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Cracks in the Foundation of Federal Law: Ameliorating the Ongoing Mortgage Foreclosure Crisis through Broader Predatory Lending Relief and Deterrence

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Cracks in the Foundation of Federal Law: Ameliorating the Ongoing Mortgage Foreclosure Crisis Through Broader Predatory Lending Relief and Deterrence

Katherine M. Lehe†

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INTRODUCTION

The ongoing U.S. mortgage foreclosure crisis worsened significantly in 2008 and the first half of 2009. At the end of September 2009, a record 14.4 percent of mortgage borrowers were either in foreclosure or delinquent on their mortgages. The Congressional Budget Office (CBO) estimated that 2.2 million homeowners with subprime and Alt-A mortgages, the categories thought to be riskiest to borrowers, will have foreclosure proceedings initiated against them between October 1, 2008, and September 30, 2011. Projections by the Center for Responsible Lending (CRL) are much higher, predicting that 9 million prime and subprime home loans will be foreclosed from 2009 to 2012. Other consumer advocates estimate 16 percent of all home mortgages will foreclose in the next four years.

1. Foreclosure filings—which include default notices, auction sale notices, and bank repossessions—rose to approximately 1.9 million on more than 1.5 million properties in the first half of 2009. This represents a 9 percent increase in total properties from the previous six months and a 15 percent increase over the first six months of 2008. One in eighty-four housing units received a foreclosure filing in the first half of 2009. Press Release, RealtyTrac, 1.9 Million Foreclosure Filings Reported on More Than 1.5 Million U.S. Properties in First Half of 2009 (July 16, 2009), http://www.realtytrac.com/ContentManagement/PressRelease.aspx?ItemID=6802.


4. Alt-A lending falls between prime and subprime lending. See Satish Mansukhani, Arjune Budhram & Mu'taz Qubba, Fixed Rate Alt-A MBS, in THE HANDBOOK OF MORTGAGE BACKED SECURITIES 207, 208 (Frank J. Fabozzi ed., 6th ed. 2006). Alt-A loans typically are issued to borrowers with little or no documentation of income, employment, or assets, and with lower FICO scores than borrowers in the prime market. Id. at 210. Alt-A loans also require borrowers to put down less than a 20 percent down payment, resulting in higher average Loan-To-Value (LTV) ratios than those of prime loans. Id.


7. Maeve Elise Brown, Exec. Dir., Hous. & Econ. Rights Advocates, Presentation to Professor Jeffrey Selbin’s Law & Poverty class at the University of California, Berkeley, School of Law (Mar. 18, 2009).
The cost of these foreclosures to U.S. homeowners is staggering. In addition to the loss of personal wealth experienced by borrowers themselves, foreclosures are estimated to decrease property values of nearby homes by more than $500 billion in 2009 alone. With regard to predatory loans in particular, the CRL estimated in 2001 that predatory mortgage lending costs $9.1 billion annually. As the foreclosure crisis worsened in recent years, CRL qualified this estimate by concluding that “the total cost of bad lending practices is almost incalculable.” Recognizing that federal government action is necessary, Congress has grappled with legislation to curb the growing tide of foreclosures and help people keep their homes. Against a backdrop of seemingly insufficient anti-predatory lending laws, the federal government has responded with loan modification (“workout”) and insurance programs that are voluntary for lenders and designed to help people keep their homes under affordable terms. Although the long-term effectiveness of these programs is unknown, very few borrowers have been able to avail themselves of these programs to date.

This Comment’s starting point is that federal government intervention is appropriate and necessary to prohibit the predatory lending practices that have contributed significantly to the current crisis and to enable homeowners at risk of foreclosure to remain in their homes. Federal intervention to ameliorate the foreclosure crisis through mortgage workout programs and predatory lending prevention is justified on several grounds. First, several groups share

