
Volume 37

Issue 2 *Symposium: Bringing Down the Curtain
on the Current Mortgage Crisis and Preventing
a Return Engagement*

Article 4

2-15-2010

Preventing a Return Engagement: Eliminating the Mortgage Purchasers' Status as a Holder-in-Due-Course: Properly Aligning Incentives Among the Parties

Alex M. Johnson Jr.

Follow this and additional works at: <https://digitalcommons.pepperdine.edu/plr>



Part of the [Banking and Finance Law Commons](#), and the [Housing Law Commons](#)

Recommended Citation

Alex M. Johnson Jr. *Preventing a Return Engagement: Eliminating the Mortgage Purchasers' Status as a Holder-in-Due-Course: Properly Aligning Incentives Among the Parties*, 37 Pepp. L. Rev. Iss. 2 (2010)
Available at: <https://digitalcommons.pepperdine.edu/plr/vol37/iss2/4>

This Symposium is brought to you for free and open access by the Caruso School of Law at Pepperdine Digital Commons. It has been accepted for inclusion in Pepperdine Law Review by an authorized editor of Pepperdine Digital Commons. For more information, please contact bailey.berry@pepperdine.edu.

Preventing a Return Engagement: Eliminating the Mortgage Purchasers' Status as a Holder-in- Due-Course: Properly Aligning Incentives Among the Parties

Alex M. Johnson, Jr.*

- I. HOW WE GOT INTO THIS MESS: BLAME IT ON THE HOLDER-IN-DUE-COURSE
- II. TURNING BACK THE CLOCK IS NOT THE ANSWER
- III. IMPOSING ACCOUNTABILITY: ELIMINATING THE PROTECTION AFFORDED THE HOLDER-IN-DUE-COURSE
 - A. *The Existing State of Affairs*
 - B. *The Holder-in-Due-Course Doctrine: Separating the Note from the Mortgage*
 - C. *Unconscionability: The Ultimate Remedy*
 - D. *Reconfiguring the Residential Real Estate Transaction*
- IV. CONCLUSION

The stories are horrific; the human tragedy unfathomable. Millions of homeowners have lost their homes, their most valuable asset and the symbol of family,¹ to foreclosure. Instead of achieving the American dream of home ownership, these families are forcibly ejected from the one place they viewed as sanctuary. Moreover, these families have lost any and all investment, financial (I am going to assume that any equity accumulated before foreclosure is lost as a result of both the declining real estate market and the inequities created by the flawed foreclosure process)² and emotional,

* Perre Bowen Professor of Law, Thomas F. Bergin Research Professor of Law, University of Virginia School of Law.

1. See, e.g., Margaret Jane Radin, *Property and Personhood*, 34 STAN. L. REV. 957 (1982).

2. As to the declining real estate market, see, for example, Dean Baker, *Housing Price Decline*

that they have made in the foreclosed property. These individual tragedies are hard to understand in the abstract, yet recitation of individual cases provides no true picture of the scope and depth of the problem created by foreclosed mortgages.³ Suffice it to say, the human costs are incalculable, and the impact that these foreclosures will have on families will reverberate throughout American society for at least the next generation.

Just as importantly, on a macro level the impact of the huge number of individual real estate foreclosures on credit and financial markets has been catastrophic leading to the demise of venerable financial institutions,⁴ the taxpayer-government financed bailout of banks and other financial institutions,⁵ and the collapse (deflation) of the stock market.⁶ In short, the demise of the residential real estate market (what I term the “foreclosure miasma”) has caused the American economy to enter into the longest recession since the Great Depression of the 1930s.⁷ Doom and gloom abound and there is no end in sight.

Furthermore, the finger-pointing has begun. What has caused this calamitous state of affairs, and, to a lesser extent, what can be done to

Accelerates, CENTER FOR ECON. & POL’Y RES., Feb. 25, 2009, <http://www.cepr.net/index.php/data-bytes/housing-market-monitor/housing-price-decline-accelerates> (data demonstrates housing prices were falling over 20% in the last quarter of 2008); David Goldman, *Housing Prices to Free Fall in 2008*, CNNMONEY.COM, http://money.cnn.com/2008/01/23/real_estate/merrill_forecast/index.htm?postversion=2008. As to the inequities caused by the flawed foreclosure process, see Alex M. Johnson, Jr., *Critiquing the Foreclosure Process: An Economic Approach Based on the Paradigmatic Norms of Bankruptcy*, 79 VA. L. REV. 959 (1993); Grant S. Nelson & Dale A. Whitman, *Reforming Foreclosure: The Uniform Nonjudicial Foreclosure Act*, 53 DUKE L.J. 1399 (2004).

3. Even someone allegedly as sophisticated as a *New York Times* economics reporter became enmeshed in the foreclosure miasma caused by the perfect storm, see *infra* note 34 and accompanying text, of economic disasters:

New York Times economics reporter Edmund Andrews describes his journey to the heart of the American nightmare—debt, default, and dread. It’s a journey that tens of millions of other Americans are now intimately familiar with If there was anybody who should have avoided the mortgage catastrophe, it was I.

Henry Blodget, *How I Became a Subprime Borrower and Blew Myself Up*, BUS. INSIDER, May 14, 2009, <http://www.businessinsider.com/henry-blodget-how-i-became-a-subprime-borrower-and-blew-myself-up-2009-5>.

4. See *Lehman Brothers Files for Bankruptcy*, FIN. TIMES, Sept. 15, 2008, http://www.ft.com/cms/s/0/52098fa-282e3-11dd-9073-000077b07658.html?nclink_check=1.

5. Emergency Economic Stabilization Act of 2008, Pub. L. No. 110-343, 122 Stat. 3765. The Act created the 700 billion dollar Troubled Asset Relief Program, which is popularly known as TARP. See James Bernstein, *Bringing Home the Bacon*, NEWSDAY, Oct. 4, 2008, at A4, available at <http://www.newsday.com/services/newspaper/printedition/saturday/news/ny-bzpork045869383oct04,0,7415762.story>.

6. See, e.g., Ben Steverman, *Stock Market Crash: Understanding the Panic*, BUSINESSWEEK, Oct. 10, 2008, http://www.businessweek.com/investor/content/oct2008/pi2008109_360708.htm.

7. See msnbc.com Staff/AP, *It’s Official: U.S. Is in Recession*, MSNBC.COM, <http://www.msnbc.msn.com/id/27999557/> (last visited Oct. 14, 2008); Timothy R. Homan & Steve Matthews, *U.S. Recession Started in 2007, Longest Since 1980s (Update 1)*, BLOOMBERG.COM, Dec. 1, 2008, <http://www.bloomberg.com/apps/news?pid=20601068&sid=a14iyIoRhvao&refer=home>.

prevent this state of affairs from reoccurring in the future? As to the former, greedy bankers and financiers immediately come to mind as convenient and well-deserving scapegoats for this economic tragedy.⁸ New terminology has become part of the vernacular of American finance. Subprime mortgages and predatory lending are now emblematic of lax lending standards and financial greed.

Moreover, the vehicle that allowed these greedy bankers and financiers to plunder the economic wealth of American society is the residential mortgage.⁹ The residential mortgage has been used in American society since the Great Depression of the 1930s and is a standard financial instrument representing the culmination of a transaction—home ownership—that is truly the American dream.¹⁰ Indeed, it is somewhat ironic that the product of the Great Depression ultimately is the primary cause of perhaps the second Great Depression.¹¹ But, I am getting ahead of myself.

History and lessons learned from the Great Depression lead almost all to conclude that the effects of the foreclosure miasma, although painful and lasting, will not be permanent.¹² Although it is impossible to predict when the American economy will emerge from its current recession that is a product of the foreclosure miasma, I believe all would agree that the American economy will ultimately emerge from this recession and once

8. See, e.g., Hamilton Nolan, *The Top Ten Scapegoats for America's Depression*, GAWKER, Oct. 10, 2008, <http://gawker.com/5061628/the-top-ten-scapegoats-for-americas-depression>.

9. Of course, although the basic mortgage transaction may be characterized as “vanilla” or simple, the securitization of same and the division of same into tranches and other sophisticated financial interests are anything but simple. Securitization and the creation of tranches are addressed *infra* notes 127–128 and accompanying text. Further, the use of hedge funds to invest (some would say bet) on the solvency of these assets adds another layer of complexity to the financial train wreck that I characterize as the foreclosure miasma. See *infra* note 34 and accompanying text.

10. Indeed, although my purpose is not to assess blame in this matter, it is indisputable that President Clinton’s goal of increasing home ownership in American society, which was achieved during his Presidency, was partially responsible for the development of what I term exotic financing devices. For further discussion of same, see *infra* notes 40–56 and accompanying text. These exotic financing devices created the opportunity for predatory and other lending practices that created the foreclosure miasma. The continuation of those policies by President George W. Bush exacerbated the situation. See *infra* note 15.

11. See Kimberly Amadeo, *Is the U.S. Headed Towards the Second Great Depression?*, ABOUT.COM, http://useconomy.about.com/od/criticalissues/i/2_great_depress.htm (last visited Oct. 14, 2009).

12. See, e.g., Daniel Gross, *The Recession Is Over! Now What We Need is a New Kind of Recovery*, NEWSWEEK, Aug. 3, 2009, at 32; Matt Krantz, *Reports Show Economy Mending*, USA TODAY, July 30, 2009, at B1.

again become the vibrant and diversified economy that is the envy of other countries. It is not a question of whether, but when?

Credit will once again become available. The stock market will rise, ultimately eclipsing its high that preceded the crash.¹³ Industry will thrive and financial institutions, strengthened by the infusion of taxpayer dollars, will seek to be free of the shackles imposed as a result of the federal bailout.¹⁴ New financial investments and instruments will develop and the federal budget deficit will ultimately disappear.¹⁵ Jobs will be created and real wages and real incomes will increase. Eventually, the major economic concern will be inflation, not stagflation.¹⁶ I am no economic prognosticator, but I have lived long enough to be confident that these events will occur within the next decade given the cyclical nature of economies.¹⁷

Just as importantly, once the economy revives, new mortgages will be created. Individuals and families will, once again, seek to achieve their dream of home ownership. Existing homeowners will, depending on their economic situation, rely on the rising value of their home as their primary asset and use that asset as their personal automated teller machine (ATM) by taking home equity loans to finance automobile purchases, vacations, or whatever else suits their fancy. Other homeowners will trade up by selling their existing homes to purchase bigger and better homes, financed by new mortgages. In short, it will be business as usual. And, therein lies the

13. See Tom Paradis, *Dow, Pushed by Earning Reports, Tops 14,000*, USATODAY.COM, July 19, 2007, http://www.usatoday.com/money/markets/2007-07-19-stocks-thur_N.htm; Alexandra Twin, *Dow Tops 14,000, Hits Record*, CNNMONEY.COM, Oct. 1, 2007, http://money.cnn.com/2007/10/01/markets/markets_0445/index.htm?cnn=yes.

14. This is already occurring. See Colin Barr, *TARP Payback May Not Help Consumers*, CNNMONEY.COM, June 9, 2009, <http://money.cnn.com/2009/06/09/news./tarp.repayment.fortune/index.htm>.

15. Although, it may take a long time for this to happen. Recall, however, that the same dire prognosis regarding the federal budget deficit was made when President Clinton was elected. Yet, it was during his tenure that the momentous deficit was eradicated and a budget surplus was accumulated. See James Gerstenzang, *Show Me the Money: What Happened to Bill Clinton's Budget Surplus?*, L.A. TIMES, Oct. 15, 2008, <http://latimesblogs.latimes.com/presidentbush/2008/10/budget-deficit.html>. Said surplus was decimated by the policies of the second President Bush, leading to the current deficit. See *id.* This is doubly ironic because it was the policies of the first President Bush that created the deficit inherited and subsequently eradicated by President Clinton. See *id.* What do we learn from this? If you want a deficit, elect a Bush. See *id.* ("When President Clinton left office, the federal budget was showing a \$127 billion surplus. The books are closed on fiscal 2008. The surplus the current President Bush has inherited as turned into a record deficit: \$455 billion.")

16. See, e.g., Daniel Gross, *Stagflation Is Back and It's Even Worse than You Feared*, SLATE, Mar. 6, 2008, <http://www.slate.com/id/2185919/>.

17. The beginning and end of recessions are officially called by the Bureau of Economic Analysis. For a list of the economic cycles in United States history, see Recession.org, United States Recession History, <http://www.recession.org/history> (last visited Oct. 14, 2009). For one economic perspective on the causes of economic fluctuations, see LUDWIG VON MISES ET AL., *AUSTRIAN THEORY OF THE TRADE CYCLE AND OTHER ESSAYS* (Richard Ebeling ed., 1996).

problem. If this cycle repeats with no legal change in the way that mortgages are either obtained or judicially interpreted, all of the defects that created the current foreclosure miasma will be present, leading perhaps to future economic problems.

Which raises precisely the issue addressed by this Article: What is it about the residential mortgage transaction that helped to create the foreclosure miasma, and what can be done to prevent its reoccurrence in the future? I will demonstrate that it is the ease of the transferability of the note that secures the mortgage and the resulting status of the assignee of that note as a holder-in-due-course that creates the opportunity for predatory and other lending practices that ultimately resulted in the creation of the foreclosure miasma.

This ease of transferability of the mortgage (actually the promissory note signed by the mortgagor which represents the amount of the debt),¹⁸ coupled with the development of exotic financing devices in the 1990s, created incentives for originators (lenders) of mortgages to pay scant or no attention to the financial capabilities of the mortgagors to actually honor the terms of the mortgage beyond the initial execution of the mortgage.¹⁹ As a result, these originators passed on the risk of mortgage default beyond the execution phase to the assignees (investors) who purchased the mortgages as mortgage-backed securities (MBSs) and collateralized debt obligations (CDOs) on the secondary market.²⁰ The assignees of the mortgage have no reason not to accept the assignment for several reasons, most of them having to do with their status as a holder-in-due-course once a valid transfer and assignment takes place.²¹ Purchasing assignees believe that the notes they

18. The mortgage typically consists of two documents: the aforementioned promissory note, which is similar to other unsecured promissory notes that are negotiable under the Uniform Commercial Code (UCC), and the mortgage, which is a security interest in the land given to the mortgagee which the mortgagee can reach upon default. For a discussion of the UCC and the transferability of the note, see *infra* notes 133–134 and accompanying text.

19. When I speak of the initial term of the mortgage, I am referring to the initial payment cycle created by the mortgage before any adjustment or resetting occurs as a result of the use of some variant of an adjustable rate mortgage. Thus, a mortgagor may make an initial monthly payment of \$1,000 for the first twelve months of a mortgage when a teaser interest rate is used. Once the adjustment of the interest rate occurs on the first anniversary date of the mortgage, the monthly payment may increase to \$1,400. The originating lender, due to its plans to transfer the note on the secondary market, is only concerned about the mortgagor's ability to make the payments during the initial term. Indeed, in some egregious cases the originator was only interested in assuring payments were made up to the time of transfer so that the mortgage would not be in default at that time. See *infra* notes 81–82 and accompanying text.

20. These financial devices are discussed *infra* at notes 81–87 and accompanying text.

21. For a discussion of the status of a holder-in-due-course, see *infra* notes 25–27 and accompanying text.

are purchasing on the secondary market are secured by two bifurcated assets: the security interest in the land represented by the mortgage, and the stream of payments represented by the amounts due and payable via the note executed by the mortgagor.

Furthermore, the assignees also naively or blindly believe that the originators of the mortgages have appropriate incentives to verify the value of both assets that are the basis of any mortgage transaction: the land (the security), and the creditworthiness of the mortgagor to make the stream of payments represented by the note.²² Although these mortgages (to be precise, the notes) are ultimately transferred (which creates the issue addressed in this Article), assignees of these notes take the seemingly rational position that originators will not make mortgage loans without verifying the value of the asset being purchased with the mortgage funds and the ability of the mortgagor to make the payments as required by the note.²³

Consequently, these investors purchased the assets as assignees without verifying either fact, relying instead, when possible with CDOs, on ratings placed on securities by third-party vendors whose conflict of interest precludes them from acting as viable agents for their principals.²⁴ The obligation to make the stream of payments, which must be made by the mortgagor irrespective of the property's value, is essentially guaranteed to the assignee of the mortgage—pre-foreclosure—because of the assignee's status as a holder-in-due-course.²⁵ That is, the assignee's status as a holder-in-due-course makes the holder of the note immune from any claims by the mortgagor that the mortgage is invalid because of the wrongful actions taken

22. My colleague, Rich Hynes, has suggested to me that I may be giving too much credit to assignees in assuming they cared at all about the financial capabilities of the mortgagor or the value of the asset. Instead, an argument can be made that all they cared about was the stream of payments accruing to their investment, and that investors assumed, like everyone else, real estate values would continue to increase causing future payments to be made.

23. Part of the disconnect which leads to inefficiency and eventually the creation of the mortgage miasma is that historically mortgages originated by a bank or financial institution were held to maturity. Hence, it clearly was in the lending institution's interest to verify all important facets of the transaction or it would be stuck with a bad loan. Once the secondary market for mortgages developed, the model for mortgage financing changed, as did the originator's incentives. If originator/lenders were no longer interested in keeping mortgages they originated in their portfolio, their interest and incentives also changed. Because their fees were realized upon origination, the lenders' primary interest was finding mortgagors willing to execute mortgages and purchasers on the secondary market who would willingly purchase the mortgage. See *infra* notes 106–108 and accompanying text for further discussion of this point. Unfortunately, the purchasers on the secondary market must have erroneously assumed that the originating lenders' priorities and incentives to verify the validity of the mortgage remained the same. This is the only plausible explanation for investors/purchasers of these debt instruments relying on ratings by third parties rather than verifying the value of the underlying asset.

