 139, 145 (1993) (citing Major's Furniture Mart v. Castle Credit Corp., 602 F.2d 538, 545 n.12 (3d Cir. 1979)). Schwarcz gives as the other important factors to determine whether a true sale has occurred the following: (1) Whether the originator has the right to redeem or repurchase the asset after it has been transferred, or has a right to any surplus generated by the asset over and above the return promised to the transferee; (2) whether the price paid for the asset is adjustable, fluctuating like a commercial loan, or fixed, with a set discount reflecting the difficulty in obtaining full value for the asset estimated at the time of the transfer; and (3) who controls the collection on and the administration of accounts, the transferor or transferee. Id. at 146-48; see also Steven L. Schwarcz, Structured Finance: The New Way to Securitize Assets, 11 Cardozo L. Rev. 607 (1990).

[Fn178] Schwarcz, 1 Stan. J.L. Bus. & Fin. at 135. For a description of the uneasy relationship between securitization and the bankruptcy process, see David Gray Carlson, The Rotten Foundations of Securitization, 39 Wm. & Mary L. Rev. 1055 (1998). Carlson argues that the securitization process should not render accounts or chattel paper bankruptcy remote, citing Octagon Gas Systems, Inc. v. Rimmer (In re Meridian Reserve, Inc.), 995 F.2d 948 (10th Cir. 1993), and especially dicta therein. Carlson, 39 Wm. & Mary L. Rev. at 1059. The basic underlying concepts of securitization have been threatened in the bankruptcy of LTV Corporation, which attempted in bankruptcy court to undo two of its own securitizations, one backed by inventory, the other by trade receivables. Though it later withdrew its attack on the securitizations after an out of court settlement, LTV's actions, buttressed by an initial Memorandum Opinion by the trial judge, threatened to challenge the belief that the securitization process could render assets "bankruptcy remote" and thus unattachable in the bankruptcy of the original owners. See David P. Jacob & Joshua P. Phillips, LTV's Threat to Securitization--Is It Over or Just Beginning?, Mar. 12, 2001, Asset Sec. Rep., 2001 WL 8009503; David Feldheim, LTV Ruling Challenges Legal Basis for Securitizations, Cap. Mkts. Rep., Feb. 16, 2001, at 15:35:00. See also the discussion of bankruptcy remoteness and the possibility of circumventing the bankruptcy remote provisions in the bylaws of corporate debtors who issue mortgage backed securities through collusion between the debtors and "friendly" creditors in Michael J. Cohn, Note, Asset Securitization: How Remote is Bankruptcy Remote?, 26 Hofstra L. Rev. 929 (1998).


[Fn186]. Although many mortgage-backed securities are not subject to the federal regulations imposing duties on most trustees, rating agencies maintain their own minimum standards for trustees and the amount of capital the trustees must maintain, for the protection of investors. Securitization: Asset-Backed and Mortgage-Backed Securities § 8.01(A) (Ronald S. Borod ed., 1997).

[Fn187]. If the servicer defaults on its obligation to pass loan payments on to the holders of the securities, the trustee must step in and remove the servicer. See FDIC v. Bernstein, No. CV 89-2080, 1990 WL 198738, at *3 (E.D.N.Y. Nov. 2, 1990), aff’d, 944 F.2d 101 (2d Cir. 1991). A master servicer collects loan payments and transmits them to the trustee, advances late loan payments to the trustee, gives pool performance reports to the holders of securities, and refers nonperforming loans to a special servicer. Sally J. Gordon, Glossary of Terms Commercial Mortgage-Backed Securities, SE76 ALI-ABA 673, 695 (2000).

[Fn188]. While specific practices vary from state to state, the standard American foreclosure process is the following: After default by the borrower, the lender gives notice of foreclosure, giving the borrower an opportunity to pay the outstanding balance to the lender. If the lender does not receive this payment, the lender may obtain a public sale of the real property securing the loan, a sale conducted either by an agent of the lender or under court supervision. Jane Kaufman Winn, Lien Stripping After Nobelman, 27 Loy. L.A. L. Rev. 541, 592 (1994). Any funds received at the sale are disbursed in the following order: first to the borrower's indebtedness to the lender, next to any junior lien holders, and last, if any funds remain, to the borrower. Id. The buyer at the public sale takes title to the property with it still encumbered by liens senior to the foreclosing lender's, but free of junior liens and the borrower's interest. Id.


[Fn190]. A recent study has concluded that while prepayment risk has a moderate effect on interest rates, the risk of defaults has only a weak effect. James W. Kolari, Donald R. Fraser & Ali Anari, The Effects of Securitization on Mortgage Market Yields: A Cointegration Analysis, 26 J. Real Est. Fin. & Econ. 677, 690 (1998).

[Fn191]. Robert Dean Ellis, Securitization Vehicles, Fiduciary Duties, and Bondholders' Rights, 24 J. Corp. L. 295, 302 (1999); Steven L. Schwarz, The Alchemy of Asset Securitization, 1 Stan. J.L. Bus. & Fin. 133, 146 (1994). Professor Hill notes that the Modigliani and Miller capital structure irrelevance theorem, which states that a firm's division of cash outflows between one or more layers of equity or debt, in other words, its capital structure is irrelevant to the value of the firm, seems to be violated by the idea that securitization can increase the value of assets held by a firm. Claire A. Hill, Securitization: A Low-Cost Sweetener for Lemons, 74 Wash. U. L.Q. 1061, 1063-64 (1996).


[Fn194]. Schwarcz, 1 Stan. J.L. Bus. & Fin. at 151.


[Fn198]. The ability to turn receivables into ready cash also creates the risk that the cash received is likely to be quickly dissipated. Chase W. Ashley, Comment, When a Company Securitizes, Its Creditors Face Higher Risks, Am. Banker., May 7, 1993, at 4. Schwarcz's response to this argument is that "given the scrutiny imposed by rating agencies and other independent parties such as credit enhancers, securitization may present fewer opportunities for self-dealing than other financing methods." Schwarcz, 1 Stan. J.L. Bus. & Fin. at 147. However, Schwarcz notes that securitization is especially suspect where the originator is near bankruptcy, presumably because the originator no longer has any fear of ratings agencies or other parties at that stage, and may feel free essentially to take the money and run. Id. Disreputable companies, with only the short term goal to deceive and defraud as many borrowers and investors as possible before folding, would have a similar freedom from fear of the long term effects of ratings agencies.


[Fn200]. Securitization is No Security Blanket, Bus. Wk., Oct. 26, 1998. The article notes that this ability of banks to reduce the amount of capital they must hold by securitizing their safer loans, while retaining their riskier loans, actually erodes the ability of bank regulators to ensure the financial stability of banks, and quotes Alan Greenspan stating, "The possibility that regulatory capital ratios may mask true insolvency probability becomes more acute."


[Fn202]. See Chris De Reza, Allegations Fly in Securities Fraud Case, Real Est. Fin. Today, Elec. Ed., June 18, 2001, at 5, 2001 WL 8192961 (describing an alleged fraudulent mortgage backed securities scheme that may have cost investors $214 million). After the company at the heart of the scheme declared bankruptcy, the bankruptcy trustee discovered that the investors were identified by number only, and alleged that some overseas investors were engaged in money laundering and tax evasion. Id.

[Fn203]. This efficiency is declining, as investors, perhaps burned once too often by declining ratings in mortgage pools, become more concerned about information regarding individual loans in the pools and securitizers are forced to disclose more and more data on those individual loans. See Mark L. Korell, The Workings of Private Mortgage Bankers and Securitization Conduits, in A Primer on Securitization 99-100 (Leon T. Kendall & Michael J. Fishman eds., 1996).

[Fn204]. Frankel, supra note 201, at § 5.11.2.

[Fn205]. Id. at § 5.11.2.