7. CTR. FOR RESPONSIBLE LENDING, supra note 5.
10. For example, between October 1, 2008, and mid-January 2009, the HOPE for Homeowners (H4H) program, discussed infra, was responsible for closing only twenty-two refinanced FHA-insured mortgage loans and only 442 cases were opened. FED. HOUS. ADMIN., U.S. DEP’T OF HOUS. AND URBAN DEV., HOPE FOR HOMEOWNERS PROGRAM MONTHLY REPORT TO CONGRESS FOR JANUARY 2009 4, available at http://portal.hud.gov/portal/page/portal/FHA_Home/lenders/h4h_monthly_reports_to_congress/H4H%20Report%20to%20Congress%20January.pdf (last visited Sept. 11, 2010). Case opening indicates that “the lender intends to qualify the borrower for a Program loan.” Id. When Congress enacted H4H on July 29, 2008, it expected to help roughly 400,000 people stay in their homes. CONG. BUDGET OFFICE, CBO’S ESTIMATE OF COST OF THE ADMINISTRATION’S PROPOSAL TO AUTHORIZE FEDERAL FINANCIAL ASSISTANCE FOR THE GOVERNMENT-SPONSORED ENTERPRISES FOR HOUSING 3 (July 22, 2008), available at http://www.cbo.gov/ftpdocs/95xx/doc9574/07-22-GSEs.pdf. The program has since been largely displaced by the Obama Administration’s Homeowner Affordability and Stability Plan. See also infra text accompanying note 24.
responsibility for the foreclosure crisis. Unscrupulous lenders, borrowers who may not have assessed realistically their ability to repay their mortgages, borrowers whose financial circumstances changed, and as discussed in Part II.A infra, regulators who permitted predatory lending practices to escape the purview of federal prohibitions, all bear some responsibility.

Second, the fact that many borrowers facing foreclosure can afford their homes if refinanced on terms that are appropriate for the level of risk they pose to lenders undermines the argument that all borrowers facing foreclosure simply should not own homes. Those opposed to federal relief efforts argue widespread foreclosures are necessary for the housing market to correct for high-risk borrowers who should never have become homeowners. Subprime loans, which account for a disproportionate share of foreclosures, properly include terms less favorable to borrowers with poor credit and higher payment-to-income ratios to compensate for additional risk of default. That such loans have become unaffordable for many owners, critics argue, is the expected result of the higher cost of borrowing and should not prompt government intervention. However, it is now widely accepted that many subprime lenders have charged fees and rates disproportionate to borrowers’ level of risk, have failed to advise borrowers of the least expensive alternatives, or have failed to disclose key loan terms and conditions. Fannie Mae estimates that up to 50 percent of subprime refinanced loans could have been financed with prime loans, which would have saved borrowers thousands of dollars in interest


A core housing policy question is whether it’s better in the long run to buy time for struggling homeowners in the hope that they and the housing market will eventually recover, or instead to just rip off the band aid as quickly as possible. Allow the housing market to adjust quickly by not trying to create artificial “stability” above a market-clearing price. Such an adjustment would be excruciating in the short run, and painful for many who would lose their homes. But like ripping off a band aid, it would get all the pain behind us, so that things could return to a normal and more stable growth pattern going forward.

Id.


14. See Roberto G. Quercia et al., Assessing the Impact of North Carolina’s Predatory Lending Law, 15 HOUS. POL’Y DEBATE 573 (2004). Such practices fall under the umbrella term “predatory lending,” which generally refers to “subprime lending practices that are considered to be so detrimental to borrowers as to be considered abusive.” Id. at 574.

rates and fees.\textsuperscript{16} Because many subprime loans are significantly more costly than justified by the risk they pose to lenders,\textsuperscript{17} it follows that many borrowers facing foreclosure are able to afford their homes if financed under terms that are risk-appropriate. Given the human cost of foreclosure-related displacement and loss of equity, the federal government has a legitimate role to play in developing programs to modify owners’ loans with affordable terms, where such modifications are feasible.

Third, research supports the conclusion that the practice of “reverse redlining,” the targeting of African American and Latino communities in particular for the marketing of subprime and predatory loans, was prevalent in the expansion of subprime lending.\textsuperscript{18} African Americans and Latinos were more likely than whites to receive subprime loans, even when controlling for income level.\textsuperscript{19} For example, a recent study demonstrated that in 2006 nearly 50 percent of home loans made to African Americans, and slightly more than 40 percent of those made to Latinos, were subprime—compared to less than 20 percent of the loans made to whites—raising concerns that subprime lending practices involved widespread violations of fair lending laws. These findings, coupled with the fact that on average African Americans and Latinos have lower median household wealth than whites, have led some researchers to conclude the resetting of adjustable-rate mortgages (ARMs) to higher interest rates will cause disproportionately more African American and Latino homeowners to default on their mortgages.\textsuperscript{20} I assert it is unjustifiable for the federal government to withdraw from its long-standing subsidization and policy support of homeownership at a time when minority homeowners have been able to make meaningful gains in homeownership and stand to suffer disproportionately from the foreclosure crisis.\textsuperscript{22} The fact that the subprime

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\textsuperscript{17} See Quercia et al., supra note 14; Fast Facts – Mortgage Lending, supra note 16; What Is Predatory Lending?, supra note 16.