24. For a discussion of these entities and the ineffectual nature of the ratings they assign to these complex financial instruments, see *infra* notes 86–87 and accompanying text.

25. See *infra* note 97 and accompanying text for a definition of a holder-in-due-course.

by the originator that induced the mortgagor to execute a mortgage that the mortgagor cannot perform.²⁶ My contention is that this status reduces the assignee's incentives to adequately monitor and verify the actions of its agent, the originator of the mortgage, and the seller/transferor of the mortgage note on the secondary market.²⁷

Conversely, mortgagors, acting as the principal and employing the originator as agent, rely on advice from their agent-originators in seeking and selecting an appropriate mortgage. This reliance is created by fact that the average mortgagor does not have the knowledge, sophistication, and foresight to adequately internalize the risks presented by a complicated financial document that represents not only the mortgagor's most significant investment, but typically the mortgagor's first foray into the residential real estate mortgage market.²⁸

As a result, mortgagors, heeding the advice received from their agent—typically a mortgage broker—contract for mortgages that, *ex ante*, they have little or no chance of performing unless one or two events occur at the time

26. In other words, in a case involving what has come to be characterized as “predatory lending,” *see infra* notes 61–65 and accompanying text, the holder will be immune from attack due to its status as a holder-in-due-course that takes free of so-called personal defenses. For further discussion of this immunity and personal defenses, *see infra* notes 133–134 and accompanying text.

27. That stream of payments the assignee is relying upon becomes uncollectable when default occurs and the security—the land—does not cover the debt due to both practical and legal problems. The practical problem is finding assets of the insolvent debtor that can be reached by the assignee/holder of the note. The legal problem is created when the debtor has assets but the holder of the note is precluded from reaching them because of anti-deficiency legislation or statutes that preclude the mortgagee or its assignees from reaching other assets of the foreclosed mortgagor. 1 GRANT S. NELSON & DALE A. WHITMAN, *REAL ESTATE FINANCE LAW* § 8.3 (5th ed. 2007).

28. *See infra* notes 89–91 and accompanying text (discussing the financial naiveté of most mortgagors and the issues it creates). The role of speculators in producing the mortgage miasma also cannot be overlooked.

There were surely some rational speculators in the subprime and Alt-A [Alt-A mortgages are subprime mortgages but with lower risk] markets who rode the real estate bubble armed with accurate *ex ante* estimates (that turned out to be false *ex post*) about the timing of the bubble's inevitable end. There were also other borrowers-speculators with optimistic expectations about future house prices that were not rationally formed. Specifically, the irrational borrowers extrapolate from past trends: if home prices increased by 10 percent over the past year, these traders expect that home prices will also increase by 10 percent over the next year. Indeed, . . . Karl Case and Robert Shiller found that many home buyers overestimate the correlation between past trends and future price movements; put differently, backward-looking tendencies drive expectations of future price growth (beyond what could plausibly be justified in a rational-expectations model). The subprime and Alt-A markets experienced both rational and irrational speculation.

Oren Bar-Gill, *The Law, Economics and Psychology of Subprime Mortgage Contracts*, 94 *CORNELL L. REV.* 1073, 1115 (2009) (footnotes omitted).

the initial term of the mortgage expires and the mortgage rate is reset on exotic financing devices, i.e., rising property values and/or the availability of refinancing at lower rates.²⁹ Although acting as agents of their principal-mortgagor, originators have no incentive to correctly advise putative mortgagors not to contract for mortgages that are doomed to fail because to do so would limit their fees and commission at the time of origination when the risk of default is passed on to assignees.³⁰

Consequently, I argue that all of the conditions that created the current foreclosure miasma will remain unless changes are made in the way mortgages are executed, transferred, and interpreted by the courts to align the transferee-principal's interest with that of the agent/originator.³¹ By making one adjustment in current law—eliminating the transferee/principal's status as a holder-in-due-course—the existing residential mortgage market can be reformed to provide appropriate incentives to the parties. In this case, the transferee/principal of the mortgage note would be incentivized to properly monitor the activities of its agent, the originator of the mortgage note, so that the originator will only induce the putative mortgagor to contract those mortgages that have a significant probability of being performed per all of their terms. I posit that the correct way to align incentives is to eliminate the transferee's status as a holder-in-due-course in residential real estate transactions by federally preempting state laws that provide that status.³²

29. Given that most mortgagors consider and internalize the initial payment terms of the mortgage when executed (i.e., it is hard to contend that mortgagors are surprised when they are told their initial mortgage payment for twelve months is \$2,025 and the first twelve mortgage payments are \$2,025), it is when the mortgage rate is subsequently adjusted (increased) to some new amount that the mortgagor did not expect or did not realistically anticipate that creates the situation that ultimately leads to the loss of home and foreclosure. Therefore, it is predominantly the use of exotic financing devices, which are discussed *infra* in Part II, and rarely the use of the traditional level-pay thirty-year amortized mortgage, that creates the foreclosure miasma.

30. For further discussion of the fees pocketed by the originator, see *infra* note 79 and accompanying text.

31. For reasons discussed later in the article, it is impossible to take the more efficient action, that is, aligning the originator's interest properly with that of the mortgagor, due to the contingent nature of the transaction that results in an end-game opportunity for strategic behavior on the part of the originator. See *infra* notes 122–124 and accompanying text. Instead, given the fact that originators deal with purchaser/assignees as repeat players, with no end-game in sight, it is more efficient to align the originator's incentives with those of the purchaser/assignees.

32. Federal preemption of inefficient state banking laws was the result created by *Wellenkamp v. Bank of America*, 582 P.2d 970 (Cal. 1978), in which the California Supreme Court held that due-on-sale clauses in mortgages could not be enforced by the mortgagee solely to protect its economic interest. This resulted in some states allowing the enforceability of these due-on-sale clauses in mortgages, and others, most notably California, precluding their exercise. Eventually, the *Wellenkamp* position was repudiated—preempted—by federal law when Congress passed the Garn-St. Germain Depository Institutions Act of 1982, Pub. L. No. 97-320, § 341, 96 Stat. 1469 (codified as amended at 12 U.S.C. § 1701j-3 (2006)).

Once the exalted holder-in-due-course status is eliminated, I then urge mortgagors and courts to liberally use the doctrine of unconscionability to police originator misconduct in order to eliminate predatory lending and to ensure that only those mortgages that, *ex ante*, are capable of performance are entered into and transferred to assignees via the secondary market. By taking both steps—the elimination of holder-in-due-course status and the expanded use of unconscionability to police the mortgage formation process—assignees as principals will be given incentives to appropriately police and monitor their agents, that is, the originators of the mortgages that are transferred on the secondary market.³³

To accomplish my goal, I divide this paper into three relatively brief parts. In Part I, I recount the factual dynamics that created the perfect storm leading to the current foreclosure miasma.³⁴ I pay particular attention to the transfer of mortgages on the secondary market as either MBS or CDOs and the differing incentives that the mortgagor (principal), originator/lender (agent), and transferee/principal have at the time the mortgage is executed given the current state of the law.³⁵ In addition, I briefly trace the development of exotic mortgage devices—adjustable rate mortgages (ARMs) or variable rate mortgages (VRMs)—and their misuse by mortgagors, paying particular attention to the complexity of the transaction and the cognitive dissonance that occurs when these transactions are completed. I demonstrate that mortgagors enter into these mortgages with inadequate and incomplete knowledge of their terms because of the incentives originators have to execute and complete mortgages at whatever cost given their value and transferability on the secondary market. I conclude this part with a focus on the role of the assignee as principal in

33. At its crux, the issue is one involving agency costs and aligning appropriate incentives between agents and principals. See Richard Hynes, *Securitization and Agency Costs* (forthcoming) (manuscript on file with *Pepperdine Law Review*).

34. I contend the economic problems that present the so-called “perfect economic storm” that created the current foreclosure miasma are predatory lending, exploding deficits created by the war in Iraq, the concomitant explosion of unregulated hedge funds, and the exploding then collapsing oil and related energy prices. See Robert Kuttner, *America’s Economic Perfect Storm*, BOSTON GLOBE, Dec. 21, 2007, at A19; Allen L. Roland, *Perfect Storm=Housing Crash, Iraq Drain & Collapsing Dollar*, SALON.COM, Nov. 15, 2007, <http://blogs.salon.com/0002255/2007/11/15.html>.

35. As I detail *infra*, note 122 and accompanying text, I posit that the lender/originator can be one or two parties. In cases involving two parties there is typically a loan broker that I designate Originator A, and there is a bank or lender that I designate Originator B. Both play important roles in the issuance of the mortgage. I also contend that at origination the lender or originator is the agent of the mortgagor, but later at the time of sale or assignment the lender or originator is the agent of the assignee or purchaser of the mortgage. See *infra* notes 122–123 and accompanying text. This dual agency is at the root of the problem leading to the foreclosure miasma.

purchasing the mortgage from its agent, the assigning originator, and the lack of incentives the principal has to police the original transaction between the mortgagor and originator.³⁶

In Part II, I address two possible solutions to the foreclosure miasma that, at first glance, seem warranted to resolve the current and future foreclosure miasmas. First, I address the claim that the way to preclude any future crisis is to eliminate exotic financing devices. Although the elimination of exotic financial devices would preclude most instances of originator misconduct, I ultimately conclude that such a broad remedy is both hurtful to the very class of individuals it is designed to protect and unnecessary once incentives are provided to the originators to be truthful about the costs and effects of exotic financing devices.

In the latter part of this section, I address the related claim that one way to resolve this issue is to eliminate the transferability of mortgage notes by eliminating the secondary market for mortgages. As one might guess, the elimination of the secondary mortgage market would have disastrous consequences on the liquidity and availability of mortgages, and should be avoided at all costs.³⁷ Instead, I argue that assignees can play a very valuable role as monitors of originators' efforts and should be viewed as part of the solution, rather than as part of the problem. By eliminating their status as holders-in-due-course, these transferees, in search of positive investment returns, will be more selective with respect to the notes they invest in.

Part III picks up where Part II concludes and asserts that the only way to properly incentivize transferees to establish an appropriate principal-agent relationship with originators, and to properly monitor those agents, is through a two-step process. The first step requires the elimination of the holder-in-due-course status as it applies to the transferees of notes initiated by originators. The second step requires the increased use of the doctrine of unconscionability by aggrieved mortgagors who have been induced to contract for unperformable mortgages by originators engaged in predatory lending practices. I focus on the formation of the contract that leads to the execution of the note and the mortgage securing the same and, subsequently, the remedy that is deployed when a mortgagor successfully brings an action claiming that a contract is unconscionable. By doing this, I show that courts

36. This is the real puzzle, why do assignee/transferees purchase these instruments on the secondary market? The short answer is that until the collapse of the secondary market and the creation of the foreclosure miasma, there was limited risk. That risk was minimized by two factors. First, a rational belief that the mortgagor would not enter into a mortgage that it couldn't afford. Why would a mortgagor act irrationally? Second, the assignee's status as a holder-in-due-course insulating the assignee from certain important claims of the mortgagor. See *infra* Part I.

37. As a result, I contend that the elimination of either MBS, CDOs, or both would not only fail to solve the problem addressed in this article, but would be harmful to mortgagors by limiting liquidity. See *infra* Part II.

have the power to reform these unconscionable contracts in a fashion that allows the mortgagor to retain their home by reducing their mortgage payments to an amount approximating the payment in the original term.

This power of reduction (via the judicial use of reformation) *ex post* will limit the assignees' income from their investment, and will provide the assignees with the appropriate incentives to police originator behavior in a way to preclude unperformable (unconscionable) mortgage contracts. Finally, I defend the core thesis of this Article that the transferee, rather than the government or the mortgagor, is the most efficient regulator and monitor of the transaction that takes place between the mortgagor and the originator.³⁸ By correctly aligning the transferee/assignee's interest with those of the originator, transferees will have an incentive to monitor the behavior of the originator, a monitoring role that cannot be filled by the mortgagor given the complexity of the transaction.

I. HOW WE GOT INTO THIS MESS: BLAME IT ON THE HOLDER-IN-DUE-COURSE

In this Part I briefly recount the various facts that led to the development of the foreclosure miasma. This brief historical detour is not meant to serve as an exhaustive or definitive history of the causal effects of the foreclosure miasma. I will leave that herculean task to others. However, it is only when we understand how the current foreclosure miasma was created that we will be able to disaggregate the various factors creating same, and focus on precluding the coalescence of these factors to create a similar miasma tomorrow.³⁹

As most know, the development of the level-pay, fully-amortized, long-term residential mortgage is a relatively recent development wrought by the collapse of the residential housing market during and immediately after the Great Depression of the 1930s. The traditional level-monthly-payment fully-amortized is perhaps the best product of the Great Depression.⁴⁰

38. In the rare case today when there is no transferee, the holder-in-due-course doctrine is not relevant and the originator has appropriate incentives to verify the ability of the mortgagor to repay the debt as well as the value of the underlying security.

39. "Those who cannot remember the past are condemned to repeat it." GEORGE SANTAYANA, *THE LIFE OF REASON* 82 (Prometheus Books 1998) (1905).

40. Before the level-pay, fully-amortized, long-term residential mortgage was created, most potential homeowners either saved one hundred percent of the purchase price paying for the subject property in full, or, if financing was necessary, it could only be obtained if the putative buyer placed a substantial down payment (typically fifty percent) and executed a promissory note with the balance due on the purchase price within a short period of time after delivery of possession (typically one or

Although one cannot point to the exact date when exotic financing devices were introduced into the residential real estate market, the origins of the popularity of these devices can be traced historically to the rampant inflation that existed in the residential real estate market in the early 1980s⁴¹:

[L]enders who make or purchase mortgage loan assets to hold in portfolio, and whose capital comes primarily from short-term or medium-term liabilities, such as savings deposits, are faced with a problem of mismatched terms. If rates rise on the liability side of the ledger, the lender's costs of funds may approach or even exceed its earnings from its mortgage portfolio. This happens because so much of the mortgage portfolio is comprised of loans made in earlier years at lower rates. The result is serious financial stress for the lender, and in some cases insolvency.

At least three types of mortgage formats have been developed in recent decades in an attempt to solve this problem. By far the most widely-used and discussed is the *adjustable rate mortgage, or ARM*. It provides for periodic readjustments to the interest rate, based on fluctuations in some external index of rates on financial instruments.

The ARM has a checkered regulatory history. . . . Not until mid-1979 were the geographic limits removed, and adjustable rate lending approved nationwide.⁴²

Indeed, the birth of exotic devices can also be traced to the development of ARMs in the late twentieth century in response to the exploding interest rates during President Carter's administration (1977–1981) and the controversy over the transferability of mortgages to subsequent purchasers of the mortgaged home.⁴³ In brief, homeowners with fixed interest rate

five years).

Today most mortgages are amortized or repaid over a substantial number of years. Until the 1930's most mortgages, however, were of the "balloon-note" type. Typically these were short-term mortgages for three or five years, and borrowers made only interest payments until the loan came due. Then if the borrower had not saved enough to pay the entire principal, he would expect the note to be renewed or would attempt to refinance it with another lender. However, during the depression period of the 1930's, many of these lenders were forced to demand full payment and to foreclose on properties when mortgagors could not pay. With the encouragement of the Federal Housing Administration and federal housing legislation, lenders during this period developed the amortized mortgage loan system under which mortgagors were permitted to repay loans over many years by making monthly principal and interest payments.

NELSON & WHITMAN, *supra* note 27, § 1.1.

41. *See infra* note 43.

42. 2 NELSON & WHITMAN, *supra* note 27, § 11.4 (footnotes omitted).

43. In 1980, for example, the inflation rate hovered at around fifteen percent annually. *See, e.g.*, InflationData.com, Historical Inflation Data from 1914 to the Present, <http://inflationdata.com/>

mortgages well below the going market rate sought to profit on their good fortune by selling their below-market, low interest rate mortgage to an assuming buyer who often would have to pay double the interest rate to initiate a new purchase money mortgage for the total purchase price. The California Supreme Court's opinion in *Wellenkamp v. Bank of America* validated the transferability of these mortgages by forbidding banks from exercising due-on-sales clauses contained therein.⁴⁴ In effect, that created a class of mortgages destined to be held to maturity given their lower interest rate and the lack of enforceability of the due-on-sale clause when the property was sold.⁴⁵ The losers were banks and other lending institutions that could only acquire money to make new home loans from depositors and governmental entities by paying higher interest rates and carrying these lower interest rate loans to maturity.⁴⁶

Although Congress ultimately passed the Garn-St. Germain Depository Institutions Act of 1982 (Act), preempting state laws that precluded banks from objecting or forbidding mortgagors from transferring their mortgage by exercising their rights under due-on-sale clauses,⁴⁷ one alternative strategy developed by banks and embraced by borrower/mortgagors is the ARM. Unlike the traditional thirty-year, level-pay-plan mortgage, the ARM is a financing device in which the interest rate on the debt secured by the mortgage may fluctuate throughout the duration of the mortgage pursuant to the terms and conditions set forth in the note.⁴⁸

The rationale behind such an apparently complicated finance device is quite simple and reasonable given the fluctuations in interest rate that can

[inflation/Inflation_rate/HistoricalInflation.aspx?dsInflation_currentPage=2](http://www.inflation.gov/inflation_rate/HistoricalInflation.aspx?dsInflation_currentPage=2) (last visited Oct. 23, 2009). On April 2, 1980, the prime interest rate was twenty percent. See, e.g., Mortgage-X.com, Mortgage (ARM) Indexes, <http://www.mortgage-x.com/general/indexes/prime.asp> (last visited Oct. 23, 2009).

44. 582 P.2d 970, 976-77 (Cal. 1978).

