Behavioral Exploitation Antitrust in Consumer Subprime Mortgage Lending

Max Huffman
Daniel Heidtke

Available at: https://works.bepress.com/max_huffman/3/
ABSTRACT

We analyze whether antitrust might provide an alternative and perhaps superior approach to regulating consumer subprime mortgage lending. Behavioral exploitation antitrust targets commercial conduct of the sort that was observed in consumer subprime mortgage lending in the years leading up to 2007. The welfare effects of that conduct are easily established. Antitrust-based regulation can mitigate those welfare effects. The regulation that does exist, which operates at the level of the individual transaction, may be easily avoided, may be short-sighted, may suffer from enforcement problems that public choice theory explains, and/or may overreach by removing consumer choice. We show that antitrust enforcement under a rule of reason approach avoids those pitfalls. However, none of the three primary approaches to antitrust enforcement – prohibitions of anticompetitive conduct by a dominant firm, prohibitions of anticompetitive agreements, and prohibitions of mergers with incipient anticompetitive effects – in their current form permit resort to antitrust remedies in the consumer subprime mortgage market. We argue that liberalized standards for antitrust enforcement under both Clayton Act section 7 (regulating mergers) and Sherman Act section 1 (regulating concerted conduct), perhaps restricted narrowly to this and closely analogous markets, would be appropriate to gain the benefits of regulation through behavioral exploitation antitrust.

TABLE OF CONTENTS

I. INTRODUCTION

II. Welfare Effects in Mortgage Markets and Failures of Existing Regulation
   A. Behavioral Exploitation in Subprime Mortgage Lending
   B. Problems with the Regulatory Status Quo Ante

III. A Role for Antitrust Law
   A. Behavioral Exploitation as Bad Antitrust Conduct
   B. Antitrust Avoids the Problems with the Leading Approaches to Consumer Mortgage Regulation

IV. Moving to Behavioral Exploitation Antitrust

V. Conclusion

I. INTRODUCTION

The grass roots of the 2007 financial crisis was the market for consumer home mortgages. This market was rife with failures, many of which occurred because consumers suffered well-understood

* Associate Professor and Dean’s Fellow, Indiana University Robert H. McKinney School of Law. A draft of this paper accompanied a talk given at the Loyola Consumer Law Review Symposium, “The Continuing Effect of the Mortgage Crisis on Consumers,” Loyola University – Chicago School of Law. Thanks to participants at that symposium; Letha Flint; and Michael Pitts for insights.

** Fellow, Institute for Consumer Antitrust Studies, Loyola University – Chicago School of Law.
limitations on their abilities to maximize their own economic welfare and lenders knew how to exploit those failures. The market failures created substantial resource misallocation: more consumers borrowed more money on different terms than they would have in a market in which consumers acted in their own economic best interest. That resource misallocation took the form of an “asset bubble”: more homes were built and sold than would have been in a market in which consumers acted in their own economic best interest.

Regulators proved to be unable or disinclined to prevent the asset bubble. Some combination of a dereliction of duty, a lack of foresight, a lack of economic rationality, and/or perverse incentives created by the structure of the political and regulatory system were at play. We accept the proposition that regulator foresight was impossible. On that basis, we seek a means to prevent future crises other than simply more regulation. We propose that behavioral exploitation antitrust may prevent future such asset bubbles in consumer markets. We go further and argue that US-style antitrust law and policy is institutionally superior to the modes of regulation that have been relied on to date.

The root cause of the asset bubble was behavioral exploitation, whereby lenders intentionally exploited consumers’ known decision-making biases, creating a market effect. That conduct should give rise to antitrust liability. Antitrust’s remedial scheme is more likely than are other regulatory schemes to forecast future such crises that have their roots in consumer markets. As Darren Bush recently observed, “antitrust law is one of the ingredients which flavors our national economy and ought to be seriously reconsidered in light of its role in helping shape the current state of that economy.”

We extend the existing literature on consumer harm from behavioral exploitation by showing that an antitrust remedy may be available and is superior to other regulatory approaches to this conduct.

Antitrust law exists to protect against the ravages of private enterprise that the market cannot be relied on to avoid market failures. Market failures might arise when one firm or a group of firms are able to prevent, or at least to delay, the market’s correcting functions. There are two primary tools in the antitrust kit that might be employed to prevent financial crises caused by the failure of systemically important firms or groups of firms. First, antitrust has been used to prevent undue concentration in an industry. At its most extreme and controversial, this market-structure-oriented approach to enforcement might encourage the forced dismantling of firms in a market that is considered unduly concentrated. Such an approach harkens to the Structure-Conduct-Performance paradigm, a now disfavored — though in some circles resurgent — school of antitrust thought from the middle of the last century. Middle-ground

2 “Market failure” is a technical misnomer for a market response that is simply too slow to protect against substantial short- and medium-term harm. Thus, broad industry collapse might not represent market failure at all, but a necessary adjunct to the establishing of a stronger industry, which will emerge after a period of shake-out. Like Keynes, who famously observed that long run solutions are of limited value in the real world, we nonetheless consider such a delayed market response to be intolerable. See John Maynard Keynes, A Tract on Monetary Reform 80 (reprinted, Prometheus Books 2000) ("The long run is a misleading guide to current affairs. In the long run we are all dead."). (Keynes wrote of monetary policy, with specific reference to price inflation in the absence of government regulation, and not of the microeconomic conduct that we consider here.) Antitrust has a place in such a non-failure circumstance as well. It can hasten discipline that the market might after time provide, but that threatens to arrive too late to prevent against substantial short- to medium-term harm.
approaches, including blocking mergers to unwieldy size and taking into account merging firms’ demonstrated propensity to engage in harmful conduct, remain vibrant and may serve a remedial purpose in consumer subprime markets.

Antitrust’s second tool is targeting bad conduct by firms that enables success on bases other than superior efficiency. That bad conduct may lead to, or help to preserve, the same unwieldy market structure that merger review exists to prevent. It is well understood that bad conduct that leads to or preserves monopoly power may also bring about resource misallocation. That resource misallocation occurs in the case of behavioral exploitation when demand is stimulated to a level inconsistent with consumers’ actual preferences.

We apply behavioral exploitation antitrust to conduct in the consumer subprime mortgage markets that underlay the 2007 financial crisis. We adopt the commonly held understanding of the root cause of the crisis: the sale of millions of mortgage products to consumers in transactions that were either actually fraudulent or exploited those consumers’ inabilities to act in pursuit of their own economic best interest. The conduct produced short-term success for firms engaged in it. That success spurred competition through similar conduct, leading to an asset bubble. We demonstrate here that an antitrust-based approach could prevent the grass-roots conduct that led to market failure. There is reason to hope that our

Serious thought has been given in very recent years to imposing structural limits in financial marketplaces. One author notes: “both the Dodd-Frank Act and the [EU Vickers Commission] Report make some ‘structural reform’ proposals for solving the problem of too-big-to-fail.” Abd Matouk, “Too Big to Fail: Banking Regulatory Reform and What Still Needs to be Done,” Comp. Pol’y’s Int’l 22, 23 (2011). Under modern approaches, however, U.S. antitrust law is limited to preventing mergers to unwieldy size, and has no tools for limiting or reducing firm size when growth is organic. Others have proposed a role for antitrust in limiting firm size, with an eye toward the systemic problems of dominant firms’ stumbling and failing, but those approaches require changes in enforcement philosophy by both enforcement agencies and by courts. See Jesse W. Markham, Jr., Lessons for Competition Law from the Economic Crisis: The Prospect for Antitrust Responses to the “Too Big to Fail” Phenomenon, 16 Fordham J. Corp. & Fin. L. 261, 262 (2011) (“Antitrust law could make a greater contribution in resolving this public-policy problem if Congress enacted or the judiciary forged more robust rules preventing and dismantling unwieldy corporate size in excess of any plausible scale efficiency justification.”).

See United States v. Aluminum Co. of Am., 148 F.2d 416, 430–31 (1945) (discussing a firm’s ability to acquire monopoly power through conduct).


arguments might be extended, and that antitrust enforcement promises to be a successful preventative strategy for future asset bubbles that rely on consumer spending.14

In Part II we first define behavioral exploitation and show how it occurred and caused harm in the consumer subprime mortgage markets. We then discuss the regulatory protections that exist and proved to be ineffective in preventing the 2007 crisis. We explain why these leading approaches to consumer mortgage regulation proved insufficient to prevent the subprime mortgage lending that led to the crisis.

Part III discuss a behavioral exploitation antitrust claim for conduct in these markets. Although the behavioral exploitation antitrust claim is a natural fit for the conduct in consumer subprime mortgage markets, we conclude the claim is not cognizable under the current state of antitrust law. We thus devote Part IV to proposals for changing the law, either through legislation, common-law interpretation, or regulation.

II. WELFARE EFFECTS IN MORTGAGE MARKETS AND FAILURES OF EXISTING REGULATION

Behavioral exploitation was common in consumer subprime mortgage transactions prior to 2007. It caused harms to consumers which aggregated to create market effects. Resources were misallocated as more consumers borrowed more money to buy more houses than they would have had they followed their utility maximizing strategies. And the regulatory schemes in place suffered from flaws including short-sightedness, regulatory capture, easy avoidability, and removal of consumer choice. Further, the statutory provisions regulating mortgage transactions have been the subject of seemingly steady reform and amendment, requiring almost constant observation to remain abreast of the current state of the law.16 The primary response to the financial crisis, the Dodd-Frank Act, does not solve those problems.

A. Behavioral Exploitation in Subprime Mortgage Lending

Behavioral exploitation is intentionally exploiting known biases in consumer decision-making.19 The theory rests on an understanding of consumer marketplaces, like those for subprime mortgages, as being characterized by sophisticated repeat-player merchant sellers and relatively naïve end-users.

14 Our argument relies on asymmetries in either information or sophistication between two parties to an ostensibly consensual transaction. It is readily applicable to consumer transactions, which are characterized by an asymmetry between the two parties: the seller of a good or the provider of a service on the one hand and the consumer on the other. One party is usually a highly sophisticated corporation, the other – an individual, prone to the behavioral flaws that make us human.” Oren Bar-Gill, Seduction by Plastic, 98 Nw. U.L. Rev. 1373, 1373 (2004). We do not in this paper extend the argument beyond consumer marketplaces.

16 See generally, T. Thomas Cottingham, III, Mortgage and Asset Backed Securities Litigation Handbook § 5:1, detailing the amendments to TILA, including: HOEPA, and then a period of several months in which TILA and the HOEPA amendments were amended by the Mortgage Disclosure Improvement Act of 2008 (MDIA), and the Emergency Economic Stabilization Act of 2008 (EESA), which further amended the MDIA’s amendments to TILA.

Behavioral Exploitation Antitrust

purchasers.\textsuperscript{20} Consumer credit markets are understood to possess these characteristics.\textsuperscript{21} In particular, consumer subprime mortgage transactions frequently involve borrowers with the dual characteristics of below-average education and limited experience with transactions in the market.\textsuperscript{3}

Those exploitable biases, sometimes called decisionmaking heuristics, are mental short-cuts that facilitate rapid decisionmaking but frequently cause consumers to deviate from their utility maximizing decision paths.\textsuperscript{23} A marriage of economics, social psychology, and management theory, termed behavioral economics, has demonstrated that individuals systematically deviate from utility maximizing conduct, sometimes by being more altruistic than their utility functions would predict; sometimes by exhibiting less will-power than their utility functions would predict; and sometimes by exhibiting cognitive shortcomings.\textsuperscript{26} Those three deviations from utility maximizing conduct have been called bounds on consumer rationality.\textsuperscript{24} They give rise to a host of demonstrated cognitive biases.\textsuperscript{26} Some empirically observed phenomena are highly relevant to consumer lending markets, including “hyperbolic discounting” or “myopia,” the tendency to ignore long-term costs and benefits such that decisions are made on the basis of short-term cost-benefit analyses,\textsuperscript{27} and the “optimism bias,” which causes a consumer to discount statistically likely future harm and over-rely on statistically unlikely future benefits.

\section{The Reality of Behavioral Exploitation}

Behavioral economics was late to the party. The real-world practice of behavioral exploitation stems from knowledge gained over many decades of study that is well documented in the marketing literature. Too few in the law and economics, and in particular in the antitrust, realm, have seen fit to study the business and management theory literature when theorizing on the development of legal rules.\textsuperscript{28}

\begin{thebibliography}{99}
\bibitem{20} Huffman, supra, draft at 38-40.
\bibitem{22} See Laurie A. Burlingame, A Pro-Consumer Approach to Predatory Lending: Enhanced Protection Through Federal Legislation and New Approaches to Education, 60 Consumer Fin. L.Q. 460, 462 (2010).
\bibitem{23} See Daniel Kahneman, Thinking Fast and Slow 25 (2011) (subconscious “System 1” decisions are “usually accurate” and are “swift and generally appropriate," but subject to “systematic errors”).
\bibitem{24} See Christine Jolls et al.,
\bibitem{25} Jolls, Sunstein & Thaler (Stanford 1998).
\bibitem{26} Empirical study has demonstrated myriad cognitive biases, many of which are closely related to long-established biases. Wikipedia contains an impressive list. See en.wikipedia.org/wiki/List_of_cognitive_biases (visited February 9, 2012). More in-depth discussion can be found in sources including Daniel Kahneman, Thinking Fast and Slow (2011), and Dan Ariely, Predictably Irrational (2008).
\bibitem{28} See id.
\bibitem{29} Spencer Waller has recognized this problem. In 2001, Professor Waller noted the oddity that we relied so much on economic teaching rather than lessons from business and management theory. Spencer W. Waller, The Language of Law and the Language of Business, 52 Case Western Res. L. Rev. 283 (2001). He was right to do so. As he pointed out in 2001, while economists found themselves hung up with theoretical concerns over whether certain practices could possibly cause harm, by, for example, creating market power that enabled a firm to raise prices or decrease output or quality, business persons recognized that in the real world just that was going on. See Spencer Weber Waller, The Language of Law and the Language of Business, 52 Case W. Res. L. Rev. 283 (2001). It is an interesting aside that the expert regulators tend to come either from legal, or economic, backgrounds, but much less from.
\end{thebibliography}
Merchants have studied means to exploit hyperbolic discounting, the optimism bias, and other cognitive biases when contracting with consumers. Another demonstrated bias causes consumers to make decisions on the basis of salient – noticeable – characteristics over characteristics that are less pronounced. Consumers may borrow money on the basis of the interest rate or down payment rather than repayment penalties. The endowment effect or ownership bias increases the value to us of what we have relative to what we do not have. Taken together, a merchant might induce a soft (psychological) commitment to a transaction by quoting a low price before interposing other expenses. This is drip pricing or shrouding, well-studied techniques of exploiting cognitive biases to induce consumers to pay more for the product or service than they would if presented with all the costs up front.  

Hyperbolic discounting and optimism biases come into play here as well. If future costs are uncertain, consumers can be expected to envision best-case scenarios or to ignore those costs altogether in their decision-making.

A 2009 study of pricing practices concluded that drip pricing is one of two practices with the “greatest potential to cause harm” by inducing consumers to enter transactions they would not have entered had the prices been fully disclosed up front. Drip pricing and price shrouding succeed both by increasing willingness to pay, exploiting the endowment effect, and by obfuscating the actual price. A consumer may learn about the actual price after the consumer is committed to the transaction, or may never learn about the actual price.

It requires little extension of these studies to see their impact on consumer subprime mortgage transactions. Scholars have identified three dominant characteristics of consumer subprime mortgage transactions. According to one leader in the study of the behavioral economics of consumer credit transactions, consumer subprime mortgage transactions are characterized by supra-normal cost deferral and an “exceedingly high level of complexity.” Neither can be explained at the level that they occur in, subprime lending under an assumption that both parties act rationally to maximize their utility. Others

The UK Office of Fair Trading has concluded that drip pricing is one of the two most pernicious pricing practices from the perspective of causing purchasers to spend more than they wished (in the absence of the pricing practice) to spend. See UK Office of Fair Trading, “Advertising of Prices,” available at oft.gov.uk/OFTwork/markets-work/current/advertising-prices/.

Consumers encounter drip pricing on a daily basis, in sales pitches as mundane as “would you like to add a cookie for only $0.99 more today?” and as frustrating as “that will be $60 for your two checked bags — how would you like to pay for that today?” See, e.g., “Optional service fees & government taxes,” U.S. Airways.com, available at usairways.com/en-US/traveltools/specialneeds/ticketingpolicies/taxesfees.html?c=hp_txt_01120 (visited Feb. 9, 2012).

have observed that subprime borrowers are on average less sophisticated, in terms both of education and experience in the market, than borrowers generally.

Supra-normal cost deferral is analogous to drip pricing techniques. A lender can charge more on a transaction if the up-front price is low by first advertising a salient up-front price in the form of a low–even zero–down payment. The supra-normal cost deferral, whereby “in 2005, 2006, and the first half of 2007, the median subprime borrower put no money down, borrowing 100 percent of the purchase price of the house,” 34 might produce both of the effects of drip pricing. Before becoming aware of the reality of their obligations, consumer borrowers can become committed to a transaction – having picked out the paint, or shared photos of the house with friends – and thereby willing to incur greater expense than they otherwise might have been willing to incur. Cost deferral, like drip pricing, has obfuscating effects as well. Because the real cost of a credit transaction depends on time value of money considerations, the more costs are deferred, the more difficult it is for a consumer accurately to calculate the real cost of borrowing.