\textsuperscript{18} This research concerns racial disparities in the receipt of subprime mortgage loans, rather than in the rate of default.


\textsuperscript{20} Godsil & Simunovich, supra note 19, at 964.

\textsuperscript{21} Id.

\textsuperscript{22} See Christopher E. Herbert & Eric S. Belsky, The Homeownership Experience of Low-
mortgage foreclosure crisis likely will fall more heavily on African American and Latino borrowers makes the expansion of predatory lending particularly odious and provides further justification for federal government intervention.\textsuperscript{23}

To eliminate predatory lending and keep borrowers in their homes, the federal government must take action where feasible to allow owners with troubled mortgages to keep their homes and to prevent the proliferation of predatory lending practices in the long-term.\textsuperscript{24} Absent sufficient deterrents against and remedies for predatory lending and legitimate alternative sources of mortgage credit, mortgage workout programs will offer only a last-ditch solution to many homeowners who could have sought remedies for their predatory loans at foreclosure if they had meaningful legal recourse. Unfortunately, those federal statutes that most directly address predatory lending have proven too inflexible to keep pace with lender innovation in the subprime and predatory mortgage lending markets. In addition to the loopholes

\textit{Income and Minority Households: A Review and Synthesis of the Literature,} 10 \textsc{Cityscape} 5, July 2008, \textit{available at} http://ssrn.com/abstract=1341163. This is not to suggest that African American, Latino, and other minority homeowners have only made inroads in homeownership through the extension of subprime loans. In fact, homeownership among minority borrowers has expanded in large part due to the “continuing and affirmative obligation” of banks under the Community Reinvestment Act (CRA) to “help meet the credit needs of the local communities in which they are chartered.” 12 \textsc{U.S.C.} § 2901 (2006); see Part IV \textit{infra}. Further, default rates for all borrowers with CRA loans, which are 66 percent less likely than non-CRA loans to be high-cost, are significantly lower than default rates for subprime loans. Warren W. Traiger, \textit{The CRA: A Welcome Anomaly in the Foreclosure Crisis}, 53 \textsc{N.Y.L. Sch. L. Rev.} 227, 229 (2008–2009); see Brown, \textit{supra} note 6; Part IV \textit{infra}.

\textsuperscript{23} See 12 \textsc{U.S.C.} § 2901 (2006); Brown, \textit{supra} note 6; Godsil & Simunovich, \textit{supra} note 19, at 964; Herbert & Belsky, \textit{supra} note 22; Traiger, \textit{supra} note 22; Part IV \textit{infra}.

\textsuperscript{24} Since 2007, several federal mortgage refinancing and modification programs have been introduced to offer borrowers emergency foreclosure avoidance, but the results of these efforts are unclear. In August 2007, the Bush Administration launched the mortgage industry-led FHASecure refinancing program. \textit{Press Release, U.S. Dep’t of Hous. & Urban Dev., Bush Administration to Help Nearly One-Quarter of a Million Homeowners Refinance, Keep Their Homes: FHA to Implement New “FHASecure” Refinancing Product} (Aug. 31, 2007), http://archives.hud.gov/news/2007/pr07-123.cfm. Although the number of foreclosures prevented by FHASecure is unknown, the Bush Administration expected the FHASecure program to help up to 240,000 families avoid foreclosure. \textit{Id.} Congress responded in July 2008 with the HOPE for Homeowners loan refinancing and modification program. \textit{Pub. L. No. 110-289, §§ 1401–04, 122 Stat. 2654, 2800 (2008)} (to be codified at 12 \textsc{U.S.C.} § 1715z-23). The most recent government attempt at foreclosure avoidance is President Obama’s Homeowner Affordability and Stability Plan, also known as Making Home Affordable, launched in February 2009 to provide mortgage refinancing and modification. \textit{Press Release, U.S. Dep’t of Treasury, Homeowner Affordability and Stability Plan Executive Summary} (Feb. 18, 2009), http://www.treas.gov/press/releases/tg33.htm. In November 2009, the Treasury Department announced its intention to withhold cash incentives and otherwise pressure lending institutions to permanently lower payments for borrowers in the program, based on the program’s limited success to date. Peter S. Goodman, \textit{U.S. Will Push Mortgage Firms to Reduce More Loan Payments}, \textsc{N.Y. Times}, Nov. 28, 2009, at A1, \textit{available at} http://www.nytimes.com/2009/11/29/business/economy/29modify.html. As of October 2009, less than 2,000 of the 500,000 loan modifications in progress had become permanent. \textit{Id.} Because the effectiveness of this program is uncertain and the federal response still evolving, this Comment will not address emergency foreclosure avoidance programs in detail.
and gaps in coverage of the federal laws themselves, practical barriers stemming from negotiable instrument law and equitable principles prevent aggrieved borrowers from seeking relief from predatory lenders. As discussed in Part II.B infra, the “do equity” and “holder in due course” doctrines effectively bar legal recourse for many homeowners who otherwise would have a cause of action or defense to foreclosure under existing (or proposed) anti-predatory lending laws.