45. To be precise, the California Supreme Court held that the lender could not exercise the due-on-sales clause in the mortgage when the original mortgagor transferred/sold the property unless the lender could show that it was exposed to increased risk as a result of the proposed transfer. *Id.* Consequently, when the buyer of the home was as credit-worthy as the seller, the lender could not object to the transfer of the mortgage along with the residence and exercise its rights under the due on sale clause. See David Greenclay Crane, *Wellenkamp v. Bank of America: A Victory for the Consumer?*, 31 HASTINGS L. J. 275 (1979); see also Richard C. Maxwell, *The Due-On-Sale Clause: Restraints on Alienation and Adhesion Theory in California*, 28 U.C.L.A. L. Rev. 197 (1980).

46. It is interesting to note that the mortgages that were the subject of the *Wellenkamp* decision are now reaching maturity.

47. Pub. L. No. 97-320, § 341, 96 Stat. 1469 (codified as amended at 12 U.S.C. § 1701j-3 (2006)). For the history and content of the Act, see NELSON & WHITMAN, *supra* note 27, § 5.24.

48. For a representative example of an Adjustable Rate Note, see *infra* notes 152-155 and accompanying text.

occur over a thirty-year mortgage.⁴⁹ The use of an ARM shifts the risk of possible higher interest rates during the term of the loan from the financial institution to the mortgagor (a fact not internalized or appreciated by unsophisticated, naive first-time borrowers).⁵⁰ Similarly, for the sake of fairness, it permits the mortgagor to benefit from declining interest rates. The problem with ARMs, however, is exacerbated when the initial interest rate on the loan is a so-called “teaser rate” that is set far below the current market interest rate. As a result, after the first year of the mortgage the mortgage payment increases significantly on these mortgages with low initial teaser rates.⁵¹

As the mortgage markets developed, the basic ARM morphed into several other exotic devices that I shall briefly define herein. Indeed, a few of these exotic devices precede the development of the ARM. Basically, there are four primary exotic financing devices in addition to the basic ARM: the graduated payment mortgage (GPM),⁵² the shared appreciation mortgage (SAM),⁵³ the shared equity appreciation mortgage (SEM),⁵⁴ and

49. From 1970 to 2000 the prime rate ranged from 1.75% to 20.50%. See Mortgage (ARM) Indexes, *supra* note 43.

50. See *infra* notes 89–91 and accompanying text for a discussion of the naiveté of many mortgagors. See *supra* note 28 for a discussion of irrational speculators in the mortgage market.

51. Unsophisticated borrowers may not be cognizant of this issue and may be surprised when they receive a notification that their mortgage payment has increased. Sophisticated borrowers aware of the impending adjustment may be relying on a quick resale of the mortgaged premises (flipping) before the teaser rate expires, or believe that they may be able to refinance the mortgage at a FRM with a lower or comparable rate at the time the teaser rate expires. For an example of this type of predatory loan and its impact on unsophisticated mortgagors, see *infra* note 70 and accompanying text.

52. As I state in my treatise, *Understanding Modern Real Estate Transactions*:

GPMs look like ARMs in that the payments made on the mortgage vary according to a schedule set forth in the mortgage. However, unlike the ARM, the payments vary in a predetermined amount according to a schedule set at the time the mortgage begins. Typically, the payments gradually increase (hence, the term graduated) by a certain percentage each year for the early years of the mortgage, and then level off at the highest rate for the remainder of the term of the loan. GPMs are used when the mortgagor anticipates that her income will increase over the initial term of the mortgage so that she will be better able to support the larger payments in the later years of the mortgage. As a result, some GPMs feature negative amortization.

ALEX M. JOHNSON, JR., UNDERSTANDING MODERN REAL ESTATE TRANSACTIONS 123 (2d ed. 2007).

53. *Id.* at 124 (“SAMs are a financing device by which the mortgagor purchases a below-market interest rate by agreeing to share any appreciation in the property with the mortgagee when the property is sold.”).

54. *Id.* (“SEMs are closely related to SAMs. In a SEM, an individual, usually a relative, acts as a private mortgagee by agreeing to become one of the owners of the property. This individual pays a percentage of the mortgage (effectively reducing the interest rate on the mortgage given by the third party mortgagee to the mortgagor) in exchange for a percentage of the equity in the property. Thus, in SEMs there are two owners of the property: one of whom occupies the property, while the other merely makes a passive investment in the property.”).

the reverse annuity mortgage (RAM).⁵⁵ In other words, as a result of the popularity of ARMs and the turmoil in the financial market created by consumer and originator demands for mortgages that are customized for every situation, certain mortgages have developed that are even more exotic in the sense that they differ not only from the traditional thirty-year level-pay-plan mortgage, they also differ significantly from the standard ARM mortgage.

The key point about the use of exotic mortgages is their complexity when compared to the traditional thirty-year level-pay-plan mortgage. The increasing complexity of the residential real estate mortgage market, fueled in large part by the sheer variety of mortgage instruments individually tailored to mortgagors, created exogenous costs that created the perfect crucible for subprime mortgages and predatory lending.⁵⁶

Subprime mortgages and predatory lending are the symbiotic twins that are the focal point of any analysis of the current mortgage crisis or foreclosure miasma. Yet, conceptually the two reference quite distinct phenomena—although each plays a distinct role in creating the foreclosure miasma.⁵⁷ Somewhat tautologically, subprime mortgages are defined by those mortgages that are deemed prime.⁵⁸ Prime mortgages that are not subprime are those given to mortgagors with solid credit histories, i.e., no history of defaults and late payments, a record of established credit, and depending on which credit service is used, a credit score that is deemed acceptable.⁵⁹ Consequently, subprime mortgages are defined by what they are not: prime mortgages.⁶⁰ Hence, subprime mortgages are given to those

55. *Id.* at 125 (“RAMs are typically used by the elderly to get the equity out of their principal residence without actually selling their principal residence. The purpose of the RAM is to allow the elderly to remain in possession of the property in order to enable them to be able to live comfortably on the proceeds of the equity that they have built up during their working lives.”).

56. My contention that the development and increasingly prevalent use of exotic financing devices led to a state of affairs that set the stage for sub-prime mortgages and predatory lending is only one half of the problem. The other half of the problem that created the foreclosure miasma is the securitization and transferability of the mortgages. The expansive use of essentially unregulated CDOs is discussed *infra* at notes 81–87 and accompanying text.

57. See *infra* notes 61–65 and accompanying text for further discussion of these issues.

58. “A note on terminology: The residential mortgage market is divided into the prime segment and the nonprime segment. The nonprime segment is further divided into subprime (higher risk) and Alt-A (lower risk), although the line between subprime and Alt-A is not always clear.” Bar-Gill, *supra* note 28, at 1076 n.5.

59. See, e.g., Pat Curry, *How Credit Scores Work, How a Score is Calculated*, BANKRATE.COM, <http://www.bankrate.com/brm/news/credit-scoring/20031104a1.asp> (last visited Oct. 23, 2009).

60. Elsewhere I have written:

Although there is no precise, legal definition of a Subprime Mortgage it is generally accepted in the industry that a Subprime Mortgage is any mortgage that a lender makes

prospective mortgagors with less than perfect credit histories, who do not have a credit score that would qualify them for a “prime” or regular mortgage.⁶¹

Predatory lending is also a nebulous term.⁶² The term is used to encompass a variety of lender practices designed to take advantage of the complexity of the mortgage process and the financial naiveté of mortgagors to exploit these putative mortgagors by charging excessive amounts in fees and interest for mortgage loans when said fees and interest are compared to the standard traditional mortgage offered to the average “prime” mortgagors.⁶³ Although one can attempt to catalogue the same predatory lenders in an attempt to stay one step ahead of regulators, they often change and modify their tactics to take advantage of regulatory and other loopholes.⁶⁴ At best, one can catalogue the different types of predatory

that it would not normally make—pursuant to its normal terms and conditions—due to some deficiency on the part of the mortgagor, i.e., the mortgagor does not make enough monthly to qualify for a traditional mortgage, the mortgagor does not have sufficient funds to place a down payment to establish the required loan-to-value [ratio], etc. Although Subprime Mortgages is an inexact term, what unites all Subprime Mortgages is the higher risk of default on the part of the mortgagor. As a result of that higher risk, Subprime Mortgages normally have a higher interest rate than traditional mortgages.

JOHNSON, *supra* note 52, at 126.

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

62. Indeed, the vagueness associated with the term was used by politicians to avoid addressing the issue created by predatory lending.

In 2000, Senator Phil Gramm, then the Chairman of the Senate Banking Committee, famously asserted that predatory lending could not be addressed until it could be defined. With that remark, Senator Gramm shrewdly seized on the difficulties in defining predatory lending, while stoking the flames that have surrounded any attempt at definition. Opponents of reforms to redress predatory lending have maintained that in the absence of a definable problem, remedies are not needed. Conversely, some community activists have brushed definitional issues aside, reasoning that “you know predatory lending when you see it.”

Id. at 1259–60 (footnotes omitted).

63. Predatory loans, through a combination of fraud, deception, and unethical sales practices, are designed to exploit financially unsophisticated parties. They disproportionately target low-to-moderate income African-American, Latino, and elderly homeowners. The media and community groups have documented thoroughly the disastrous results of these loans. The successful growth of the secondary market for subprime loans has fueled a laudable expansion of subprime lending opportunities across the country. But this expansion also brings a concomitant increase in abusive lending opportunities for unethical lenders who can obtain lines of credit from securities underwriters with relative ease.

Siddhartha Venkatesan, Note, *Abrogating the Holder-in-Due-Course Doctrine in Subprime Mortgage Transactions to More Effectively Police Predatory Lending*, 7 N.Y.U. J. LEGIS. & PUB. POL’Y 177, 181 (2003) (footnotes omitted).

64. For a discussion of the regulatory scheme covering mortgage lending, see Bar-Gill, *supra* note 28, at 1093–95.

lending practices by recognizing that the specifics of each change over time and practice.⁶⁵

Some of the more abusive practices include loans with extraordinarily high annual percentage (interest) rates, which are used when putative mortgagors are not aware of the market or average interest rate. Other practices include “packing,” that is, charging excess costs in the form of points and fees to unsophisticated borrowers who are not aware of these charges because they are deducted from the mortgage money advanced by the mortgagee to the mortgagor.⁶⁶ Other methods of predatory lending include: the use of excessive single premium financing of credit insurance (with the originator obtaining a fee equal to a percentage of the insurance), negative amortization of loans when the originator knows or should know that the putative mortgagor has no ability to perform the mortgage without a subsequent refinancing of the mortgage with additional fees, balloon payments at the end of short term mortgages requiring the mortgagor to refinance shortly after the execution of the original predatory mortgage, and finally, loans issued without regard to the borrower’s ability to make the payments.⁶⁷

Indeed, this last type of predatory lending practice is exacerbated by the use of exotic financing devices, and is perhaps the most prevalent type of abusive or predatory lending practice.⁶⁸ In the prototypical predatory loan,

65. According to one source:

To date, predatory lending generally has been described as a catalogue of onerous lending practices, which are often targeted at vulnerable populations and result in devastating personal losses, including bankruptcy, poverty, and foreclosure.

This catalogue provides a useful starting point for detecting and describing the pathologies that underline predatory lending. When these lists are examined, five basic problems emerge. We can thus define predatory lending as a syndrome of abusive loan terms or practices that involve one or more of the following five problems:

- (1) loans structured to result in seriously disproportionate net harm to borrowers,
- (2) harmful rent seeking,
- (3) loans involving fraud or deceptive practices,
- (4) other forms of lack of transparency in loans that are not actionable as fraud, and
- (5) loans that require borrowers to waive meaningful legal redress.

Most, if not all, predatory loans combine two or more of these problems. Similarly, some abusive terms or practices fall into more than one category. Rather than serving as a proposed statutory definition, our definition of predatory loans is intended as a diagnostic tool for identifying problematic loans that require redress.

Engel & McCoy, *supra* note 61, at 1260–61 (footnotes omitted).

66. In effect, these fees are hidden because they are added to the amount of the mortgage, and the mortgagor is told that these points and fees are normal for this type of mortgage given the mortgagor’s status as a subprime lender/mortgagor. See Venkatesan, *supra* note 63, at 182.

67. *Id.* at 182–83.

68. For a discussion of exotic financing devices, see *supra* notes 40–56 and accompanying text.

the originator, relying on the lack of sophistication of the putative mortgagor and that party's lack of access to independent or third-party advisors, packages an adjustable rate loan that not only contains excessive fees, but is sold to the putative mortgagor based on initial monthly payments which are incredibly low (and perhaps affordable) given the teaser rate used by lenders to entice these mortgagors.

What is not adequately explained to the mortgagor is that the initial teaser rate, which may be below market, will adjust. In other words, the interest rate on the outstanding balance will increase by several points on the initial anniversary date of the mortgage and typically increase by two points or more on subsequent anniversary dates.⁶⁹ Just as importantly, perhaps more so, is the fact that even if the putative mortgagor is made aware that the loan interest rate will increase by, say, four points in one year, these mortgagors may have no idea what that increase means in terms of their monthly payment until they receive the notice in the mail thirty or sixty days before the anniversary date announcing the new rate and monthly payment.⁷⁰

However, not all subprime mortgages are the products of predatory lending, nor does all predatory lending take place with only subprime mortgages.⁷¹ The key fact that unites subprime mortgages and predatory lending practices is the initial profit made by the originator of the mortgage at the time of execution and prior to transfer of the mortgage note on the secondary market. In other words, the party that initiates the mortgage and deals with the mortgagor has a very powerful incentive (money) to cause the execution of the mortgage. Irrespective of whether the mortgage is labeled subprime, predatory, or both, the current system that provides mortgage financing to residential purchasers is dysfunctional because the originator's profits or fees are divorced from the quality of the mortgage executed or the subsequent performance of that mortgage.

An analysis of a representative predatory subprime mortgage that is being foreclosed will clearly demonstrate this point. Soledad Aviles purchased a home in Southern California for \$615,000 with no money down

69. For an example of an adjustable rate mortgage and the use of an index, see *infra* notes 152–155 and accompanying text.

70. Take, for example, a \$200,000 adjustable rate mortgage that will be amortized over thirty years and has a teaser rate of 5% for the first year that readjusts to 7% on the first anniversary date and 9% on the second. The initial monthly payment will rise from \$1,073 a month to a little over \$1,600—a sixty percent increase in two years.

71. Unfortunately, predatory lending practices can even affect those who are not candidates for subprime mortgages. The current poster child for predatory lending is RAMs with their exorbitant fees. RAMs are discussed *supra* note 55 and accompanying text. One of the standard features of the RAM is the excessive fees charged to borrowers, which sometimes reach up to 8% of the amount lent. See MortgageFit.com, Reverse Mortgage Costs, <http://www.mortgagefit.com/reverse-costs.html> (last visited Oct. 24, 2009) (“Costs associated with reverse mortgages are comparatively higher than traditional mortgages. In total, the closing costs range from 4% to 8% of the loan amount.”).

based on a loan application filled out by a loan broker and financed (originated) by now bankrupt Washington Mutual Bank (WaMu).⁷² Mr. Aviles was a glass cutter who made \$9.00 an hour at the time the mortgage was executed.⁷³ Mr. Aviles was told that his monthly payment would be \$3,600 a month which, although steep based on the \$9.00 an hour salary, he figured he could afford based on additional income generated by his wife and three of his six daughters.⁷⁴

Relying on the broker's word, he signed loan documents written in English, a language he neither speaks nor reads He was shocked to learn afterward that the monthly payment would not be \$3,600, but \$4,800—a price that forced him to rent out bedrooms, the garage and an enclosed porch while he and his wife slept on the couch.

Aviles says he was not aware that the February 2006 loan application he signed dramatically exaggerated his family's income. The application lists him as the owner of a landscaping business with a \$7,400 monthly income. His 27-year-old daughter, Marlene, who earns \$9 an hour in a noodle factory, appears as the owner of a housekeeping company who makes \$5,700 a month. The application lists their yearly income as \$157,000, when, according to Aviles, it was really closer to \$60,000.

Now, five months behind on his payments, Aviles is scrambling to sell the house before the bank forecloses.⁷⁵

Aviles's situation is hardly unique. Add his name to the ever-expanding list of casualties in the nationwide sub-prime mortgage debacle, his experience echoing that of thousands who bought homes in recent years only to find themselves in a sagging market saddled with payments they cannot make.⁷⁶

Who in their right mind would assist someone in obtaining two mortgages totaling \$615,000 (Aviles took out two mortgages—one for

72. Christopher Goffard & Jennifer Delson, *When Dream Homes Become Nightmares—Alleged Predatory Lending Often Leads to Higher Payments and Foreclosure. Language Barriers Are an Issue in Heavily Latino Areas*, L.A. TIMES, Oct. 8, 2007, at B4, available at <http://articles.latimes.com/2007/oct/08/local/me-housing8>.

73. *Id.*

74. *Id.*

75. *Id.*

76. *Id.*

\$492,000 at 8.5% and a second mortgage for \$123,000 at 11.1%)⁷⁷ when the primary borrower/mortgagor makes \$9 an hour? More importantly, why would someone process and help the mortgagor obtain such a mortgage when it is obvious to everyone (except the mortgagor—of which more anon)⁷⁸ that the mortgagor will not be able to make the payments on the mortgage, either presently or in the future, unless some fortuitous event occurred, like a rapid increase in the home's valuation that would allow for refinancing at lower, more affordable rates? The answer, of course, lies with the fees extracted by the originator and folded into the mortgage that are paid to the originator at the time the mortgage is funded by the lender.⁷⁹

77. *Id.*

78. See *infra* note 112 and accompanying text for a discussion of the types of cognitive dissonance that could cause even a well-informed mortgagor to execute a mortgage when there is almost no probability that the mortgagor will be able to perform the mortgage according to its terms. Mr. Aviles presents a slightly different situation since the claim is made that Mr. Aviles does not speak or understand English and therefore did not allegedly understand the documents he signed. Mr. Aviles's contention, if true, represents an example of fraud in the inducement, as opposed to fraud in factum. Fraud in the inducement, if proven by Mr. Aviles, is a personal defense that will not be valid against a transferee of the note if that transferee is determined to be a holder-in-due-course. See *infra* notes 133–134 and accompanying text for a discussion of personal versus real defenses and their impact on holders-in-due-course.