The obfuscating effect is compounded by complex credit terms that prevail in consumer subprime mortgage transactions. Those may include “multiple, indirectly defined interest rates . . . “further complicated by maximum adjustment caps.” 35 Steffen Huck and Zidong Zhou, leading commentators on the competitive effects of exploiting cognitive biases, have concluded that this complexity serves to hide from the consumer the actual price of the credit. Markets operate more efficiently in the presence of information and transparency. A profit maximizing lender that is able to hide real prices in complex terms will charge higher prices because of the reduced risk that the borrower will shop around. 36

Finally, the consumer subprime borrower is characterized by limited education and experience, rendering him or her susceptible to exploitation. Education and experience render consumers more able to protect themselves against the harms from behavioral exploitation. 37 The lack of those advantages leaves the consumer relatively more susceptible. Experience usually will be limited because home mortgage transactions are consummated infrequently in any one borrower’s economic lifetime, so consumer borrowers do not have the opportunity to realize their errors and act differently in future transactions. 38 As lower income borrowers, subprime borrowers may not have the experience of frequent recourse to credit markets in any form. A related characteristic of many subprime borrowers is old age, 39 which some evidence indicates correlates with reduced cognitive abilities as regards financial transactions. 40

35 Id. at 1078.
36 Huck & Zhou argue: “The adverse effects of poor decisions with regards to search and quality can be made worse through firms’ deliberate attempts to make price comparisons and search harder – through complex pricing, shrouding, obfuscation and other means.” Huck & Zhou, supra, at 7.
38 Huck and Zhou suggest that ex post detection and realization of errors offers “the biggest scope for alleviating market failures”. Huck & Zhou, supra, at 8.
39 See Burlingame, supra, at 462.
40 See Huck & Zhou, supra, at 58.
Behavioral Exploitation Antitrust

2. Welfare Effects: Harms to Consumers and Suboptimal Resource Allocation

Behavioral exploitation is well understood to cause harm by undermining efficient resource allocation. Consumers are induced to enter transactions they would eschew but for the conduct, or to enter transaction on terms that they would consider intolerable but for the conduct. Resources flow to consumers' ostensible, rather than actual, preferences. That creates a surplus (relative to unbiased demand) of one sort of goods and services and a commensurate shortage of another. For example, high dollar subprime mortgages may crowd out small dollar prime mortgages if consumers are induced to enter inappropriate transactions. Aggregate welfare is thereby diminished.

This effect differs from demand-curve shifting that underlies dynamic competition, whereby the introduction of the iPad created demand for tablet computers that previously did not exist. Behavioral exploitation is not a question of introducing and marketing new products, changing consumers' utility functions permanently (or until the next innovation comes along). Behavioral exploitation is a question of a short-term shift in the demand curve, altering consumers' understandings of their own utility functions long enough to bring about a transaction that cannot be reversed.

Oren Bar-Gill has recognized the welfare effects of conduct meeting the definition of behavioral exploitation that we outline here. He explains how those welfare effects occur in subprime mortgage contracts that “share two suspect features” of cost deferral and complexity we discuss above. Bar-Gill identified a “demand-side market failure” that occurred when imperfectly rational borrowers “demanded” complex deferred-cost loans and lenders met this demand. That market failure produced welfare effects in four ways. Complexity hinders competition by undermining comparison shopping; cost-deferral leads to increased rates of default with consequent harm to borrowers and third parties (including “the economy at

---

41 See Huck & Zhou, supra, at 7 (warning of “overproduction of goods that in the end will be thrown away or suboptimal design of products that may have too much of one attribute and too little of another”).
42 For another concrete example, behavioral exploitation may produce too much demand for consumer subprime mortgage lending. The supply response will reduce the supply of (for example) student loans and increase their cost relative to subprime mortgage loans.
46 Bar-Gill, Competition and Consumer Protection, supra n. at 13-16. Scholars have for years observed the market failures associated with information asymmetries, which are closely related to the disparities in sophistication that underlie merchants’ abilities to exploit naïve consumers. See, e.g., Richard Craswell, Tying Requirements in Competitive Markets: The Consumer Protection Issues, 62 B.U. L. Rev. 661, 671 (1982). Craswell also noted the efficiency loss resulting from this exercise of power. Id. at 672.
48 Id. at 1080.
large"); subprime contracts suffer distributive consequences because poor borrowers are uniquely affected; and demand for home mortgage products is artificially inflated.49

It is possible to theorize the size of the welfare effect in any individual transaction. Any amount paid on an expected value basis over the consumer’s reservation price in the mortgage transaction should be considered pure wealth transfer to the lender. 50 (Although it is possible that consumers will be willing to pay some additional to a trusted lender, whether in exchange for avoided search costs or due to perceived quality difference, that effect will be very small. It may also be possible to compare amount paid to reservation price on a lender-by-lender basis, eliminating any effect from brand loyalty.)

Determining exactly what that differential is in a particular transaction is more challenging. One could engage in exit polling-type surveys of consumer borrowers, asking after the transaction was consummated how much the consumer was willing to pay and comparing it to the actual transaction terms. The advantage of this approach is that any such survey would account for factors that may have been unforeseeable prior to the consumer’s actually consummating the transaction, such as falling in love with a home that is more expensive than originally anticipated.51 It suffers from the drawback that exit polling is both administratively difficult and not necessarily reliable.

A second approach would be to compare the loan terms of the consummated transaction against those of transactions that the consumer eschewed. A consumer borrower who chooses an adjustable-rate mortgage over a fixed-rate mortgage that is less expensive on an expected value basis may have been behaviorally exploited. This approach suffers two drawbacks. First, many subprime borrowers fail to qualify for an array of lending options. Second, there are a variety of factors that might explain a borrower’s choice of loan terms, even under an assumption of rational choice. For example, a borrower with no money available for a down payment but who reasonably expects to come into money in the medium term might purchase immediately (to take advantage of low prices, or so as not to lose a particularly attractive property) on terms that would be unattractive for most borrowers, but avoid the problems of the onerous loan terms by paying the loan off early.

The determination of welfare effects across the market is more readily determined than it is in any one transaction. Determining the costs of particular pernicious loan characteristics gives an approximation for market-wide welfare effects. Eric Stein conducted an early study that preceded the most substantial excesses in subprime mortgage lending over the past decade. His report estimated “that U.S. borrowers lose $9.1 billion annually to predatory lending practices,” following a definition of predatory lending that included conduct within the ambit of behavioral exploitation.52 Of the lending practices studied, “equity stripping” – the charging of fees, credit insurance, and prepayment penalties – represented 2/3 of the

49 Id. at 1083.
50 This definition of the transaction-level welfare loss accommodates the possibility that but for the behavioral exploitation the transaction would not have occurred at all. If a consumer borrower is willing to pay X but the lender is able to convince him or her to pay X+1 (not changing his or her mind, but undermining his or her ability to appreciate the actual cost), the consumer will have paid X+1 for a product he or she values at X and would gladly exchange for something valued at X+1.
51 This effect may itself be the result of behavioral exploitation by the seller of the home or a real estate agent.
Behavioral exploitation is a close cousin of deception, the practice of inducing a transaction on the basis of material misrepresentations (or omissions that operate as misrepresentations) that has long been regulated at common law and by both federal and state statute.\textsuperscript{53} A simple example illustrates the difference between the two. A materially false statement of, or a material omission to state (in a context where the omission creates a misimpression), a transaction term is deceptive.\textsuperscript{54} Thus, a deceptive lender might say “that’s everything,” but later include a fee that was not disclosed. By contrast, an accurate statement of the same transaction term in a context that renders the consumer unable to appreciate its importance is behavioral exploitation. A behaviorally exploitative lender might disclose the fee only at the very last minute, when the consumer is psychologically and practically (having, for example, agreed to the underlying purchase transaction) committed to proceed.

Deception certainly took place in the market for consumer subprime home mortgages leading up to the 2007 financial crisis. The Financial Crisis Inquiry Commission reports, among other examples, anecdotes of consumers who agreed to one set of loan terms and signed papers reflecting other loan terms.\textsuperscript{55} This conduct creates harm in the same way as does behavioral exploitation: the deceived consumer enters a transaction he or she otherwise would not consummate, creating an economy-wide welfare loss.\textsuperscript{56}

B. The Problems With the Regulatory Status Quo Ante

A hodge-podge of targeted, consumer-protection based regulation developed in the years leading up to the financial crisis. The existing consumer protection and remedial structure remains insufficient, inefficient, and bewildering. One court expressed regret evidencing insufficiency of the current state of regulation of the mortgage lending industry: “The power to curb predatory practices lies either in consumer education or with Congress; as a court of limited jurisdiction, I may only enforce the laws as written, not as I would wish they were written.”\textsuperscript{57}

1. Existing Federal and State Mortgage Regulation

Federal regulation of grass-roots transactions revolved around two primary statutes. First, the Truth in Lending Act (TILA) is a “remedial consumer protection statute,” which requires and regulates lender disclosures at the time of a consumer loan application, including those for home mortgage loans.\textsuperscript{58}

\begin{itemize}
\item \textsuperscript{53} See generally Michael M. Greenfield, Consumer Transactions 6-183 (2009) (discussing federal and state regulation of deception)
\item \textsuperscript{54} See supra Part II.
\item \textsuperscript{55} See Financial Crisis Inquiry Report at 7-8, 12; Bernstein Senate Testimony 3.
\item \textsuperscript{56} Cite to Stucke deception paper.
\item \textsuperscript{57} Parker v. Long Beach Mort., 534 F. Supp. 2d 528, 530 n. 2 (E.D. Pa. 2008); See also Bryce, Foreclosure Developments, Mortgage Fraud…
\item \textsuperscript{58} 15 U.S.C.A. § 1601 et seq.; see also, Reg. Z § 226.19 (requiring lenders is to give early estimated disclosures at the time of the loan application).
\end{itemize}
TILA provides a private right of action for consumers against creditors who fail to make required disclosures, which may be pursued in either federal or state court.\(^{59}\) At bottom, TILA is an unambitious statute, with the purpose of “protect[ing] consumers from inaccurate and unfair credit practices and assur[ing] meaningful disclosure of credit terms … [t]o avoid the uninform[ed] use of credit.”\(^ {60}\) Indeed, “TILA was not intended to, and does not in fact, govern or provide causes of action for alleged mortgage fraud.”\(^ {61}\)

Second, the Home Ownership and Equity Protection Act (HOEPA) amended certain provisions in TILA to respond more directly to so-called predatory lending in the mortgage market.\(^ {62}\) Whether a mortgage is subject to HOEPA’s increased regulation “is determined by triggers related to a loan’s annual percentage rate or its points and fees, rather than any definition of ‘predatory lending.’”\(^ {63}\) Those triggers proved easy to avoid, permitting creditors to escape HOEPA’s increased disclosure requirements. “[L]enders make loans very close to the triggering thresholds, but low enough to avoid the trigger,” “offer open lines of credit as opposed to closed-end loans,” and charge “junk fees” for “services that are related to, but technically independent of, the mortgage.”\(^ {64}\) This ability to end-run the statutory requirements limits HOEPA’s effectiveness from a consumer protection standpoint.

The Federal Trade Commission Act is a third basis for protection against harmful lending practices. The FTC has authority to challenge “unfair or deceptive acts or practices.” The FTC’s unfairness authority generally has been applied by rulemakings, defining specific instances of conduct that may be enjoined as unfair. Deception is defined according to precedent and administrative guidance to include conduct that is likely to mislead a consumer acting reasonably under the circumstances.\(^ {65}\) The FTC has been successful in reaching settlements including restitution in cases of deception. The FTC Act remedy promises only limited effectiveness for two reasons. First, only the FTC has standing to enforce the FTC Act, precluding consumer and competitor plaintiffs from suing. Second, the reasonableness requirement for deception might be seen to exclude suits for behavioral exploitation, which by definition rely on economically irrational conduct.\(^ {66}\)

State law remedies frequently are redundant to federal regulation. They may rely on duties imposed by federal statute.\(^ {67}\) Statutory unfair or deceptive acts and practices claims may simply adopt the

---


\(^{61}\) Martin C. Bryce, Jr., Foreclosure Developments, Mortgage Fraud, Counterclaims and Defenses, 64 Consumer Fin. L.Q. Rep. 4 (Spring, 2010) (citing as examples TILA § 102(a); 12 C.F.R. § 226.1(b); Cunningham v. Nationscredit Fin. Serv. Corp., 497 F.3d 714, 718 (7th Cir. 2007); Parker v. Long Beach Mort., 534 F. Supp. 2d 528 (E. D. Pa. 2008)).


\(^{63}\) Letter from Edward M. Gramlich, Member of the Board, Federal Reserve to The Honorable Phil Gramm, Chairman of Committee on Banking, Housing and Urban Affairs, United States Senate, dated April 28, 2000; available at: http://banking.senate.gov/docs/reports/predlend/fed.htm

\(^{64}\) Burlingame, supra, at 467.

\(^{65}\) In re International Harvester, 104 F.T.C. 949 (1981).

\(^{66}\) It is not logically necessary that “economically irrational” be equated to “unreasonable.” Proof that a consumer “acted in a way consistent with the broad range of ordinary or average people” would suffice to render that conduct reasonable under International Harvester. Id. at

\(^{67}\) Id.
standards established by interpretations of the Federal Trade Commission Act.\(^{68}\) In *Washington Mutual Bank v. Superior Court*,\(^{69}\) remedies were based on the conduct of the defendant-bank for allegedly imposing inflated charges for required settlement services and for failing to disclose charges in standard settlement form required by federal statute.\(^{70}\) The Illinois Consumer Fraud and Deceptive Business Practices Act does not extend disclosure requirements beyond those already required by federal disclosure statutes. Compliance with TILA is a defense to liability under the Illinois law.\(^{71}\)

In a national economy, states that are net importers of consumer lending products can be expected to regulate those more vigorously than those that are net exporters. Commentators do recognize some states’ proactive role in regulating consumer lending practices.\(^{72}\) State laws can provide broader protections than federal law in two primary ways. First, state and local laws may increase restrictions on mortgage lenders and apply to a wider spectrum of loans.\(^{73}\) Second, state claims may expand the nature of the right of action available. Consumers and state attorneys general lack standing to sue for a violation of the Federal Trade Commission (FTC) Act but will frequently be granted standing for the same claim brought under state law. Finally, state claims may also arise under the common law of fraud and misrepresentation. Such a claim requires proof of a misrepresentation of fact by the mortgagee and reasonable reliance by the consumer borrower.\(^{74}\)

But where states do outpace federal regulation, their efforts may be preempted. In 2003 the Office of the Comptroller of the Currency (OCC), a banking regulator, preempted state efforts to regulate the lending practices of national banks. States were prevented from outlawing loan terms such as balloon payments, negative amortization, late fees, and prepayment penalties, all of which represent the dual characteristics of complexity and deferred cost and capitalize on consumer decision-making biases.\(^{75}\)

\(^{68}\) See, e.g., Mass. Gen. Laws Ann. Ch. 93A, § 2 (outlawing unfair methods of competition and unfair or deceptive acts or practices and adopting FTC interpretations of FTC Act § 5 to assist in the interpretation of this section).


\(^{70}\) Id.

\(^{71}\) Consumer Credit Protection Act, §102 et seq., 15 U.S.C.A. § 1601 et seq.; S.H.A. 815 ILCS 505/1 et seq.; see also MorEquity, Inc. v. Naeem, 118 F. Supp. 2d 885, 893 (N.D. Ill., Oct. 25, 2000)(citing Jackson v. South Holland Dodge, Inc., 312 Ill. App. 3d 158, 167, 244 Ill. Dec. 835, 726 N.E. 2d 1146 (1st Dist. 2000)(holding when a creditor is exempt from TILA liability, the creditor is also exempt from Consumer Fraud Act liability.).

\(^{72}\) See Burlingame, *supra*, at 468-69 (discussing the North Carolina’s anti predatory-lending statute).

\(^{73}\) Cottingham, Mortgage and Asset Backed Securities Litigation Handbook, §5:8 (Nov. 2011). Detailing, for example, the Georgia Fair Lending Act (Ga. Code Ann. §§ 7-6A-1, at seq.), which initially sought to impose nearly unlimited liability on assignees of many Georgia mortgage loans.


\(^{75}\) See Burlingame, *supra*, at 473.
2. Predictable Limitations

Much of this regulation was well-intentioned and designed to accomplish narrow and legitimate purposes. The regulation nonetheless failed due to regulator inability to foresee problems that were deemed unlikely by even the most expert of observers and agency capture problems that developed due to powerful political interests supporting the regulated entities. Targeted regulation under the leading approaches also present what are best described as “whack-a-mole” problems, resolving only problems that are known or foreseeable and not “unknown unknowns.” Discussing regulation targeting the downstream financial industry, Darren Bush noted the problem with reactionary, rather than anticipatory, regulation. “[T]he missing piece in this discussion of economic crises is an examination of the *ex-ante* regulation of failed markets and the economy as a whole.” A regulatory scheme that avoids this trap would permit challenges to conduct that threatens harm, before that harm is realized.

Consumer-protection-based regulation suffers a third category of limitations as well. Consumer protection based regulation is inherently disempowering. An approach that outlaws substantive transaction terms, which may be appropriate for a subset of consumers, limits those consumers’ abilities to choose from among the broadest possible array of available transactions. As Neil Averitt and Robert Lande argue, consumer protection laws should preserve consumers’ abilities to exercise choice, while antitrust laws should preserve the existence of choice. The two schemes would work at cross purposes if consumer protection regulation were permitted to remove consumer choice.

Finally, existing consumer-protection based regulation undermines consumers’ incentives to educate themselves with regard to the transaction at issue. Mark Armstrong recently observed the concern for moral hazard if transaction terms are restricted or consumers are allowed a remedy for improvident transactions. This understanding flows from the “well understood” concern that “if someone is insured, she will take less care protecting her possessions.” The insurance in the consumer protection story is the regulatory scheme and the possessions are the consumer’s interests in the transaction terms. So “[t]he victim of a scam, or an unexpectedly high credit card penalty charge, will usually be more vigilant in the future.” Armstrong’s moral hazard argument relies on a rational choice model of consumer behavior. But it holds for boundedly rational consumers as well. Evidence from empirical studies of individuals’ behavior demonstrates that education reduces the effect of cognitive biases.