Taken together, these practical barriers to bringing suit and the overly rigid statutory approach to predatory lending prohibitions effectively preclude many borrowers facing foreclosure from seeking remedies for predatory loans under current law. To remedy these problems, I propose four federal legislative and agency actions to effectuate a new private enforcement framework and a backdrop of regulatory oversight under the Community Reinvestment Act (CRA). First, as discussed in Part III.A, Congress should amend existing anti-predatory lending laws to place on mortgage lenders a “suitability duty of care” that requires a mortgage to be suitable for the borrower’s unique financial situation. Second, as discussed in Part III.B, Congress should eliminate the requirement that borrowers “do equity” by paying in full their outstanding mortgage debt as a prerequisite to challenging predatory loans, particularly at foreclosure. Third, as discussed in Part III.B, the Federal Trade Commission (FTC) should abrogate the “holder in due course” doctrine in the home mortgage context to ensure borrowers can access federal remedies against the current holder of their mortgage. These first three actions will enable litigation-based enforcement, built around a private attorney general scheme, permitting borrowers to seek redress for a broader class of predatory loans than is actionable under existing law. Fourth, as discussed in Part IV, Congress should extend coverage of the CRA to all mortgage lenders. The duties and oversight the CRA imposes are correlated with origination of fewer high-cost mortgage loans (those most likely to be foreclosed), as a percentage of CRA-covered institutions’ total loan portfolios.

To examine these ideas, Part I first explains the differences between predatory and subprime lending. Part II explores the major existing federal laws that restrict predatory lending and the reasons they have been ineffective. Finally, Parts III and IV set forth recommendations for legislative and agency

25. Of course, the fact that a borrower is facing foreclosure does not necessarily mean they received a predatory loan, and a loan does not become predatory simply because a borrower no longer can afford it. Rather, this Comment advocates a more flexible predatory lending liability standard, discussed in Part III.A infra, that will enable a broader class of borrowers to challenge its loans at foreclosure if that loan was predatory. Definitions of predatory and subprime lending are discussed in Part I infra.

26. The private attorney general doctrine is an “equitable principle that allows the recovery of attorney’s fees to a party who brings a lawsuit that benefits a significant number of people, requires private enforcement, and is important to society as a whole.” BLACK’S LAW DICTIONARY 1315 (9th ed. 2009).
action to establish a litigation-based private enforcement scheme and ensure federal regulatory oversight of the entire mortgage lending industry. As outlined above, these proposals will help deter and prevent predatory lending and steer borrowers toward loans suitable for their financial situations. Moreover, by making remedies available for a broader class of predatory loans than current law permits, the proposed private enforcement scheme will help alleviate the ongoing foreclosure crisis by permitting more borrowers with predatory loans to obtain relief from such loans during foreclosure proceedings.

1. Distinguishing Predatory and Legitimate Subprime Lending

Before examining any long-term solutions to the foreclosure crisis, it is important to note the difficulty in distinguishing predatory lending and legitimate subprime lending. Subprime lending "serves the market of borrowers whose credit histories would not permit them to qualify for a conventional 'prime' loan" and, like predatory lending, is conducted primarily by non-bank institutions. While the Federal Deposit Insurance Corporation (FDIC) has acknowledged the close relationship between predatory lending and legitimate subprime lending, some distinction is important to preserve access to legitimate sources of subprime credit. However, there is no universally accepted definition of predatory lending, in part because mortgage loan terms that are predatory to some consumers may be affordable and appropriate for others.