79. The Federal Reserve Board publishes *A Consumer's Guide to Mortgage Settlement Costs* that provides the details of the many and costly fees incurred by the mortgagor who successfully obtains a mortgage. FED. RESERVE BD., *A CONSUMER'S GUIDE TO MORTGAGE SETTLEMENT COSTS* (2008), available at <http://www.federalreserve.gov/pubs/settlement/default.htm>. The recipient of all of these fees, estimated to be between 3–6% of the sale price of a home, *id.*, is of course the originator/lender providing a strong economic incentive to execute and transfer as many mortgages as possible. The list of settlement costs includes:

Mortgage- and Lender-Related Settlement Costs

Most people associate settlement costs with mortgage loan charges. These fees and charges vary, so it pays to shop around for the best combination of mortgage terms and settlement costs. Mortgage-related costs that may apply to your loan include the following items.

Application fee

Imposed by your lender or broker, this charge covers the initial costs of processing your loan request and checking your credit report.

Estimated cost: \$75 to \$300, including the cost of the credit report for each applicant

Loan origination fee

The origination fee (also called underwriting fee, administrative fee, or processing fee) is charged for the lender's work in evaluating and preparing your mortgage loan. This fee can cover the lender's attorney's fees, document preparation costs, notary fees, and so forth.

Estimated cost: 1% to 1.5% of the loan amount

Points

Points are a one-time charge imposed by the lender, usually to reduce the interest rate of your loan. One point equals 1% of the loan amount. For example, 1 point on a \$100,000 loan would be \$1,000. In some cases—especially in refinancing—the points can be financed by adding them to the amount that you borrow. However, if you pay the points at settlement, they are deductible on your income taxes in the year they are paid (different

deduction rules apply when you refinance or purchase a second home). In your purchase offer, you may want to negotiate with the seller to have the seller pay your points.

Estimated cost: 0% to 3% of the loan amount

Appraisal fee

Lenders want to be sure that the property is worth at least as much as the loan amount. This fee pays for an appraisal of the home you want to purchase or refinance. Some lenders and brokers include the appraisal fee as part of the application fee; you can ask the lender for a copy of your appraisal. If you are refinancing and you have had a recent appraisal, some lenders may waive the requirement for a new appraisal.

Estimated cost: \$300 to \$700

Lender-required home inspection fees

The lender may require a termite inspection and an analysis of the structural condition of the property by an engineer or consultant. In rural areas, lenders may require a septic system test and a water test to make sure the well and water system will maintain an adequate supply of water for the house (this is usually a test for quantity, not for water quality; your county health department may require a water quality test as well, but this test may be paid for outside of the settlement). Keep in mind that this inspection is for the benefit of the lender; you may want to request your own inspection to make sure the property is in good condition.

Estimated costs: \$175 to \$350

Prepaid interest

Your first regular mortgage payment is usually due about 6 to 8 weeks after you settle (for example, if you settle in August, your first regular payment will be due on October 1; the October payment covers the cost of borrowing the money for the month of September). Interest costs, however, start as soon as you settle. The lender will calculate how much interest you owe for the part of the month in which you settle (for example, if you settle on August 16, you would owe interest for 15 days—August 16 through 31).

Estimated cost: Depends on loan amount, interest rate, and the number of days for which interest must be paid (for example, a \$120,000 loan at 6% for 15 days, about \$300; a \$142,500 loan at 6% for 15 days, about \$356)

Private mortgage insurance (PMI)

If your down payment is less than 20% of the value of the house, the lender will usually require mortgage insurance. The insurance policy covers the lender's risk in the event that you do not make the loan payments. Typically, you will pay a monthly premium along with each month's mortgage payment. Your private MI can be canceled at your request, in writing, when you reach 20% equity in your home, based on your original purchase price, if your mortgage payments are current and you have a good payment history. By federal law your private MI payments will automatically stop when you acquire 22% equity in your home, based on the original appraised value of the house, as long as your mortgage payments are current.

Estimated cost: 0.5% to 1.5% of the loan amount to pre-pay for the first year

Some lenders will pay for private MI—called lender's private mortgage insurance (LPMI)—and in turn will charge a higher interest rate. Unlike private MI that you pay, there is no automatic cancellation once you acquire 22% equity. To eliminate the LPMI, you must refinance the loan, which in turn means carefully considering market interest rates and settlement costs at the time to see if refinancing would be an advantage, rather than keeping your current mortgage.

FHA, VA, or RHS fees

The Federal Housing Administration (FHA) offers insured mortgages and the Veterans

But why would the lender, in this case the now-defunct WaMu,⁸⁰ make such a loan knowing well that the odds the mortgagor would default on the mortgage were very high? The answer is twofold: First, as noted above, the fees that the originator receives upon the execution and completion of a mortgage are powerful inducements for the originator to make the loan,

Administration (VA) and the Rural Housing Service (RHS) offer mortgage guarantees. If you are getting a mortgage insured by the FHA or guaranteed by the VA or the RHS, you will have to pay FHA mortgage insurance premiums or VA or RHS guarantee fees. As with Private MI, insurance premium payments will stop when you acquire 22% equity in your home. FHA fees are about 1.5% of the loan amount. VA guarantee fees range from 1.25% to 2% of the loan amount, depending on the size of your down payment (the higher your down payment, the lower the fee percentage). RHS fees are 1.75% of the loan amount.

Homeowner's insurance

Your lender will require that you have a homeowner's insurance policy (sometimes called hazard insurance) in effect at settlement. The policy protects against physical damage to the house by fire, wind, vandalism, and other causes. This insures that the lender's investment will be secured even if the house is destroyed. If you are buying a condominium, the hazard insurance may be part of your monthly condominium fee; you may still want homeowner's insurance for your furnishings and valuables.

Estimated cost: \$300 to \$1,000 (depending on the value of the home and the amount of coverage; you can estimate the cost to be about \$3.50 per \$1,000 of the purchase price of the home)

Flood determination fee

If your home is in a flood hazard area where federally subsidized flood insurance is available, lenders cannot make a mortgage loan for your home unless you buy flood insurance. Your lender may charge a fee to find out whether the home is in a flood hazard area.

Estimated cost: \$15 to \$50 (this is not the cost for the flood insurance; flood insurance, if required, would be in addition to your homeowner's insurance and may cost from \$350 to \$2,800 depending on location and property value)

Escrow (or reserve) funds

Some lenders require that you set aside money in an escrow (reserve) account to pay for property taxes, homeowner's insurance, and flood insurance (if you need it). Lenders use escrow funds to ensure that these items are paid on time to protect their interest in your home. With an escrow account, money is held by the lender or the lender's agent, who then pays the taxes and insurance bills when they are due. At settlement, you may need to provide some payment into this account, depending on when payments will be due. For example, if you are buying your home in August and property taxes are due the following January, you will need to deposit funds into your escrow account at settlement so that you have enough to pay the taxes when they become due in January.

Survey costs

Lenders require a survey to confirm the location of buildings and improvements on the land. Some lenders require a complete (and more costly) survey to ensure that the house and other structures are legally where you and the seller say they are.

Estimated cost: \$150 to \$400

Id.

80. The failure of WaMu may actually prove that chickens do come home to roost. That does not help, however, all of the mortgagors who have lost their homes as a result of the venality and greed of WaMu. See ABC/Reuters, *Washington Mutual Collapse 'Biggest in United States History'*, ABC NEWS, Sept. 26, 2008, <http://www.abc.net.au/news/stories/2008/09/26/2375597.htm>.

irrespective of the long-term viability of the mortgage. Second, and most importantly for the thesis of this Article, these original lender originators were able to take advantage of the explosion of the use of CDOs as securities to transfer the mortgage and the debt securing same,⁸¹ including the risk of default on the mortgage, to investors purchasing the CDOs.

CDOs were first sold in the 1980s, part of a revolution in corporate finance called “securitization” that fueled the unprecedented boom in available credit. Lenders [originators] could package their mortgages, credit card loans, equipment leases, even corporate debt, and sell securities backed by the interest payments. This maneuver transferred the risk of not getting paid to the investors who bought the securities. The deals returned cash to lenders, which they could plow into new loans. This efficient machine pushed borrowing rates lower, creating a win-win-win for consumers, lenders and investors.⁸²

Although CDOs were used to securitize credit card debt, corporate debt, junk bonds, and other debt streams, the foreclosure miasma was created in large part because the use of MBSs—the epitome of a CDO—exploded after 2004, and the purchasers of the CDOs did literally no investigation of the financial solvency of the mortgages they were purchasing. Given the fees that were generated in the process of creating and selling these mortgages, the emphasis was on the transfer of the asset and not on its worth or verifiability.⁸³

81. As my colleague, Richard Hynes notes: “A bank securitizes [a pool of] mortgages by selling them to a special purpose entity (“SPE”) [like Lehman Brothers or Merrill Lynch] formed to hold the mortgages. The SPE raises the money needed to buy the mortgages by selling securities that are claims on the [pool of] mortgages.” See Hynes, *supra* note 33 (manuscript at 2). It’s that simple.

82. Jill Drew, *Frenzy: The Crash—What Went Wrong*, WASH. POST, Dec. 16, 2008, at A1, available at <http://www.washingtonpost.com/wp-dyn/content/article/2008/12/15/AR2008121503561.html>. Of course, the win-win scenario envisioned at the creation of the mortgage and its immediate transfer did not result in a win-win, but rather a loss-loss when mortgagors lured into subprime mortgages they could not afford failed to pay their mortgages, thereby exposing investors who had assumed the risk to staggering losses.

83. CDO sales sputtered on and off until the surge in mortgage loans from the housing boom earlier this decade. Because mortgage-backed securities paid higher yields than other securities with the same ratings, they became widely popular for use as CDO collateral. The CDO market took off. From \$157 billion issued in 2004, it ballooned to \$557 billion in 2006.

Unfortunately, a toxic chain was also forming. Consumers jumped into houses they couldn’t afford. Mortgage brokers closed deals swiftly, sometimes by inventing phony income data for borrowers. The loans were quickly sold into pools that issued securities, so the brokers were rarely on the hook for defaults. Wall Street traders swirled like

No one in this complicated process vetted the mortgages that were packaged as CDOs to ensure that the property being mortgaged was worth at least the amount of the mortgage debt.⁸⁴ Similarly, no one determined whether the mortgagor had the financial capacity to make the initial payments and, even more importantly, the subsequent scheduled payments, and the interest rate adjusted pursuant to the exotic financing devices that were the staple of subprime mortgages.⁸⁵ None of those important details mattered. Instead, what mattered to the investors was the rating on the bonds being purchased—the higher the rating (AAA to unrated, with AA, BBB, and BB above unrated) presumably the higher the quality of the bond and the lower the rate of return given the perceived lower risk.⁸⁶ Putting aside for a moment any claim that those issuing the ratings had a conflict of interest since they were being paid by those packaging and selling the CDOs (which is the subject of perhaps another article), the crucial fact to note is that purchasers of these CDOs were purchasing these mortgages based on ratings and not on the value of the security interest (the land) or the financial solvency of the obligor (mortgagor) of the note. These latter two factors were deemed largely irrelevant by the purchasers of the CDOs, much to their regret later.⁸⁷

piranhas, snapping up the securities for repackaging as CDOs. Everyone feeding on this chain earned money upfront, in the form of fees.

....

Getting the bonds sold was the key objective. That's when the firms would collect their underwriting fee, estimated by Thomson Reuters at 1.1 percent, or \$11 million for every \$1 billion deal.

Id.

84. *See id.*

85. *See id.*

86. *See id.*

There was only one possible catch in the seamless CDO machine: the bond-rating firm. Without high marks from at least one independent rating company, it would be impossible to sell large swaths of bonds to the intended market of big institutional investors—pension funds, insurance companies and many overseas buyers—because their rules required them to purchase only highly-rated, lower-risk securities.

Ratings were the linchpin of the CDO sales frenzy. The Wall Street engine had considerable influence here, too: It paid fees to the ratings firms for every approved deal.

Id.

87. Perhaps one would assume that the rating agencies would rate the mortgages based on these two factors, serving the role of efficient signaler of the quality of the mortgages packed in the CDO. Alas, that was not the case:

Richard Gugliada . . . was managing director in charge of structured finance at Standard & Poor's ratings services.

....

Gugliada acknowledged that S&P [Standard & Poor] was under pressure to increase its revenue and was seeking to take market share from its two main competitors, Moody's Investors Service and Fitch Ratings. To do that, he said, the firm needed to do three things: provide better service, cut its fees and loosen its criteria a smidge for what would earn a triple-A rating. "It's fair to say we did a little bit of all three," said Gugliada, who was criticized at a recent congressional hearing for sending an e-mail pressing one of his

But none of this adequately explains one other piece in the puzzle: Why would mortgagors knowingly enter into and execute mortgages that they have little chance of performing? Putting aside the unfortunate Mr. Aviles who may have been duped into executing a mortgage that he could not read nor understand,⁸⁸ should not the typical putative mortgagor be aware of his or her financial limitations, and not contract for a predatory, subprime, or even prime mortgage that they can rationally predict they will not be able to afford in one or two years?⁸⁹ The answer is both simple and frightening. Most mortgagors do not have sufficient financial knowledge to understand the complexities of a standard mortgage let alone a complicated ARM.

Mortgage products raise similar concerns—that consumers lack fundamental understanding of how financial products work.

A recent FTC survey found that many consumers do not understand, or even identify, key mortgage terms. Survey evidence suggests that some consumers with fixed rate mortgages (FRMs) do not know the interest rates on their mortgages. A survey conducted by the Federal Reserve found that homeowners with adjustable rate mortgages (ARMs) were poorly informed about the terms of their mortgages. The survey results showed that “[t]hirty-five percent of ARM borrowers did not know the value of the per-period cap on interest rate changes. Similarly, 44 percent of respondents . . . did not know the values of one or both of the two variables used to calculate the lifetime interest cap.” Moreover, many consumers do not understand that rising interest rates can lead to increases in their ARM rate. And a 2003 survey of financial literacy in Washington

managers to make a credit estimate on a CDO deal without examining details of the underlying mortgage pools.

....
The Securities and Exchange Commission, charged with overseeing the private ratings companies, did little to scrutinize their procedures during this time. In the summer of 2007, after S&P, Moody’s and Fitch began slashing their grades on CDO bonds they had once blessed, the SEC stepped in to investigate what had gone wrong. This summer, without naming names, an SEC staff report faulted the ratings firms for not doing enough to police their conflict-of-interest policies.

Id.

88. *See supra* notes 72–77 and accompanying text.

89. Of course, one rational explanation for contracting for an “irrational” ARM that will increase is the mortgagor’s plan to flip the property—resell it for a profit in a rising market—before the interest rate adjusts. In the rest of this Part, I am unconcerned about this type of real estate speculator and any loss that might occur as a result of this sort of scheme. My focus is on individuals who are contracting for a mortgage to purchase their primary residence with the hope that they will be able to make the payments and remain in same.

State found that victims of predatory lending did not understand the cost of mortgages. Focusing on closing costs, the Department of Housing and Urban Development (HUD) has concluded that “[t]oday, buying a home is too complicated, confusing and costly. Each year, Americans spend approximately \$55 billion on closing costs they don’t fully understand.”⁹⁰

I am not the only one to contend that the information asymmetries created in this context allows originators to manipulate both mortgagors and purchasers of CDOs and other securitized interest in mortgages.

The emergence of new market intermediaries has led to a significant increase in information asymmetries among brokers, lenders, secondary-market participants, and borrowers. For example, lenders and secondary-market purchasers have different levels of knowledge about borrowers’ risk and different levels of commitment to accurate risk assessment. This enables lenders to gain an advantage by withholding information from secondary-market purchasers.

Lenders and brokers have extensive knowledge about the credit market and mortgage products. In contrast, the typical victims of predatory lenders are unsophisticated about their options. Many were historically excluded from the home-mortgage market because of credit rationing [sic] and discrimination. . . . And when lenders and brokers give these borrowers estimates and loan documents, the borrowers may not be able to comprehend the information. Predatory brokers and lenders take advantage of these information asymmetries and induce borrowers to commit to predatory loans.⁹¹

To return some measure of rationality to the mortgage market and preclude the reoccurrence of the foreclosure miasma, while maintaining the benefits created by CDOs, ratings must be eliminated from the process and investors purchasing CDOs must instead purchase these MBSs based on the traditional indices for the validity of mortgages: the value of the land securing the mortgage and the creditworthiness of the mortgagor. Key to returning to that rational state of affairs is the elimination of the transferee’s status as a holder-in-due-course. This will provide the purchasing transferee with appropriate incentives to monitor the activities of the originators of the mortgages. However, before I address the elimination of the holder-in-due-course, I must address the contention that there are simpler solutions to the

90. Oren Bar-Gill & Elizabeth Warren, *Making Credit Safer*, 157 U. PA. L. REV. 1, 29–30 (2008) (footnotes omitted).

91. Engel & McCoy, *supra* note 61, at 1280–81 (footnotes omitted).

foreclosure miasma—eliminating exotic financing devices, and limiting or expressly precluding the transferability of the mortgages on the secondary market.