[Fn206]. During the year 2000, for example, investment houses issued 510 different upgrades to the highest quality mortgage-backed securities, due to the strong economy. See Chris De Reza, Structured Finance Upgrades Break Records, Real Est. Fin. Today, Elec. Ed., Jan. 29, 2001, at 8, 2001 WL 8192517. Securities backed by lower quality, subprime loans did much less well despite the thriving economy, with seventy-one downgrades and only
twenty-five upgrades. Id. The rating of the pool can also be changed through market forces separate from the pool itself. If, for example, interest rates drop more than expected, then more of the homeowners whose loans are part of the pool will likely refinance, and early refinancing disrupts the flow of income to the pool. Frankel, supra note 201, at § 5.11.2. Frankel also details other risks to investors, stating, "asset-backed securities can be complex. They may require full information on what the Pools contain, high level expertise, and the right software to determine and verify both the underlying assumptions on which the securities are based and their price." Id.


[Fn209]. Leon T. Kendall lists as securitization’s benefits to consumers/borrowers the following:
1. Lower costs of funds
2. Increased buffet of credit forms
3. Competitive rates and terms nationally and locally
4. Funds available consistently.

[Fn210]. Kolari, Fraser, and Anari report significant decrease in yield spreads, the difference between the effective interest rate on home loans and the interest rate generated by Treasury bills with an average maturity equal to that of the home loans, as securitization increases. James W. Kolari, Donald R. Fraser & Ali Anari, The Effects of Securitization on Mortgage Market Yields: A Cointegration Analysis, 26 J. Real Est. Fin. & Econ. 677, 679 (1998). However, the studies surveyed by these authors, though generally supporting their conclusion, do not universally demonstrate that securitization lowers borrowers’ loan or costs, and even some of these authors’ own data seems to contradict the results of their study. Id. at 685.


[Fn216]. See Ronald J. Mann, Searching for Negotiability in Payment and Credit Systems, 44 UCLA L. Rev. 951, 971 (1997) (regarding the GSEs' promulgation of standardized documents and how, through their market dominance, these documents have become the industry standard).

[Fn217]. Richard A. Posner, Economic Analysis of Law 127 (Aspen 5th ed. 1998). Given the rarity of consumers actually reading and understanding form contracts, I think it is questionable whether many sellers have sufficiently captured the market using better form contracts to force other sellers to change their form contracts in response, but at least, in the absence of an industry-wide standardized contract, a few individual consumers can express displeasure at particularly harsh form contract terms, which may lead a seller to change those terms.

[Fn218]. The standardization of loan documents is so important to loan securitization that failing to use standardized documents is one of the ten ways to make a loan nonsecuritizable listed in the article Maura B. O'Connor & James Bryce, Ten Easy Ways to Make a Loan Nonsecuritizable, 470 PLI/Real 11, 11 (2001), which deals with commercial loans.


[Fn225]. "Mortgage brokers do not have as much invested in their company [as mortgage bankers], can operate with little or no overhead, and can disappear quickly if difficulties arise." Dominick A. Mazzagetti, Dealing with Mortgage Loan Brokers: Legal and Practical Issues, 114 Banking L.J. 923, 939-40 (1997).


[Fn227]. For example, Ocwen Financial Services, headquartered in West Palm Beach, was reported to acquire mortgages from roughly 1,000 independent regional bankers and brokers from across the country as of 1998. Debra Sparks, Bad Loans Made Good, Bus. Wk., Oct. 26, 1998, at 128, 1998 WL 19884632.

[Fn229]. Keest, 1241 PLI/Corp at 1135.


[Fn232]. For a 1997 review of the bond and minimum net worth requirements of mortgage brokers, see David Unseth, Note, What Level of Fiduciary Duty Should Mortgage Brokers Owe Their Borrowers?, 75 Wash. U. L.Q. 1737, 1751-52 (1997) (reporting that thirty-nine states required some licensing to be a mortgage broker, twenty-nine required paying a fee along with a security bond and/or proof of minimum net worth, though in many cases the bond or net worth was much less than the amount of one typical home equity loan, six states required some proof of competence to be a mortgage broker, while four provided the heightened level of scrutiny they would give to real estate brokers).


[Fn239]. Myron Levin, Hitting Home Critics Say California's Lax Regulation of Loan Firms Is Allowing Unscrupulous Businesses to Prey on Unwary Homeowners, L.A. Times, July 26, 1998, at D1, 1998 WL 2448852. The broker whose license is rented is typically elderly or retired. Id.

[Fn240]. Id.

[Fn241]. Leland C. Brendsel, Securitization's Role in Housing Finance, in A Primer on Securitization 24 (Leon T.
Kendall & Michael J. Fishman eds., 1996). Brendsel opines that the easy entry into the business helps consumers by fostering competition in service, mortgage rates and products, and takes a benign view of the use of telephone and in home tactics of mortgage brokers, comparing them to the house calls of small town doctors. Id. at 24-25.


[Fn244]. Bankruptcies by these undercapitalized lenders have become epidemic. See infra note 522 and the accompanying text.


[Fn246]. Id.

[Fn247]. The HUD/Treasury Joint report notes:
State oversight of brokers, appraisers and contractors is uneven, and in some cases non-existent. Even if state enforcement in these areas were heightened, interstate problems might remain. Legal aid attorneys at the regional forums testified about unscrupulous, thinly capitalized brokers, contractors and lenders who abused consumers, declared bankruptcy, moved to new states and began operating there under different names.


[Fn250]. Dimuzio, 68 F.3d at 779.


[Fn260]. Brown, 79 F.3d at 1557, 1561.

[Fn261]. For the homeowners' too ineffectual efforts to recover their damages, see Rolo v. City Investing Co. Liquidating Trust, 155 F.3d 644 (3d Cir.1998); Dimuzio v. Resolution Trust Corp., 68 F.3d 777 (3d Cir. 1995); Rolo v. General Dev. Corp., 949 F.2d 695 (3d Cir. 1991); Rolo v. City Investing Co. Liquidating Trust, 845 F. Supp. 182, 194 (D.N.J. 1993), aff'd, 43 F.3d 1462 (3d Cir. 1994), vacated on reh'g, 66 F.3d 312 (6th Cir. 1995).

[Fn262]. James, 639 So. 2d at 1034.

[Fn263]. See also Roach v. Fed. Nat'l Mortgage Corp., 641 So. 2d 186, 187 (Fla. Dist. Ct. App. 1994), in which the court, also faced with allegations of fraud by GDC, remanded the case to the trial court to determine, among other things, whether the owner of the mortgage had ever become a holder in due course, and Najera v. NationsBank Trust Co., 707 So. 2d 1153, 1155 (Fla. Dist. Ct. App. 1998), where the court overturned summary judgment for the holder in a foreclosure action, remanding for further evidence regarding the fraud on the borrower.

[Fn264]. For a discussion of this effect in the commercial loan context, see James Bryce Clark & Maura B. O'Connor, Ten Easy Ways to Make a Loan Nonsecuritizable, 457 PLI/Real 907 (2000).


[Fn266]. Id.


[Fn268]. Id. at § 5.6.

[Fn269]. Id.; Securitization: Asset-Backed and Mortgage-Backed Securities § 8.01(C) at 8-3 (Ronald S. Borod ed., 1998). How aggressively a servicer will attempt to collect or foreclose on a loan varies from servicer to servicer, and an individual servicer may treat different borrowers disparately, depending on the time lines contained in the securitization documents, the circumstances and payment and communication record of individual borrowers, state laws, and local economic conditions. See Cordell & Trianna, Sec. Mortgage Mkts Online, Dec. 1999, at http://www.freddiemac.com/finance/smm/dec99/pdfs/whopays.pdf (last visited Feb. 16, 2002).


[Fn271]. Id.


[Fn274]. Securitization: Asset-Backed and Mortgage-Backed Securities § 8.01(C) at 8-4 (Ronald S. Borod ed., 1998).

[Fn275]. Id. at § 8.04(C) at 8-13.


[Fn277]. Even when lenders continue on as servicers, they may well be loath to work with borrowers to avoid a default, since allowing any modification of the loan may make the lender's original representations, upon which the investors relied, untrue, which could require the lender to take back the loan from the mortgage pool. K.C. McDaniel, Impact of Securitization and Conduit Financing, SF11 ALI-ABA 69, 73 (2000).