Broadly stated, predatory loans are characterized by a "mismatch . . . between the borrower's financial circumstances, needs, and objectives and the loan that the professional lender offers." Such a mismatch may exist if the loan terms do not meet the borrower's needs for the mortgage, or if they are so disadvantageous to the borrower at the time of origination that there is little possibility the borrower will be able to repay the loan. I adopt this definition of predatory lending throughout this Comment to focus attention not on any specific predatory loan terms or practices but rather on the practice of selling

27. Predatory loans may include prime loans, but predatory loans typically are considered to be a subset of subprime loans. Engel & McCoy, supra note 8, at 1265.
29. See Engel & McCoy, supra note 8, at 1258. For example, in 2005, more than half of subprime loans were made by independent mortgage companies not subject to oversight by federal bank regulatory agencies. Laderman & Reid, supra note 11, at 5.
31. See id. at 4.
33. Id.
high-cost loans to consumers without regard to whether the loan is appropriate for the consumer’s financial situation. Examination of lending practices and loan terms commonly considered predatory reveals a common thread: predatory loans are not value enhancing for the borrower. I argue that for the purposes of determining lender liability to borrowers for exploitative mortgage lending, the law should adopt a flexible definition of predatory lending that facilitates case-by-case evaluation of the mortgage’s suitability for the individual consumer.

Regulators and scholars who define predatory lending with greater specificity typically catalogue loan terms and practices abusive to most borrowers; they recognize many predatory loans involve more than one predatory characteristic.\textsuperscript{34} For example, the FDIC has identified the following loan and lending characteristics that are potentially predatory:\textsuperscript{35}

1. abusive collection practices;
2. large balloon payments due at loan maturity, which are accompanied by lower monthly payments to disguise the true cost of the loan;
3. encouraging borrowers to default on an existing loan in order to refinance all or part of it with a new one;
4. equity stripping schemes, in which the lender depletes the borrower’s home equity by repeatedly refinancing a loan and applying new fees with each transaction;
5. loan fees in excess of the amount justified by the costs and risks involved;
6. interest rates in excess of the amount justified by risk-based pricing calculations;
7. fraud, deception, and abuse, which may include “inflating property appraisals and doctoring loan applications and settlement documents”\textsuperscript{36};
8. high loan-to-value ratios, which “effectively prohibit homeowners from selling their homes” or filing bankruptcy “without losing their home”;\textsuperscript{37}
9. lending without regard to borrower’s ability to repay, also known as asset-based lending;\textsuperscript{38}
10. loan flipping, in which mortgage originators refinance loans

\textsuperscript{34} See Office of Inspector Gen., Fed. Deposit Ins. Corp., \textit{supra} note 28, at 5; Engel & McCoy, \textit{supra} note 8, at 1260.
\textsuperscript{36} Id.
\textsuperscript{37} Id.
\textsuperscript{38} Asset-based loans are approved based on the value of the home, which is used as collateral. The FDIC noted that in some cases monthly payments on asset-based loans have “equaled or exceeded the borrower’s total monthly income,” soon resulting in foreclosure. Id.
"repeatedly in a short period of time without any economic gain for the borrower" and fold high fees into the loan balance;

(11) mandatory arbitration clauses that prevent predatory lending victims from suing for damages;

(12) pre-payment penalties;

(13) refinancing special subsidized mortgages that are favorable to borrowers with loans that offer borrowers less economic benefit;

(14) refinancing unsecured debt, such as credit card or medical debt, using a borrower's home as collateral;

(15) single-premium credit insurance, which requires the borrower to pay the total premium upfront as an additional amount financed in the loan, thus raising the amount of interest paid;

(16) spurious open-end loans that permit lenders to circumvent statutory disclosure requirements for closed-end credit, including HOEPA restrictions discussed in Part II.A infra, and borrowers' right of rescission;

(17) "steering" borrowers who qualify for lower-cost prime loans to high-cost subprime loans; and

(18) yield-spread premiums that lenders pay to mortgage brokers "based on the difference between the actual interest rate on the loan and the rate the lender would have accepted on the loan given the risks and costs involved," which incentivize mortgage brokers to steer borrowers to higher cost loans.