II. TURNING BACK THE CLOCK IS NOT THE ANSWER

By now it should be obvious that the confluence of two developments—the creation and use of exotic financing devices, on the one hand, and the evolution and growth of the securitization of mortgages and their transfer on the secondary market, on the other—have inexorably led to the formation of an environment ripe for the development of predatory lending, the subprime mortgage market, and rampant mortgage fraud: all predicates to the foreclosure miasma. The elimination of one or both developments could conceivably preclude future financial shocks like the current foreclosure miasma. Indeed, many examining the current crisis will review its causes and argue for a return to a time when neighborhood lending was the norm,⁹² exotic financing devices were illegal and non-existent,⁹³ and the securitization of mortgages was unheard of because entities like Ginnie Mae

92. Many have argued that agency costs will be reduced if we return to the alleged bucolic state of affairs when neighborhood savings and loans associations were the primary lenders for residential mortgages. *See, e.g.*, Hynes, *supra* note 33. This ignores, of course, the redlining and other discriminatory policies employed by these local lenders that prevented many borrowers of color from attaining their goal of home ownership. *See* 2 NELSON & WHITMAN, *supra* note 27, § 11.5.

93. Savings and Loan Associations were not allowed to invest in ARMs until 1982 when, in a wave of regulation, Congress essentially preempted state laws regulating savings and loans associations. *See* 2 NELSON & WHITMAN, *supra* note 27, § 11.1; *supra* note 32. This culminated in the FDIC Improvement Act of 1991 that “authorized all four of the principal federal banking agencies (FDIC [Federal Deposit Insurance Corporation], OTS [Office of Thrift Supervision], the Federal Reserve Board, and the Office of the Comptroller of the Currency, which regulates national banks) to issue consistent regulations on mortgage lending.” 2 NELSON & WHITMAN, *supra* note 27, § 11.1 (footnote omitted). In addition to the explicit regulation of federal banks, Supreme Court decisions interpreting the National Bank Act essentially eliminated state laws and regulations policing usury and other lending practices.

In the past, all financial institutions—federally chartered national banks and state banks as well—were subject to the laws of the borrower’s state, especially to the usury laws in the borrower’s state. This changed in the late 1970s when the United States Supreme Court, interpreting the word “located” in section 85 of the National Bank Act (NBA), decided that national banks are governed by the usury laws of the state where their headquarters are located, not by the usury laws of the state where the customer is located. In 1996, the Court extended this ruling to any payment compensating a creditor for an extension of credit, including numerical periodic rates, annual and cash-advance fees, bad-check fees, overlimit fees, and late-payment fees. As a result, state interest rate regulation has been effectively preempted. . . . States have become powerless to protect their citizens from such lending practices going on within their borders.

Bar-Gill & Warren, *supra* note 90 at 80–81 (footnotes omitted).

and Freddie Mac did not purchase residential mortgages for resale on a secondary market.⁹⁴

If, as I contend, the creation of the current foreclosure miasma is, in part, a product of exotic financing devices, why not eliminate them and return to the traditional level-pay long-term amortized mortgage that was the staple of residential mortgages for over half of the twentieth century?⁹⁵ Similarly, if the securitization of mortgages and their transfer to distant investors precludes these investors from monitoring and adequately assessing the quality of the mortgages they are investing in (due in large part to the investors' misplaced reliance on mortgagor self-interest, i.e., a mistaken belief that the mortgagor will not rationally execute a mortgage that it cannot perform⁹⁶ and to investor protection created by the investors' status as holders-in-due-course)⁹⁷ then the elimination of the securitization of mortgages should be advocated and adopted as a means to preclude a future foreclosure miasma. Although both proposals have merit, each misses the mark and creates more harm than good, especially when, as detailed below, the elimination of the transferee's status as a holder-in-due-course precludes the future development of a miasma with little or none of the cost.

Although it is beyond cavil that the use of exotic financing devices created the financial structure and opportunity which fostered subprime

94. Note that Freddie Mac's and Ginnie Mae's original purpose was not the securitization and transfer of mortgages. See Title III of National Housing Act, 12 U.S.C. §§ 1716–23 (2006), available at <http://www.ginniemae.gov/guide/statutes.pdf>.

95. See *supra* notes 40–42 and accompanying text. I am not alone in identifying that originators have an incentive to dupe purchasers on the secondary market with respect to the quality of the mortgages they are transferring. In addition, lenders may have an incentive to make loans even when they know that the loans are destined to default. “Lenders who sell loans on the secondary market may not care whether brokers deceive them about borrowers’ default risks because the lenders do not bear the ultimate risk of loss. In these situations, lenders have reduced incentive to police the brokers they use.” Engel & McCoy, *supra* note 61, at 1287 (footnotes omitted).

96. See *supra* text accompanying notes 89–91 (discussing the fact that mortgagors are not sophisticated enough to realize when they are being duped or executing a mortgage that they cannot realistically perform).

97. Similarly, I am not the first to notice that the holder-in-due-course doctrine precludes the use of a very good remedy by the mortgagor—unconscionability—when the mortgagor has been fraudulently induced to execute a predatory mortgage.

The ability to raise unconscionability as a defense, like many other contract defenses, is subject to further restrictions when parties who purchased loans on the secondary market sue delinquent borrowers. In those cases, the borrowers’ ability to raise defenses is severely limited by the holder-in-due-course doctrine. Under that doctrine, a secondary-market purchaser can defeat “personal” defenses if it meets the following requirements for a holder-in-due-course: (1) the purchaser is the holder, (2) of a negotiable note, (3) who took the note for value, (4) in good faith, and (5) without notice of the defenses.

Once a purchaser qualifies as a holder-in-due-course, it can cut off the defense of unconscionability, as well as all other personal defenses to the loan agreement.

Engel & McCoy, *supra* note 61, at 1301 (footnotes omitted). For further discussion of this issue, see *infra* notes 168–178 and accompanying text.

mortgages and predatory lending, the original purpose of such loans was laudable. From the mortgagee's perspective, these devices shifted some of the risk of subsequent interest rate increases to the mortgagor.⁹⁸ This shift of risk allows the mortgagee to offer lower interest rates to mortgagors who thereby benefit if they are risk preferring.⁹⁹ The benefit to the mortgagor of these flexible financing devices is also obvious. ARMs and other exotic devices benefit mortgagors who may desire the flexibility of a GPM, or senior citizens who may be able to live their sunset years in comfort financed by a RAM.¹⁰⁰ These exotic financing devices serve a very important function in today's mortgage market, and their limitation or elimination will have detrimental consequences to mortgagors benefitted by their use. In short, the elimination of exotic devices will limit the choices available to mortgagors and reduce their ability to tailor a mortgage to their ability to pay while raising costs to mortgagees who face increased risk of loss when interest rates rise and they can only apply for fixed rate mortgages (FRMs).

More importantly, the elimination of exotic devices will not eliminate the originator's incentive to engage in predatory lending practices by deceiving a mortgagor into executing even a traditional mortgage that is beyond the means of the mortgagor at the time of execution. Although it is hard to envision a scenario where a mortgagor would agree to a mortgage pursuant to which the mortgagor was unable to pay the initial monthly mortgage payments at the inception of the mortgage, it is certainly true that this unfortunate situation has occurred with some degree of regularity.¹⁰¹

98. This avoided the problem of portfolio lag—that is, having below market interest rate mortgages on one's balance sheet. See 2 NELSON & WHITMAN, *supra* note 27, § 11.4.

99. If mortgagors are risk averse they can always opt for a traditional mortgage by paying a slightly higher initial interest rate, which is the cost of locking in that rate for the term of the mortgage as long as the mortgagor remains the owner of the property—that is, the mortgagor does not sell the property triggering the mortgagee's right to exercise the mortgage's due-on-sale clause. See *supra* notes 44–47 and accompanying text for a discussion of due-on-sale clauses and their enforceability.

100. For a definition of GPMs and RAMs, see *supra* notes 52–55 and accompanying text.

101. See *supra* notes 72–77 and accompanying text; see also *supra* note 90 and accompanying text (detailing some mortgagors' failure to understand even the most basic terms of the mortgage).

A recent study . . . using records on 75,000 home equity loans made in 2002, identified persistent consumer mistakes in loan applications. In particular, consumer mistakes in estimating home values increased the loan-to-value ratio and thus the interest rate charged. Such mistakes increase the APR [annual percentage rate] by an average of 125 basis points [1.25%] for home equity loans and 150 basis points [1.5%] for home equity lines of credit. While only 5% of borrowers in their forties and fifties made "rate-changing mistakes," more than 40% of younger and older borrowers made these mistakes, with the likelihood of mistakes reaching 80% for some age groups.

Furthermore, there are predatory mortgages that are predatory because even though they are level-pay-plan mortgages, they create long-term obligations with no chance that the mortgagor can meet these obligations. For example, one traditional FRM can be an interest only level-pay mortgage with the balance due in five or ten years.¹⁰²

Finally, it must be noted that many of the predatory practices that lead to foreclosure and mortgagor harm can be present with respect to level-pay plan mortgages that are affordable by the mortgagor and do not contain balloon payments. Hence, packing, flipping, and the use of single premium financing on credit insurance as well as other predatory tactics will continue to be used by unethical originators against unsophisticated and naive borrowers unless some agent or entity is given the appropriate incentive to police and forbid such scurrilous behavior—a task I turn to in Part III.

However, before I address that issue in Part III, one other possible remedy to the foreclosure miasma must also be addressed and discarded. Many, no doubt, blame the current foreclosure miasma on the existence of the secondary mortgage market and the transfer of MBSs or, as they are often referred to, CDOs.¹⁰³ It therefore stands to reason that many will argue that the way to preclude the future occurrence of the foreclosure miasma is to eliminate the use of MBSs and the secondary mortgage market. That contention, too, is short-sighted and not responsive to the current cataclysmic situation.

One of the strengths of the current mortgage process is that it is national in scope, thereby allowing money to flow across state boundaries into local neighborhoods where it is needed. The elimination of the secondary mortgage market on which MBSs are sold and traded would return mortgage origination to the dark days when local banks held the key to mortgage financing and could redline neighborhoods by refusing to lend money to African-Americans and other “different” people.¹⁰⁴ This is not to say that discrimination in the lending market does not currently exist. Quite the contrary, it does.¹⁰⁵ My assertion is that a return to solely localized lending

Bar-Gill & Warren, *supra* note 90, at 42–43 (footnotes omitted).

102. With this type of FRM, the mortgagor is betting on increased property values which will allow refinancing later at a lower rate, or a fall in interest rates that will allow subsequent refinancing at a lower rate. On whether such a mortgage is rational, see Bar-Gill, *supra* note 28, at 1107–18.

103. See, e.g., Alan S. Blinder, *Six Fingers of Blame in the Mortgage Mess*, N.Y. TIMES, Sept. 30, 2007, § 3, at 4, available at http://www.nytimes.com/2007/09/30/business/30view.html?_r=2&o.

104. See, e.g., Peter P. Swire, *The Persistent Problem of Lending Discrimination: A Law and Economics Analysis*, 73 TEX. L. REV. 787 (1995).

105. Although it may seem surprising at this late date, discrimination on the basis of race and ethnicity in home mortgage lending continues to be a significant problem in the United States. The available evidence indicates that, even after controlling for income, credit-worthiness, and other relevant factors, minorities are more likely to have their applications for mortgage credit rejected or to be offered loans on less favorable terms than other applicants.

will exacerbate this problem and result in more discriminatory treatment of persons of color.

III. IMPOSING ACCOUNTABILITY: ELIMINATING THE PROTECTION AFFORDED THE HOLDER-IN-DUE-COURSE

As demonstrated above, the current foreclosure miasma is a product of the confluence of three discrete phenomena created, in large part, by the structure of the mortgage market and the sequencing of mortgage financing. The first phenomenon occurs because given the subsequent transfer of mortgages on the secondary market, originators have an overriding incentive to initiate mortgages irrespective of the credit-worthiness of the mortgagor.¹⁰⁶ Originators (and brokers) profit from the initiation of the mortgage and could care less about what happens after the mortgagor applies for and is granted the mortgage.¹⁰⁷ All of the originators fees and profits are packaged at the front end of the process. That, of course, leads originators to focus on one factor and only one factor: qualifying the mortgagor for the mortgage.¹⁰⁸

The second phenomenon and the key factor in the creation of the foreclosure miasma is the lack of sophistication on the part of borrowers (putative mortgagors), which leads them to apply and contract for mortgages that they have no ability to successfully perform, causing them to lose their

2 NELSON & WHITMAN, *supra* note 27, § 11.5. (footnotes omitted).

106. Indeed, to be quite precise, originators includes not only lenders but mortgage brokers who act as middlemen between the putative mortgagor and the lender. "Lenders who sell loans on the secondary market often use brokers to market their products. These brokers have little incentive to ensure that borrowers are creditworthy because they do not bear the risk of loss in the event of default." Engel & McCoy, *supra* note 61, at 1286–87 (footnotes omitted); *see also supra* text accompanying note 57.

107. Brokers do, however, have an incentive to deceive lenders regarding the borrowers' ability to pay. . . . For example, predatory brokers may write loans with very high interest rates that borrowers cannot afford and then falsify borrowers' credit histories to indicate to the lenders that the borrowers have the financial wherewithal to meet their loan obligations. Brokers stand to benefit from such fraud in three ways: (1) loans are made that otherwise would have been denied, thereby generating commissions for the brokers, (2) these commissions are larger than normal because the face amount of the loans often is more than borrowers can afford, and (3) the brokers may earn yield-spread premiums. Meanwhile, lenders have assumed the risk of loans that are very likely to default.

Engel & McCoy, *supra* note 61, at 1287 (footnotes omitted).

108. *See supra* notes 72–77 and accompanying text for a tale of predatory lending, the sole purpose of which is to qualify the mortgagor for the mortgage. Indeed, the system is so out of whack that it is not the mortgagor who commits fraud to obtain the mortgage, but the originator of the mortgage whose sole motivation is the profit achieved once the mortgage is executed.

down payment and equity they might have in the foreclosed premises.¹⁰⁹ The mortgagors' actions, which appear to cut against their self-interest, are confounded by three differing variables.

The first variable is created because putative mortgagors who cannot qualify for a conventional mortgage (read: not subprime) still have a strong desire for home ownership—a desire stoked by governmental policies that make owning a home a priority for low and middle income buyers and equates home ownership with the American dream.¹¹⁰ The second variable is created because these putative mortgagors have no clue about the obligation they are undertaking when they sign complicated subprime mortgages due to the explosion of exotic financing devices that are beyond the ken of the average low-income mortgagor.¹¹¹ The third and most important variable arises through a process known as cognitive dissonance; putative mortgagors are aware of the future increased mortgage payments, which they will have little or no chance of paying, yet these mortgagors are self-deluded into believing that they will be able to make said payments in the future notwithstanding the overwhelming evidence to the contrary.¹¹²

The third phenomenon occurs when purchasers and investors of these subprime mortgages on the secondary market mistakenly fail to internalize the inefficiencies noted above and make five key assumptions that are erroneous. Purchasers and investors first assume that originators only initiate mortgages that creditworthy mortgagors qualify for under normal lending practices—a mistake that begins the sequence of events leading to the foreclosure miasma. Second, these investors and purchasers assume (as most rational investors would) that putative mortgagors will only apply and

109. See *supra* notes 89–91 and accompanying text.

110. See Joe Schwarz, *American Dream of Home Ownership Turns Sour for Many Low-Income Buyers*, UW NEWS, Apr. 12, 2004, <http://uwnews.org/article.asp?articleid=4009> (“The American dream of buying and owning a home all too frequently doesn’t have a happy ending for many low-income families. Despite federal government policies encouraging home ownership among minority and low-income families, more than half of them left their houses and returned to renting within five years, according to a new study by a University of Washington researcher. One third of the families returned to renting in the first two years.”).

111. See *supra* notes 40–56 and accompanying text.

112. For half a century, social psychologists have been trying to figure out the human gift for rationalizing irrational behavior. Why did we evolve with brains that salute our shrewdness for buying the neon yellow car with bad gas mileage? The brain keeps sending one message—*Yesss! Genius!*—while our friends and family are saying, “Well . . .”

This self-delusion, the result of what’s called cognitive dissonance, has been demonstrated over and over by researchers who have come up with increasingly elaborate explanations for it.

.....

But in general, people deal with cognitive dissonance—the clashing of conflicting thoughts—by eliminating one of the thoughts.

John Tierney, *Go Ahead, Rationalize. Monkeys Do It, Too*, N.Y. TIMES, Nov. 6, 2007, at F1, available at <http://www.nytimes.com/2007/11/06/science/06tier.html>.

accept mortgages that they have a reasonable prospect of paying once the payments become due—whatever the amount.¹¹³ Third, the investors and purchasers of these securitized mortgage interests assume that payments will be made and that the note which the mortgage secures will be honored, irrespective of any bargaining process imperfections that caused the formation of a flawed mortgage, due to the holder-in-due-course doctrine. Fourth, investors and purchasers assume that, even if foreclosure occurs, the asset securing the debt will be worth more than the debt because no rational originator will lend more than the land is worth. If it is worth less, they expect that insurance will cover the amount of the deficit.¹¹⁴ Fifth, and perhaps most damning, the purchasers on the secondary market relied on ratings by credit agencies to verify the value of the assets being purchased.¹¹⁵ All of these assumptions are predicated on a rational, efficient bargaining process that is finalized with the execution of a mortgage—long-term debt that is hopefully worth less than the value of the land.

Integral to these three phenomena is the existence of the holder-in-due-course doctrine that insulates the purchaser and investor in securitized mortgages from any claim by the mortgagor that bargaining process imperfections caused the mortgagor to execute a mortgage that the mortgagor did not understand and could not pay. At each step of the process—1) broker solicitation and predator actions against the mortgagor; 2) lender originator; and 3) subsequent purchase on the secondary market—the “downstream” actors, i.e., the lender originator and the purchaser, are relying on the protection provided by the holder-in-due-course doctrine to insulate them from any issue or claim by the mortgagor regarding the validity of the underlying transaction.¹¹⁶

113. See *infra* notes 119–21 and accompanying text.

114. See Patrick Barta, *Is Appraisal Process Skewing Home Values?*, WALL ST. J., Aug. 13, 2001, at A1 (detailing that since lender/originators sell their loans on the secondary market, they should be less concerned about the accuracy of any property appraisals given as part of the loan process). For a discussion of the role of insurance in the foreclosure miasma, see *infra* note 118.