[Fn278]. The jargon of securitization is heavy with acronyms and initials. Mortgage-backed securities can be sliced up and repackaged as collateralized mortgage obligations, which are known as CMOs. A CMO that divides the ownership of the mortgage-backed securities into interest-only (IO) and principal-only (PO) pieces is called a STRIP, which stands for "Separate Trading of Registered Interest and Principal." See Robert C. Downs & Lenora J. Fowler, Derivative Securities: Governmental Entities as End Users, Bankrupts and Other Big Losers, 65 UMKC L. Rev. 483, 491 (1997). "Tranche" is, as previously mentioned, French for "strip."

[Fn279]. This conflict of interest is examined in the commercial loan context in Georgette C. Poindexter, Subordinated Rolling Equity: Analyzing Real Estate Loan Default in the Era of Securitization, 50 Emory L.J. 519 (2001). While this article extensively examines the potential conflicts of interests between the servicer and the various tranches of a commercial loan pool, it virtually ignores the effect of this conflict on the borrower, concluding that, while resolutions of this conflict may disadvantage the marginal borrower who, with time and indulgence, could work out the troubled loan... the borrowers in securitized transactions are sophisticated parties whom we can assume understand the nuances of the transaction. Hence, if a choice must be made, market efficiency should win out over borrower's rights. Id. at 562. Clearly, Professor Poindexter's analysis is not meant to apply to the much less sophisticated residential borrowers.

[Fn280]. See Downs & Fowler, 65 UMKC L. Rev. at 491 n.65 (noting that early prepayment or late payment of a loan causes one tranche of a securitization to benefit at the expense of another).

[Fn281]. Professor Poindexter points out that, at least for the securitization of commercial loans, most pooling and servicing agreements establishing the securitization limit the liability of some of the parties steering the loan pool, allowing them to take some actions even though they favor one class of securities holders over another. Poindexter, 50 Emory L.J. at 560. Providing the opportunity for immunity would not necessarily make a servicer willing to test the limits of that immunity by restructuring a loan for the benefit of a defrauded borrower.

[Fn282]. Fidelis Oditah, Selected Issues in Securitization, in The Future for the Global Securities Market 83, 89 (Fidelis Oditah ed., 1996). Oditah argues that separating the various aspects of the loan process provides greater efficiency by allowing lending institutions to specialize, concentrating on specific parts of the process while leaving the remainder to other specialized institutions. See also Frankel, 8 Duke J. Comp. & Int'l L. at 259. Frankel also stresses the efficiency that unbundling creates, stating, 

[While banks provide "bundled" services (raising funds, usually through deposits, originating and servicing loans, and holding them to maturity), securitization has "unbundled" these functions, enabling separate actors to perform one or more of these functions and linking the actors through a sponsor rather than one super-intermediary. This "unbundling" and the use of specialized actors can enhance efficiency.]

Id. (internal footnote omitted).
[Fn283]. See Frankel, 8 Duke J. Comp. & Int'l L. at 259 (noting that the borrower may be dealing with foreign corporations, who would be even more immune to local pressure).


[Fn285]. Diana B. Henriques & Lowell Bergman, Mortgaged Lives: a Special Report, N.Y. Times, Mar. 15, 2000, at A1, Abstract available at 2000 WL 19064943. Currently, in the wake of wide publicity about predatory lending as well as suits against firms such as Lehman Brothers regarding their securitization of loans originated by predatory lending, these Wall Street firms may have finally taken some steps to ascertain whether they are involved with predatory loans. See Kyriaki Venetis, Case's Progress a Concern for 'Street'?, 26 Nat'l Mortgage News, Jan. 28, 2002, at 2, 2002 WL 8158690. This action may only be short lived, however, if the Wall Street firms win those suits and if the public outcry against predatory lending, now at a feverish pitch, abates somewhat.

[Fn286]. Frankel, 8 Duke J. Comp. & Int'l L. at 263. The extent to which securitization depersonalizes the lending process is demonstrated by Frankel's discussion of off-shore SPVs, so that the beneficial owner of the loan pool could be located, to the extent an SPV has any exact location, in another country. Id. at 266.

[Fn287]. For a discussion of this rationale for the prohibition against assigning the right to collect a debt, see W. M. Holdsworth, The Origins and Early History of Negotiable Instruments, Part I, 31 Law Q. Rev. 12, 13 (1915).


In securitization, the endorsement requirement raises a serious practical problem when the number of notes involved (e.g., in the sale of mortgage loans) is enormous, and endorsement is very costly. In addition, the borrowers may default, and notes should be in the name of the servicer or collector to facilitate court proceedings against the borrowers.

Id. Ronald Mann also asserts that in the course of securitization, notes are not transferred by endorsement and delivery. Ronald J. Mann, Searching for Negotiability in Payment and Credit Systems, 44 UCLA L. Rev. 951, 970 (1997).


[Fn290]. See Michael G. Jacobides, Mortgage Banking Unbundling: Structure, Automation and Profit, Mortgage Banking, Jan. 1, 2001, 2001 WL 28402001 for this observation of the decline in servicing by the originators of loans and the probable causes for that decline.


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(last visited Mar. 22, 2002).


[Fn298]. For cases in which the court held that an allonge could be used only when there was insufficient space on the note for an indorsement, see Crossland Sav. Bank v. Constant, 737 S.W.2d 19, 21 (Tex. Ct. App. 1987); Pribus v. Bush, 173 Cal. Rptr. 747, 749, 751 (Ct. App. 1981); and Bishop v. Chase, 56 S.W. 1080 (Mo. 1900). But see Osgood's Admrs. v Artt, 17 F. 575 (C.C. Ill. 1883); Haug v. Riley, 29 S.E. 44, 46 (Ga. 1897); and Com. Secur. Co. v. Main St. Pharmacy, 94 S.E. 298, 299 (N.C. 1917) for cases in which the court held that use of an allonge was proper even though the note had space available for indorsement. For a discussion of these cases generally, see V.G. Lewter, Annotation, Indorsement of Negotiable Instrument by Writing Not on Instrument Itself, 19 A.L.R.3d 1297 (1968).

[Fn299]. "An indorsement on an allonge is valid even though there is sufficient space on the instrument for an indorsement." U.C.C. § 3-204, cmt.1 (1999). See also John Krahmer, Commercial Transactions, 53 SMU L. Rev. 729, 737-38 (2000) (discussing conflicting opinions on whether cases arising under the previous Article 3 should be interpreted under the more flexible rules of the 1990 revision).

[Fn300]. U.C.C. § 3-202(2) (Pre-1990 Version). See Barry Hart Dubner, The Case of the $19 Million Staple, 6 Cooley L. Rev. 37, 45 (1989). See also S.W. Resolution Corp. v. Watson, 964 S.W.2d 262, 264 (Tex. 1997) (holding that an allonge was "firmly affixed" to a note where it had been stapled, clipped, and taped to the note, then removed and restapled multiple times, as the holder removed the staple in order to photocopy the note and allonge separately).


[Fn305]. Id. at 1195-97.

[Fn306]. Id. at 1197-98.


[Fn308]. Midfirst Bank, 893 F. Supp. at 1312 (citation omitted). See also James v. Nationsbank Trust Co., 639 So. 2d 1031 (Fla. Dist. Ct. App. 1994) discussed supra, in which a trustee of a mortgage pool moved for summary judgment based on its alleged status as a holder in due course. The court denied that motion, based on allegations by the borrowers that the trustee had purchased the pool of mortgages with actual knowledge of the fraudulent sales scheme of the originator of the loans, a wholly-owned subsidiary of a company indicted for criminal fraud for its sales of overpriced houses through fraudulent appraisals that misrepresented the value of the homes. Id. at 1034. However, it appears that unless the borrowers could somehow show that the trustee had knowledge of the originator's fraud at the time the trustee acquired the mortgages for the pool, then the borrowers' defenses based on the fraud conducted by the originator of the note would be cut off because the trustee would be a holder in due
course.