This extensive, but non-exhaustive list illustrates the creativity of predatory lenders and in turn the difficulty of regulating predatory lending simply by restricting or mandating disclosure of specific loan terms and lending practices.

In their comprehensive analysis of the law and economics of predatory lending, Kathleen Engel and Patricia McCoy group these specific lending practices and loan terms, as well as several not mentioned by the FDIC, into categories describing their impact on borrowers. According to Engel and McCoy, predatory loans fall into one or more of the following categories: "(1)
loans structured to result in seriously disproportionate net harm to borrowers,\(^{46}\) (2) harmful rent seeking,\(^{47}\) (3) loans involving fraud or deceptive practices,\(^{48}\) (4) other forms of lack of transparency in loans that are not actionable as fraud,\(^{49}\) and (5) loans that require borrowers to waive meaningful legal redress.\(^{50}\) The numerous manifestations of predatory lending described above provide context for examining the failure of existing anti-predatory lending laws. The complexities of mortgage lending provide unscrupulous lenders with numerous and varied opportunities to exploit borrowers for the lenders' financial gain. The extensive list of examples above suggests that legislation addressing abusive lending by mandating certain information disclosures or by prohibiting certain loan terms inevitably invites lenders to create new and unregulated means of extracting profits. Instead, a legislative solution is needed that confronts the essence of predatory lending by determining whether the loan at issue is value-enhancing for the borrower or mismatched to the borrower's financial situation.\(^{51}\)

II. SHORTCOMINGS OF EXISTING FEDERAL ANTI-PREDATORY LENDING STATUTES AND EXTERNAL BARRIERS TO RELIEF

There are currently numerous federal laws in place aiming to prevent predatory lending both directly and indirectly. Many of these laws ostensibly provide remedies to borrowers in foreclosure proceedings who have been victimized by predatory lending. Why then have predatory lending practices persisted, and why aren't more borrowers able to avoid foreclosure by seeking remedies through these federal laws?\(^{52}\) I argue that the federal government's

\(^{46}\) The first category, loans structured to result in disproportionate net harm to borrowers, encompasses asset-based lending, loan-flipping and equity stripping, steering, and negative amortization mortgages. \textit{Id.} at 1261–65. Negative amortization mortgages require borrowers to make scheduled payments insufficient to cover the interest due, which causes the loan principal to increase over time. \textit{Id.} at 1263. Lenders are able to finance loans in this category only by disregarding conventional loan underwriting norms. \textit{Id.} at 1262.

\(^{47}\) The second category, harmful rent seeking, occurs when lenders "charge rates and fees that exceed the rates and fees they would obtain in the competitive market," and may encompass steering and the inclusion of credit life insurance in the mortgage loan. \textit{Id.} at 1265–67.

\(^{48}\) The third category, fraud and deceptive practices, involves violation of state consumer protections laws or fiduciary duties, the statute of frauds, and federal disclosure laws such as RESPA, TILA, and HOEPA, discussed in Part II.A \textit{infra}. \textit{Id.} at 1267–68. Predatory lending committed through fraud and deceptive practices may be aimed at borrowers or at capital sources such as secondary-market loan purchasers, federal guarantors, and loan originators. \textit{Id.}

\(^{49}\) The fourth category describes loans that lack transparency but are not actionable under existing law, including loans that exploit loopholes in the federal disclosure laws, as discussed in Part II.A \textit{infra}. \textit{Id.} at 1268–70.

\(^{50}\) \textit{Id.} at 1260. The fifth category addresses loans that require borrowers to waive meaningful legal redress, including mandatory arbitration clauses, as well as prohibitions against joining class action lawsuits and clauses shifting lenders' attorneys' fees to borrowers. \textit{Id.} at 1270.

\(^{51}\) See Ehrenberg, \textit{ supra} note 32, at 125.