115. The national wave of home foreclosures, many concentrated in lower-income and minority neighborhoods, has created a strong temptation to find the villains responsible. Among the nominees are the major credit rating agencies like Moody's and Fitch, which certified that the securities backed by subprime loans were a good investment. There's little doubt that the rating agencies helped inflate the housing bubble.

Howard Husock, *Housing Goals We Can't Afford*, N.Y. TIMES, Dec. 11, 2008, at A49, available at <http://www.nytimes.com/2008/12/11/opinion/11husock.html>; see also *supra* notes 86–87 and accompanying text.

116. The broker's liability to the defrauded mortgagor is unaffected by the doctrine and may provide some recourse to the mortgagor assuming the broker can be found and is solvent at the time of the mortgagor's claim. Of course, any recourse against the broker has no effect on the validity

The assumption that the mortgagor will continue to be obligated to pay the mortgage is buttressed by the fact that investors and purchasers of these securitized mortgage interests assume that payments will continue to be made as long as the property mortgaged is increasing in value. This premise was shared by the mortgagor and the originator until the collapse of the residential real estate market, when the decline in the value of real estate caused many subprime mortgagors to owe more on their property than its worth (an event known popularly as “being underwater”).¹¹⁷ This last factor may be overstated somewhat because at the time the mortgages are purchased on the secondary market the purchaser gives little thought to mortgagor failure. This is because the purchaser fails to investigate the financial capabilities of the mortgagors of the mortgages they are investing/purchasing, and the mortgages may be insured by a federal agency like Housing and Urban Development (HUD).¹¹⁸ And there’s the rub.

and enforceability of the note. This is the essence of the holder-in-due-course doctrine and the protection afforded to the holder of the note against personal claims by the maker of the note. See *supra* notes 25–27 and accompanying text.

117. Reuters, ‘Under Water’ Mortgages Are Growing Threat to US, CNBC, Oct. 22, 2008, <http://www.cnbc.com/id/27316653> (“Long before she filed for bankruptcy, Ann Neukomm was ‘under water’—she owed more on her mortgage than her house was worth—a situation more and more Americans are finding themselves in.”). As to the decline in value of real property and its impact on the rate of foreclosure, see JOHN KRAINER, STEPHEN F. LEROY & MUNPYUNG O, *SUBPRIME MORTGAGES 2* (2008), available at, http://richmondfed.org/conferences_and_events/research/2008/pdf/subprime_mortgages.pdf (“In the current US financial crisis these priorities have been reversed. Fluctuations in prepayment behavior are not a major issue now. However, the increasing use of subprime mortgages, often with initial loan-to-value ratios around 100%, combined with house price drops on the order of 15% or more, have left millions of homeowners with negative equity . . . possibly creating a financial incentive to default. To the extent that the resulting wave of defaults involved uninsured mortgages, it caused serious problems for financial institutions around the world. It is true that many of the defaults have been on mortgages insured by government-sponsored enterprises, in which case the investors are not at risk.”).

118. See Engel & McCoy, *supra* note 61, at 1277. At best, the investor/purchaser’s status as a holder-in-due-course can be thought of as a security for repayment of the debt represented by the note. At the very least, the investor/purchaser can rest assured that the stability and finality of the note cannot be attacked by the maker of the note as a result of the maker’s flawed interaction with the originator. As a result, the investor/purchaser must assume that he is buying a secured stream of payments from the mortgagor—secured in the sense that it is not subject to attack and repudiation by the mortgagor. The only risk for the investor/purchaser is the possibility of mortgagor default created or induced by a decline in the value of the mortgaged property that puts the mortgagor under water, thereby providing a strong incentive for the mortgagor to default. The investor/purchaser will only suffer a loss if the mortgage loan is not insured by an entity like the FHA:

FHA insurance through HUD creates an additional incentive for lending in LMI [low-to-moderate-income] neighborhoods by reducing the cost to lenders of default. The majority of borrowers who are covered by FHA insurance are low-to-moderate-income households. If and when these FHA-insured borrowers default, the FHA reimburses the lenders for their foreclosure costs and expenses related to the sale of the covered property. In addition, FHA insurance reimburses lenders for the outstanding interest that accrues between default and foreclosure, property taxes, and maintenance costs. Given that there is evidence that LMI borrowers have elevated risks of default, the increased availability of FHA insurance decreases the downside risk to lenders.

The originator is only interested in the execution of the mortgage and the fees generated as a result.¹¹⁹ The originator of the mortgage has absolutely no interest in the creditworthiness of the mortgagor or the capacity/ability of the mortgagor to make future payments pursuant to the executed mortgage. Indeed, once the mortgage is executed the originator of the mortgage has no incentive to work with or for the mortgagor. Following execution of the mortgage, the originator's interest is focused solely on transferring the mortgage to the investor/purchasers.¹²⁰

Concomitantly, the mortgagor, operating under a state of delusion either believes that they can make any and all future payments or that they can ride a wave of appreciating property values and refinance to lower interest rates once the current mortgage becomes too burdensome. The investor/purchaser mistakenly assumes that the originator has done its job properly by only originating mortgages to qualified mortgagors, and that in so doing the originator exercised due diligence in the creation of the mortgage. More importantly, the investor/purchaser also mistakenly believes that the mortgagor has acted rationally and executed a mortgage that is affordable and within the means of the mortgagor. At each stage of the process, origination, execution and performance, and finally, transfer, mistaken assumptions are made regarding the validity, solvency, and security of the subprime residential mortgage because no one is accountable to assure the validity of the transaction.¹²¹

In effect, the originator is acting as the agent of the mortgagor at the time of origination of the mortgage and then, later, at the time of transfer to the investor/purchaser, the originator is acting as the agent of the

Id. (footnotes omitted).

119. See *supra* notes 106–08 and accompanying text.

120. See *supra* notes 81–82 and accompanying text.

Lenders who sell loans on the secondary market may not care whether brokers deceive them about borrowers' default risks because the lenders do not bear the ultimate risk of loss. In these situations, lenders have reduced incentives to police the brokers they use. Even when lenders retain predatory loans generated through brokers, if the lenders themselves are predatory, they can still make tidy profits by repeatedly refinancing the properties to strip the borrowers of their equity, and then foreclosing.

Lenders who are not predatory may find it difficult to identify and exert control over predatory brokers. They can inadvertently finance predatory loans through brokers and not learn of the predatory nature of the loans for some time because borrowers generally do not default immediately.

Engel & McCoy, *supra* note 61, at 1287 (footnotes omitted).

121. Or, as my colleague Rich Hynes would allege, no party to the transaction has appropriate incentives to monitor the actions of the agent that leads to loss. See Hynes, *supra* note 33 (manuscript at 11–12).

investor/purchaser.¹²² However, in both agency relationships, the principal/agent relationship is doomed to fail because the agent's interest is not aligned with the principal's. By that I mean the unsophisticated putative mortgagor is relying on the broker-originator—Originator A—mortgagor's agent, to guide her through the complicated mortgage application process and to protect the mortgagor's interest in so doing. Similarly, the investor/purchaser of the mortgage executed by the mortgagor and facilitated by Originator A is relying on the acts of the financial institution packaging and selling the mortgage—Originator B—its agent, in purchasing the mortgage. The problem with both agency relationships is that the principal's interests are not in any way aligned with the agent's.

Quite the contrary, Originator A's interest is inapposite to that of the mortgagor because the agent's duty and connection to the mortgagor are terminated once the mortgage is executed. Indeed, given the monetary incentives prevalent in the residential mortgage transaction, Originator A's interest is to close the deal (execute the mortgage) at whatever cost because, once executed, the mortgagor is no longer a viable client of the originator. Because these mortgages are executed by Originator A with the assumption that the mortgagor will not be able to make the mortgage payments and be foreclosed or that the mortgagor will be able to make the mortgage payments and not require a new mortgage, the possibility of repeat players, that is, the principal-mortgagor returning to the originator-agent, for the execution of a subsequent mortgage is not likely, to say the least.¹²³ This represents the epitome of the end-game problem with agency relationships.¹²⁴ Except in

122. For the ease of exposition, I am dividing the role of the originator into two distinct actors. Originator A is the agent (mortgage broker) of the lender/mortgagee that lends the money for the purchase price. Originator B is the bank or entity that lent the money and, more importantly, is the entity that transfers the mortgage on the secondary market as CDOs or MBS. In certain situations it is possible that there will be only one originator who will work with the mortgagor to obtain the loan and then fund the loan before transferring same on the secondary market. More often, however, is a situation like that of the unfortunate Mr. Aviles, in which the mortgage agent, Originator A, fraudulently induces the mortgagor to apply for the loan, and Originator B (WaMu in Mr. Aviles's case) funds the loan and then packages it and sells it on the secondary market. See *supra* notes 72–77 and accompanying text.

123. The one situation that could cause a repeat play situation, that is, when the mortgagor makes payments and then seeks to refinance with a new mortgage when payments are increased on the original mortgage, is unlikely in this scenario for two reasons. First, once the mortgagor realizes that his initial subprime mortgage is a predatory loan that placed the mortgagor in a position to require financing to avoid foreclosure, it seems highly unlikely that said mortgagor would return to the same originator and trust said originator to act on the mortgagor's behalf in the mortgagor's best interest. Second, given the elapsed time between the origination of the mortgage and the execution of a new mortgage coupled with the fluidity of the mortgage industry, the odds are quite high that the initial originator is no longer in business in the same locale.

124. See, e.g., ROBERT COOTER & THOMAS ULEN, *LAW AND ECONOMICS* 229–30 (4th ed. 2004). “The phrase ‘the endgame problem’ describes the unwinding of cooperation as a repeated game approaches its final round. Eastern Europe provided a dramatic example of the endgame problem after 1989” *Id.* at 230 (describing the negative impact of the demise of communism on political

this circumstance, the end-game problem of opportunism is present at the initiation of the arrangement, that is, when the putative mortgagor trusts the broker—Originator A—to act on his or her behalf.

The same sort of information asymmetry is present with respect to the relationship (actually non-existent) between Originator B and the purchaser/assignee of the mortgages.¹²⁵ In fact, the interests of the parties are inapposite given the fact that the seller of the asset is terminating the relationship with the asset upon sale, and the buyer of the asset is relying on the due diligence of Originator B in producing the asset purchased.

Principal-agent problems also arise because lenders have first-hand access to information about borrowers' creditworthiness. This information is not normally available to secondary-market purchasers who must, instead, rely on lenders' assurances about credit quality. An additional factor compounds the effect of this informational asymmetry. Predatory lenders, who sell their loans on the secondary market, make their profits from high origination fees. Thus, their incentives to maintain credit quality are low relative to those of loan purchasers. As a result of the information asymmetry and the lenders' reduced commitment to creditworthiness, lenders can obscure from loan purchasers the true risk of borrowers' defaulting while generating substantial profits from up-front points and fees.¹²⁶

The situation is exacerbated because of the lack of any meaningful connection or relationship between Originator B and the purchaser/assignee of the mortgages as a result of the way the residential mortgages are bundled and sold in tranches.¹²⁷ Hence, the purchaser of these investments has no

life and economic relationships).

125. Here, I am including purchasers of MBSs as well as purchasers of securities in SPEs that raise the money needed to buy the mortgages by selling securities that are claims on the pool of mortgages. See *supra* note 81 and accompanying text.

126. Engel & McCoy, *supra* note 61, at 1288 (footnotes omitted).

127. *Id.* A tranche is defined as follows:

One of the classes, portions or segments of a bond or mortgage-backed security, such as a collateralized mortgage obligation (CMO). Each tranche normally offers different terms, usually involving the length of time it takes for principal to be repaid to investors. With this type of security, all payments of principal from the underlying mortgages are diverted initially to the first tranche. When all principal has been repaid in the first tranche, payments of principal begin to the second tranche and, after the second tranche is retired, the payments continue in turn to the rest of the tranches, like a series of steps, until investors in the last tranche have been repaid. By selecting a particular tranche, investors choose whether they want their funds repaid quickly or whether they want to

practical way to verify the due diligence of its agents or police the future behavior of any agents. The securitization process ensures the anonymity of Originator B and precludes the creation of repeat players in the mortgage market. This situation has caused some to contend that securitization is the issue.

Conventional wisdom suggests that securitization creates agency costs that enhanced the housing bubble and that are making its deflation more painful. Banks that sell the mortgages that they originate may not sufficiently scrutinize the ability of debtors to repay, and may be more willing to offer risky terms. Banks that service mortgages owned by others may refuse to modify a loan even if doing so would avoid a costly foreclosure and increase the amount actually recovered. Explicitly or implicitly, conventional wisdom argues that if banks retained the mortgages on their balance sheets they would have made much better decisions.¹²⁸

Because I believe securitization of mortgages benefits society if the lender's interest can be properly aligned with that of the investors purchasing the mortgages,¹²⁹ the key question that must be answered is how to ensure that the purchasing investors properly police the actions of their agents. The only way to properly incentivize purchasers to establish an

lock in their investment for a longer period of time. In another meaning, tranche also refers to a portion of a bond that is distributed in another geographic area, such as a foreign country.

DocLoan, Loan and Mortgage Terms Glossary, http://www.docloan.com/loans/loan_terms/Tranche (last visited Oct. 25, 2009). Tranches were used heavily to sell packages of subprime mortgages:

The word "tranche" is French in origin meaning a 'slice', portion, or piece. When it comes to creating a mortgage backed security (MBS), tranches represent a 'slicing' of a MBS into specific investments inside an offering where each tranche gives investors a different yield and risk profile. The lower the risk, the lower the yield for the investor.

This ability to take a huge pool of subprime mortgages [and] use them as the security for the MBS (also known as a mortgage derivative), allowed Wall Street to then sell all kinds of investor a piece regardless of their risk tolerance. Many institutional investor [sic] are very conservative, so they would never get involved in these types of investments if they could get a AAA rated investment.

Creating a subprime mortgage backed security that conservative investors would normally run from and convert it so at least a portion of the investment could be considered AAA rated . . . allowed Wall Street to find more capital for this market. Wall Street found that not only could they sell the AAA rated tranches, but there were plenty of investors willing to invest in the higher yielding, higher risk BBB and CCC tranches too.

This thirst of investors for these kinds of investments provided the capital the subprime wholesale lenders provided [sic] to fund the closing of all the mortgage broker sold subprime loans.

Rob K. Blake & Terri Ewing, *The Mortgage Insider*, <http://themortgageinsider.net/glossary/tranche.html> (last visited Oct. 25, 2009).

128. See Hynes, *supra* note 33; see also Economist, *Chain of Fools: Hard Evidence that Securitisation Encouraged Lax Mortgage Lending in America*, *ECONOMIST*, Feb. 9, 2008, available at http://www.economist.com/finance/displaystory.cfm?story_id=10641119.

129. See *supra* notes 122–24 and accompanying text.

appropriate principal-agent relationship with originators that creates the proper monitoring of those agents, is through a two-step process. The first step requires the elimination of the holder-in-due course status as it applies to the purchasers of notes from Originator B. The increased use of the doctrine of unconscionability by aggrieved mortgagors who have been induced to contract for unperformable mortgages by Originator A is step two.

By focusing on the remedy that is deployed when a mortgagor successfully brings an action claiming that a contract is unconscionable, I show that courts have the power to reform these unconscionable contracts in a fashion that allows the mortgagor to retain their home by reducing their mortgage payments to an amount approximating the payment in the original term. This power of reduction (reformation) *ex post* will limit the purchaser's income from its investment and will provide it with the appropriate incentives, *ex ante*, to police originator behavior in a way to preclude unperformable (unconscionable) mortgage contracts.

To be precise, the way to correct the imperfections in the formation process that lead to the execution of unperformable, subprime, and exotic mortgages that are doomed to default is to create a potential loss situation for the purchaser of the mortgages that provides that party with an incentive to ensure the validity of the underlying transaction before making a decision to invest in the mortgage or purchase the note.¹³⁰ The key is destroying the negotiability of the note and employing the doctrine of unconscionability as the remedy for originator or lender misbehavior. The purchaser of the mortgage debt is then subject to all of the defenses the maker of the note (the mortgagor) may assert against any attempt to collect the note or foreclose based on non-payment of the note.¹³¹

A. The Existing State of Affairs

Part of the mystery of the current foreclosure miasma is why investor/purchasers bought assets—in this case, packaged mortgages—on

130. To properly police the lenders who originate mortgages, purchasers will have to establish relationships with lenders that allow them to verify, with some degree of certitude, that the lender is acting appropriately in executing the mortgage. This will eliminate the current anonymity of lenders vis-a-vis purchasers, and may require the equivalence of vertical integration between brokers, lenders, and purchasers in the same entity or alliance to accomplish this task successfully. *See supra* note 127 and accompanying text (describing tranches).

131. That is, real and personal defenses under the UCC. *See infra* notes 133–34 and accompanying text (discussing the distinction between real and personal defenses).

the secondary mortgage market when those notes, viewed ex post, were clearly not worthy of such an investment given the financial qualifications of the mortgagors. No doubt, there are multiple answers.¹³² One such answer focuses on the negotiability of the note and the protection afforded the transferee/purchaser of the note as a holder-in-due course.

Under the provisions of the UCC which govern the negotiability of the note, the transferee of the note takes free of personal defenses that can be asserted by the maker of the note when enforcement of the note is sought by the holder of the note.¹³³ Personal defenses are defined by what they are not—real defenses.