---


79 Id. at 3; see also generally Steven Shavell, *On Moral Hazard and Insurance*, 93 Q. J. Econ. 541 (1979).


3. The Dodd-Frank Act Reforms to Mortgage Lending Regulations

The Dodd-Frank Act revised regulation of the mortgage lending industry in the United States. The effectiveness of Dodd-Frank regulation has yet to be determined. “The Dodd-Frank Act may have a significantly greater [or lesser] effect depending on how the new Bureau of Consumer Financial Protection (“CFPB”) exercises its considerable powers.” Thus, to the extent that the CFPB does not take steps far enough to remedy the structural problems inherent in mortgage lending transactions, fraudulent conduct is likely to remain pervasive.

The Dodd-Frank Act has both expanded and restricted coverage of existing statutes and regulations in the mortgage lending industry. For instance, the Dodd-Frank Act established a new “duty of care” for residential mortgage originators. However, the “duty of care” only requires a mortgage originator: (1) to be licensed or registered as a loan originator if required by the SAFE Act; and (2) to include on all loan documents the unique identifier provided by the Nationwide Mortgage Licensing System and Registry (NMLSR).

Title XIV of the Dodd-Frank Act enacted several new requirements for mortgage originators. Under Title XIV a loan originator is required to make a good faith and reasonable effort based upon verified information that “at the time the loan is consummated, the consumer has a reasonable ability to repay the loan.” However, a “qualified mortgage” will be free of many of the restrictions and limitations imposed by Title XIV on other mortgage loans, presenting the same concerns we encounter under HOEPA of easy avoidability. Although the Dodd-Frank Act provides a new enforcement role for the FTC with respect to

---

84 Robert A. Cook and Meghan Musselman, Summary of the Mortgage Lending Provisions in the Dodd-Frank Wall Street Reform and Consumer Protection Act, 64 Consumer Fin. L.Q. Rep. 231 (Summer/Fall, 2010).
85 Id.
86 Id., for a greater discussion of the impact of the Dodd-Frank Act on mortgage lending regulation in which the authors detail Dodd-Frank’s expanded HOEPA coverage, new mortgage originator rules, increased penalties, new disclosure burdens, new escrow and force-placed insurance rules, among other reforms.
88 See e.g., Cook and Musselman, supra note 77; the authors note—“By placing this duty in TILA, the Dodd-Frank Act allows the TILA penalties to be imposed on a mortgage originator for a failure to comply with these rules.” Id.
89 The Mortgage Reform and Anti-Predatory Lending Act.
90 Dodd-Frank Act § 1491; A “qualified mortgage” is defined as a mortgage loan “(i) that does not allow for negative amortization and is not a balloon loan, (ii) for which the creditor verifies and documents the borrower’s income and assets, (iii) that is underwritten using a fully-amortizing payment schedule (for an ARM loan, underwritten based on the maximum rate permitted during the first five years of the loan term) taking into account all applicable taxes, insurance and assessments, (iv) for which total points and fees do not exceed 3% of the total loan amount, and (v) that complies with debt-to-income ratios established by the Federal Reserve Board.” Dodd-Frank Act § 1411; see Robert M. Jaworski, Jaworski on the Mortgage Reform and Anti-Predatory Lending Act, 2010 LEXISNEXIS EMERGING ISSUES 5346 (Oct. 5, 2010).
home appraisals, and has increased penalties for violations of TILA, the reforms do not go so far as to prevent a need or negate the justification for antitrust law and policy infused into this area.

91 Title XIV Dodd-Frank Act
92 "TILA penalties have been increased as follows: the class action liability cap is raised to $1,000,000; mortgage originators are subject to TILA penalties for compensation and steering violations; the heaviest penalties (by far) are applied to violations of the rules related to appraisal independence; and state attorney general enforcement is expanded." Id.

162 See supra Part II.F (describing the failings of the regulatory status quo).
Behavioral Exploitation Antitrust

III. A ROLE FOR ANTITRUST LAW

The limitations of targeted regulation in preventing a harmful spiral in which conduct leads to market structure characterized by dominance or market leadership, which in turn facilitates conduct, suggests that legal protections must not rely on foresight on the part of regulators; must not rely on whack-a-mole responses to problems as they appear; must be structured to limit concerns for agency capture by regulated entities; must not limit consumer choice; and must not present moral hazard concerns.  

Antitrust offers a quiver of legal protections that satisfy those requirements.  Broad private rights of action create incentives for consumers or competitors to bring suit, mitigating the problem of limited regulator foresight into the long-term consequences of a course of bad conduct.  Private plaintiffs both are likely to be better informed about the actual or threatened market effects of an observed course of conduct, because they themselves participate in the market.  Private plaintiffs also have financial incentives to seek both injunctive and monetary relief before possible extra-market consequences of the conduct are realized.  

Second-order regulation like antitrust mitigates agency capture concerns.  The decision-makers -- courts -- are diffuse, unelected and life-tenured (in the federal system), and subject to appellate review.  Federal enforcement agencies will not be free from capture concerns.  But those concerns are mitigated in antitrust because the agencies are themselves generalist; the two federal agencies compete between themselves -- and with state enforcers -- in their enforcement programs; and private enforcement remains as a check on public enforcers’ abdication of their role.  

A. Behavioral Exploitation as Bad Antitrust Conduct

The antitrust approach to behavioral exploitation operates by treating behavioral exploitation as conduct of concern under the antitrust laws.  A plaintiff can challenge behavioral exploitation with a showing of general intent and a market effect, giving rise to antitrust remedies including injunctive relief and treble damages liability.  Our approach differs from to-big-to-fail approaches because we do not advocate challenges on the basis of market structure, which can be achieved through innocent and even efficient conduct.  Our approach differs from the status quo of antitrust doctrine because we expand the class of conduct that will be seen to raise concerns.

There are three broad categories of antitrust analysis under the modern state of doctrine.  First is dominant firm conduct, whereby a firm engages in conduct of concern and in doing so creates, threatens to create, or preserves a monopoly position.  Remedies are available under Section 2 of the Sherman Act on a showing of both market power (dominance) and bad conduct.  Second is concerted conduct, whereby more than one firm agrees jointly to engage in a course of conduct of concern.  Remedies are available under Section 1 on a showing of agreement and bad conduct.  Third is merger review, whereby firms seek to combine to create a single firm, and after the combination the market structure will facilitate harmful conduct.
All three categories of analysis rely on a showing of harmful conduct. It is subject to interpretation- and common-law change what exactly that conduct is. Unilateral conduct requires proof of both market power and conduct. Concerted conduct requires proof of agreement and conduct. And merger review requires proof of actual or likely harmful effects, which turns on increased incentive and opportunity to engage in either unilateral or concerted bad conduct. A deep literature has developed over what constitutes “bad conduct,” and there is no comprehensive definition. It should be relatively non-controversial to defined conduct of concern to be conduct that threatens market-wide harm and can be regulated without unduly restricting economically desirable activity.

Behavioral exploitation antitrust is a new approach that one of us recently has described in detail. None of the examples of harmful conduct that have presented bases for antitrust liability are easily analogizable to behavioral exploitation. The most likely extension of current doctrine would be a creative application of the theory of predatory pricing. Predatory pricing occurs when a firm prices its product or service below some measure of the firm’s costs to provide the product or service. Understanding the subprime boom as a series of improvident loan transactions that were cheap relative to their risks (a component of lender cost structure), we might find an example of below-cost pricing.

One scholar has suggested a comparable expansion of the malleable definition of bad antitrust conduct for deception that brings about market effects. Recognizing that deceptive conduct lacks any redeeming characteristics and presents real competitive dangers, Maurice Stucke argued for application of antitrust’s “quick look” standard to reviewing deceptive conduct, shifting the burden of proof to the defendant to demonstrate a lack of harm once the conduct is proved. Behavioral exploitation may have a

168 See, e.g., Competition and Monopoly: Single Firm Conduct Under Section Two of the Sherman Act § 1 (2008) (report withdrawn) (noting that bad conduct for Section 2 purposes is “willful acquisition or maintenance of monopoly power” as opposed to “growth or development as a consequence of a superior product, business acumen, or historic accident”) (quoting Grinnell).
170 See id. at 30.
172 This first principles understanding of what constitutes bad conduct invokes the complex question of optimal deterrence. See generally: Daniel A. Crane, The Economics of Antitrust Enforcement, in Antitrust Law & Economics 1, 3-5 (Keith N. Hylton, ed., 2010). Trusting that, as Crane observes, id. at 4, there are ample forces at play seeking to undermine existing, and limit innovation in the development of, antitrust liability rules, we leave it to others to articulate the overdeterrence argument.
173 Huffman, Marrying Behavioral Antitrust, supra n. 169, at
175 See Brookes Group v. Brown & Williamson, 509 U.S. 209, (1993) (“below an appropriate measure of cost”). "Brooke Group also requires a dangerous probability of recoupment of the losses incurred during the course of predation. Id. at . Recoupment ordinarily is found when a firm achieves a durable monopoly position. A plaintiff might be able to establish the dangerous probability of recoupment over the course of a borrower’s long-term relationship with the lender adeediteedtne852trof257isize500000현도.
176 See id. at 1113-19.
stronger claim than deception to antitrust remedies. Existing regulation at both the federal and state levels
prohibits and remedies deception, including in consumer subprime mortgage lending. In contrast,
behavioral exploitation is regulated only at the margins. Applying an antitrust remedy for behavioral
exploitation does not threaten the same level of redundancy.

Applying behavioral exploitation antitrust to the consumer subprime mortgage marketplace, we
propose that behavioral exploitation meets the conduct element of a claim under Sherman Act section 1 or
2 or merger review under Clayton Act section 7. Considering briefly the state of the consumer subprime
mortgage marketplace leading up to 2007, we conclude that behavioral exploitation antitrust fits most
naturally with merger review; might be (with some doctrinal adjustment) an appropriate fit with a
challenge to concerted action under section 1; and is unlikely to inform a challenge to dominant firm
conduct under section 2. We order the following sections in order of most to least appropriate fit.

I. Behavioral Exploitation Antitrust in Merger Review

Injunctive and damages remedies under Clayton Act section 7 and FTC Act section 5 (injunction
only) for a merger that "tends to create a monopoly" arises where the merger increases the incentive and
opportunity for a firm to engage in conduct of concern. The merger theory will be the simplest
application of behavioral exploitation antitrust in an industry characterized by mergers with substantial
increases in concentration.

Merger enforcement under the Clayton Act does not require proof of conduct that harms
competition, in contrast with the dominant firm conduct and concerted conduct we discuss above. The
recently revised Merger Guidelines recognize increased opportunity and incentive to raise prices to be an
effect that provides a basis for blocking a merger, although raising prices in isolation is conduct that
benefits competition by incentivizing market entry. Similarly, increased likelihood of tacit collusion
provides a basis for blocking a merger, although the tacit collusion itself, under the current state of the
law, is not illegal. In both cases the competitive harm is in the merger itself rather than in the conduct
that it allows.

A successful merger challenge usually requires proof of a sufficient increase in concentration to
have a market effect. Merger review in a market like that for consumer subprime mortgage lending
under behavioral exploitation antitrust would not change that requirement. A merger between two firms
engaged in behavioral exploitation, or in which the acquiring firm engages in behavioral exploitation, can be
expected to increase the incidence of that conduct in the market. In either circumstance the merger limits

unilateral and coordinated effects in merger review).
180 See id. § 1 (noting concerns for incipient price increases, output reductions, reductions in innovation, or
other “diminished competitive constraints or incentives”).
181 See Merger Guidelines § 6.3.
182 Cite.
183 See Merger Guidelines § 7.
184 See supra (previous section).
185 cf. Merger Guidelines § 2.1.3 (increases in concentration “presumed to be likely to enhance market
power”).
there is one fewer firm that might find it advantageous to stop and to educate consumers as to the existence of the conduct.\footnote{We discuss infra our view that this competitive effect is unlikely in any event.}

Increased concentration also increases the likelihood of tacitly collusive behavioral exploitation. Tacit collusion occurs when competitors act in coordinated fashion rather than competing, but do so without the agreement necessary to bring about a section 1 violation for conspiring. One market structure characteristic that increases its likelihood is concentration. Where a merger brings about increased concentration, which increases the likelihood of tacitly collusive behavioral exploitation, that merger creates an incipient harm that may be sufficient to permit antitrust remedies.

2. Behavioral Exploitation Antitrust in a Concerted Action Challenge

Sherman Act section 1 provides a basis for competitors, government enforcers and consumers to challenge groups of firms who act by agreement. Concerted conduct requires proof of two elements: agreement and conduct. Under behavioral exploitation antitrust, engaging in behavioral exploitation with general intent, producing a market effect, meets the conduct element. Antitrust remedies should be available on proof of agreement.

We do not know of evidence that mortgage lenders actually conspired, whether explicitly or implicitly, with regard to transaction terms or marketing tactics employed in consumer subprime mortgage lending in the years leading to the financial crisis. Instead, the market appears to have been vigorously competitive. Proving the existence of an agreement would require relying on evidence of tacit collusion, by which lenders achieved de facto consensus through a course of interdependent conduct.

Faceted with behaviorally exploitative conduct by a competitor, a firm may compete by itself eschewing the conduct and advertising its knowledge of its competitor’s actions. It also may find it profitable to engage in the same conduct itself. Evidence of industry-wide behavioral exploitation in consumer home mortgages suggests firms found the latter option to be more appropriate. The welfare effect is the same as if the competitors had colluded. In the absence of a merger review proceeding, section 1 and FTC Act section 5 are the most frequently cited sources of authority for challenging tacitly collusive harmful conduct.

The law is clear that tacit collusion based on interdependent conduct does not amount to an agreement cognizable under section 1.\footnote{See Bell Atlantic Corp. v. Twombly, 550 U.S. ___ (2007); Max Huffman, The Necessity of Pleading Elements in Private Antitrust Conspiracy Claims, 10 U. Pa. J. Bus. & Emp. L. ___ (2008).} There have been calls to broaden the definition of agreement to include tacit collusion. Richard Posner argued in 1969 that there is no economic distinction between tacit and actual collusion. Both present the same welfare effects and should be outlawed.\footnote{Richard Posner, Stanford L. Rev. (1969); see also Posner, Antitrust Law (2d ed., 2001).} Some have suggested a middle ground, outlawing tacit collusion under the broader language of FTC Act section 5 but not under section 1.\footnote{: see also Donald Turner, (1962). But see [Official Airline Guides, Ethyl Corp.] See Leary. But see Kovacic & Winerman. (Cites in ALJ article.)} The middle-ground approach has the perceived benefit of preventing excessive litigation by private plaintiffs, who have standing to enforce the Sherman Act but not the FTC Act.\footnote{See Leary. But see Kovacic & Winerman. (Cites in ALJ article.)}
We advocate an expansive enforcement program for tacitly collusive behavioral exploitation in consumer subprime mortgage lending. Consumer subprime mortgage lending has proved to be subject to enduring lemons equilibria, where sub-optimal transaction terms push out welfare maximizing terms. The benefits of antitrust enforcement under section 1 or FTC Act section 5 outweigh the harms from overenforcement. We believe it is possible to limit an expanded enforcement program targeting tacit collusion to markets with characteristics like that for consumer subprime mortgage lending. Under our middle-ground approach, tacitly collusive conduct in consumer lending would provide a basis for both private and public enforcers to sue seeking damages and injunctive relief.

3. Behavioral Exploitation Antitrust in a Dominant Firm Conduct Challenge

Proof of dominant firm conduct in violation of Sherman Act section 2 requires proof of both monopoly power (or a dangerous probability of achieving it) and bad conduct. Section 2 presents the simplest example of an enforcement theory relying on behavioral exploitation. The claim works this way: A plaintiff, probably a competitor, sues Countrywide Financial in 2006. That competitor may be Wells Fargo, which testified to the FCIC that it lost money by refusing to engage in the most extreme forms of subprime lending. The plaintiff would argue that Countrywide was on its way to achieving market dominance because it acted with intent in exploiting consumer biases, inducing them to enter into transactions that are suboptimal. The result is that the plaintiff is prevented from lending to those same consumers – presumably making smaller loans, but ones that are more consistent with the consumer’s abilities to pay – the phenomenon of bad loans crowding out good loans or even wholly different types of lending (e.g., student loans). The competitor’s remedy would treble the hypothetical profit on the loans that were lost to the competitor plaintiff competitor as well as injunctive relief to prevent the defendant from engaging in the conduct in future transactions.

Enforcement actions might be brought also by government enforcers seeking injunctive relief against further behavioral exploitation. In an extreme case, the government enforcer might seek a structural remedy to reduce the size of the dominant firm. Consumer enforcement is hypothetically available, but is not realistic. It is difficult to envision a basis for monetary relief to consumers, and consumers lack incentives to finance a lawsuit seeking injunctive relief.

Available evidence does not suggest that any firm achieved sufficient market presence to meet the standards for dominance required by section 2. In a nation- or world-wide market for financial products and the ease of entry and exit into mortgage lending, it seems unlikely market dominance or the dangerous probability of its occurring, as section 2 requires, might ever be achieved.

The problems with consumer protection style regulation that we detail in Part II, above, demonstrate the need for legal protections (1) that do not depend on regulator foresight, (2) that do not present concerns for agency capture, (3) are not whack-a-mole in nature, and (4) do not present consumer choice or moral hazard concerns. Antitrust enforcement meets those requirements.

---

191 See George Akerloff. For an application of the theory of lemons equilibria to consumer home mortgage lending, see Janger & Block-Lieb, supra n. __, at __.
1. Competition for Enforcement Mitigates Problems of No Foresight and Agency Capture

U.S. antitrust is known for its "decentralized and largely uncoordinated" enforcement mechanisms. Antitrust does not rely on neutral or foresighted regulators. Both concerns are mitigated by the competitive, belts and suspenders form of antitrust enforcement. One result of the diffuse nature of U.S. antitrust enforcement is the competition for enforcement that it produces. As an independent agency, the FTC is perhaps less quickly responsive to external political forces than the Antitrust Division. Another benefit of overlapping enforcement authority is that we have a host of sets of eyes on potential problems. Where government enforcers are blind to something, consumers and competitors may see them. Where consumers and competitors know too little, government enforcers have enhanced fact-finding powers. So there is less likelihood something slips by.