\(^{52}\) An estimated 16 percent of all home mortgages will foreclose in the next four years.
regulation of predatory lending has failed to stem the growing tide of foreclosures primarily for three reasons. First, by focusing on the disclosure, prohibition, and regulation of specific loan terms and lending practices, federal anti-predatory lending statutes have developed in a manner that is too under-inclusive and inflexible to adapt to the lending market as it evolves or to address the varying individual circumstances of borrowers. This line-drawing in federal anti-predatory lending laws thus has permitted lenders to craft mortgage products that fall outside the scope of federal protections but are nonetheless unsuitable for the individual borrower. Second, most aggrieved borrowers are effectively precluded from bringing equitable challenges to predatory loans at foreclosure because the current statutory framework does not affect the requirement that borrowers “do equity” by tendering the full amount of their debt to seek equitable relief during foreclosure proceedings.

Third, by preserving the “holder in due course” doctrine for all mortgages except those that fall under the Home Ownership and Equity Protection Act (HOEPA), the federal government has failed to ensure that many borrowers can avail themselves of the remedies provided by federal anti-predatory lending laws. Once a mortgage originator assigns the mortgage to another entity, the negotiable instrument law doctrine of “holder in due course” shelters the assignee from liability associated with the mortgage’s origination. Because mortgage assignment has become nearly universal given the widespread practice of securitization in the subprime market, the “holder in due course” doctrine in many cases negates borrowers’ remedies against the current holder of their mortgage. Further, because many non-bank lenders that originated subprime mortgages are now insolvent, assignee liability may be the best option for borrowers to access meaningful relief and assert defenses to

Maeve Elise Brown, supra note 6.

53. See Ehrenberg, supra note 32, at 125.

54. Congress abrogated the “holder in due course” doctrine only for mortgages that fall under HOEPA, discussed infra. 15 U.S.C. § 1641(d)(1) (2006). However, because the scope of predatory lending extends beyond the class of mortgages covered by HOEPA, this abrogation is insufficient.

55. Susan E. Hauser, Predatory Lending, Passive Judicial Activism, and the Duty to Decide, 86 N.C. L. REV. 1501, 1515–16 (2008). An assignee may nonetheless be liable for mortgage origination if the assignee took the negotiable instrument with notice of the problems at issue, here, the loan’s predatory characteristics. See U.C.C. § 3-302(a) (2002); JAMES J. WHITE & ROBERT S. SUMMERS, UNIFORM COMMERCIAL CODE (HORNBOOK SERIES) 509 (5th ed. 2000).

56. Hauser, supra note 55, at 1528.

57. In 2007, more than eighty subprime lenders went out of business; many more subprime lenders have since stopped new loan activity, declared bankruptcy, gone out of business, or been sold. Worth Civils & Mark Gongloff, Subprime Shakeout: Lenders that Have Closed Shop, Been Acquired or Stopped Loans, WALL ST. J. ONLINE, http://online.wsj.com/public/resources/documents/info-subprimeloans0706-sort.html (last visited May 27, 2010); see also FACTBOX: Subprime Lenders Sold, Closed, or Bankrupt, REUTERS.COM, May 10, 2007, http://www.reuters.com/assets/print?aid=USN0420974520070510 (documenting fifteen subprime lenders that closed, went bankrupt, or were sold between late 2006 and May 2007, representing only a “partial list” of total subprime lender closures).
foreclosure under anti-predatory lending laws.

In Part II.A, I briefly describe the major federal anti-predatory lending laws and their shortcomings. In Part II.B, I elaborate upon the "do equity" requirement and the "holder in due course" doctrine, which present practical barriers to borrowers seeking to challenge predatory loans.

A. Under-Inclusivity and Inflexibility of the Major Federal Anti-Predatory Lending Laws: RESPA, TILA, and HOEPA

Although numerous federal statutes regulate lending practices and aim to curb various aspects of predatory lending, there is currently no single federal law under which borrowers can seek comprehensive relief. Rather, a patchwork of federal statutes exists to address lending fraud, consumer education and counseling, nondiscrimination, and disclosure of loan terms. The utility of these federal statutes may be limited by the under-inclusivity of the statutes themselves and by the background law with which the statutes interact, such as the "do equity" requirement and the "holder in due course" doctrine. The statutes that most directly address predatory lending—namely the Real Estate Settlement Procedures Act (RESPA), the Truth in Lending Act (TILA), and

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58. In addition to the federal anti-predatory lending statutes, aggrieved borrowers may pursue state law claims for fraud or deceptive business practices. However, these causes of action are beyond the scope of this paper and are also limited by the "do equity" and "holder in due course" doctrines, discussed in Part II.B infra.