[Fn311]. Dupuis, 879 F. Supp. at 146.

[Fn312]. Philip S. Porter, The Two Faces of Truth--in Lending, 12-APR S.C. Law. 18 (2001). At the time of his article, Porter was South Carolina's Consumer Advocate and current administrator of its Department of Consumer Affairs. Id.

[Fn313]. Donna Tanoue, 'Predatory Lending' Raises Default Risk, Mortgaging Serv. News, June 16, 2000, at 4, 2000 WL 18803344 (quoting Interagency Guidance on Subprime Lending, March 1, 1999). As the subprime market continues to expand and mature and traditional banks increasingly enter the subprime market, this definition will become anachronistic, since it will become traditional for banks to lend to subprime borrowers.


[Fn315]. Id. at 2.


[Fn319]. Joint U.S. Dep't of Housing and Urban Dev.--U.S. Dep't of the Treasury Task Force on Predatory Lending, Curbing Predatory Home Mortgage Lending 34 (June 2000), at http://www.hud.gov/library/bookshelf18/pressrel/trearsrpt.pdf (last visited Mar. 9, 2002). These borrowers with little documentation are labeled "low-doc" or "no-doc" borrowers. Id.


borrowers and credit into categories such as "A," "B," "C," "C-" and "D" even though there is no universal industry standard for these categories. Borrowers with almost unblemished credit records are given "A" ratings, while those currently in bankruptcy or foreclosure are rated "F". See Predatory Lending Practices: Hearing Before United States Senate Special Comm. on Aging, 105th Cong. (1998) (statement by Prof. Gene A. Marsh, University of Alabama School of Law), available at 1998 WL 8993224.


[Fn327]. Mansfield, 51 S.C. L. Rev. at 536-37. Professor Mansfield's findings correlate with the 1998 estimate of the subprime industry's own trade group, the National Home Equity Mortgage Association (NHEMA), that subprime mortgages' average interest rate is between two percent and six percent higher than the prime rate. See Statement of the National Home Equity Mortgage Association on Home Mortgage Lending Disclosure Reform Before the Housing & Community Development and Financial Institutions & Consumer Credit Subcomms. of the U.S. House of Representatives Committee on Banking and Financial Services (September 16, 1998), at http://www.house.gov/financialservices/91698nhec.htm (last visited June 19, 2001). A more recent estimate is that subprime mortgages average 1.5% to 7% higher than prime mortgages. Robert Pollsen, Joseph Hu & Jay Elengical, Residential MBS Post Solid Year, Mortgage Banking, May 1, 2001, at 4254, 2001 WL 11398554.


[Fn329]. See Harold L. Bunc, et al., Subprime Foreclosures: The Smoking Gun of Predatory Lending? 258-59, available at http://www.huduser.org/publications/polleg/hpcproceedings.html (last visited Feb. 23, 2002). A basis point is 1/100 of 1 percent, so that 215 basis points equal 2.15%, and a 10% interest rate is 200 basis points higher than an 8% interest rate.


[Fn335]. Id. at 48.

[Fn336]. A Woodstock Institute Report, Two Steps Back: The Dual Mortgage Market, Predatory Lending, and the Undoing of Community Development, found that the prime lenders who serve white and upper-income neighborhoods have not provided credit as widely in lower income and minority neighborhoods. Report Finds Dual Market in Refinance Loans Subprime Lenders Dominate Lending in Minority Neighborhoods, Woodstock Institute, at http://www.woodstockinst.org/twosteps.html (Nov. 15, 1999) (last visited Feb. 24, 2002). The Woodstock Institute concludes that this failure by prime lenders to lend in lower income or minority neighborhoods has provided great impetus to subprime lenders to dominate these neighborhoods. Id.


[Fn338]. Timothy C. Lambert, Fair Marketing: Challenging Pre-Application Lending Practices, 87 Geo. L.J. 2181, 2221 (1999). Lambert notes that "a particular segmentation of the market may be permissible if the additional process costs of obtaining the needed information to extend credit to a smaller number of borrowers in a low-income neighborhood exceeds the expected losses to the financial institution for not lending to this creditworthy group." Id.

[Fn339]. Lambert, 87 Geo. L.J. at 2221-22. Lambert notes that financial institutions seeking to lend in low income neighborhoods will have greater information gathering costs, as much of the income and assets of potential borrowers in these neighborhoods does not fit into the lenders' typical models for credit standards; income such as informal rent payments and assets held outside of bank accounts are not counted by underwriters, and there may be fewer property appraisals in neighborhoods where banks have offered fewer loans, making any new appraisals less reliable. Id. Credit scoring is a process of assigning numerical values to a variety of factors that indicate the creditworthiness of a potential borrower, then applying a statistical formula to those various numerical values, creating an individual number representing the creditworthiness of the subject. Among the factors examined are income, assets, employment, debt and repayment history, and age. Kenneth G. Gunter, Computerized Credit Scoring's Effect On the Lending Industry, 4 N.C. Banking Inst. 443, 444 (2000).

[Fn341]. For example, an estimated thirty-five percent of subprime borrowers were fifty-five years old or older, compared to only twenty-one percent of subprime borrowers. Joint U.S. Dep't of Housing and Urban Dev.--U.S. Dep't of the Treasury Task Force on Predatory Lending, Curbing Predatory Home Mortgage Lending 36 (June 2000), at http://www.hud.gov/library/bookshelf18/pressrel/treasrpt.pdf (last visited Mar. 9, 2002).


[Fn347]. Joint U.S. Dep't of Housing and Urban Dev.--U.S. Dep't of the Treasury Task Force on Predatory Lending, Curbing Predatory Home Mortgage Lending 26, 28 (June 2000) (citation omitted), at http://www.hud.gov/library/bookshelf18/pressrel/treasrpt.pdf (last visited Mar. 9, 2002). In their article, Mortgage Credit Outlook, Mark M. Zandi and Brian Nottage cite an estimate by Economy.com that there is $400 billion in subprime loans currently outstanding, which is 9% of the total mortgage debt outstanding. Mark M. Zandi & Brian Nottage, Mortgage Credit Outlook, Sec. Mortgage Mkts. Reps, Feb. 2001, at 3.


[Fn351]. Id.

[Fn352]. Id.


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[Fn355] Lawrence Richter Quinn, Subprime's Thaw, Mortgage Banking, May 1, 1999, at 18, 1999 WL 12029538. First Franklin Financial Corp., of San Jose, CA, is another example of such rapid growth in the mortgage industry. See First Franklin, About First Franklin Financial Corp., at http://www.first-franklin.com/about/corporate.html (last visited Mar. 10, 2002).

[Fn356] For example, one mortgage originator dropped from three hundred employees nationwide in late 1998 to just six in 2000, though its chief executive said, "[I]f the secondary market changes, I'll be back in business in a big way." Mary Fricker, Lender Exits Subprime Loans, The Press Democrat (Santa Rosa, Cal.), June 18, 2000, at E1, 2000 WL 6213513.


[Fn364] Id.


[Fn368] Id.


[Fn374]. See id.


[Fn376]. For a defense of including non-economic losses, such as pain and suffering, in any economic analysis of the effects of tortious behavior, see generally Steven P. Croley & Jon D. Hanson, The Nonpecuniary Costs of Accidents: Pain-and-suffering Damages in Tort Law, 108 Harv. L. Rev. 1785 (1995) (defending the inclusion of non-economic losses, such as pain and suffering, in any economic analysis of the effects of tortuous behavior).


[Fn378]. See Jeanne L. Schroeder, Rationality in Law and Economics Scholarship, 79 Or. L. Rev. 147, 244-45 (2000) (discussing the "Madelaine" effect and its economic implications).


[Fn380]. Forrester, 69 Tul. L. Rev. at 386.