The role of state attorney general and private plaintiff enforcement both in supporting federal government antitrust enforcement and in filling gaps left by federal government inactivity also has been

Behavioral Exploitation Antitrust

recognized. A ready example of state attorney general activity is the continued pursuit of Microsoft Corporation by state enforcers after the Justice Department settled its claim. Private plaintiff enforcement also complements or replaces federal government enforcement. For example, Bell Atlantic Corp. v. Twombly was a private action brought after the Department of Justice closed its investigation and declined to pursue the alleged conduct. Sprint Corporation recently brought its own complaint challenging the AT&T/T-Mobile merger, in what one news outlet reported as a supplement to the Justice Department’s suit.

Strong incentives exist for private plaintiffs to bring antitrust claims. Those incentives increase the likelihood of aggressive regulation by antitrust enforcement, which promises to fill the gaps in regulation in the pre-crisis status quo. Importantly, the incentives operate independently of foresight about extra-market, economy-wide harms, so private plaintiffs can be relied on to use their antitrust enforcement authority when extra-market harms are not otherwise observable. And private enforcement offers another benefit. Knowledgeable consumers and competitors are the plaintiffs best situated to understand the potential harm from a course of behavioral exploitation. They are likely to be more nimble in responding to the conduct than would be public enforcers.

The unique structure of antitrust enforcement also substantially mitigates concerns for agency capture. That is for two reasons: first, the enforcement agencies are not closely tied to any one industry. Second, competition for enforcement acts as a check on inactivity by any one enforcing entity. Tim Wu observes the lesser public choice concerns with antitrust enforcement vis-à-vis one sectoral regulator (the FCC), noting that deferring to regulators over antitrust ignores the public choice problems that can make alternatives to antitrust ineffective. A strong firm can overpower an agency, which is why I think the antitrust law must always be around as a backup.

2. Antitrust’s Rule of Reason Avoids Whack-a-Mole Regulation

The story of consumer protection-based regulation in the consumer mortgage industry has not been a happy one. The regulation is insufficiently sweeping cure all potential problems. Congress has tended to regulate in reaction to perceived existing problems, rather than proactively to ward off incipient ones. It is

201 Daniel A. Crane, The Institutional Structure of Antitrust Enforcement 145 (2011) (noting the “power of states to be more aggressive in antitrust enforcement than the federal government”); id. at 163 (“private enforcement of the antitrust laws vastly outstrips public enforcement”).


205 By contrast, prescient regulators who sought to act during a time of economic expansion risked being labeled Henny Pennys.

206 But see Daniel Crane, Rethinking Merger Efficiencies, 11 U. Mich. L. Rev. 1000 (2011) (“Public choice literature suggests that antitrust enforcers are not merely detached public servants on a truth-seeking expedition.”) (citing The Causes and Consequences of Antitrust: The Public Choice Perspective (Fred S. McChesney & William F. Shughart II eds., 1995) (discussing the application of public choice theory to antitrust enforcement)).

207 Interview with Tim Wu, Summer 2011 Antitrust 55, 57.
also subject to arbitrage, opening new opportunities for deceptive or behaviorally exploitative conduct. Short of onerous regulation of substantive transaction terms that would have the effect of foreclosing access to the market to both marginal lenders and marginal borrowers, consumer protection regulation cannot escape the problems of narrowness, reactivity, and opportunity for arbitrage.

Antitrust’s rule of reason avoids whack a mole regulation. The rule of reason is the regulatory version of a very large tent. Conduct with harmful welfare effects that exceed the benefits by a sufficient margin to warrant the expense of investigation and prosecution potentially is subject to antitrust challenge. That malleable definition is broad enough to encompass the behavioral exploitation conduct that we discuss here.

3. Consumers Retain Choice and Are Not Subject to Moral Hazard Concerns

Two benefits the behavioral exploitation antitrust approach to mortgage lending regulation flow from the nature of the antitrust remedy. Antitrust enforcement targets market-wide conduct and effects rather than transaction-level conduct and effects, mitigating concerns that (1) less-efficient competitors might use regulation and litigation to protect themselves against their efficient rivals, and (2) consumers use regulation and litigation to avoid the consequences of improvident decisions.

A major failing of consumer-protection-based regulatory schemes is the regulatory removal of consumer choice. In this sense, mortgage lending is no different from selling widgets: regulation that prescribes the dimensions of a widget prevents a consumer from satisfying a different want or need. If we assume nearly infinite variability in ideal transaction terms (not an extreme assumption in a market with millions of transactions entered yearly) regulation that prohibits or limits access to any contract terms necessarily prevents some would-be contracting parties from maximizing their utility.

The emphasis in the Dodd-Frank Act on protecting consumers by limiting opportunities to engage in certain mortgage transactions raises the concern for limited choice. Even the most potentially abusive of transaction terms present economically rational options for some customers. For example, an “option ARM” is a form of subprime mortgage transaction frequently touted as abusive because it couples a low introductory interest rate with interest-only or minimum payment requirements. Under Dodd-Frank, the option ARM is considered a “non-qualified mortgage,” a status that limits the ability of and incentives for brokers to make the lending product available to consumers. But it is not difficult to envision an appropriate customer for such a mortgage: a borrower faced with a known large future income stream – perhaps a college football player who has been drafted in the first round, or a trust beneficiary who stands to access the corpus of the trust at a known point in time.


Innovation in mortgage products became permissible in the 1980s when federal legislation recognized the problems of state laws that limited consumer choice by restricting consumers to narrow parameters for transaction terms. See McLean & Nocera, supra n. –, at 29 (discussing the Alternative Mortgage Transaction Parity Act of 1982).


Antitrust enforcement based on behavioral exploitation does not suffer the failing of limiting consumer choice. As a second-order regulatory scheme, antitrust almost never prohibits conduct without demonstrated effects (only when rules of per se illegality apply).215 Behavioral exploitation offers a remedy only on proof of a market effect. Lenders retain broad discretion to negotiate transaction terms that meet consumer demand. It is possible, of course, that lenders will shy away from transaction terms that do not represent industry standards because of a perceived danger of antitrust liability, creating a chilling effect on innovation in mortgage markets. We limit or eliminate that chilling effect with our requirement of a market effect for behavioral exploitation antitrust. Antitrust remedies will be available only where that discretion is abused in a sufficiently broad range of cases to have a non de minimis market effect.

Consumer protection regulation presents moral hazard concerns by freeing consumers from the consequences of their decisions.216 That concern is not present in the application of behavioral exploitation antitrust to consumer subprime mortgages for two reasons. First, the repeat player circumstance is infrequent in the context of mortgage transactions, and perhaps even less frequent for subprime mortgages. Consumers do not go through these transactions frequently enough to become conditioned by over availability of remedies. Second, a single consumer with buyer's remorse does not meet the requirement of a market effect. Only across a large number of transactions can the market effects be found.

The Limits of Behavioral Exploitation Antitrust

We are cognizant of the dominant modern view that innovation in theories of antitrust harm like that we propose here must be justified in terms of the cost of regulation balanced against the cost of not regulating.217 But we also do not ignore that courts, enforcers, and commentators have largely internalized the concern for overenforcement, or false positives, that the dominant strain of antitrust thought succeeded in advancing in the 1970s and 1980s.218 Behavioral exploitation antitrust is an innovative theory of enforcement, but one that promises to help to rein in otherwise difficult-to-regulate conduct that is well understood to bring about welfare effects. Behavioral exploitation antitrust in the consumer subprime mortgage industry mitigates an underenforcing status quo.

The countervailing concern for overenforcement from a behavioral exploitation theory of liability is the chilling effect on desirable activity, most notably advertising and related communication with regard to products and services. Agencies, judges and commentators have noted the competitive concerns that flow.

215 Per se illegality is reserved for a narrow class of conduct including price fixing, bid rigging, and market allocation, which are deemed always to be harmful and to lack serious countervailing benefits. See generally, Anderson & Huffman, Cornell J. L. & Pub. Pol'y (2010).

216 Mark Armstrong article. Where exemplary damages might be available, the concern is even greater.


218 Crane, Economics of Antitrust Enforcement, supra n. 2 at 4 ("courts tend to frame liability rules in a deliberately underinclusive manner . . . . [T]he recent tendency in US antitrust law has been to tilt both the procedural rules and substantive liability rules toward underinclusion"). See also Huffman, Marrying, supra n. 2 at (describing the position of Chicago School adherents with regard to antitrust enforcement).
Behavioral Exploitation Antitrust

from advertising restrictions. According to then-FTC Chairman Robert Pitofsky in 1995, “Advertising is a key source of price and other information and when competitors band together to restrict it, consumers lose.” The response to this overenforcement concern is two-fold.

First, behavioral exploitation is much more than advertising, which communicates and even persuades consumers with regard to the merchant’s products. Behavioral exploitation targets established cognitive biases to induce decisions that consumers would not make but for the merchant’s conduct. It describes a narrow class of conduct that has demonstrated effects on consumer decision-making. Second, the antitrust theory of behavioral exploitation recognizes the potential for over-enforcement concerns. It addresses those concerns by narrowly cabining the claim, including requiring proof of both general intent on the part of the defendant and non de minimis effects on the marketplace.

Behavioral exploitation antitrust is limited to protect against overreaching in enforcement and the consequent dangers of false positives in enforcement. Criticisms of the theory nonetheless continue to exist. These include the limited ability of behavioral economics to inform antitrust in general; de minimis impacts of transaction-level conduct; and the possibility of consumer education to overcome the welfare effects of behavioral exploitation. We explore below the protections against over-enforcement and responses to those criticisms.

1. Intent and Effects

Behavioral exploitation as a theory of antitrust liability relies on proof of (1) general intent on the part of the merchant seller, and (2) an effect on the market. The required proof of general intent limits enforcement against innocent advertising conduct, mitigating chilling effect concerns from enforcement spillovers. A merchant might be held to have had sufficient intent to exploit a particular decisionmaking heuristic if it had studied the heuristic or paid for focus groups to learn the most effective way to increase consumer response.

For example, sales manuals describing the benefits of opaque pricing strategies or setting out scripts for sales pitches might make strong evidence. Testimonial evidence by current or former employees may


233 General intent is consistent with other scienter standards in civil antitrust claims. See, e.g., United States v. Aluminum Co. of Am., 148 F.2d 416, 432 (2d Cir. 1945); Ronald A. Coss & Keith N. Hylton, Antitrust Intent, 74 S. Cal. L. Rev. 657, 661 (2001). A merchant has this mental state if it acts deliberately, knowing the probable consequences of its actions.

234 See supra notes and accompanying text.
be available. One leading commentator on behavioral exploitation by merchants, Robert Cialdini, supported his own academic research with “a decidedly more entertaining program of systematic immersion into the world of compliance professionals – sales operators, fund-raisers, recruiters, advertisers, and others.” His immersion program included observation, interviews, and review of written materials, including sales manuals.239

The required proof of market effect serves to prevent overuse of behavioral exploitation in consumer, competitor, and government suits based on antitrust laws.240 An effect on the market requires a market failure that competition cannot be relied on to mitigate. That will occur where, for example, the course of behavioral exploitation assists a firm in establishing or maintaining a monopoly position.241 Bar-Gill notes that “sellers benefit from the divergence between perceived and actual benefits and between perceived and actual prices. They will design their products and prices to maximize this divergence.”242 The firm that is most effective at doing this will succeed and become dominant, unless other firms successfully imitate the strategy or consumers become sufficiently educated about the firm’s conduct that it ceases to be a successful strategy.

The behavioral exploitation theory is not novel in requiring a market effect. A market effect requirement is nearly ubiquitous in antitrust, with the (increasingly narrow) exception of conduct held to be illegal per se.243 Such an effect existed in Kodak, where on remand from the Supreme Court’s holding that a lock-in sufficed to demonstrate market power, a jury concluded that Kodak did have a monopoly in the parts after-market despite the competitive market for its equipment.244 Proving that the effect flows from the behavioral exploitation, rather than some other cause, is a more complex problem, but no more so than the causal demonstration required throughout antitrust litigation focusing on a defendant’s conduct. Private plaintiffs are saddled with a causation requirement as a matter of the antitrust standing doctrine.245 and all plaintiffs, including public enforcers, face functionally the same burden under the rule of reason.246

239 Cialdini, Psychology of Persuasion, supra n. __, at xii-xiii.
240 See the dangers to be avoided, for example, the threat of treble damages liability in a suit by a purchaser suffering buyer’s remorse. See Edwards, supra note __, at 360 (“Could a consumer who impulsively purchases a candy bar and a copy of a gossip magazine claim that he has suffered a cognizable injury under the FTC Act?”).
241 Establishing, maintaining, or creating a dangerous probability of establishing a monopoly through a course of bad conduct implicates Section 2 of the Sherman Act, 15 U.S.C. § 2.
242 Bar-Gill, Competition and Consumer Protection, supra n. __, at 5. Bar-Gill works from the same assumption we do, that behavioral exploitation is a less expensive strategy than is product innovation.
243 See Chicago Bd. of Trade v. United States, 246 U.S. 231, 238 (1918) (defining the rule of reason to include examination of “the nature of the restraint and its effect, actual or probable”); Levin Creative Leather Prods., Inc. v. PSKS, Inc., 551 U.S. 877, 886-87 (2007) (per se rules “eliminated the need to study the reasonableness of an individual restraint in light of the real market forces at work”).
244 See Image Technical Servs., Inc. v. Eastman Kodak Co., 125 F. 3d 1195, 1201 (9th Cir. 1997).
245 See 15 U.S.C. § 4 (harm must be “by reason of” a violation of the antitrust laws); Palmrya Park Hosp., Inc. v. Phoebe Putney Mem’l Hosp., 604 F. 3d 1291, 1299 (11th Cir. 2010) (holding that plaintiff’s harm must be of the sort that makes the conduct illegal).
246 See, e.g., Brooke Grp., Inc. v. Brown & Williamson Tobacco Corp., 509 U.S. 209, 225 (1993) (requiring a showing of a causal connection between conduct and an increase in prices); Cal. Dental Ass’n,
2. Criticisms and Responses

Others who have recognized the reality of behavioral exploitation have not taken the next step in proposing an antitrust remedy. A common recommendation is improved disclosure regulation, designed with a recognition of the realities of limited abilities to understand and use voluminous and complicated disclosures. 247

a. The Limits of Behavioral Antitrust

Some criticize the entire practice of developing antitrust rules on the basis of behavioral law and economics teaching, arguing, among other things, that behavioral economics opens doors to undisciplined analysis. 248 Some may see behavioral economics as “liberalism masquerading as economic thinking.” Among the critics of behavioral antitrust, Joshua Wright and Judd Stone most directly address the antitrust theory of behavioral exploitation. While acknowledging that behavioral economics offers interesting lessons in consumer behavior, and thus is in theory relevant for antitrust analysis, Wright and Stone contend that the methods of antitrust economics as currently practiced are sufficient to accommodate cognitive biases that influence consumer decisions. They also argue that behavioral economists have not produced theories that accommodate the many, sometimes conflicting, proven cognitive biases. 249 This argument builds on Gregory Mitchell’s argument that deviations from rational choice assumptions are non-uniform, so fail to produce a workable alternative theory. 250

Those challenges might together be summed up as expressions of doubt as to the possibility of articulating a general theory of antitrust economics on the basis of currently available research. Such criticisms were more compelling before the increasingly substantial body of evidence supporting the

\[\text{v. FTC, 526 U.S. 756, 774–77 (1999) (government enforcement action where Court required proof that the complained of conduct caused a harmful effect).}\]

247 See Oren Bar-Gill, Warren, others?
248 See Douglas Ginsburg & ___, Competition Policy Int’l.
249 Rosch speech (characterizing the views of critics).
250 Others go further to question the viability of any policy measures pursued on the basis of the lessons from behavioral economics research. Gregory Mitchell was an early critic who argued in part that non-uniform deviations from rationality assumptions suggested that reforms on the basis of behavioral lessons should be modest. See Gregory Mitchell, Why Law and Economics’ Perfect Rationality Should Not Be Traded for Behavioral Law and Economics’ Equal Incompetence, 91 Geo. L. J. 67 (2002). Richard Epstein argued that “notwithstanding the potential resource misallocations that may flow from these errors” in failing to optimize individual utility, the law should not remedy those misallocations outside of preventing fraud. Richard Epstein, Human Errors and Market Corrections, 73 U. Chi. L. Rev. 111, 118-120 (2006). Matthew Edwards expressed concern with the necessarily paternalistic nature of policymaking on the basis of observed bounds on consumer rationality. See Matthew Edwards, The FTC and New Paternalism, 60 Admin. L. Rev. 323, 333-36 (2008) (canvassing critical reactions). Tom Brown and Lacey Plache argued that empirical evidence is insufficient to support many of the policy recommendations that have been advocated on the basis of behavioral economics research. See Tom Brown & Lacey Plache, Paying With Plastic: Maybe Not So Crazy, 73 U. Chi. L. Rev. 63, 66 (2006).
251 See Mitchell, supra n.
existence of cognitive biases and demonstrating their operation in real world transactions had been 
developed. Empirical evidence is both more voluminous and more directly applicable to real-world 
settings, with much of it derived from actual market settings.252 Just as Posner once observed Chicago 
School antitrust economics began as isolated attacks on then-existing antitrust economics,253 behavioral 
antitrust is developing by starting with individual instances of observed deviations from rational choice 
thories. Where those theories are robust they should influence the development of legal rules, such as the 
creation of the behavioral exploitation theory we advance here.

b. Behavioral Exploitation is De Minimis

A second challenge to the expanding of antitrust liability to cover instances of behavioral 
exploitation is that the harm in any one instance of behavioral exploitation is transaction level harm, and its 
regulation is the stuff of the law of contract and consumer protection. Vis-à-vis the market in which the 
transaction occurs the harm frequently will be de minimis, producing no harm to “competition.” This 
argument has been leveled against efforts to regulate tortious conduct through antitrust254 and against efforts 
to regulate deception through antitrust.255 The de minimis challenge applies equally to behavioral 
exploitation, where harm is transaction level. A single $250,000 mortgage transaction will not impact 
competition in a market for home mortgage lending that in 2006 was worth $2.5 trillion.256

Arguments that behavioral exploitation should be regulated under the law of consumer protection 
ultimately are unconvincing. First, comparisons to tort law and deception are misplaced. Both of those 
fields are well regulated under common law and federal and state statute. Adding an antitrust remedy is at 
best redundant and possibly threatens inefficient overenforcement. Behavioral exploitation is regulated 
only marginally under common law and federal and state consumer protection laws. In the 2002 study of 
the welfare effects of predatory lending that we discuss above, Stein noted that the conduct causing welfare 
effects was entirely legal.257 An antitrust remedy targeting this conduct would not be redundant. In its 
absence, we have a status quo characterized by inefficient underenforcement.