The Code defines “personal defenses”—that is, those cut off by negotiation to an HDC—by exclusion from [UCC § 3-305(a)(1)]. Such defenses include fraud in the inducement. . . . They also include lack of consideration (which would make the note unenforceable under normal contract theory), partial or total failure of consideration (e.g., the failure of the mortgagee-creditor to make the loan of money which the note is supposed to evidence an obligation to repay), accord and satisfaction, waiver, *unconscionability*, mutual mistake, and any sort of setoff or counterclaim, which the debtor-mortgagor might raise against the

132. Indeed, an entire article can be written regarding why these investor/purchasers failed to exercise due diligence in their capacity as purchasers on the secondary mortgage market. Fortunately that is not my task. However, a few insights come to mind. First, it seems reasonable that many of said purchaser/investors relied on past history in making current bets. In other words, given the positive gains these investor/purchasers realized until the collapse of the market and the creation of the foreclosure miasma, it was plausible (note, I did not say reasonable) to assume that the gains would continue. Hence, there was no need to change the way the business operated, including the purchase of securities. Second, many of the initial purchasers of these investment packages purchased them for resale and therefore believed they were limiting their exposure to these instruments by passing on the ultimate risk of loss to others. Third, some have argued that the “herd” mentality exhibited by investors is largely responsible for their irrational actions. Claire A. Hill, *Why Financial Appearances Might Matter: An Explanation for “Dirty Pooling” and Some Other Types of Financial Cosmetics*, 22 DEL. J. CORP. L. 141, 174–78 (1997). Finally, as discussed *supra*, many of these purchasers relied on a belief that the underlying instruments purchased were valid because mortgagors would not execute mortgages that were not capable of being performed.

133. Interestingly enough, the UCC lists certain defenses that any transferee or assignee of the note takes subject to and that the maker can assert. U.C.C. § 3-305(a) (2006). With respect to these so-called “real” defenses that can be asserted by the maker, no protection is afforded to the holder-in-due-course. U.C.C. § 3-305(a)(1)(i)–(iv) (2006) reads:

(i) infancy of the obligor to the extent it is a defense to a simple contract, (ii) duress, lack of legal capacity, or illegality of the transaction, which under other law, nullifies the obligation of the obligor [mortgagor or maker of the note], (iii) fraud that induced the obligor to sign the instrument with neither knowledge nor reasonable opportunity to learn of its character or its essential terms [fraud in factum as opposed to fraud in the inducement], or (iv) discharge of the obligor in insolvency proceedings.

See also Clayton P. Gillette, *Rules, Standards, and Precautions in Payment Systems*, 82 VA. L. REV. 181, 238–39 (1996).

original mortgagee. Payment of the debt by the mortgagor [to one who is not the holder of the note and therefore not entitled to payment] is also regarded as a personal defense¹³⁴

What this means is that the purchaser of the mortgage on the secondary market has no incentive to investigate the formation process that created the mortgage if the purchaser is willing to take the very rarely encountered risk that the mortgage was executed in a fashion that provides the maker/mortgagor with real defenses.¹³⁵ Instead, the purchaser can rely on the validity of the underlying obligation (debt) represented by the mortgage note, even assuming formation imperfections (evidence of predatory lending that can be shown to rise to the level of fraud in the inducement) that would otherwise cause the underlying transaction to be voided. The enforceability of the note is, in effect, guaranteed.

Interestingly enough, what is not guaranteed by the formation process and then the negotiation process by which the mortgage note is transferred from the originator to the purchaser on the secondary market is the solvency or value of the note's maker.¹³⁶ The note may be valid, but when it is given in the mortgage transaction, the note's value and validity is inextricably intertwined with the asset that the note was executed to purchase. Given the legal and practical impediments to obtaining a personal judgment against the mortgagor who executes a note to purchase residential real estate,¹³⁷ the note is only as good as either the mortgagor's ability and willingness to pay the mortgage, or the value of the land that is the underlying security for the mortgage.¹³⁸

134. NELSON & WHITMAN, *supra* note 27, § 5.31 (footnotes omitted) (emphasis added).

135. For example, a note that is signed because the broker held a gun to the head of the mortgagor would not be enforceable even by a holder-in-due-course given the real defense of duress. *See supra* note 133 and accompanying text.

136. If the note is insured, however, the note is essentially guaranteed by the Federal Government. *See supra* note 118.

137. Many jurisdictions have mortgagor protection devices like the "one action" rule that requires the holder of a note secured by a mortgage to exhaust its security interest in the land before pursuing the mortgagor for a judgment on the underlying debt represented by the note. NELSON & WHITMAN, *supra* note 27, § 8.2. Moreover, even if mortgagees or assignees of mortgagees may proceed against the mortgagor for the debt represented by the note, they are often limited or entirely precluded from proceeding against the mortgagor for a deficiency judgment, once the asset's value has been exhausted through either a private power of sale foreclosure or a judicial foreclosure by the aptly-named anti-deficiency statutes. *Id.* § 8.3.

138. Indeed, the value of the land is going to be significantly impacted by the mortgagor's ability to pay the mortgage. In other words, if most mortgagors are unable to make the payments on the property purchased, the pool of potential purchasers for that property shrinks. Fewer putative buyers leads to less competition for housing, which leads to a reduction in price. The current reduction in

Note that I am not making the argument that these purchasers of mortgages and mortgage-backed assets or CDOs have expressly relied on the fact that they were holders-in-due-course when making their determination to purchase these assets.¹³⁹ I do not believe that the fact these mortgages were negotiated to provide the secondary-market purchasers with the status as holders-in-due-course was central or even important in the decision making process to purchase or invest in these types of instruments. In truth, I believe many purchaser/investors of these unique assets were unaware of the protection afforded them by the UCC. In fact, one can probably make a credible argument that the creation or use of holder-in-due-course status on the part of the transferee/assignee purchasers of these assets had little, if anything, to do with the creation of the foreclosure miasma.¹⁴⁰

Why, then, have I focused on eliminating holder-in-due-course status as the key remedial strategy to preclude future foreclosure miasmas? The answer is simple.

What is needed in this complicated series of transactions—that starts with the putative mortgagor relying on the assistance of his or her agent, Originator A, in applying for and receiving a mortgage that concludes with that mortgage being packaged by Originator B with several other similar mortgages and then sold/transferred to purchaser/assignees by Originator B in distant locales—is a reliable and efficient monitor. This monitor must be an entity with a sufficient interest in the transaction to be incentivized to adequately police the important phases of the transaction to ensure, to the extent possible, that there is no debtor (mortgagor) or originator misbehavior that would create a note, ultimately worth less than its face value, that is purchased on the secondary market.¹⁴¹ For reasons that should be

home values is proof of this theory. Again, the presence of insurance changes this outcome. See *supra* note 118 and accompanying text (describing how purchasers do not investigate the financial capabilities of mortgagors because the mortgages are likely insured by a federal agency).

139. However, I think it is fair to say that the investor/purchasers of these mortgages and mortgage-backed assets relied on a process that was predicated on negotiability and holder-in-due-course status, which in turn, created the financial instruments that caused the foreclosure miasma.

140. Theories abound as to why investors blindly bought assets without verifying their value. Many of these theories have been addressed herein, including the “herd” mentality theory of investors which caused them to continue to invest notwithstanding the rather substantial risks. See Hill, *supra* note 132 and accompanying text. The only plausible and rational reason for their actions is that these investors relied to their detriment on the ratings provided by credit agencies. See *supra* notes 86–87 and accompanying text. What is clear is that most of these investors did not investigate or use due diligence regarding the quality of the mortgages, i.e., the value of the land and the creditworthiness of the mortgagor, prior to purchasing the mortgages on the secondary market. See *supra* note 23 and accompanying text.

141. I contend that given the debtor-mortgagor protection statutes and schemes (anti-deficiency legislation) in place at the local level, a note secured by a mortgage is only worth its face value if either the debtor continues to make the payment or the value of the land that secures the debt exceeds the value, or both. Given the relationship between the value of the land and the mortgagor’s ability and willingness to pay, it is more than likely that the mortgagor will continue to make

apparent,¹⁴² the only entity capable of performing this task, assuming mortgages continue to be bought and sold on the secondary market,¹⁴³ is the purchaser of these mortgages on the secondary market.¹⁴⁴

To ensure that the purchaser adequately performs this task, legislatures and courts need to adopt an immutable rule¹⁴⁵ that sufficiently induces the purchaser to act as a monitor.¹⁴⁶ The immutable rule I propose is that any mortgage debt purchased on the secondary market as a CBO or MBS is subject to personal defenses that the maker may have against the broker (Originator A), the selling originator (Originator B), or both. As a result, this will induce purchasers on the secondary market to ensure that any debt purchased is not subject to any bargaining imperfection. The removal of immunity from personal defenses will ensure that if the underlying mortgage transaction is subject to bargaining imperfections typical to a predatory loan, the loan can be found unconscionable and modified by the court. By providing the remedy available via the doctrine of unconscionability, courts will be given power to police the actions of brokers and originators and to subsequently minimize predatory actions on their part. The elimination of the holder-in-due-course doctrine provides a measure of quality control over the mortgage origination process that is sorely lacking under the current legal regime.

payments as long as he or she has an affordable payment schedule and the value of the land is worth more than the mortgage, i.e., the mortgagor is not under water. *See supra* notes 117–18 and accompanying text.

142. The mortgagor is not sophisticated enough to protect its interest in the typical transaction or in one involving an exotic financing device. *See supra* notes 89–91 and accompanying text. Similarly, brokers or lenders cannot be relied upon to effectively monitor the transaction given their interest in obtaining fees as quickly as possible and the lag time between origination and default. *See supra* notes 119–20 and accompanying text.

143. *See supra* note 104 and accompanying text for a discussion of the importance of maintaining the transferability of these instruments on the secondary market given the liquidity issues that would arise absent these markets.

144. *See supra* notes 89–91 and accompanying text for a discussion of why the mortgagor is incapable of policing its agent, the originator of the mortgages.

145. An immutable rule, as opposed to a default rule, is a rule that the parties to a contract cannot change by agreement. *See* Ian Ayres & Robert Gertner, *Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules*, 99 *YALE L.J.* 87, 87 (1989).

146. *See, e.g.*, Saul Levmore, *Monitors and Freeriders in Commercial and Corporate Settings*, 92 *YALE L.J.* 49 (1982).

B. The Holder-in-Due-Course Doctrine: Separating the Note from the Mortgage

Key to understanding the financing of residential real estate in an era where mortgages are packaged and sold on the secondary market¹⁴⁷ is understanding the negotiability of the notes that secure the mortgages made to residential buyers. As most are aware, the mortgage is a fairly straightforward transaction involving two documents. The first, of course, is the note which is executed by the maker/mortgagor and contains the maker's¹⁴⁸ promise to repay and the terms and conditions therefore. With respect to the traditional level-pay-plan mortgage,¹⁴⁹ the note is quite simple: it identifies the obligor-maker (mortgagor), the obligee-lender (originator), the amount of the debt, the interest rate, and the term of the mortgage.¹⁵⁰ With respect to exotic financing devices that contain adjustable rates,¹⁵¹ the Adjustable Rate Note (Note) contains more complicated provisions which indicate that the Note is adjustable and allow for changes in the interest rate and the monthly payment.¹⁵² It also includes an index that will be used to calculate the change in interest on the Interest Change Date,¹⁵³ the changes in the interest rate,¹⁵⁴ and the limits on interest rate changes.¹⁵⁵

147. See *supra* note 127 and accompanying text.

148. When referring to the execution and transfer of the note, I will designate the signer as the "maker" of the note to be consistent with the terminology employed by the UCC regarding the execution of both secured or unsecured notes. See U.C.C. § 3-302 (2006). When referring to the security interest created to insure repayment of the note, I will designate the signatory as "mortgagor" to reflect the fact that the note signed by the maker is secured by a real property interest. See *infra* note 156 and accompanying text (discussing and differentiating the mortgage and deed of trust).

149. See *supra* note 40 and accompanying text for the definition of the traditional level-pay-plan mortgage.

150. Once these three variables—monthly payment, interest rate, and term—are established, the amortization rate of the mortgage can be computed.

151. See *supra* notes 40–56 and accompanying text for a discussion of exotic financing devices.

152. For example, the Freddie Mac Single-Family Uniform Instrument for Multistate Initial Interest Adjustable Rate Notes states in bold and all caps: "THIS NOTE CONTAINS PROVISIONS ALLOWING FOR CHANGES IN MY INTEREST RATE AND MY MONTHLY PAYMENT. THIS NOTE LIMITS THE AMOUNT MY INTEREST CAN CHANGE AT ANY ONE TIME AND THE MAXIMUM RATE I MUST PAY." Freddie Mac, 1-Year LIBOR Index Form 5536: Multistate Initial Interest Adjustable Rate Note (Assumable during Life of Loan) (45-day Lookback), <http://www.freddiemac.com/uniform/unifnotes.html> (follow "Form 5536" hyperlink) (last visited Oct. 25, 2009).

153. The note states:

Beginning with the first Interest Change Date, my interest rate will be based on an Index. The "Index" is the one-year London Interbank Offered Rate ("LIBOR") which is the average of interbank offered rates for one-year U.S. dollar-denominated deposits in the London market, as published in *The Wall Street Journal*. The most recent Index figure available as of the date 45 days before each Interest Change Date [which is why the note is called 45 Day Lookback] is called the "Current Index."

If the Index [figure] is no longer available, the Note Holder will choose a new index which is based upon comparable information. The Note Holder will give me [the Maker] notice of this choice.

Id.

154. The pertinent portion of the Note reads:

4. INTEREST RATE AND MONTHLY PAYMENT CHANGES

(A) Interest Change Dates

The interest rate I will pay may change on the first day of _____, _____, and may change on that day every 12th month thereafter. Each date on which my interest rate could change is called an "Interest Change Date."

(B) The Index

Beginning with the first Interest Change Date, my interest rate will be based on an Index. The "Index" is the one-year London Interbank Offered Rate ("LIBOR") which is the average of interbank offered rates for one-year U.S. dollar-denominated deposits in the London market, as published in *The Wall Street Journal*. The most recent Index figure available as of the date 45 days before each Interest Change Date is called the "Current Index."

If the Index is no longer available, the Note Holder will choose a new index which is based upon comparable information. The Note Holder will give me notice of this choice.

(C) Calculation of Changes

Before each Interest Change Date, the Note Holder will calculate any new interest rate by adding _____ percentage point(s) (_____%) to the Current Index. The Note Holder will then round the result of this addition to the nearest one-eighth of one percentage point (0.125%). Subject to the limits stated in Section 4(D) below, this rounded amount will be my new interest rate until the next Interest Change Date.

The Note Holder will then determine the amount of my monthly payment . . . [that would be] sufficient to repay the unpaid principal that I am expected to owe at the Interest Change Date in full on the Maturity Date at my new interest rate in substantially equal payments. The result of this calculation will be the new amount of my monthly payment.

Id.

155. The pertinent portion of the Note reads:

(D) Limits on Interest Rate Changes

The interest rate I am required to pay at the first Interest Change Date will not be greater than _____% or less than _____%. Thereafter, my interest rate will never be increased or decreased on any single Interest Change Date by more than _____ percentage point(s) (_____%) from the rate of interest I have been paying for the preceding 12 months. My interest rate will never be greater than _____%.

(E) Effective Date of Changes

My new interest rate will become effective on each Interest Change Date. I will pay the amount of my new monthly payment beginning on the first monthly payment date after the Interest Change Date until the amount of my monthly payment changes again.

(F) Notice of Changes

The Note Holder will deliver or mail to me a notice of any changes in my interest rate and the amount of my monthly payment before the effective date of any change. The

Both the Fixed Rate Note and the Adjustable Rate Note will be secured by a mortgage or a deed of trust providing the lender with a security interest in the land and residence. Although much has been written about the distinction between a mortgage and a deed of trust and the historical reasons why a deed of trust developed and is used in certain parts of the country and not others,¹⁵⁶ for all intents and purposes, the two documents are identical and serve the same purpose. Both documents allow the lender to foreclose on the residence to repay the debt represented by the note in the event that a mortgagor is unable or unwilling to pay and a default on the note occurs.¹⁵⁷

What is important in this transaction is that whatever type of note the maker signs, be it fixed-rate or adjustable, it is negotiable. This means that it may be transferred by the original lender/originator to an assignee through the simple process of negotiation.¹⁵⁸ Once negotiation is successfully accomplished and the transfer of the note takes place, the transferee of the note is designated as the holder-in-due-course.¹⁵⁹ This status is very important because it means that the holder-in-due-course takes the transferred note free of any personal defenses that the maker may have against the original lender/originator of the loan.¹⁶⁰

Given the transferee's status as holder-in-due-course, the transferee is unconcerned about any imperfections in the bargaining process that lead to the execution of the note and its security interest, the mortgage. Specifically, the transferee is unconcerned about whether the maker of the note was misled during the negotiation process leading up to the note's execution because the maker/mortgagor may not assert this defense against the transferee.¹⁶¹ Similarly, the transferee of the note is unconcerned that the mortgagor may have been duped into signing a mortgage that is unconscionable in that it is not capable of performance by the mortgagor.

notice will include information required by law to be given to me and also the title and telephone number of a person who will answer any question I may have regarding the notice.

Id.

156. See, e.g., NELSON & WHITMAN, *supra* note 27, § 1.6 ("In many states the deed of trust represents the most commonly used mortgage instrument. This device normally involves a conveyance of the realty to a third person in trust to hold as security for the payment of the debt to the lender-noteholder whose role is analogous to that of the mortgagee. Deeds of trust will almost always contain a power of sale in the trustee to be exercised after a default at the request of the lender-noteholder. Such a deed of trust is essentially similar to a mortgage with a power of sale.")

157. *Id.* §§ 7.1–32.

158. See *id.* §§ 5.28–32.

159. *Id.* § 5.29.