[Fn381]. For a discussion of the humiliation and threatened loss of independence the elderly experience as a result of being victims of crime, see Jeffrey L. Bratkiewicz, "Here's a Quarter, Call Someone Who Cares"; Who Is Answering the Elderly's Call for Protection from Telemarketing Fraud?, 45 S.D. L. Rev. 586, 590 (2000); Trent M. Murch, Note, Revamping the Phantom Protections for the Vulnerable Elderly: Section 3A1.1(b), New Hope for Old Victims, 6 Elder L.J. 49, 55-56 (1998).

[Fn382]. One study concluded that the life expectancy of the homeless is only fifty-one years, over twenty years less than the national average. See Sandra Guthans, Homeless Elderly Live Their Lives On the Brink, New Orleans Times-Picayune, Dec. 19, 1999, at 3C, 1999 WL 29019056. According to a study by the Federal Interagency Council on the Homeless, eight percent of the homeless clients interviewed were fifty-five years old or older, but forty-five percent of the non-homeless that used homeless services were elderly, likely showing the effects of efforts to prevent homelessness among elderly. See Martha R Burt, et al., Homelessness: Programs and the People They Serve, at http://www.huduser.org/publications/homeless/homelessness/ (Dec. 1999) (last visited Aug. 27, 2001).

[Fn383]. Marybeth Shinn & Jim Baumohl, Rethinking the Prevention of Homelessness, at http://aspe.hhs.gov/progsys/homeless/symposium/13-Preven.htm (last visited Feb. 26, 2002) ("The HOPE program in Pennsylvania, Ohio, Kentucky, Texas, and Colorado (Sch wartz et al., 1991) to prevent mortgage foreclosures provided good evidence that homelessness prevention has benefits to the community that go beyond benefits to people whose homelessness is averted.").


[Fn386]. Id. at 49.


[Fn388]. See supra note 188-89 and accompanying text for the foreclosure process and a discussion of how a borrower normally loses any equity in the house when it is foreclosed.


[Fn400]. See In re Murray, 239 B.R. 728 (Bankr. E.D. Pa. 1999) (noting that the remedies are “(1) termination of the creditor’s security interest; (2) statutory damages for failing to properly respond to the rescission demand; (3) a penalty measured by at least recoupment against the remaining unsecured claim on account of the original TILA disclosure violations; (4) elimination of all finance charges; and (5) where equitable to do so, elimination of the debtor’s entire obligation to the creditor and (6) recovery of all payments made; and (7) recovery of reasonable
attorneys’ fees and costs by the successful debtor’s counsel").


[Fn411]. 12 C.F.R. § 226.32(e)(3).


[Fn416]. One lender, for example, revealed how near its fees were to the fee trigger when it estimated that ninety percent of its loans would be covered by HOEPA if the fee trigger would include the cost of single premium credit insurance. See Sandra Fleishman, Fed Favors Tougher Loan Rules, Abuses in SUBPRIME Lending Are Targeted, Wash. Post, Dec. 14, 2000, at E01, 2000 WL 29921414.


[Fn418]. Id. "While most analysts consider HOEPA to have been effective, we hear reports of lenders skating just below the HOEPA requirements and still engaging in egregious practices," said Gramlich, on the board of governors of the Federal Reserve. Carol Hazard, Predatory Loans Often Set up Borrowers for Failure and Can Cost Them Their Biggest Investment: Their Homes. Move Afoot to Halt Abusive Lending; Big Business Targets Low-income Districts, Richmond Times-Dispatch, Oct. 9, 2000, at A1, 2000 WL 5049721.


[Fn426]. This point is made in Keest, 1241 PLI/Corp at 1139.


[Fn429]. This discussion of the complexity of HOEPA and the detrimental effect of that complexity to the enforcement of HOEPA was suggested to me, along with examples of that complexity, by Kathleen Keest, to whom I am grateful.


[Fn432]. How unlikely it is that a borrower will find an attorney who understands HOEPA can be seen in the case Bostic v. Am. Gen. Fin., Inc., 87 F. Supp. 2d 611 (S.D. W. Va. 2000), in which the court accepted as reasonable the statement of borrower's attorney that no other attorney in the state of West Virginia sufficiently understood TILA (of which HOEPA is a complicated part) and the Equal Credit Opportunity Act (ECOA) to aid him in litigating the case, necessitating that he bring in counsel from out of state. The attorney stated that the out of state counsel's role was key in dealing [with] the Truth in Lending as well as the ECOA claim. I know of no one else in West Virginia who has any substantial knowledge of Truth in Lending and ECOA claims, and it was essential to go out-of-state to get this kind of experience.

[Fn433]. An example of how difficult HOEPA is for judges to apply can be found in the case In re Barber, 266 B.R. 309 (Bankr. E.D. Pa. 2001). There, the court wrestled with the basic question of whether HOEPA abrogates the holder in due course doctrine, stating all too tentatively, at least one court has held that Section 1641(d) "eliminates HDC [holder in due course] defenses as to all claims asserted by the consumer under TILA or other laws, unless the assignee proves, by a preponderance of the evidence, that it could not determine that the loan was a HOEPA loan."

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[Fn439]. Id.

[Fn440]. Michael Youngblood, real estate analyst for Banc of America Securities, explained how lenders can conceal that a loan is covered by HOEPA: "And if they're lying to the company that buys their loans, and saying there's been no more than five points, or no more than ten points associated with a given loan, when in reality the total number of points is much higher, it's very difficult to uncover fraud until it's too late." Michael Gregory, If Trusts Were To Break Wide Open: The Shake-Up in Subprime Lending and Its Impact on ABS, Asset Sales Rep., June 26, 2000, 2000 WL 3953601.

[Fn441]. Arguably, HOEPA deters even the dishonest predatory lender once the buyers of mortgage discover this fraud. However, as demonstrated by the examples of fraud described herein, the damage that a dishonest lender can do before its fraud is discovered is extreme.

[Fn442]. E. Scott Reckard, California Mortgage Lender Hit With State Lawsuit, L.A. Times, June 13, 2001, at C2, 2001 WL 2495071. Because First Alliance is such a central figure in the ineffectiveness of efforts to deal with predatory lending, any detailed discussion of this issue must account for First Alliance's stunning success and even more sudden bankruptcy.


[Fn448]. Dan Weikel, Mortgage Company Spared From Receivership, Orange County (Cal.) Reg., Oct. 7, 1988, at A03, 1988 WL 4453689. The judge also rejected the state's ban on First Alliance's advertising. Id.


[Fn463]. Id.


[Fn465]. Id. at 11.


[Fn467]. Id.


[Fn470]. Id.


[Fn479]. See Alan S. Kaplinsky & Mark J. Levin, Anatomy of An Arbitration Clause: Drafting and Implementation Issues Which Should Be Considered By a Consumer Lender, SF81 ALI-ABA 215, 223-24, 228 (2001) (citing several First Alliance cases involving arbitration clauses, including Jones v. First Alliance, No. 98 C 3848 (N.D. Ill., Nov. 30, 1998) (holding an arbitration clause binding despite the lender's failure to explain it, stating "Loans generate a lot of paper, and no law of which I am aware requires the papers to be orally explicated to the signers"); Bagley v. First Alliance Mortgage Co., No. 299-CV-578B (D. Utah, Feb. 10, 2000); Bright v. First Alliance Mortgage Co., Case No. 99CV3762 (Dist. Ct., City and County of Denver, CO, Feb. 28, 2000); McAndrew v. First Alliance Mortgage Co., No. 1:99-CV-00206 (N.D. Ill., May 5, 1999); Pajter v. First Alliance Mortgage, No. CV766996 (Cal. Super. Ct., Dec. 12, 1997) and Durney v. First Alliance Mortgage Co., No. HO18267 (Cal. App. 1999)).

[Fn480]. For a discussion of the benefits to a consumer lender generally of arbitration agreements, as well as the drafting issues involved and a discussion of the resulting litigation, see Alan S. Kaplinsky & Mark J. Levin, Anatomy of an Arbitration Clause: Drafting and Implementation Issues Which Should Be Considered by a
Consumer Lender, SF81 ALI-ABA 215 (2001).