Second, the de minimis argument proves both too much. Nearly all of antitrust is concerned with 
conduct, any single instance of which would have a de minimis impact on competition.258 Consumer

252 See Reeves & Stucke, Behavioral Antitrust, supra, at 

253 Posner, The Chicago School of Antitrust Analysis, supra, at 

254 See Joshua D. Wright, Antitrust Analysis of Category Management: Conwood v. U.S. Tobacco Co., 17 S. 
Ct. Econ. Rev. 311, 332 & n.69 (2009) (analyzing antitrust claims based on vandalizing competitor retail 
equipment).

255 See III Herbert Hovenkamp, Antitrust Law ¶ 782d (3d ed. 2006) (deceptive disparagement of a rival 
has a de minimis competitive impact).

256 Financial Crisis Inquiry Report, supra n. 70 (noting $600 billion subprime mortgage originations 
representing 23.5% of the total mortgage originations in 2006).

257 See Stein, supra n. 70, at 

258 See Huffman, supra n. 70 (single instance of price fixing is de minimis). The exception is merger 
review, in which the conduct of concern is two firms’ combining to create an unwieldy level of 
concentration.
transactions, in the ordinary course, must be aggregated to produce the kind of market-wide harm that supports antitrust treatment. Where a course of conduct impacts a large enough number of individually *de minimis* transactions, it will produce the kind of market effect that justifies antitrust intervention.

c. Consumer Education Is a Cure

A third criticism is that competition will lead to consumer education that will mitigate harms from behavioral exploitation. Implicit in this criticism is the concern that providing a remedy removes or limits consumers incentives to become educated with regard to the transactions in which they are engaged.

Consumer education relies on one of third-party intervention; competitor intervention; or sufficient repeat interactions that consumers self educate. Durable goods markets or markets for long-term financial contracts are unlikely to permit consumer self-education. Competitor education through advertising is a possibility, but where a firm achieves dominance through behavioral exploitation, competitors will not sufficiently understand the dominant merchant’s marketing strategy to create effective educational advertising and/or will not have sufficient market presence for educational advertising to have an impact. A small local lending institution would have found it impossible to achieve sufficient advertising distribution to make a campaign challenging conduct by a major national lender like Countrywide Financial worth the candle.

Too, behavioral exploitation, unlike its cousin, deception, is subtle. If, for example, the product in question is a long-term lending contract, and the merchant exploits the consumer’s tendency to over-optimism (“you are sure to have earned a raise by the time the interest rate adjusts”), it is not clear what educational advertising would undermine the merchant’s conduct. The relevant information would be “you are not statistically likely to have earned that raise” – but any such statement is at best likely to be ineffective, and at worst may offend.

Competitor education is an unreliable cure for the market failure behavioral education causes for another reason. Competitors are likely to find it a better strategy to imitate, rather than to undermine, behavioral education by a merchant. Richard Posner recognized this phenomenon in the context of markets for harmful products, like cigarettes. Bar-Gill demonstrated that little advantage is to be gained by a competitor from consumer education, apart from the first-mover advantage of being the first firm fully to disclose product attributes or pricing. Xavier Gabaix and David Laibson go further, arguing that “it is not possible to profitably lure . . . myopes . . . to non-exploitative firms.” This demonstrates the second basis for antitrust concern – concerted behavioral exploitation, which can occur even in a market without a dominant firm. Concerted exploitation can either be through actual agreement or consciously parallel

---

271 See Huffman, supra, *Marrying Antitrust* L.J. at ___ (discussing price fixing).

272 Conversely, nobody seriously could argue that all conduct with a substantial competitive impact represents an antitrust harm. Blowing up a competitor’s factory or assassinating a competitor’s chief executive would impact competition, but neither is believed to present antitrust harms.


conduct, although under the current state of the law of concerted conduct, consciously parallel conduct does not establish that element of the offense.\textsuperscript{276}

We can therefore expect market failures caused by behavioral exploitation to be sustained over a sufficiently large time horizon to lead to both intra-market and external harm. With specific regard to the home mortgage marketplace, the targeted regulation that exists either has been proved, or can be expected, to be insufficient to prevent or remedy those failures and harms.

IV. MOVING TO BEHAVIORAL EXPLOITATION ANTITRUST

Antitrust exists to cure for market failures that arise where one firm, or a group of firms, is (are) able to profit at the expense of consumers by charging quality-adjusted prices exceeding what the consumers would pay but for a course of conduct on the part of the firm or group of firms. Behavioral exploitation antitrust operating in the consumer subprime mortgage industry would allow the application of antitrust remedies to transaction-level conduct in consumer subprime mortgage lending, if it is undertaken with general intent and on a broad enough scale to produce a market effect. In this final Part we argue antitrust standards should be relaxed to permit resort to antitrust review and remedies in the market for consumer subprime mortgages and closely analogous marketplaces.

Evidence regarding the consumer subprime mortgage industry prior to the 2007 financial crisis suggests that even under a definition of harmful conduct that includes behavioral exploitation, antitrust remedies would be difficult to achieve under the current state of doctrine. The subprime mortgage market lacked sufficient concentration and sufficient barriers to entry to satisfy modern standards for challenging a merger as “tending to create a monopoly.”\textsuperscript{306} A lack of evidence that market participants reached either express or implied agreement, rather than acting independently or tacitly colluding, undermines efforts to pursue remedies under Sherman Act section 1.\textsuperscript{307} And insufficient market share by even Countrywide Financial, the most substantial player in the consumer subprime mortgage market, coupled with insufficient

\textsuperscript{276} See Bell Atlantic Corp. v. Twombly, 550 U.S. 544 (2007).
\textsuperscript{306} See supra notes \ldots \ldots and accompanying text.
\textsuperscript{307} See supra notes \ldots \ldots and accompanying text.
barriers to entry, makes enforcement against dominant firm conduct under Sherman Act section 2 unlikely. 308

All three avenues of analysis should remain available should the market structure or observed conduct change sufficiently to meet the existing requirements. A course of mergers or failures might well render the subprime mortgage market sufficiently concentrated to present both dominant firm and monopolization by merger concerns, and evidence of actual agreement would implicate section 1. Other avenues exist to a closely cabined course of broader enforcement intended to prevent and to remedy known welfare effects in this and similar industries.

Standards for blocking and remediying harm caused by a merger might be broadened to encompass transactions not leading to a monopoly position as that is traditionally defined. There is an increasing understanding that market share is a highly imperfect proxy for the welfare harm from a merger. 309 Such an understanding would permit courts to block a merger on a demonstration of actual or likely welfare effects through unilateral or coordinated conduct. This approach to merger review allows a challenge that increases the likelihood of harm regardless of structural changes in the market. Under this approach, a relative lack of concentration and low barriers to entry would not hinder merger challenges claiming incipient behavioral exploitation.

The long-standing rule for proving agreement under section 1, which excludes tacit collusion, has been the subject of occasional challenge in the courts and frequent questioning by commentators. It is well understood that tacitly collusive conduct presents the same welfare effects as does agreement. For that reason, noted judges and commentators have questioned a definition of agreement that is too narrow to encompass such conduct. 310 The law governing tacit collusion has been firmly established and recently reaffirmed. 311 It also rests on a sound basis: imposing liability for profit-maximizing interdependent conduct dampens incentives for vigorous competitive activity. Any relaxation of the strict requirement for proving agreement under section 1 to allow challenges to tacit collusion should be narrowly cabined to avoid overreaching in enforcement. We believe a narrow rule permitting challenges to tacitly collusive behavioral exploitation in markets that are shown to be subject to enduring lemons equilibria, like that for consumer subprime mortgage lending, serves the needs of permitting antitrust enforcement where other regulatory approaches have proved ineffective while not inappropriately chilling aggressive unilateral competitive conduct.

The limited broadening of existing approaches to antitrust enforcement discussed in the prior paragraphs offers to bring to bear the benefits of belts and suspenders enforcement, competition among enforcers, and the unique incentives facing private plaintiffs, to regulating excesses in consumer subprime mortgage markets like those that led to the 2007 financial crisis. Another approach is to rely on broader language in the Federal Trade Commission Act to base a broader theory of enforcement against behavioral exploitation antitrust. Instead of enforcing sections 1 and 2, the Federal Trade Commission enforces a broad prohibition of "unfair methods of competition." Although there is value generally to employing the

---

308 See supra notes ___ and accompanying text.
309 For example, the revised Horizontal Merger Guidelines consider "market shares and concentration in conjunction with other reasonably available and reliable evidence for the ultimate purpose of determining whether a merger may substantially lessen competition." Merger Guidelines § 5.
310 Cite to Posner and Turner.
FTC Act to its fullest extent consistent with the efficiency principles underlying antitrust enforcement, the FTC Act lacks a private right of action and a competitive enforcement regime. It offers few of the advantages of antitrust enforcement generally.

V. Conclusion

The grass-roots cause of the 2007 financial crisis was the market for consumer home mortgages. That market was rife with failures, including deception and behavioral exploitation. The particular nature of mortgage lending—in the words of the CEO of one lender, its “bewildering array” of terms and fees—created a particularly vulnerable industry in which behavioral exploitation could flourish. In turn, the market provided substantial short-term success for firms engaged in conduct with well documented welfare effects. The regulatory status quo ante for consumer subprime mortgage lending was inadequate. Mortgage lending regulation is concerned with conduct at the transactional level. That regulation proved insufficient to remedy effects that were felt market- and economy-wide. Repeat player lenders could successfully avoid regulation by complying with the letter of the law while relying in large part on inexperienced consumers’ ability to understand complicated terms.

Our argument above operates under several premises. Behavioral exploitation disturbs efficient resource allocation as consumers would otherwise act differently, but for the conduct. Behavioral exploitation occurred in the mortgage lending industry leading up to the 2007 financial market crisis, and in the absence of regulation realistically designed to prevent it, persists today. The 2007 financial market crisis was caused, in large part, by failures—caused in part by inefficient resource allocation—in consumer home mortgage lending firms. Antitrust law exists to prevent market failures; thus, antitrust law could and should be used to prevent the pervasive type of market failures that led to the 2007 financial crisis.

Ours is a far-reaching argument. Many have recognized the welfare effects in behavioral exploitation, including in subprime lending. A handful of writers seem to agree that transaction level harms should give rise to antitrust remedies, although that exceeds the bounds of antitrust doctrine and the mainstream of antitrust scholarship. However, the market failures caused by behavioral exploitation at the individual transactional level had broad welfare effects both in the market and external to it. In the aggregate, those individual transactions presented competitive harm raising antitrust concerns. The impact of behavioral exploitation in the mortgage lending industry was not and is not confined to individual transactional level concerns. Rather, in order for firms undertaking to profit from the behavioral exploitation, of the type we suggest occurred in mortgage lending practices, a firm must consistently and systemically engage in behavioral exploitation.

Rather than the individual transactional level focus of disclosure statutes in place today, antitrust provides an avenue to regulate the mortgage industry at the firm level. In turn, by regulating firm-level conduct, antitrust regulation will remove incentives for a particular firm to engage in “mortgage malpractice,” which success and profits require more than just one transaction. Indeed, by removing incentives to engage in “bad” conduct at both transactional and firm levels, and even encouraging competitors to monitor one another’s conduct, antitrust may be an elegant and even superior solution to the grass-roots problems that ultimately led to massive economic dislocations that were exposed in the 2007 financial crisis.

327 Testimony of Scott Stern, CEO of Lenders One, supra n. 1.
We address the question how regulation might foresee and forestall the circumstances that lead to financial and economic crises. We argue that antitrust law, with its emphasis on market effects and mechanisms for competitor enforcement, promises to serve that role better than does the consumer protection-style regulation that has generally been relied on.

Leading Approaches to Mortgage Regulation

A. Federal statutory provisions available for consumers
B. State statutory or common law claims available for consumers
C. Government regulation of mortgage transactions
D. Impact of fraudulent conduct on mortgage lenders
E. Other parties impacted by fraud in mortgage transactions
F. The Dodd-Frank Act reforms to mortgage lending regulations
G. 

The Problems with the Leading Approaches
A Model of Preventative Regulation Through Antitrust Enforcement

A. Taxonomy of Antitrust Claims
B. Antitrust Enforcement
C. A Model Claim
D. Antitrust Avoids the Problems with the Leading Approaches to Consumer Mortgage Regulation
   1. Competition for Enforcement Mitigates Problems of No Foresight, Whack-a-Mole Regulation, and Agency Capture Concerns
   2. Antitrust’s Rule of Reason Avoids Whack-a-Mole Regulation
   3. Consumers Retain Choice and Are Not Subject to Moral Hazard Concerns
It is by now well understood, and to the extent that there remains any dispute, easily demonstrated, that this

Those failures

Crisis Prevention Role for Antitrust

( Failures occurred also because some firms found it profitable to engage in outright deception, made easier by the nature of unilateral possession of information in this context.)

relative to a market

inability

ation

crisis also is well understood.

m, prevented regulators from taking sufficiently aggressive measures to prevent the asset bubble developing and leading to financial collapse.
relatively commonplace suggestion
alternative
to — , to prevent future such crises.

here

law has a place both in preventing the development of market structures that lead to crises when firms stumble or fail and in preventing the failures themselves.

, with at least with respect to our approach,

that

Those ravages frequently are categorized under the general heading “market failures.”

“Market failure” is a technical misnomer for a market response that is simply too slow to protect against substantial short- and medium-term harm. Thus, broad industry collapse might not represent market failure at all, but a necessary adjunct to the establishing of a stronger industry, which will emerge after a period of shake-out.

Antitrust has a place in such a non-failure circumstance as well. It can hasten discipline that the market might after time provide, but that threatens to arrive too late to protect against substantial short- to medium-term harm.
Serious thought has been given in very recent years to imposing structural limits in financial marketplaces. One author notes: “both the Dodd-Frank Act and the [EU Vickers Commission] Report make some ‘structural reform’ proposals for solving the problem of too-big-to-fail.” Under modern approaches, however, U.S. antitrust law is limited to preventing mergers to unwieldy size, and has no tools for limiting or reducing firm size when growth is organic. Others have proposed a role for antitrust in limiting firm size, with an eye toward the systemic problems of dominant firms’ stumbling and failing, but those approaches require changes in enforcement philosophy by both enforcement agencies and by courts.  

Legal scholars have not analyzed a different problem. Market dominance achieved through certain bad conduct, such as deception, may be exceptionally fragile. The dominance relies on competitive success in bringing about resource misallocation rather than on competitive success in serving demand. It is fragile because when the deception is discovered and remedied, the ostensibly successful firm – and indeed, its entire business model – will stumble or fail, leaving a void in the market that is uniquely difficult to fill.

That difficulty is unique from other circumstances of failed firms because in addition to the inherent barriers to entry that exist in the market, there are (1) entry barriers resulting from the trust deficit that the sustained fraudulent activity created; and (2) entry barriers relating to a lack of reliable signals of the equilibrium level of price and quantity. If a firm not engaged in fraudulent activity fails due to inefficiencies having nothing to do with its sales practices – for example, labor unrest – a new entrant need only purchase the failed firm’s assets and duplicate its business model, thus correcting the failed firm’s inefficiency. By contrast, if a market is maintained on the basis of consumer misapprehension of the product, there is no way to judge consumer demand, even whether it exists at all, once the misapprehension has been cured.

apply our approach to the financial crises that engulfed the US economy beginning in 2007.

The consumer mortgage markets were the grass roots of economy-wide overinvestment in real estate markets – first through lending to minimally credit-worthy consumers, and then

1 Abel Mateus, “Too Big to Fail”: Banking Regulatory Reform and What Still Needs to be Done, 7 Comp. Pol’y Int’l 22, 23 (2011).
2 See Jesse W. Markham, Jr., Lessons for Competition Law from the Economic Crisis: The Prospect for Antitrust Responses to the “Too Big to Fail” Phenomenon, 16 Fordham J. Corp. & Fin. L. 261, 262 (2011) (“Antitrust law could make a greater contribution in resolving this public-policy problem if Congress enacted or the judiciary forged more robust rules preventing and dismantling unwieldy corporate size in excess of any plausible scale efficiency justification.”).
3 Certainly the financial crisis has not been limited to the US economy. For reasons of tractability, we limit our analysis to the US experience.
downstream through the purchases of loans and attendant mortgage interests from the original lenders.⁴

In Part IV we describe a model antitrust claim that a plaintiff might bring against a firm that achieved, or maintained, monopoly power in mortgage lending through the practice of behavioral exploitation. We borrow from the U.S. Financial Crisis Inquiry Commission Report⁵ the example of Countrywide Financial Corp., which became the largest mortgage lender in the United States through an aggressive course of subprime lending. We discuss the various possible plaintiffs and remedies ranging from criminal prosecution at the unlikely extreme, to injunctive relief, to treble damages liability. We conclude Part IV by demonstrating that the antitrust claim, brought under antitrust’s “rule of reason,” overcomes the problems of the leading approaches to consumer mortgage regulation.

We conclude in Part V.