160. See *supra* notes 133–134 and accompanying text.

161. Indeed, and this is true with respect to all claims of the maker/mortgagor that are deemed to be personal defenses. The fact that the transferee is immune from the maker's claims that are personal defenses, but the originator is not if it retains ownership of the note, provides the originator with a very strong incentive to transfer the note to a transferee.

Finally, the fact that the mortgagor was lied to by the originator/lender (i.e., “We will provide refinancing at a lower rate before the first Interest Change Date.”)¹⁶² is also not relevant because the holder-in-due-course, assuming there has been a valid negotiation and that the originator is not affiliated with the transferee,¹⁶³ cannot be held responsible for the lies and misfeasance of the originator.

Thus, the holder-in-due-course is free to enforce the terms of the note irrespective of these bargaining process imperfections and any allegations of unfairness and illegality. The holder-in-due-course status thus insulates the transferee from most claims by the mortgagor¹⁶⁴ and provides no incentive for the transferee to investigate the bona fides of the transaction between the mortgagor and the originator.¹⁶⁵ Indeed, the transferee, in order to protect its status as a good faith holder-in-due-course, may be better off not inquiring about the bargaining process than making inquiries and discovering imperfections in the bargaining process present in the note/mortgage the transferee wishes to purchase.¹⁶⁶

Consequently, in this case, ignorance may be bliss and is rewarded in this transaction. That ignorance, which deters the transferee-assignee of the mortgage from investigating the quality of the bargaining process and the validity of the mortgage, provides no incentive to the transferee-assignee to monitor the performance of the party who is essentially acting as its agent: the originator-lender of the mortgage. This has led at least one commentator to call for the elimination of the transferee-assignee’s status as a holder-in-due-course in order to eliminate predatory lending.¹⁶⁷ What is lacking in that thesis is any focus on the abrogation of the doctrine to induce monitoring by the principal (purchaser) of the agent (originator) to correct imperfections in the secondary market for mortgages that affect all mortgages, including prime mortgages. In addition, the thesis fails to articulate the remedial benefits that would be created if the holder-in-due-course doctrine were abrogated and the remedy of unconscionability became available against the

162. With respect to the Interest Rate Change Date, see *supra* notes 152–155 and accompanying text.

163. Here, I am referring to the close-connectedness doctrine that is used to destroy the holder’s status. JAMES J. WHITE & ROBERT S. SUMMERS, *UNIFORM COMMERCIAL CODE* § 14-7 (5th ed. 2000).

164. Of course, the transferee is still subject to any real defenses that the mortgagor may have against the originator. Those real defenses are very rarely present in the typical residential real estate transaction. See *supra* note 133 and accompanying text.

165. See WHITE & SUMMERS, *supra* note 163, §§ 14-1 to -10.

166. *Id.*

167. See Venkatesan, *supra* note 63.

purchaser of the mortgage on the secondary market. I now address that remedy.

C. *Unconscionability: The Ultimate Remedy*

At first glance, the doctrine of unconscionability seems inapposite to the issues addressed in this Article. As almost all law students are aware, unconscionability is typically associated with an analysis of the sale of goods and the application of the UCC to said sale. In particular, section 2-302 provides:

(1) If the court as a matter of law finds the contract or any term of the contract to have been unconscionable at the time it was made the court may refuse to enforce the contract, or it may enforce the remainder of the contract without the unconscionable term, or it may so limit the application of any unconscionable term as to avoid any unconscionable result.

(2) If it is claimed or appears to the court that the contract or any term thereof may be unconscionable, the parties shall be afforded a reasonable opportunity to present evidence as to its commercial setting, purpose, and effect to aid the court in making the determination.¹⁶⁸

Although the subject of many articles,¹⁶⁹ it is beyond peradventure that the doctrine of unconscionability has been embraced by American courts as a vehicle to remedy cases of both procedural and substantive unconscionability. Procedural unconscionability focuses on the process by which the contract is formed to ascertain whether one party with superior bargaining power has used that power to force the other party to sign a contract or agreement that he or she would not otherwise execute. It arises most often when standardized form contracts are used and the party employing the standardized form contract offers it to the other party on a “take-it or leave-it” basis, precluding any negotiation over the contract’s

168. U.C.C. § 2-302 (2004).

169. For some representative articles analyzing the doctrine of unconscionability in detail, see Arthur Allen Leff, *Unconscionability and the Code—The Emperor’s New Clause*, 115 U. PA. L. REV. 485 (1967); Richard A. Epstein, *Unconscionability: A Critical Reappraisal*, 18 J.L. & ECON. 293 (1975); and Robert A. Hillman, *Debunking Some Myths About Unconscionability: A New Framework for U.C.C. Section 2-302*, 67 CORNELL L. REV. 1 (1981).

terms¹⁷⁰ (and resulting in a contract that is one-sided, favoring the party who prepared the contract).¹⁷¹

On the other hand, substantive unconscionability results when the terms of the deal are so unjust or one-sided that the court, employing its equitable powers, will not enforce them. The prototypical case is *Williams v. Walker-Thomas Furniture Co.*,¹⁷² in which the legendary Judge Skelly J. Wright found that Mrs. Walker's contract with said furniture company was substantively unconscionable because it contained an incomprehensible clause (buried deep in the bowels of the contract),¹⁷³ which provided that new purchases of items were to be added to old purchases of items and that the security interest in all items remained as long as the purchaser owed any balance on any items previously purchased.¹⁷⁴ Substantive unconscionability, then, focuses on the actual terms of the deal and is impossible to define with precision. Suffice it to say, unconscionability involves oppression and unfairness:

“Unconscionable” is a word that defies lawyer-like definition. It is a term borrowed from moral philosophy and ethics. As close to a

170. See, e.g., Todd D. Rakoff, *Contracts of Adhesion: An Essay in Reconstruction*, 96 HARV. L. REV. 1174 (1983); W. David Slawson, *The New Meaning of Contract: The Transformation of Contracts Law by Standard Forms*, 46 U. PITT. L. REV. 21 (1984).

171. The fact that the contract is inevitably one-sided in favor of the dominant party naturally leads to the second prong of the unconscionability doctrine: substantive unconscionability, which is discussed *infra* at notes 172–175 and accompanying text. This has led many commentators to correctly note that procedural and substantive unconscionability are usually inextricably intertwined—procedural unconscionability is present when substantive unconscionability is found. See, e.g., Hillman, *supra* note 169.

172. 350 F.2d 445 (D.C. Cir. 1965).

173. The offending clause reads as follows:

The contract further provided that “the amount of each periodical installment payment to be made by [purchaser] to the Company under this present lease shall be inclusive of and not in addition to the amount of each installment payment to be made by [purchaser] under such prior leases, bills or accounts; and all payments now and hereafter made by [purchaser] shall be credited pro rata on all outstanding leases, bills and accounts due the Company by [purchaser] at the time each such payment is made.”

Id. at 447 (alteration in original).

174. This clause is similar to a dragnet clause. See 2 NELSON & WHITMAN, *supra* note 27, § 12.8 (footnotes omitted) (“The dragnet clause is a mortgage provision that purports to make the real estate security for other, usually unspecified, debts that the mortgagor may already owe or may owe in the future to the mortgagee. . . . Dragnet clauses are frequently included in the printed language of mortgages drafted by mortgagees. They are seldom the subject of negotiation, and may go entirely unnoticed by the mortgagor until the mortgagee attempts to enforce them. . . . Dragnet clauses are generally considered enforceable, but because their apparent coverage is so broad, and because the mortgagor is often unaware of their presence or implications, the courts tend to construe them narrowly against the mortgagee.”).

definition as we are likely to get is “that which ‘affronts the sense of decency.’” The purpose of the doctrine is to prevent two evils: “*oppression and unfair surprise*.” Although this twofold purpose has led to a distinction between “substantive” (oppression) and “procedural” (unfair surprise) unconscionability, the cases do not neatly fall into these two divisions. More frequently elements of both are present.¹⁷⁵

Predatory loans, loans that are not adequately explained to the putative mortgagor, and loans that have no chance of being performed are quintessentially unconscionable under the UCC.¹⁷⁶ Yet, there are no cases involving predatory loans that have successfully employed the doctrine to provide a remedy for an aggrieved mortgagor. The reason for this lacuna is the existence of the holder-in-due-course doctrine that impedes its use.¹⁷⁷

Moreover, once these mortgages are subject to the doctrine of unconscionability they are then subject to a panoply of remedies that will provide the courts with tools to adequately police agent or originator misconduct. In particular, once unconscionability is found the court can use its equitable powers to modify or reform the note in order to provide the mortgagor with fair and equitable payment terms.¹⁷⁸

D. Reconfiguring the Residential Real Estate Transaction

The argument that the holder-in-due-course status should be eliminated for transferees of MBSs has been made previously.¹⁷⁹ Although the focus of that article was rather narrow, addressing issues raised solely by predatory lending and subprime mortgages,¹⁸⁰ the student Note did provide part of a theory that would, if expanded, supply an incentive for transferees to rely upon and verify the substantive fairness of the dealings and the contract between the originator and the mortgagor before making a decision to invest in a package of mortgages. Why the student Note provides only a partial

175. JOSEPH M. PERILLO, CALAMARI AND PERILLO ON CONTRACTS § 9.40 (6th ed. 2009) (footnotes omitted).

176. *See id.*; Engel & McCoy, *supra* note 61, at 1299 (“Predatory loans are grounded in the law of contract and the Uniform Commercial Code, which govern promissory notes and security agreements. . . . The doctrine of unconscionability holds out some promise for victims of predatory lending, although its utility in practice has been limited.”).

177. Engel & McCoy, *supra* note 61, at 1301 (“The ability to raise unconscionability as a defense, like many other contract defenses, is subject to further restrictions when parties who purchased loans on the secondary market sue delinquent borrowers. In those cases, the borrowers’ ability to raise defenses is severely limited by the holder-in-due-course doctrine.”).

178. *See, e.g.*, Larry A. DiMatteo, *Equity’s Modification of Contract: An Analysis of the Twentieth Century’s Equitable Reformation of Contract Law*, 33 NEW ENG. L. REV. 265 (1998).

179. *See Venkatesan, supra* note 63.

180. *Id.* at 177–78.

solution to the issue addressed herein has to do with both the narrow focus of the Note (on predatory lending and subprime mortgages) and the state of affairs at the time it was authored.

What is illuminating and informative about the aforementioned student Note, however, is its examination of Georgia's law, which did in fact abrogate the holder-in-due-course doctrine for purchasers of mortgages, and the purchasers' reaction to that state of affairs.¹⁸¹ As the Note discusses, Georgia passed a law in 2002 that, in effect, limited the holder-in-due-course status for assignees of certain mortgages when the originators engaged in certain practices at the point of origination.¹⁸² The liability provision of the statute read:

Notwithstanding any other provision of law, where a home loan was made, arranged, or assigned by a person selling home improvements to the dwelling of a borrower, *the borrower may assert against the creditor all affirmative claims and any defenses that the borrower may have against the seller or home improvement contractor*, provided that this subsection shall not apply to loans other than high-cost loans unless applicable law requires a certificate of occupancy, inspection, or completion to be obtained and said certificate is not obtained.¹⁸³

Although the statute could be read to apply only to loans obtained by mortgagors to finance home improvements,¹⁸⁴ apparently the statute, given

181. *Id.* at 198–200

182. *Id.* at 198.

183. GA. CODE ANN. § 7-6A-6(a) (2003) (emphasis added).

184. Indeed, this is a credible reading of the statute which I would contend was designed to address a common problem with home improvement contracts and mortgages executed to secure payment of the home improvement contract. A common scam perpetrated on unsophisticated homeowners is to convince the homeowner to agree to a contract for a grossly inflated, usually poorly-done or incomplete home improvement like a roof repair that may cost \$1,000, but for which the homeowner is convinced to spend \$20,000. To add insult to injury, the improvement is not completed. Yet the note that the homeowner signs to "repay" the home improvement contract, which is secured by a mortgage and may or may not be a junior encumbrance, is immediately transferred by the person selling the home improvement (in this case, the roof repair) for a fraction of its face value (say, \$5,000) to a transferee. The transferee, assuming the status of a holder-in-due-course, is then immune from any claim by the homeowner that she was fraudulently induced to sign the contract for the roof and resultant note because these are personal defenses. Note that the "contractor" makes out by pocketing \$5,000 for a minimal repair and the transferee makes a significant profit by paying in this hypothetical \$5,000 for a note worth \$20,000. Furthermore, even if that note is not performed and results in a default, the assignee has the very valuable right to foreclose on the note and, by purchasing at the foreclosure sale, obtain perhaps very valuable property for a fraction of its cost which it can later resale at a profit. This scam has been repeated

the way the language is parsed, has been read so that it can be interpreted to say, “notwithstanding any other provision of law, where a home loan was made, . . . *the borrower may assert against the creditor all affirmative claims and any defenses that the borrower may have against the seller,*” with the seller being read to mean transferor. Whether the statute was designed to reach purchase money mortgages is, debatable. The response to the statute, assuming it did reach same, was, in short, amazing.

The apparent result of this provision is to abrogate the HDC doctrine, thus allowing borrowers private rights of action for violations of the GFLA [the statute] against any party holding his or her mortgage. The financial industry responded aggressively to the passage of the GFLA by accelerating the preemption debate to avoid Georgia’s high-cost loan requirements and liability provisions. And, more alarmingly for proponents of the expanded liability rule, Standard & Poor’s—one of the three largest securities rating agencies—refused to continue rating MBS containing high-cost loans from Georgia, citing the uncertain breadth of liability under the GFLA. This move irritated the financial entities in the lending pipeline as Moody’s quickly followed suit. This move was a major blow to the GFLA, as rating agencies play a crucial role in the securitization process, and unrated bonds have a very limited market among securitization entities and bond investors.¹⁸⁵

The state of Georgia responded to the actions taken by these entities, as well as the threat by the Federal Home Loan Mortgage Corporation to no longer purchase Georgia mortgages,¹⁸⁶ by modifying the law to expressly define the term “creditor” so that it would not include assignees of mortgages,¹⁸⁷ and refined the assignee liability provision to provide for no liability when the holder “exercises reasonable due diligence at the time of purchase of the home loans” (whatever this means).¹⁸⁸ Consequently, the Georgia “experience” abrogating the holder-in-due-course doctrine for purchasers of mortgages belies any claim that the status of being a holder-in-due-course is unimportant or inconsequential. Quite the contrary, the status

again and again and there are a number of representative cases where the scam succeeds and the homeowner’s equity in her premise is eliminated. *See, e.g.,* Fed. Trade Comm’n, Home Equity Scams: Borrowers Beware!, <http://www.ftc.gov/bcp/edu/pubs/consumer/homes/real1.shtm> (last visited Oct. 25, 2009); Nat’l Consumer Law Ctr., Consumer Concerns for Older Americans, http://www.consumerlaw.org/action_agenda/seniors_initiative/home_improv.shtml (last visited Oct. 25, 2009).

185. *See* Venkatesan, *supra* note 63, at 199–200 (footnotes omitted).

186. *Id.* at 200.

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

188. *Id.* § 7-6a-6(b).

of holder-in-due-course is key to the imperfections in the existing mortgage market leading to the current foreclosure miasma.

It is my contention and thesis in this Article that the Georgia statute eliminating holder-in-due-course status, if read broadly to apply to transferees of purchase money mortgages, is exactly what is required on a national level¹⁸⁹ to eliminate assignee reliance on spurious ratings for MBSs.¹⁹⁰ What have we learned since Georgia modified its statute to succumb to the pressure of originators and purchasers of MBSs to maintain the assignees status as holder-in-due-course? We have learned that the ratings system by which MBSs were graded was ineffective and riven with conflicts of interest that guaranteed that suboptimal and fatally defective subprime and other mortgages would be originated and transferred on the secondary market. To preclude the reoccurrence of the foreclosure miasma it is essential that the holder-in-due-course be eliminated and purchasers be incentivized to monitor the actions of their agent-originators.¹⁹¹

Expanding the elimination of the holder-in-due-course doctrine to all mortgages, and coupling the elimination of the doctrine with an expansive use of the doctrine of unconscionability provides the answer to the current foreclosure miasma if the goal is precluding such a state of affairs in the future.¹⁹² It also has the salutary effect of providing remedies to an entire class of aggrieved mortgagors who have been fraudulently induced to execute mortgages they have no or little possibility of performing.

IV. CONCLUSION

Although it may take more than the elimination of a simple legal status—the holder-in-due-course—and the protection it affords to guarantee that the foreclosure miasma will not reoccur, it must be the first step in any meaningful reform of existing mortgage laws if mortgages continue to be bought and sold on the secondary market. The cost of the destruction of the negotiability of the note will be the transfer of more information from the

189. For a discussion of the problem of state by state regulation, see the discussion of preemption *supra* note 32 and accompanying text.

190. See *supra* notes 86–87 and accompanying text for a discussion of the role of rating agencies.

191. The sum effect of these limitations (the use of the holder-in-due-course doctrine to preclude the assertion of personal defenses) is to make it extremely difficult for borrowers to challenge predatory-loan agreements as void under traditional contract law or the UCC. In addition, because secondary-market purchasers can evade responsibility for most misconduct by loan originators, they have little incentive to police originators. Engel & McCoy, *supra* note 61, at 1301–02.

192. Given the focus of the Note on predatory lending, the student author made no attempt to address the larger question presented by this Article. See Venkatesan, *supra* note 63.

originator of the mortgage to the purchaser of the mortgages before the transaction is finalized. And that increased transaction cost may be substantial given the legal exposure the purchaser will have once the mortgage is purchased and said purchaser is subject to all of the mortgagor's defenses to the collection of the mortgage. However, it is a cost that must be embraced if the existing practice of securitization of mortgages, which has created a revolution in mortgage financing and expanded the resources available to mortgagors, is to continue. It is a cost that must be borne.