[Fn482]. See Smith, 50 DePaul L. Rev. at 1223 ("Thus, out of court dispute arbitration is attractive to large corporations because, without precedent, it can continue engaging in harmful or unlawful practices without fearing lawsuits or bad publicity.").


[Fn496]. Jan Norman, Maintaining Their Optimism First Alliance Mortgage's Leaders Say Their Company Will
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[Fn514]. Id.


[Fn519]. Although the language of HOEPA already seems clear, the Federal Reserve Board has proposed a "clarification" that HOEPA does in fact eliminate the holder in due course doctrine for high cost loans, a proposal that the Federal Trade Commission opposes because it could be used by targets of current FTC action as a basis to claim that the holder in due course doctrine survived HOEPA even in high cost loans before the "clarification." See Letter from the FTC, to the Board of Governors of the Federal Reserve System (Mar. 9, 2001), available at http://www.ftc.gov/be/v010004.htm (last visited Mar. 7, 2002) (commenting on proposed changes to HOEPA).


[Fn525]. Citibank may be trying to clean up the lending practices of Associates, as it reportedly stopped doing business with over 4,000 brokers, suspended more than 1,300 foreclosures "over concerns about the original Associates loan," and ceased using single premium credit insurance. Mike Vogel, Hazel Ruffin Got a Loan... How Far Should Florida Go in Curbing Credit?, Fla. Trend, Mar. 1, 2002, at 42, 2002 WL 11485547.


[Fn528]. Mansfield, 1242 PLI/Corp at 11.


[Fn544]. Cal. Fin. Code § 4979.8 (2002) ("The provisions of this division shall not impose liability on an assignee that is a holder in due course. The provisions of this division shall not apply to persons chartered by Congress to engage in secondary market transactions.").
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[Fn553]. See discussion of the early warning system created by lenders and securitizers at notes 583-87, infra, and the accompanying text.


[Fn556]. Posner, supra note 554, at 13-15. Posner states that, because "[t]he conditions for Pareto superiority are almost never satisfied in the real world, ... the operating definition for efficiency in economics must not be Pareto superiority. When an economist says that [a transaction] is efficient, nine times out of ten he means Kaldor-Hicks efficient." Id. at 14-15.

[Fn557]. According to Milton Friedman, the test to determine whether a transaction benefits both parties is whether the transaction is bilaterally voluntary and informed. See Milton Friedman, Capitalism and Freedom 13 (1962).

[Fn558]. For a discussion of how rational consumers price risk to factor it into their choices, see Milton Friedman & Leonard J. Savage, The Utility Analysis of Choices Involving Risk, 56 J. Pol. Econ. 279, 288-93 (1948).


[M]arket imperfections, especially those contributing to consumers' imperfect knowledge, undermine the core postulate of the classic Chicago School model. The consumer's signature cannot be viewed as a voluntary acceptance of terms that will necessarily result in wealth maximization. Consumers cannot 'voluntarily' accept terms of which they are unaware. Similarly, consumers' lack of knowledge precludes the assumption that each has acted in his or her self-interest to maximize his or her wants.

Id.

[Fn560]. Lary Lawrence, Misconceptions about Article 3 of the Uniform Commercial Code: A Suggested Methodology and Proposed Revisions, 62 N.C. L. Rev. 115, 152 (1983) (footnotes omitted). Nelson and Whitman defend the rule, even while acknowledging how few understand it, stating: "[T]he word order warns the mortgagor that he or she is signing a negotiable instrument, with the potential liabilities that implies. Perhaps many
mortgagors have no idea what the word means, but the rule is clear, all the same." Grant S. Nelson & Dale A. Whitman, Real Estate Finance Law 390-91 (4th ed. 2001). But what importance is clarity, one might ask, when few of the residential borrowers affected know of the rule which Nelson and Whitman assert is clear? See section VI(C)(4), infra, for the argument that the holder in due course rule not only is relatively unknown by the borrowing public, but also its effect is not even clear, to borrowers, to lenders or even to judges.

[Fn561] The holder in due course doctrine is "hard...to explain." Grant Gilmore, The Commercial Doctrine of Good Faith Purchase, 63 Yale L.J. 1057, 1098 (1954).

[Fn562] See Am. Fin. Serv. Ass'n v. FTC, 767 F.2d 957, 980-81 (D.C. Cir. 1985) (stating that HDC rule promulgated "to prevent consumers from being victimized by a counter-intuitive legal doctrine").


[Fn565] Evidence that subprime borrowers are regularly entering into loan agreements that do not benefit them can be seen in the mounting numbers of foreclosures of subprime loans, discussed in section IV(C) supra, as well as in the staggering percentage of subprime borrowers who would have qualified for prime loans, discussed in notes 366-67, supra, and the accompanying text.

[Fn566] In his article, "The External Triangles of the Law:" Toward a Theory of Priorities in Conflicts Involving Remote Parties, 90 Mich. L. Rev. 95 (1991), Menachem Mautner calls this conflict between two victims of a con artist, (the original victim and the innocent purchaser of the interest obtained from the original victim by fraud), a "triangle conflict," as all three parties have a hand in creating the conflict, but typically only the two victims will bear any of the loss. Mautner also notes that these triangle conflicts may be analyzed as accidents, using the same "efficiency imperative" developed for tort accidents. Id. at 102.

[Fn567] As we have seen from the examples of First Alliance and GDC, even large, apparently well-funded organizations can strand their victims without adequate recourse by declaring bankruptcy. See discussion at notes 255 and 503, supra, and the accompanying text.

[Fn568] See discussion of the real defenses in note 102, supra, and the accompanying text.

[Fn569] Karl Llewellyn performed perhaps the first economic analysis of the holder in due course doctrine and recognized that the doctrine was, in the banking system of the day, probably an inefficient method of resolving the dispute between the borrower and the holder in due course of a note. He wrote, in a fascinating footnote to his chatty article Meet Negotiable Instruments:

Negotiability presupposes a policy judgment, conscious or unconscious, that we shall throw the total loss one way, not seek to split it. Much more deeply and much more dubiously, today, it presupposes a policy judgment that despite the growth (1) of our commercial banking system, and (2) of our insurance system, and (3) of our not wholly negligible machinery for the policing and prevention of frauds and forgeries, and (4) of our also not undeveloped system of policing bankers' credit risks--despite all of these things (and with bankers constituting the overwhelming mass of holders in due course of commercial paper) we shall go on applying the "party versus party" legal machinery for seeing the issue and solving it which goes back to the commercial and financial conditions of Lord Holt. It would seem plain that the agency-or-sale approach to collection risks requires rethinking in the light of the modern institution of deposit-insurance. Is there not similar thinking to be done about negotiability, in terms of risk-spreading and of risk-reduction? I offer no answer.

K.N. Llewellyn, Meet Negotiable Instruments, 44 Colum. L. Rev. 299, 321 n.5 (1944). And so he stepped back from the brink, concluding that even wise alterations might be too disruptive if applied solate in the day, but noting that there might be material differences in how "personal" and business instruments should be treated.
[Fn570]. Robert D. Cooter & Edward L. Rubin, detailed three of these four principles, namely loss reduction, loss imposition, and loss spreading in A Theory of Loss Allocation for Consumer Payments, 66 Tex. L. Rev. 63, 67 (1987). To these, I have added loss activity assignment, a detailed discussion of which can be found in Guido Calabresi, Some Thoughts on Risk Spreading and the Law of Torts, 70 Yale L.J. 499 (1961).

[Fn571]. Loss activity assignment appears to be a toss-up in the question of assigning risk of loss between investors and borrowers, since both are fairly equally engaging in the creation, sale and collection of the loans. Therefore, this issue will not be addressed separately outside of this footnote.

[Fn572]. Cooter & Rubin, 66 Tex. L. Rev. at 73.

[Fn573]. See Robert Cooter & Melvin Aron Eisenberg, Damages for Breach of Contract, 73 Cal. L. Rev. 1432, 1464 (1985) ("Incentives for precaution [in contract] are efficient if they compel the promisor to balance the cost of his precaution against the cost of failing to take precaution, including the risk to the promisee of losing his share of the contract's value.").