As we have stated above, one commonly held understanding of the cause of the most recent financial crisis is the sale of millions of mortgage products in transactions that exploited consumers. This section sets out to address the current regulatory protections in place in the United States. Examined within are the causes of action and remedies available not only to consumers, but also the government, and even lenders themselves. From the outset a party to a mortgage transaction is presented with an avalanche of acronyms, overlapping authorities, and varying degrees of consumer protection and business regulation. Further, the statutory provisions regulating mortgage transactions have been the subject of seemingly constant reform and amendment, requiring almost constant observation of amendments and reforms.⁶

Nevertheless, there are a number of remedies and causes of action available to consumers and others involved in mortgage origination; however, the existing scheme is inadequate. Moreover, as the focus of this paper is aimed at preventative rather than reparative efforts in the mortgage origination context, the remedies and causes of action outlined below do not go so far as to prevent market failures in mortgage lending; thus, antitrust law has a place in regulating the conduct concerned herein. The length of a comprehensive discussion of statutory, regulatory, and common law relevant in this area would prove to be prohibitive in an article of this size. Yet, a brief overview of much of the relevant existing law and several illustrative cases follow to give the reader a better sense of the outstanding issues facing parties in a mortgage transaction.

In the mortgage origination context, consumers have asserted misconduct on behalf of lenders alleging: (1) the lender made a loan to the consumer that the consumer was unlikely able to

---

⁶ See e.g., Cottingham, detailing the amendments to TILA, including: HOEPA, and then a period of several months in which TILA and the HOEPA amendments were amended by the Mortgage Disclosure Improvement Act of 2008 (MDIA), and the Emergency Economic Stabilization Act of 2008 (EESA), which further amended the MDIA’s amendments to TILA.
pay; (2) the consumer was tricked into agreeing to terms he/she did not understand; (3) the terms of the loan were unconscionable; and (4) loan closing charges were improperly excluded from the finance charge. Each of aforementioned contemplates different sources for which the consumer may bring a cause of action. Yet, a particular consumer’s remedies are limited in more than one way: federal and state statutes may lack a private cause of action, and further, court decisions have restricted the availability and success of bringing common law fraud and tort claims. In addition, many of the cases brought by consumers against lenders are brought closely in time with foreclosure proceedings, and as such, have contentious and often complicated factual and procedural backgrounds.

A. Federal statutory provisions available for consumers

Perhaps the most notable federal statute applicable to mortgage transactions is the Truth in Lending Act (“TILA”). TILA is defined as a “remedial consumer protection statute,” and is a statute that pertains to disclosures at the time of a loan application. TILA provides a private right of action for consumers against creditors who fail to make required disclosures and may be brought in either federal or state court. Yet, because the purpose of TILA is to “protect consumers from inaccurate and unfair credit practices and to assure a meaningful disclosure of credit terms so that the consumer will be able to compare more readily the various credit terms available to him and avoid the uninformed use of credit,” TILA does not go far enough to prevent pervasive fraud in the mortgage origination context. In fact, “TILA was not intended to, and does not in fact, govern or provide causes of action for alleged mortgage fraud or ‘predatory lending.’”

Often present in mortgage litigation is the Home Ownership and Equity Protection Act of 1994 (“HOEPA”), which amended certain provisions in TILA and added new consumer protection restrictions on specified home mortgage loans. Although HOEPA amended TILA to respond more directly to predatory lending in the mortgage market, “a transaction’s coverage under the act is determined by triggers related to a loan’s annual percentage rate or its points and fees, rather

---

7 Martin C. Bryce, Jr., Foreclosure Developments, Mortgage Fraud, Counterclaims and Defenses, Consumer Finance Law Quarterly Report, Spring 2010
8 Ariagno, Bennett, and Mersel. §5:18. (“Claims of lender liability are often asserted as defensive strategies by borrowers who are faced with collection or foreclosure actions.”).
9 15 U.S.C.A. § 1601 et seq.; In general, TILA applies only to credit transactions less than $25,000; however, the $25,000 cap on TILA coverage does not apply to transactions “secured by real property, or by personal property used or expected to be used as the principal dwelling of the consumer.” Regulation Z § 226.3(b).
10 15 U.S.C.A. § 1601 et seq.; see also, Reg. Z § 226.19 (requiring lenders is to give early estimated disclosures at the time of the loan application).
13 Martin C. Bryce, Jr., Foreclosure Developments, Mortgage Fraud, Counterclaims and Defenses, 64 Consumer Fin. L.Q. Rep. 4 (Spring, 2010) (citing as examples TILA § 102(a); 12 C.F.R. § 226.1(b); Cunningham v. Nationscredit Fin. Serv. Corp., 497 F.3d 714, 718 (7th Cir. 2007); Parker v. Long Beach Mort., 534 F. Supp. 2d 528 (E.D. Pa. 2008)).
than any definition of ‘predatory lending’. Thus, a creditor can avoid HOEPA’s increased disclosure requirements by avoiding the two triggers, which certainly limits the overall effectiveness of HOEPA from a consumer protection standpoint. In addition, consumers often allege violations based upon several other federal statutes when bringing a cause of action against a mortgage lender (e.g., FDCPA, ECOA, RESPA, FCRA, among others); however, an in depth discussion is neither possible nor necessary in this space. Rather, the plethora of statutes in existence at the time of the financial crisis only serves to echo the need for the remedies discussed within this paper.

Another difficulty facing consumers pursuing causes of action arising out of mortgage transactions is the frequency of which mortgage products change hands. Looking at existing regulation, an assignee of a creditor may be liable for the creditor’s TILA violations. However, such liability is limited to the extent that a civil action for a TILA violation against a creditor may only be maintained against an assignee of such creditor, if the violation is apparent on the face of the disclosure statement. HOEPA substantially expanded assignee liability when it amended TILA. For HOEPA loans, the burden is placed on an assignee to prove, by a preponderance of the evidence, that the assignee did not know and could not reasonably determine that the loan was a...

---

15 Letter from Edward M. Gramlich, Member of the Board, Federal Reserve to The Honorable Phil Gramm, Chairman of Committee on Banking, Housing and Urban Affairs, United States Senate, dated April 28, 2000; available at: http://banking.senate.gov/docs/reports/predlend/fed.htm

16 The Fair Debt Collection Practices Act, 15 U.S.C.A. § 1692 et seq., (“FDCPA”) only applies when a loan is already in default and regulates the collection practices associated with the loan in default. 15 U.S.C. § 1692a(6) (“‘debt collector’ means any person who uses any instrumentality of interstate commerce or the mails in any business the principal purpose of which is the collection of any debts, or who regularly collects or attempts to collect, directly or indirectly, debts owed or due or asserted to be owed or due another.”); Important here, creditors and their fiduciaries are not “debt collectors” subject to the FDCPA. See 15 U.S.C. §§ 1692a(4), (6)(f) (A “creditor” includes “any person … to whom a debt is owed,” unless the debt is transferred or assigned after default by the consumer solely for the purpose of facilitating collection on the original creditor’s behalf); See e.g., Mansour v. Cal-Western Reconveyance Corp., 618 F. Supp. 2d 1178 (D. Arizona 2009)

17 The Equal Credit Opportunity Act, 15 U.S.C.A § 1691 et seq., (“ECOA”) which makes it unlawful for any creditor to discriminate on the basis of race, color, religion, national origin, sex, marital status, or age; on the basis that all or part of an applicant’s income is derived from public assistance; or on the basis that the applicant has in good faith exercised any right under the Consumer Credit Protection Act; See e.g., Enriquez v. Countrywide Home Loans, FSB, 814 F. Supp. 2d 1042 (D. Hawai’i Aug. 31, 2011) (plaintiff unsuccessfully brought a claim based upon ECOA).

18 The Real Estate Practices Act , 12 U.S.C. § 2601 et seq., (“RESPA”) is a disclosure statute, which is designed to ensure that consumers are made aware of settlement procedures and costs by imposing certain disclosure requirements, and to eliminate kickbacks and referral fees that increase the cost of the settlement process. 12 U.S.C. § 2601(b).

19 The Fair Credit Reporting Act, 15 U.S.C.A. § 1681 et seq., (“FCRA”) requiring consumer reporting agencies to “adopt reasonable procedures for meeting the needs of commerce for consumer credit, personnel, insurance, and other information in a manner which is fair and equitable to the consumer, with regard to confidentiality, accuracy, relevancy, and proper utilization of such information in accordance with the requirements of this subchapter.”


HOEPA extends liability by providing that assignees “shall be subject to all claims and defenses” that the borrower could assert against the original creditor. Thus, “[i]n effect, under HOEPA, lenders and assignees are jointly and severally liable for the lender’s illegal act, unless the assignee could not have discovered the illegal act with reasonable due diligence.”

B. State statutory or common law claims available for consumers

Consumers may also have the ability to bring a cause of action against mortgage lenders under state statutory or common law. Common law or state statutory claims, however, may be in essence duplicative of claims brought under federal statutes, doing little to increase consumer protection. For instance, the Illinois Consumer Fraud and Deceptive Business Practices Act does not extend disclosure requirements beyond those already required by federal disclosure statutes, and compliance with TILA is defense to liability under the Illinois Consumer Fraud Act. Thus, when a creditor is exempt from TILA liability, the creditor is also exempt from Consumer Fraud Act liability. However, other state and local laws often increase restrictions on mortgage lenders and apply to a wider spectrum of loans. Yet again, however, the insufficient and unclear nature of the existing remedial structure is demonstrated by varying degree of overlap and protection depending on jurisdiction.

As for common law causes of action brought against a mortgage lender, the consumer will typically bring suit alleging fraud. A consumer will likely be required to prove the elements of fraud, including a misrepresentation of fact by the mortgagee. Courts have almost uniformly concluded that reasonable reliance by the borrower is an element of any claim under state consumer protection law. Further, an assignee may be liable for aiding and abetting fraud against

---

22 HOEPA 15 U.S.C.A. § 1641(d)(1)
21 15 U.S.C.A. § 1641(d); c.f. TILA, which only authorizes assignee liability for TILA violations by the original creditor, not violations of other state or federal laws. See Cottingham.
24 Cottingham.
26 MorEquity, 118 F. Supp. 2d at 893 (citing Jackson v. South Holland Dodge, Inc., 312 Ill. App. 3d 158, 167, 244 Ill. Dec. 835, 726 N.E. 2d 1146 (1st Dist. 2000)).
27 Cottingham. §5:8. Detailing, for example, the Georgia Fair Lending Act (Ga. Code Ann. §§ 7-6A-1, et seq.), which initially sought to impose nearly unlimited liability on assignees of many Georgia mortgage loans.
the creditor’s customers or under a claim of civil conspiracy.\textsuperscript{29} In addition, a growing line of cases have held assignees liable under a joint venture analysis.\textsuperscript{30}

C. Government regulation of mortgage transactions

Actions taken by consumers may lead to government actions filed against them. For instance, false statements on loan applications are against federal law.\textsuperscript{31} Indeed, the Federal Bureau of Investigation defines mortgage fraud as “the intentional misstatement, misrepresentation, or omission by an applicant or other interested parties, relied on by a lender or underwriter to provide funding for, to purchase, or to insure a mortgage loan.”\textsuperscript{32} The FBI targets two main types of fraud, “fraud for property” and “fraud for profit.” When a loan applicant intentionally overstates his income or misrepresents other relevant facts for the purpose of purchasing a property to occupy as his residence, the loan applicant commits “fraud for property.”\textsuperscript{33} When a loan applicant’s purpose, however, is to cause a lender to make a loan and then escape with the money, the loan applicant commits “fraud for profit.”\textsuperscript{34} However, since the FBI began investigating mortgage fraud in 1999, its primary focus has been on “industry insiders” (e.g., corrupt mortgage brokers, real estate appraisers, or settlement agents) who often commit “fraud for profit.”\textsuperscript{35}

To the extent that a mortgage lender is engaged in deceptive or unfair acts or practices, the Federal Trade Commission (“FTC”) may use its power to bring a cause of action against a mortgage lender under Section 5 of the Federal Trade Commission Act (“FTC Act”).\textsuperscript{36} Although no federal statute exists that is addressed solely to mortgage fraud, federal prosecutors can select from existing financial crime statutes, such as bank fraud, mail and wire fraud, and money laundering.\textsuperscript{37} More recently, the Fraud Enforcement and Recovery Act of 2009 (“FERA”) has enhanced several federal statutes pertaining to financial fraud, and in particular, those statutes applicable to mortgage fraud prosecution.\textsuperscript{38} Yet, although FERA broadens the range of conduct that is subject to criminal prosecution, allows for less constrained prosecutions with a ten year statute of limitations, and


\textsuperscript{30} See e.g., In re: First Alliance Mortgage Co., 471 F. 3d 977 (9th Cir. 2006).


\textsuperscript{33} James Charles Smith, at 478.

\textsuperscript{34} Id.


\textsuperscript{36} 15 U.S.C. §§ 41-58 (as amended)


\textsuperscript{38} Fraud Enforcement Recovery Act of 2009, Pub. L. No. 111-21, 123 Stat. 1617 (2009) (which provides: “an Act to improve enforcement of mortgage fraud, securities and commodities fraud, financial institution fraud, and other frauds related to Federal assistance and relief programs, for the recovery of funds lost to these frauds, and for other purposes.”).
increases penalties for fraudulent conduct, it is difficult to predict whether increased criminal penalties will deter fraudulent conduct in the mortgage industry.

State governments have moved to enact statutes explicitly criminalizing mortgage fraud, which state government agencies may enforce by filing criminal charges and/or bringing a civil cause of action. In fact, thirteen states have statutes that specifically define and criminalize mortgage fraud. As discussed above, however, the overlapping and unequal nature of consumer protection statutes with respect to different jurisdictions does little to remedy an issue that is felt on a national scale. For example, although FDCPA and RESPA do not preempt state laws that afford greater consumer protection, in some instances FCRA may preempt state laws that are more protective, and in other instances FCRA may not.

Some states have codified prohibited practices for mortgage loan originators. For instance, Illinois has set out as part of the Residential Mortgage License Act of 1987 (the “License Act”), twenty enumerated prohibited acts and practices for mortgage loan originators, which incorporate and expound upon federal statutory provisions regulating mortgage loan originators. In addition, Illinois law regulates advertising in connection with the License Act, but also separate from the License Act, untrue, misleading or deceptive advertising in connection with the offering of credit or loans constitutes a Class A misdemeanor. Further, under Illinois’ “Loan Advertising to Bankrupts Act,” lenders are also prohibited from soliciting or advertising that a loan will be made to a person who has been adjudged bankrupt, and violators may be fined up to $1,000.

D. Impact of fraudulent conduct on mortgage lenders

Mortgage Lenders are faced with fraudulent conduct in the marketplace as well. For example, in Morilus, the plaintiffs alleged that the defendants conspired to unfairly and deceptively induce them to execute loan documents premised upon a falsely inflated appraisal price to qualify them for a loan with monthly payments they could not possibly afford. However, the defendant Countrywide counterclaimed that the plaintiff had committed fraud in filing out her mortgage

39 See id. at 475-476, in which James Smith cites to laws in Arizona, Colorado, Florida, Georgia, Kentucky, Maryland, Minnesota, Mississippi, Missouri, New York, North Carolina, Utah, and Washington, and notes that “in other states acts of fraud committed in connection with mortgage lending will often violate other criminal statutes.”


41 Id.

42 See 205 ILCS 635/7-13 (prohibiting: “(1) Directly or indirectly employ any scheme, device, or artifice to defraud or mislead borrowers or lenders or to defraud any person … (7) [f]ail to make disclosures as required by this Act and any other applicable State or federal law, including regulations thereunder … (11) [m]ake any payment, threat or promise, directly or indirectly, to any person for the purpose of influencing the independent judgment of the person in connection with a residential mortgage loan, or make any payment threat or promise, directly or indirectly, to any appraiser of a property, for the purpose of influencing the independent judgment of the appraiser with respect to the value of the property…”)


45 Id. at 296.
application, and that the plaintiffs together had conspired to commit fraud against Countrywide. 46 The court held that Countrywide was entitled to summary judgment on its fraud counterclaim against one of the plaintiffs, however, the court dismissed Countrywide’s conspiracy to commit fraud counterclaim. 47 When signing the documents, Ms. Morilus had represented to Countrywide that the property would be her primary residence—a material representation, which was found to be a lie. 48 In the end, the court found that Countrywide suffered cognizable damages in that it would have charged a higher interest rate for the loan, and the difference between the actual interest rate charged represented an economic injury of lost profits that Countrywide was entitled to absent Ms. Morilus’ misrepresentation. 49

Another cause of action that might be pursued by a mortgagee against a mortgagor is based upon the doctrine of waste, which protects reversionary interests in real property from damage, destruction, alteration, misuse or neglect by a party rightfully in possession. 50 Typical mortgage documents require a mortgagor to maintain the property in a good, safe condition and require prevention of any waste to the premises. 51 Thus, a cause of action based upon the doctrine of waste may sound in contract, as well as in tort law, and may find some statutory support as some states have enacted statutes regarding waste. 52 Indeed, “[t]he doctrine of waste has taken on increased importance in recent years in litigation between mortgagees and mortgagors in loans that have been placed in securitized mortgage pools.” 53

E. Other parties impacted by fraud in mortgage transactions

46 Morilus, 651 F. Supp. 2d at 310. In Morilus, the plaintiff Ms. Morilus executed a home mortgage for $212,000 for a property valued $238,000 located in Pennsylvania. Ms. Morilus did not read or speak English. Plaintiffs Christopher and Filonise Celian were husband and wife and reside at the property subject to the mortgage; however, they were not signatories to the agreement. The Celians had initially tried to secure their own mortgage but their poor credit prevented them from getting favorable terms. Their broker, Mr. Alkhal, asked if someone else could sign the application for them. On Mr. Alkha;’s suggestion, the Celians asked Ms. Morilus to sign on their behalf. The Celians would not be leasing the property nor would they be receiving it as a gift; rather, they would live there as if it were their own and make the mortgage payments.