[Fn574]. Robert Cooter, Unity In Tort, Contract, and Property: the Model of Precaution, 73 Cal. L. Rev. 1, 3-29 (1985). See also Robert D. Cooter & Thomas S. Ulen, An Economic Case for Comparative Negligence, 61 N.Y.U. L. Rev. 1067 (1986) (arguing that comparative negligence is an effective system because it allocates some risk of loss to all parties to a loss, thus inducing each to take precautionary measures).

[Fn575]. Cooter & Rubin, 66 Tex. L. Rev. at 74.

[Fn576]. Id. at 127.

[Fn577]. See Michael Ferry, Home Buyers Should Be On the Lookout for Predatory and Abusive Lending, St. Louis Dispatch, July 20, 2000, at 4, 2000 WL 3537854 (offering advice to borrowers for avoiding predatory loans).


[Fn579]. See discussion of predatory lending charges against First Alliance and other subprime lenders in section V(B) supra.

[Fn580]. Predatory Mortgage Lending: The Problem, Impact and Responses: Hearing Before the Senate Comm. on Banking, Housing and Urban Affairs, 107th Cong. (2001) (testimony of John A. Courson, President and CEO, Central Pacific Mortgage Co., on behalf of the Mortgage Bankers Association), available at http://banking.senate.gov/01_07hrg/072701/courson.htm (last visited Mar. 11, 2002). Courson states: "[T]he complexity of the current system is the camouflage that allows unscrupulous operators to hide altered terms and conceal crucial information without fear of the consumer discovering or even understanding the import of the masked or undisclosed items." Id. See also Cooter & Rubin, 66 Tex. L. Rev. at 69 (discussing the "incomprehensible legalisms of form contracts and statute books" in consumer payments contracts).


[Fn582]. For a discussion of the complexity that security to a loan inevitably causes, see Kurt Eggert, Held Up in Due Course: Codification and the Victory of Form Over Intent in Negotiable Instrument Law, 35 Creighton L. Rev. 363, 401-03 (2002), and also Lincoln Nat. Bank v. Perry, 66 F. 887, 894 (8th Cir. 1895), in which the judge held that such a complex loan document should not be negotiable because it could too easily become a trap for the
unwary.


[Fn585]. See Draft Memorandum from the FDIC Staff, How to Avoid Purchasing or Investing in Predatory Mortgage Loans (November 2000), at http://www2.fdic.gov/epc/predlend/ (last visited Mar. 9, 2002).


[Fn590]. This process is discussed in notes 583-87, supra, and the accompanying text.

[Fn591]. See discussion of the requirement of standardized documents for securitization in note 218, supra, and the accompanying text.

[Fn592]. Cooter & Rubin, 66 Tex. L. Rev. at 75.

[Fn593]. According to Cooter and Rubin: "The parties' responsiveness to liability rules depends on their knowledge of law and their ability to factor this information into a calculus of costs." Cooter & Rubin, 66 Tex. L. Rev. at 75.


[Fn595]. Cooter & Rubin, 66 Tex. L. Rev. at 77 ("The responsiveness element of loss reduction, like the innovation element, correlates with the size and nature of the party, particularly for losses that arise infrequently and involve esoteric laws.").

[Fn596]. See discussion of the inherent difficulty of the holder in due course doctrine in notes 560-65, supra, and the accompanying text.
[Fn597]. Cooter and Rubin distinguish responsiveness and learning as separate elements of the operation of the loss reduction principle, but at the same time note that learning is a dynamic factor of responsiveness. See Cooter & Rubin, 66 Tex. L. Rev. at 73. I have chosen to analyze them together because, without learning of the assignment of risk, parties cannot be responsive to it, and without any resulting responsiveness, learning by itself would come to naught.


[Fn603]. A recent report by researchers for Freddie Mac reports the following rates of reduction in 90-day delinquency rates on mortgages for the following types of counseling: individual counseling: 34 percent reduction; classroom counseling 26 percent reduction; home study 21 percent reduction; and telephone counseling: no statistically significant impact on borrower delinquency. See Abdighani Hirad & Peter M. Zorn, A Little Knowledge Is a Good Thing: Empirical Evidence of the Effectiveness of Pre-Purchase Homeownership Counseling 2 (2001), at http://www.freddiemac.com/corporate/reports/ (last visited Mar. 9, 2002).


[Fn605]. For a description of recent, extensive efforts by the mortgage industry to institute effective methods of investigating mortgage fraud, see Dona DeZube, Fraudgate, Mortgage Banking, Nov. 1, 2000, at 1825, 2000 WL 12170912.


[Fn607]. "Consumer protection... is likely to increase at a decreasing rate in response to further liability." Cooter & Rubin, 66 Tex. L. Rev. at 92.
[Fn608]. Id. at 78 ("If reallocating the loss is required for increased efficiency, then the most desirable enforcement
process is the one that will shift liability as cheaply as possible from the creditor to the party that should suffer the
final loss. This goal can be achieved by fashioning simple, clear, and decisive liability rules.").

[Fn609]. See discussion of the difficulty of obtaining uniform results in applying the holder in due course doctrine
and how that doctrine is often overruled by TILA, though in a way non-uniformly applied by the courts, in the
Diamond/Obie cases, discussed in section II(D) supra.

[Fn610]. See discussion of HOEPA in section V(A) supra.


[Fn615]. Given that both Advanta and Bankers Trust claimed to be holders in due course in these two published
decisions, one wonders how often they both claimed to be holders in due course in unpublished cases, either before
arbitrators or trial judges.

apparently became defunct. Id.

[Fn617]. Hays, 46 F. Supp. 2d at 495.

[Fn618]. Id. at 496-97.

[Fn619]. See 15 U.S.C. § 1641(d)(1). See also the discussion of HOEPA's limited abrogation of the holder in due
course doctrine for HOEPA loans in notes 409-13, supra, and the accompanying text.

[Fn620]. Hays, 46 F. Supp. 2d at 497 n.12.

[Fn621]. Id. at 497.

[Fn622]. As Guido Calabresi noted in 1961, this was even then not a novel proposition. Guido Calabresi, Some
Thoughts on Risk Distribution and the Law of Torts, 70 Yale L.J. 499, 517 & n.49 (1961) (citing L.W. Feezer,
Capacity to Bear Loss as a Factor in the Decision of Certain Types of Tort Cases, 78 U. Pa. L. Rev. 805, 809-10
(1930)).


[Fn624]. Posner views the risk averseness of people in general as a corollary to the diminishing marginal utility of
money, Richard A. Posner, Economic Analysis of Law 12 (Aspen 5th ed. 1998), apparently with the idea that if
people value what they already have, or could be certain to get, more than they value a smaller chance at obtaining
a much larger amount, then it must be because they value the smaller amount of money more for each dollar than
they value the chance at the larger amount of money.

[Fn625]. Calabresi, 70 Yale L.J. at 518. Calabresi disparages the theory of the diminishing marginal utility of
money, stating that then-recent studies indicate that a loss of a relatively small amount of money can have nearly
as significant an effect on an individual as a much larger loss if they each cause approximately the same change in
the person's social position. However, simply because particular instances can be found where the marginal utility
diminishes at a much smaller rate than is ordinary does not invalidate this theory as a general matter, so long as one is mindful that exceptions exist.

[Fn626]. This point is made, using a consumer installment contract as an example, in Russell B. Korobkin & Thomas S. Ulen, Efficiency and Equity: What Can Be Gained by Combining Coase and Rawls?, 73 Wash. L. Rev. 329, 334-35 (1998). Arguably, such an allocation of risk may damage society by discouraging the accumulation of wealth and the energetic endeavors that produce wealth. However, it is not clear that the wealthy provide more valuable service to society than the less wealthy, or that loss allocation would be sufficient to dampen anyone's desire to gain more wealth or willingness to take measures to do so.


[Fn630]. Frank S. Alexander, Mortgage Prepayment: The Trial of Common Sense, 72 Cornell L. Rev. 288, 330 (1987) (stating that the secondary market, including securitization, "allows issuers and investors to hedge against risks associated with individual mortgages by aggregating mortgages from different geographical areas").

[Fn631]. Calabresi noted the insurance effect of pools of mortgages even before the advent of securitization, stating, "[F]rom the standpoint of total loss spreading, the ideal would be for all insureds to be in one great pool so that the burden of all accidents would be evenly distributed among all people." Calabresi, supra, note 627, at 48.

[Fn632]. Cooter & Rubin, 66 Tex. L. Rev. at 78.

[Fn633]. Id.


[Fn635]. U.C.C. § 3-104(d).

[Fn636]. See Gregory E. Maggs, The Holder in Due Course Doctrine as a Default Rule, 32 Ga. L. Rev. 783, 798 (1998) ("A waiver of defense clause (also known as a "cut off" or "hell or high water" clause) says that the obligor under the contract waives the right to assert defenses against subsequent assignees.").

[Fn637]. For the most complete explication of this argument, see Gregory E. Maggs, The Holder in Due Course Doctrine as a Default Rule, 32 Ga. L. Rev. 783 (1998).


[Fn639]. Id.

Held Up in Due Course: Predatory Lending, Securitization, and the Holder in Due Course Doctrine, 35 Creighton L. Rev. 503 (2002)

[Fn641]. Maggs, 32 Ga. L. Rev. at 816.

[Fn642]. Id. at 805.

[Fn643]. Id. at 818.


[Fn645]. See also the discussion of the efficiency of the holder in due course doctrine in Clayton P. Gillette, Rules, Standards, and Precautions in Payment Systems, 82 Va. L. Rev. 181, 237-43 (1996), in which Gillette concludes that the rule is efficient over all, even though the so called "real defenses" seem a motley collection of defenses thrown together with little rhyme or reason.


[Fn647]. Ayres & Gertner, 101 Yale L.J. at 760.

[Fn648]. Id.

[Fn649]. Id. at 761. Of course, in the consumer setting, this argument depends on the notion that consumers can be sufficiently alerted to the doctrine of the holder in due course, would understand that doctrine if they were alerted to it, and would take an active role in replacing the default rule with a separately negotiated provision. Instead, as discussed in notes 561-66, supra, and the accompanying text, consumers would be unlikely to understand the holder in due course doctrine even if they were alerted as to its existence. Furthermore, most consumer notes are essentially contracts of adhesion, neither understood nor negotiated by consumers, and if the holder in due course doctrine were to be abolished, with no explicit rules taking its place, no doubt lenders would merely insert nearly identical terms in the boilerplate of the contract and so achieve the same effect with the same lack of efficiency or intent by the consumer to waive any of her defenses.

[Fn650]. Calabresi notes, in a discussion of accidents equally applicable to fraud: "[F]ree market determination of the value of accident costs will lead to an acceptable result only if the potential injurers and victims are reasonably aware of and take account of the risks, i.e. only if they have adequate statistical knowledge of the risks involved and act on that knowledge. Injurers may often obtain and act on such knowledge, but as we have seen... victims are unlikely to do either." Calabresi, supra, note 627, at 91.


[Fn652]. Kripke, 68 Colum. L. Rev. at 473.


[Fn657]. Ayres and Gertner state: "While ex post each party will have economic incentives to shift costs to the
other side, ex ante the parties have an incentive to place the risks on the least-cost avoider," Ian Ayres & Robert Gertner, Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules, 99 Yale L.J. 87, 89 n.18 (1989) (citing Kronman, Mistake, Disclosure, Information and the Law of Contracts, 7 J. Legal Stud. 1 (1978)). Ayres and Gertner propose an alternative to the traditional "what the parties would have wanted" theory, arguing that penalty defaults would better force the parties to disclose material information to each other. For the more traditional view, see Richard A. Posner, Economic Analysis of Law 104-05 (Aspen 5th ed. 1998) and see Charles J. Goetz & Robert E. Scott, The Mitigation Principle: Toward a General Theory of Contractual Obligation, 69 Va. L. Rev. 967, 971 (1983) ("Ideally, the preformulated rules supplied by the state should mimic the agreements contracting parties would reach were they costlessly to bargain out each detail of the transaction.").

[Fn658]. See Michael I. Meyerson, The Efficient Consumer Form Contract: Law and Economics Meets the Real World, 24 Ga. L. Rev. 583, 587 (1990) ("To be consistent with the principle that efficient contracts arise from voluntary negotiations, default rules must approximate what the parties would have agreed to had they negotiated the issue.").

[Fn659]. Todd D. Rakoff, in his article Contracts of Adhesion: An Essay in Reconstruction, 96 Harv. L. Rev. 1173, 1177 (1983) has identified seven characteristics of contracts of adhesion:
(1) The document whose legal validity is at issue is a printed form that contains many terms and clearly purports to be a contract.
(2) The form has been drafted by, or on behalf of, one party to the transaction.
(3) The drafting party participates in numerous transactions of the type represented by the form and enters into these transactions as a matter of routine.
(4) The form is presented to the adhering party with the representation that, except perhaps for a few identified items (such as the price term), the drafting party will enter into the transaction only on the terms contained in the document. This representation may be explicit or may be implicit in the situation, but it is understood by the adherent.
(5) After the parties have dickered over whatever terms are open to bargaining, the document is signed by the adherent.
(6) The adhering party enters into few transactions of the type represented by the form--few, at least, in comparison with the drafting party.
(7) The principal obligation of the adhering party in the transaction considered as a whole is the payment of money.

Rakoff, 96 Harv. L. Rev. at 1177.

[Fn660]. The terms of the standardized form contracts are unlikely even to be bargained on in the aggregate by consumers choosing lenders with better terms since, as noted supra, where the harsh terms are not known or understood by consumers, the presence of those terms will not deter customers or lead to a loss of business by the lender. See Meyerson, 24 Ga. L. Rev. at 605.

[Fn661]. Rakoff, 96 Harv. L. Rev. at 1179.

[Fn662]. As discussed in note 218, supra, and the accompanying text, the standardization of contracts necessary for securitization has effectively eliminated the loan customer's ability to bargain for form contracts with more beneficial terms.


[Fn665]. Edward L. Rubin, Learning From Lord Mansfield: Toward a Transferability Law for Modern Commercial Practice, 31 Idaho L. Rev. 775, 777 (1995). Rubin notes the inelgance of using the term "balance," stating "the recent revisions of Articles 3 and 4 were specifically designed not to change the original balance between banks
and consumers, even though one observer described that balance, when established in 1950, as 'a deliberate sell-out of the American Law Institute and the Commission of Uniform State Laws to the bank lobby.'


[Fn668]. See Homer Kripke, Consumer Credit Regulation: a Creditor Oriented Viewpoint, 68 Colum. L. Rev. 445, 473 (1968) (observing that in a legitimate market, the holder in due course doctrine is statistically insignificant).

[Fn669]. See supra notes 366-67 and the accompanying text for a discussion on the surprisingly large number of subprime borrowers who could have obtained conventional loans with much better terms, such as lower interest rates and fees.

[Fn670]. As discussed in note 343, supra, and the accompanying text, subprime borrowers are, on average, less educated than prime borrowers, which may to some extent explain subprime lenders' ability to charge them above market rate loans.

[Fn671]. It was this predatory competition that led legitimate North Carolina lenders to press state legislators to pass laws designed to suppress predatory lending. The legitimate lenders were weary of seeing their customers stolen by predatory lenders charging higher interest and fees through aggressive and deceptive marketing. "We saw these horrible abuses of the people who are our customers," one such legitimate lender declared. See Jim Peterson, Lender Beware. "Predatory Lending" Threatens Subprime Lenders, A.B.A. Banking J., at 40, Feb. 1, 2001, 2001 WL 11595148.

[Fn672]. See supra discussion at note 329.

End of Article