47 Id., at 311. The court held that because Countrywide failed to produce any evidence of the plaintiffs’ malice, Countrywide failed to make out a prima facie case for conspiracy to commit fraud. Id., at 312. (quoting Thompson Coal Co. v. Pike Coal Co., 488 Pa. 198, 412 A.2d 466, 472 (1979)) (“Proof of the intent to injure, however, is essential, and this intent must be absent justification.”)

48 Id., at 312. The court found the misrepresentation to be material for two reasons: (1) the mortgage document itself explicitly made the misrepresentations “material; and (2) the mortgage’s terms would have been different if Countrywide had been aware of Ms. Morilus’ actual intentions.

49 Id.


51 Id.

52 See e.g., Mo. Rev. Stat. § 537.420; see also, N.D. Cent. Code § 32-17-22; see also, Or. Rev. Stat. § 105.805. For example, Missouri law provides “If any tenant, for life or years, shall commit waste during his estate or term … he shall be subject to a civil action for such waste, and shall lose the thing wasted and pay treble the amount at which the waste shall be assessed.” Mo. Rev. Stat. § 537.420; For an in-depth look at considerations in pursuing waste claims, see Talcott J. Franklin and Thomas F. Nealon III, Mortgage and Asset Backed Securities Litigation Handbook, §5:42 (Nov. 2011).

53 Id.
As a result of the collapse of the United States residential mortgage market beginning in 2007, there has been a dramatic increase in the rates of defaults on residential mortgage loans, and mortgage and financial guaranty insurers have undertaken a series of steps to avoid having to pay claims. The risk of default (occurring from growing unemployment and other economic factors) is exactly the type of risk mortgage insurers are supposed to insure. However, “rather than paying based on the actual merits of the claim,” mortgage insurers “have increasingly relied on rescissions and repurchase demands (in addition to various tort claims) in a concerted effort to minimize their mortgage-related losses.” Indeed, “[i]n the wake of the housing market deterioration, mortgage insurers have sought to rescind coverage on a ‘pool-wide’ basis, alleging fraud and misrepresentation by the mortgage originator in order to avoid billions of dollars in liability.

Mortgage insurers’ success in claiming fraud, however, has been limited. Courts have dismissed mortgage insurers claims of fraudulent inducement by finding that the mortgage insurers had access to all the information necessary regarding the transaction, and as sophisticated parties, could not have reasonably relied on any of the lenders’ alleged misrepresentations.

Another layer of insurance that protects investors against losses due to borrower default is a monoline policy. Relevant to our discussion herein, monolines may not be required to make payments under a policy if the lender is found to have breached a specific representation and warranty it made during the origination process, if the breach is materially adverse to the interest of the investors. Monolines have argued that, unlike mortgage insurers, the companies are not sophisticated parties with respect to the mortgage origination process, or alternatively, the monoline could not have ascertained the deficient quality of the loans, or had no duty to undertake the diligence that would have exposed the deficient quality of the loans. Authors Ellison and Rosso have noted that “[s]o far, courts have sided at the preliminary stages with monolines.” The point here, however, is that increased litigation between parties that were not originally part of the initial mortgage transaction is illustrative of the failings of the current regulatory structure as a whole.

F. The Dodd-Frank Act reforms to mortgage lending regulations

55 Id.
56 Id.
58 Ellison and Rosso
60 Ellison and Rosso
61 Id.
62 Id.
63 Id.
The Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank" Act) has significantly revised regulation of the mortgage lending industry in the United States. However, it must be noted, “the Dodd-Frank Act may have a significantly greater effect depending on how the new Bureau of Consumer Financial Protection (or the ‘CFPB’ as it is commonly referred to) exercises its considerable powers.” Thus, to the extent that the CFPB does not take steps far enough to remedy the structural problems inherent in mortgage lending transactions, fraudulent conduct is likely to remain pervasive.

The Dodd-Frank Act has both expanded and restricted coverage of existing statutes and regulations in the mortgage lending industry. For instance, the Dodd-Frank Act established a new “duty of care” for residential mortgage originators. However, the “duty of care” which is limited to two requirements: (1) a mortgage originator must be licensed or registered as a loan originator if required by the SAFE Act; and (2) a mortgage originator must include on all loan documents the unique identifier provided by the Nationwide Mortgage Licensing System and Registry (NMLS), does little to increase consumer protection. Indeed, the Dodd-Frank Act has even reduced regulation of the mortgage industry with respect to certain loans. For instance, the Mortgage Reform and Anti-Predatory Lending Act ("MRAPLA"), which is Title XIV of the Dodd-Frank Act, creates the concept of a “qualified mortgage.” A “qualified mortgage” will be free of many of the restrictions and limitations imposed by the MRAPLA on other mortgage loans. Further, although the Dodd-Frank Act provides a new enforcement role for the FTC with respect to home appraisals, and has increased penalties for violations of TILA, the reforms do not go so far as to prevent a need or negate the justification for antitrust law and policy infused into this area.

---

64 Robert A. Cook, Meghan Musselman, Summary of the Mortgage Lending Provisions in the Dodd-Frank Wall Street Reform and Consumer Protection Act, 64 Consumer Fin. L.Q. Rep. 231 (Summer/Fall, 2010)
65 Id.
66 See Cook and Musselman for a greater discussion of the impact of the Dodd-Frank Act on mortgage lending regulation in which the authors detail Dodd-Frank’s expanded HOEPA coverage, new mortgage originator rules, increased penalties, new disclosure burdens, and new escrow and force-placed insurance rules, among other reforms.
67 Cook and Musselman; the authors note—“By placing this duty in TILA, the Dodd-Frank Act allows the TILA penalties to be imposed on a mortgage originator for a failure to comply with these rules.” Id.
68 Dodd-Frank Act § 1491; A “qualified mortgage” is defined as a mortgage loan “(i) that does not allow for negative amortization and is not a balloon loan, (ii) for which the creditor verifies and documents the borrower’s income and assets, (iii) that is underwritten using a fully-amortizing payment schedule (for an ARM loan, underwritten based on the maximum rate permitted during the first five years of the loan term) taking into account all applicable taxes, insurance and assessments, (iv) for which total points and fees do not exceed 3% of the total loan amount, and (v) that complies with debt-to-income ratios established by the Federal Reserve Board.” Dodd-Frank Act § 1411; see Robert M. Jaworski, Jaworski on the Mortgage Reform and Anti-Predatory Lending Act, 2010 LEXISNEXIS EMERGING ISSUES 5346 (Oct. 6, 2010).
69 Jaworski
70 Title XIV Dodd-Frank Act
71 “TILA penalties have been increased as follows: the class action liability cap is raised to $1,000,000; mortgage originators are subject to TILA penalties for compensation and steering violations; the heaviest penalties (by far) are applied to violations of the rules related to appraisal independence; and state attorney general enforcement is expanded.” Id.
A hodge-podge of targeted, consumer-protection based regulation developed in the years leading up to the financial crisis. The existing consumer protection and remedial structure remains insufficient, inefficient, and bewildering. Indeed, at least one court has expressed regret evidencing insufficiency of the current state of regulation of the mortgage lending industry: “The power to curb predatory practices lies either in consumer education or with Congress; as a court of limited jurisdiction, I may only enforce the laws as written, not as I would wish they were written.”

Much of this regulation was well-intentioned and well-designed to accomplish its narrow purpose, but failed due to the inability of regulators to foresee problems that were deemed unlikely by even the most expert of observers and agency capture problems that developed due to powerful political interests supporting the regulated entities. Targeted regulation under the leading approaches also present what are best described as “whack-a-mole” problems, resolving only problems that are known or foreseeable and not “unknown unknowns.”

Discussing regulation targeting the downstream financial industry, Darren Bush noted the problem with reactionary, rather than anticipatory, regulation. “[T]he missing piece in this discussion of economic crises is an examination of the ex-ante regulation of failed markets and the economy as a whole.” A regulatory scheme that avoids this trap would permit challenges to conduct that threatens harm, before that harm is realized.

Consumer-protection-based regulation suffers a third category of limitations as well. Those schemes remove consumer choice if they outlaw substantive transaction terms, when those terms may be appropriate for a subset of consumers. They also undermine consumers’ incentives to educate themselves with regard to the transaction at issue. Mark Armstrong has observed the concern for moral hazard if consumers are allowed a remedy for improvident transactions.

The limitations of targeted regulation in preventing harmful spiral in which conduct leads to market structure characterized by dominance or market leadership, which in turn facilitates conduct, suggests that legal protections must be designed with two goals in mind. First, legal protections must not rely on foresight on the part of regulators. Second, they must be structured to limit concerns for agency capture by regulated entities.

Antitrust offers a quiver of legal protections that satisfy those requirements. The incentives for consumers or competitors to bring suit do not depend on foresight into the long-term consequences of a course of bad conduct cognizable as an antitrust violation. Those private plaintiffs have financial incentives to seek both injunctive and monetary relief before possible extra-market consequences of the conduct are understood. Agency capture concerns are less likely to

---

72 Parker v. Long Beach Mort., 534 F. Supp. 2d 528, 530 n. 2 (E.D. Pa. 2008); See also Bryce, Foreclosure Developments, Mortgage Fraud…
74 Bush, Too Big to Bail, supra, at 278.
arise under antitrust’s second-order regulation, where the decision-makers – courts – are diffuse, life-tenured, and subject to appellate review. While federal enforcement agencies may be subject to industry capture, that too is less likely, because the agencies are themselves generalist; the two federal agencies compete between themselves, and with state enforcers, in enforcement; and private enforcement remains as a check on public enforcers’ abdication of their role.

There are other benefits to antitrust enforcement as a protection against a course of conduct that is itself harmful and threatens to lead to a dangerous industry structure. Antitrust enforcement targets market-wide conduct and effects rather than transaction-level conduct and effects. Transaction-level harms do not provide standing to competitors, who may be best situated to understand and challenge the conduct.

Behavioral Exploitation as Bad Antitrust Conduct

Behavioral exploitation is intentionally exploiting known biases in consumer decision-making. The theory rests on an understanding of consumer marketplaces, like those for home mortgages, as being characterized by sophisticated repeat-player merchant sellers (mortgage originators, whether brokers or lenders) and relatively naïve end-user purchasers. Elizabeth Warren and Oren Bar-Gill, among others, concur in our understanding of consumer credit markets as being so characterized.

Those cognitive biases or “decisionmaking heuristics” are mental short-cuts that facilitate consumer decisionmaking but frequently cause consumers to deviate from their utility maximizing decision paths. A marriage of economics, social psychology, and management theory has demonstrated – and continues to demonstrate – that individuals systematically deviate from utility maximizing conduct, sometimes by being more altruistic than their utility function would predict; sometimes by exhibiting less will-power than their utility function would predict; and sometimes by exhibiting cognitive short-comings.

---

75 See Huffman, Marrying Behavioral Antitrust and With Neo-Chicago, Antitrust L.J. (forthcoming 2012).
77 Id., draft at 38-40.
79 See Christine Jolls et al.,
Those so-called bounds on consumers’ abilities to tailor their conduct to a rational choice model give rise to a host of empirically proved biases.\(^\text{80}\) One, referred to as “hyperbolic discounting” or “myopia,” is the tendency hyperbolically to discount future costs and benefits, such that decisions are made on the basis of short-term cost benefit analyses.\(^\text{81}\) A related bias is the optimism bias.\(^\text{82}\) An overly optimistic consumer will discount statistically likely future harm.

Merchants have studied and understand means to exploit these and other biases in negotiations with consumers. Drip pricing is a well-studied technique of exploiting individuals’ empirically-demonstrated tendencies to make either soft (psychological) commitments on the basis of salient up-front prices before disclosing other expenses that might fundamentally alter the nature of the transaction.\(^\text{83}\) Consumers encounter drip pricing on a daily basis, in sales pitches as mundane as “would you like to add a cookie for only $0.99 more today?” and as frustrating as “that will be $60 for your two checked bags – how would you like to pay for that today?"\(^\text{84}\)

Scholars also speak in terms of “framing” techniques, sometimes interchangeably with the biases that framing can exploit.\(^\text{85}\) Framing is the practice of structuring a negotiation to alter the consumer’s reaction to certain transaction terms. A common example is that of televisions in an electronics store: although a consumer may not seriously consider purchasing the $5000 model, its very presence increases the consumer’s reservation price.\(^\text{86}\) Dan Ariely’s popular press book,
Predictably Irrational, effectively reduced these concepts to plain English. Drip pricing and framing both succeed because of the size of transaction terms relative to some other metric.87

Capitalizing on this knowledge about consumer decision-making – intentionally exploiting known cognitive biases – is the crux of the behavioral exploitation strategy. Courts and regulators have for decades recognized the reality of behavioral exploitation in the commercial marketplace.88 And academic commentators recognize the ability of sophisticated sellers to profit at the expense of less-sophisticated purchasers in zero-sum competitions for surplus welfare.89

Behavioral exploitation causes harm through the disturbance of efficient resource allocation as consumers are induced to enter transactions they would otherwise eschew but for the conduct. Resources flow to consumers’ ostensible, rather than actual, preferences. Aggregate welfare is thereby diminished.90 It is important to distinguish this effect from the demand-curve shifting that

87 See Ariely, supra n.__, at 1-21.
underlies dynamic competition. Behavioral exploitation is not a question of introducing and marketing new products, changing consumers’ utility functions permanently (or until the next innovation comes along). Behavioral exploitation is a question of a short-term shift in the demand curve, altering consumers’ views of their own utility functions long enough to create a lock-in effect.

Merchant sellers employing sophisticated marketing practices are known to engage in such conduct in the ordinary course of their business. Robert Cialdini, whose work has only recently been studied in the law and economics literature, has discussed merchants’ abilities to prey on consumer’ cognitive biases in profound popular press works including *Influence: The Psychology of Persuasion*. Cialdini explains the success of drip pricing strategies by individuals’ proved desire to be consistent with prior decisions. Once a consumer commits to a transaction under certain terms, adjusting those terms in a manner favorable to the merchant is possible because the consumer remains consistent to the original decision. Cialdini describes other so-called “weapons of influence,” which are marketing practices designed to maximize consumers’ positive responses to merchants’ wishes, noting that marketers “have much more than the vague and amateurish understanding of what works than the rest of us have."

Cialdini then reduces behavioral economics insights into a practical discussion of the merchant-consumer relationship. Merchants can rely on “the rule for reciprocation” which dictates “that we should repay, in kind, what another person has provided to us.” Cialdini notes the tendency of individual consumers to become committed to decisions, even after the bases for those decisions have become eroded. This phenomenon renders “foot in the door” sales techniques successful: after a person has agreed to a trivial request, he or she is substantially more likely later to concede to a much larger request. A third example is social proof – the effectiveness of being
told “this is a popular choice”;\textsuperscript{98} another is the “liking rule,” whereby consumers tend to accede to requests from people they like – a category that includes physical attractiveness;\textsuperscript{99} a fifth, deference to perceived or actual authority;\textsuperscript{100} and a sixth, the rule of scarcity, by which consumers are more inclined to take advantage of a vanishing opportunity.\textsuperscript{101}

Cialdini’s findings might be best explained as meta-descriptions of the teachings of behavioral economists. The scarcity principle, for example, is an example of the “loss-aversion bias,” whereby people find avoiding losses more valuable than gaining.\textsuperscript{102} The loss being to be averted is that of the opportunity to make a purchase, which a marketer can describe as fast closing.

B. Deception Compared

Behavioral exploitation is a close cousin of deception, the practice of inducing a transaction on the basis of material misrepresentations, or omissions that operate as misrepresentations, that has long been regulated at common law and by both federal and state statute.

Maurice Stucke has discussed a theory of competitive harm from deception that can be analogized to the antitrust theory of behavioral exploitation. In \textit{How Do (and Should) Competition Agencies Treat a Dominant Firm’s Deception},\textsuperscript{103} Stucke argued under both the common law history and early applications of the Sherman and Federal Trade Commission Acts that deceptive conduct by a dominant firm presented the kind of “unfair competition” antitrust law was intended, and interpreted, to remedy.\textsuperscript{104} Stucke then gave modern examples of deceptive marketing and business practices, frequently arising in high technology markets, that were deceptive and thereby presented competitive concerns.\textsuperscript{105} Concluding that deceptive conduct lacked any redeeming characteristics, but presented real competitive dangers, Stucke argued for application of antitrust’s “quick look” standard to reviewing this conduct when undertaken by a dominant firm.\textsuperscript{106}

It is not hard to find examples of deception in markets for consumer home loans. Deception certainly existed in subprime mortgage lending. The Financial Crisis Inquiry Commission reports, among other examples, anecdotes of consumers who agreed to one set of loan terms and signed papers reflecting other loan terms.\textsuperscript{107} Bar-Gill agrees with Stucke’s assessment of

\textsuperscript{98} Id. at 116.
\textsuperscript{99} Id. at 167, 171.
\textsuperscript{100} Id. at 208. This psychological finding explains the success of the infamous Milgram experiment.
\textsuperscript{101} Id. at 237.
\textsuperscript{103} 63 SMU L. Rev. 1069 (2010). See also Maurice E. Stucke, \textit{When a Monopolist Deceives}, 76 Antitrust L.J. 823 (2010) (analyzing the specific context of deceptive advertising by a dominant firm).
\textsuperscript{104} See id. at 1080-83.
\textsuperscript{105} See id. at 1099-1113.
\textsuperscript{106} See id. at 1113-19.
\textsuperscript{107} See Financial Crisis Inquiry Report at 7-8, 12; Bernstein Senate Testimony 3.
welfare effects from deception, and demonstrates in particular in the context of subprime mortgage lending that

Stucke and Bar-Gill correctly observe the welfare effects of deceptive conduct. But Stucke’s approach—subjecting deceptive conduct to antitrust scrutiny—is subject to reasonable challenge. Deception is regulated at the level of the individual transaction under a host of state and federal schemes. Those include disclosure regulation, which mitigates the possibility of deception by omission,108 as well as remedial regulation under state and federal unfair and deceptive acts or practices legislation.109

C. Competitive Harm from Behavioral Exploitation

That same challenge will not succeed in the context of behavioral exploitation, which is a step removed from deception. A successful deceiver will defraud a fully rational borrower. A behavioral exploiter will not. By definition, to exploit a cognitive bias, you need a counter-party whose conduct deviates from economic rationality. The result of that difference is that it is difficult objectively to demonstrate the conduct that cause the problem. Disclosures can be complete and all statements can be truthful. Unlike deception, regulating to stop any one instance of this conduct is thus quite difficult. Under the current state of regulation, much of the conduct that meets the definition of behavioral exploitation is legal.

But behavioral exploitation presents welfare effects just as surely as does deception. One study by Eric Stein, which preceded the most substantial excesses in subprime mortgage lending over the past decade, estimated “that U.S. borrowers lose $9.1 billion annually to predatory lending practices,” following a definition of predatory lending that included conduct within the ambit of behavioral exploitation.110 Of the two lending practices studied, “equity stripping”—the charging of fees, credit insurance, and prepayment penalties—represented 2/3 of the annual loss. Stein’s description of these practices as including fees that are “painless at closing” but lasting “forever” invokes the availability heuristic and hyperbolic discounting. Stein points out that a lender may “recoup costs on riskier loans” by “charging higher interest rates” rather than fees.

Bar-Gill explains how those welfare effects occur in subprime mortgage contracts that “share two suspect features” of “cost deferral” and “complexity.”111 This reflected a “demand-side market failure,” as imperfectly rational (as distinct from reckless) borrowers “‘demanded’ complex deferred-cost loans and lenders met this demand.”112 That market failure produced welfare effects in four ways: by undermining comparison shopping, complexity hinders competition; cost-deferral leads to default and harm to borrowers and third parties (including “the economy at

---

112 Id. at 1080.
subprime contracts suffer distributive consequences because poor borrowers are uniquely affected; and demand for home mortgage products is artificially inflated.\textsuperscript{113}

The harm in any one instance of behavioral exploitation is transaction level harm, and its regulation is the stuff of the law of contract and consumer protection. Vis-à-vis the market in which the transaction occurs the harm frequently will be de minimis, although it is possible that a single large transaction may be large enough to have an effect on the market. Consumer transactions, in the ordinary course, must be aggregated to produce the kind of market-wide harm that supports antitrust treatment.\textsuperscript{114} Where a course of conduct impacts a large enough number of individually de minimis transactions, it will produce the kind of market effect that raises the possibility of antitrust harm.

Bad conduct giving rise to a market effect is relevant to all three of the major areas of antitrust enforcement – unilateral conduct, concerted conduct, and merger review. Unilateral conduct requires proof of both market power and conduct.\textsuperscript{115} Concerted conduct requires proof of agreement and conduct.\textsuperscript{116} And merger review requires proof of actual or likely harmful effects, which turns on increased incentive and opportunity to engage in unilateral, or concerted, bad conduct.\textsuperscript{117} A deep literature has developed over what constitutes “bad conduct,” and there is no comprehensive definition. Conduct that threatens market-wide harm and can be regulated without unduly restricting desirable activity certainly meets the definition.\textsuperscript{118}

One of us has proposed an antitrust claim for behavioral exploitation.\textsuperscript{119} In Marrying Neo-Chicago with Behavioral Antitrust, Huffman argued that behavioral exploitation’s welfare effects, the existence of which is relatively non-controversial, may be sufficiently substantial and sustained to present competitive consequences.\textsuperscript{120} The competitive consequences of behavioral exploitation explains antitrust authorities including Eastman Kodak Co. v. Image Technical Services, Inc., holding that a manufacturer’s could hold monopoly power in a parts aftermarket for its durable products, giving rise to a tying claim when that manufacturer sought to prevent competition in the market for repair services.\textsuperscript{121}

Maurice Stucke has agreed with the theory of competitive effects from behavioral exploitation, noting the danger of “systemic behavioral exploitation,” where “rational firms can

\textsuperscript{113} Id. at 1083.
\textsuperscript{114} See Huffman, supra, Marrying, __ Antitrust L.J. at __.
\textsuperscript{116} See id. at 30.
\textsuperscript{117} U.S. Dep’t of Justice & Federal Trade Comm’n, Horizontal Merger Guidelines §§ 6, 7 (2010).
\textsuperscript{118} This first principles understanding of what constitutes bad conduct invokes the complex question of optimal deterrence. See generally Daniel A. Crane, The Economics of Antitrust Enforcement, in Antitrust Law & Economics 1, 3-5 (Keith N. Hylton, ed., 2010). Trusting that, as Crane observes, id. at 4, there are ample forces at play seeking to undermine existing, and limit innovation in the development of, antitrust liability rules, we leave it to others to articulate the overdeterrence argument.
\textsuperscript{119} See Max Huffman, Bridging the Divide? Theories for Integrating Competition Law and Consumer Protection, 6 Eur. Comp. J. 7, 16-17 (2010); Huffman, Marrying, supra, __ Antitrust L.J. at __.
\textsuperscript{120} See Huffman, Marrying, supra, at __.
\textsuperscript{121} 504 U.S. 451 (1992).
compete in ways to reduce price transparency and increase the complexity of their products (or product terms)."\textsuperscript{122} Bar-Gill also has examined this question, recognizing the welfare effects of conduct meeting the definition of behavioral exploitation outlined here.\textsuperscript{123} Bar-Gill stops short of proposing an antitrust claim.

A claim for a violation of the antitrust laws on the basis of behavioral exploitation would lie where the defendant had general intent to exploit a counter-party’s known cognitive bias, succeeded in doing so, and the conduct had an effect on the marketplace.\textsuperscript{124} Proof of the specific intent would be made through documents or testimony relating to the defendant’s marketing practices. For example, sales manuals describing the benefits of opaque pricing strategies or setting out scripts for sales pitches might make strong evidence. Testimonial evidence by current or former employees may be available – Robert Cialdini supported his own academic research with “a decidedly more entertaining program of systematic immersion into the world of compliance professionals – sales operators, fund-raisers, recruiters, advertisers, and others.” His immersion program included observation, interviews, and review of written materials including sales manuals.\textsuperscript{125}

An effect on the market requires a market failure that competition cannot be relied on to mitigate. That will occur where, for example, the course of behavioral exploitation assists a firm in establishing or maintaining a monopoly position.\textsuperscript{126} Bar-Gill notes that “sellers benefit from the divergence between perceived and actual benefits and between perceived and actual prices. They will design their products and prices to maximize this divergence."\textsuperscript{127} The firm that is most effective at doing this will succeed and become dominant, unless other firms successfully imitate the strategy or consumers become sufficiently educated about the firm’s conduct that it ceases to be a successful strategy.

Consumer education, while possible over time, depends on third-party intervention; competitor intervention; or sufficient repeat interactions that consumers self-educate. Durable goods markets or markets for long-term financial contracts are unlikely to permit consumer self-education. Competitor education through advertising is a possibility, but where a firm achieves dominance through behavioral exploitation, it seems likely competitors will not sufficiently understand the dominant merchant’s marketing strategy to create such advertising, or may not have sufficient market presence for advertising to have an impact. Too, behavioral exploitation, unlike its close cousin, deception, is subtle in nature. If, for example, the product in question is a long-term lending contract, and the merchant exploits the consumer’s tendency to over-optimism (“you

\textsuperscript{122} Maurice E. Stucke, \textit{Reconsidering Competition}, 81 Miss. L.J. 107, 136-137 (2011).

\textsuperscript{123} Bar-Gill, \textit{Competition and Consumer Protection}, supra n.\underline{\underline{__}}, at 13-16. Scholars have for years observed the market failures associated with information asymmetries, which are closely related to the disparities in sophistication that underlie merchants’ abilities to exploit naïve consumers. \textit{See, e.g.}, Richard Craswell, \textit{Tying Requirements in Competitive Markets: The Consumer Protection Issues}, 62 B.U. L. Rev. 661, 671 (1982). Craswell also noted the efficiency loss resulting from this exercise of power. \textit{Id.} at 672.

\textsuperscript{124} See Huffman, \textit{Marrying}, supra, at __.

\textsuperscript{125} Cialdini, \textit{Psychology of Persuasion}, supra n.\underline{\underline{__}}, at xii-xiii.

\textsuperscript{126} Establishing, maintaining, or creating a dangerous probability of establishing a monopoly through a course of bad conduct implicates Section 2 of the Sherman Act, 15 U.S.C. § 2.

\textsuperscript{127} Bar-Gill, \textit{Competition and Consumer Protection}, supra n.\underline{\underline{__}}, at 5. Bar-Gill works from the same assumption we do, that behavioral exploitation is a less expensive strategy than is product innovation.
are sure to have earned a raise by the time the interest rate adjusts”), it is not clear what educational
advertising would undermine the merchant’s conduct. The relevant information would be “you
are not statistically likely to have earned that raise” – but any such statement is at best likely to be
ineffective, and at worst may offend.

Competitor education is an unreliable cure for the market failure behavioral education
causes for another reason. Competitors are likely to find it a better strategy to imitate, rather than
to undermine, behavioral education by a merchant. Richard Posner recognized this phenomenon
in the context of markets for harmful products, like cigarettes. 128 Bar-Gill demonstrated that little
advantage is to be gained by a competitor from consumer education, apart from the first-mover
advantage of being the first firm fully to disclose product attributes or pricing. Xavier Gabaix and
David Laibson go further, arguing that “it is not possible to profitably lure . . . myopes . . . to non-
exploitative firms.” 129 This demonstrates the second basis for antitrust concern – concerted
behavioral exploitation, which can occur even in a market without a dominant firm. 130 Concerted
exploitation can either be through actual agreement or consciously parallel conduct, although under
the current state of the law of concerted conduct, consciously parallel conduct does not establish
that element of the offense. 131

We can therefore expect market failures caused by behavioral exploitation to be sustained
over a sufficiently large time horizon to lead to both intra-market and external harm. With
specific regard to the home mortgage marketplace, the targeted regulation that exists either has
been proved, or can be expected, to be insufficient to prevent or remedy those failures and harms.

IV. A MODEL OF PREVENTATIVE REGULATION THROUGH ANTITRUST ENFORCEMENT

[Part IV reflects notes from Huffman presentation at LUC Symposium, Feb. 24. Needs
editing, expanding, and footnoting.]

Antitrust exists to cure for market failures that arise where one firm, or a group of firms, is
able to profit at the expense of consumers, by charging prices that exceed what the consumers
would charge but for a course of conduct on the part of the firm or group of firms.

A. Taxonomy of Antitrust Claims

By way of a brief taxonomy, in antitrust we have dominant firm conduct, concerted
conduct, and merger review.

We challenge dominant firms who have or are acquiring monopoly power, and doing so
through a course of what I will call "bad conduct," defined as anything other than building a better
mousetrap.

129 Xavier Gabaix & David Laibson, Shrouded Attributes, Consumer Myopia, and Information Suppression in
Competitive Markets, MIT Dep’t of Econ. Working Paper (2005), available at
papers.ssrn.com/abstract=728545.
We challenge groups of firms who act by agreement and, once again, engage in "bad conduct," defined more or less the same way.

We challenge mergers when the merged entities will be in a better position as a result of the merger to engage in the bad conduct.

Antitrust claims nearly always require proof of market effects. That means welfare effects that are sufficiently broad based that they are not de minimis, and sufficiently long lasting that they are not transient.

Antitrust is so-called second order, or indirect, regulation. Conduct is challenged after the fact, rather than regulated in advance. There are ways to quibble with that, but the story generally holds.

B. Antitrust Enforcement

Antitrust is enforced in several different ways. One is federal enforcement. Another is state enforcement. A third is competitor enforcement. And a fourth is consumer enforcement.

This belts and suspenders approach has a few impacts. One is competition among enforcers, whereby the FTC and DOJ, for example, are believed to compete for publicity by bringing more, or better, cases.

Another impact is that we have a host of sets of eyes on potential problems. Where government enforcers are blind to something, consumers and competitors may see them. Where consumers and competitors know too little, government enforcers have enhanced fact-finding powers. So there is less likelihood something slips by.

C. A Model Claim

The claim works this way. A plaintiff, probably a competitor, sues Countrywide in 2006. That competitor may be Wells Fargo, which told the FCIC that it lost money by refusing to engage in the most extreme forms of subprime lending.

It argues that Countrywide is on its way to market dominance because it is exploiting consumer biases, inducing them to enter into transactions that are suboptimal. That is the required "bad conduct." Alternatively, it argues a group of lenders are acting in concert, pursuant to an agreement.

The result is that the plaintiff is prevented from lending to those same consumers -- presumably smaller loans, but ones that are more consistent with the consumer's abilities to pay.

The remedy is the lost profit on the loans that were lost to the competitor plaintiff -- trebled.

D. Antitrust Avoids the Problems with the Dominant Regulatory Paradigm
The problems with consumer-protection style regulation that we detail in Part II, above, demonstrate the need for legal protections (1) that do not depend on regulator foresight, (2) that do not present concerns for agency capture, (3) are not whack-a-mole in nature, and (4) do not present consumer choice or moral hazard concerns. Antitrust enforcement meets those requirements.

1. Competition for Enforcement Mitigates Problems of No Foresight and Agency Capture

U.S. antitrust is known for its “decentralized and largely uncoordinated" enforcement mechanisms. Those include enforcement by two federal agencies – the Department of Justice and the Federal Trade Commission; federal “sectoral" regulators with public interest mandates, which frequently include competition policy enforcement; enforcement of both federal and state law by state attorneys general; and enforcement by private plaintiffs. The procedural mechanisms and remedies available to the various enforcers differ as well, creating what Crane calls a "crazy quilt of enforcement mechanisms." Antitrust does not rely on neutral or foresighted regulators. Both concerns are mitigated by the competitive, belts and suspenders form of antitrust enforcement.

One result of the diffuse nature of U.S. antitrust enforcement is the competition for enforcement that it produces. "As an independent agency, the FTC is perhaps less quickly responsive to external political forces than the Antitrust Division."
The role of state attorney general and private plaintiff enforcement both in supporting federal government antitrust enforcement and in filling gaps left by federal government inactivity also has been recognized. A ready example of state attorney general activity is the continued pursuit of Microsoft Corporation by state enforcers after the Justice Department settled its claim. Private plaintiff enforcement also complements or replaces federal government enforcement. For example, Bell Atlantic Corp. v. Twombly was a private action brought after the Department of Justice closed its investigation and declined to pursue the alleged conduct. Sprint Corporation recently brought its own complaint challenging the AT&T/T-Mobile merger, in what one news outlet reported as a supplement to the Justice Department’s suit.

Strong incentives exist in the U.S. system for private plaintiffs to bring antitrust claims. Those incentives increase the likelihood of aggressive regulation by antitrust enforcement, which promises to fill the gaps in regulation in the pre-crisis status quo. Importantly, the incentives operate independently of foresight about extra-market, economy-wide harms, so private plaintiffs can be relied on to use their antitrust enforcement authority when extra-market harms are not otherwise observable.

The unique structure of antitrust enforcement also substantially mitigates, if not eliminates, realistic concerns for agency capture. That is for two reasons: first, the enforcement agencies are not closely tied to any one industry. Second, competition for enforcement acts as a check on inactivity by any one enforcing entity.

Tim Wu observes the lesser public choice concerns with antitrust enforcement vis-à-vis sectoral regulators. “My criticism of Trinko is political: the decision ignores the public choice problems that can make alternatives to antitrust ineffective. For example, a fear that the FCC had lost control of AT&T is part of what led the Justice Department to bring an independent antitrust lawsuit in the 1970s. A strong firm can overpower an agency, which is why I think the antitrust law must always be around as a backup.”

139 Dan Crane, Antitrust L.J. 2010 (citing Kovacic).
140 Daniel A. Crane, The Institutional Structure of Antitrust Enforcement 145 (2011) (noting the “power of states to be more aggressive in antitrust enforcement than the federal government”); id. at 163 (“private enforcement of the antitrust laws vastly outstrips public enforcement”).
144 See Max Huffman, A Standing Framework for Private Extraterritorial Antitrust Enforcement, 60 SMU L. Rev. 103, 114 (2007) (private plaintiffs are “motivated solely by their individual best interests”).
145 But see Daniel Crane, Rethinking Merger Efficiencies, ___ U. Mich. L. Rev. ___ (2011) (“Public choice literature suggests that antitrust enforcers are not merely detached public servants on a truth-seeking expedition.”) (citing The Causes and Consequences of Antitrust: The Public Choice Perspective (Fred S. McChesney & William F. Shughart II eds., 1995) (discussing the application of public choice theory to antitrust enforcement)).
146 Interview with Tim Wu, Summer 2011 Antitrust 55, 57.
2. Antitrust’s Rule of Reason Avoids Whack-a-Mole Regulation

Antitrust’s rule of reason avoids whack a mole regulation.

The law remains that conduct with harmful welfare effects that overcome benefits is the kind of bad conduct that gives rise to problems. It is a malleable definition that should be able to encompass the behavioral exploitation that underlies much consumer lending.

3. Consumers Retain Choice and Are Not Subject to Moral Hazard Concerns

A major failing of consumer-protection-based regulatory schemes is the removal of consumer choice. Antitrust enforcement is less likely to suffer that failing.

Mark Armstrong’s moral hazard concern is not present here for two reasons. First, the repeat player circumstance does not arise in the context of mortgage transactions. Consumers don’t go through these transactions frequently enough to become expert. Second, a single consumer with buyer’s remorse can’t show the kind of non de minimis, non transient market effect that the antitrust claim requires. Only across a large number of transactions can the market effects be found. Antitrust looks at the market, not the individual transaction.

[Huffman notes from LUC 2/24 Symposium. Needs expanding, footnoting, editing.]

We recognize that ours is a far-reaching argument.

Many have recognized the welfare effects in behavioral exploitation, including in subprime lending.

A handful of writers seem to agree that transaction level harms should give rise to antitrust remedies, though that exceeds the bounds of mainstream antitrust thought.

We go further and propose antitrust may be an elegant and even superior solution to the grass-roots problems that ultimately lead to massive economic dislocations of the sort we have recently been experiencing.