60. For example, the Home Equity Conversion Manager program is a consumer-counseling program administered by the Department of Housing and Urban Development (HUD) that is mandatory for senior citizens contemplating purchase of a reverse mortgage. Eric C. Seitz, U.S. Subprime Crisis: H.R. 3915—A Far-Sighted Solution to the Mortgage Crisis, 14 LAW & BUS. REV. AM. 759, 767 n.86 (2008); see also HUD Approved Housing Counseling Agencies, U.S. DEP’T OF HOUS. & URBAN DEV., http://www.hud.gov/offices/hsg/sfh/hcc/hcs.cfm?weblistaction=summary (last visited May 2, 2009).

61. The Equal Credit Opportunity Act prohibits creditors from discriminating against any applicant, with respect to any aspect of a credit transaction . . . on the basis of race, color, religion, national origin, sex or marital status, or age (provided the applicant has the capacity to contract); . . . because all or part of the applicant’s income derives from any public assistance program; . . . or because the applicant has in good faith exercised any right under this chapter.

15 U.S.C. § 1691(a). The Fair Housing Act prohibits discrimination on the basis of race, color, national origin, religion, sex, familial status, or disability, in the form of refusal to make a loan, refusal to provide information regarding loans, imposing different terms or conditions on loans, and property appraisal. 42 U.S.C. §§ 3604–06 (2006).


the Home Ownership and Equity Protection Act (HOEPA) require lenders to disclose certain loan terms to consumers and prohibit or restrict certain loan terms and lending practices.

RESPA was first enacted in 1974 to "help consumers become better shoppers for settlement services and . . . to eliminate kickbacks and referral fees that unnecessarily increase the costs of certain settlement services." Under RESPA, lenders and mortgage brokers must provide consumer borrowers with a good faith estimate of loan closing costs within three business days of the borrower applying for the loan, and must at closing provide the borrower with a detailed statement of the actual costs. Although providing consumers with information on loan costs in advance of closing may in theory enable some borrowers to avoid predatory loans, RESPA’s disclosure requirements are rendered largely ineffective because lenders and brokers are not held liable for failure to provide a good faith estimate of costs, and RESPA does not require lenders or brokers to advise borrowers of their right to review these final statements before closing. However, RESPA does establish a private right of action if a borrower can prove the lender “failed to inform the borrower that the loan could be transferred, received a kickback, or steered the borrower to a particular company in exchange for a referral fee.”

TILA, enacted in 1968 to require “meaningful disclosure of credit terms” and thereby encourage comparison shopping, provides that any material aspect of a loan must be disclosed to a mortgage borrower. Under TILA, home mortgage borrowers have a limited three-day right to rescind the mortgage, which extends to three years if the lender fails to notify the borrower of her rescission right or fails to disclose material loan terms. Upon rescission, the security interest in the home is voided automatically, and lenders or their assignees must void the mortgage and refund or credit any amount paid by the borrower within twenty calendar days of receiving the rescission notice. TILA provides for statutory and actual damages, as well as criminal penalties against lenders.

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68. Seitz, supra note 60, at 768 n.96.
69. Id.
at 768.
71. 12 C.F.R. § 226.23(a)(3) (2010). Material loan terms that lenders must disclose include “the annual percentage rate, the finance charge, the amount financed, the total of payments, the payment schedule, and the disclosures and limitations referred to in § 226.32(c) and (d) and 226.35(b)(2).” Id. at n.48.
72. 12 C.F.R. § 226.23(d)(1)–(2).
74. Id. § 1611.
However, TILA’s consumer protections are limited by significant loopholes in its disclosure requirements and by practical barriers to bringing suit. TILA does not require lenders to disclose fees for credit reports, inspections, appraisals, document preparation, title searches and insurance, notary and recording fees, and even taxes, which leaves room for lenders to conceal the real costs of consumers’ home loans. Further, the one-year statute of limitations has the practical effect of precluding borrowers’ remedies for undisclosed loan terms that do not go into effect for more than one year. For example, the statute of limitations would preclude many borrowers from seeking TILA remedies against lenders who do not disclose properly the terms of adjustable rate mortgages (ARMs), which frequently reset at higher interest rates after more than one year. For borrowers who beat the statute of limitations, actual damages often are difficult to obtain because borrowers must prove detrimental reliance on the lender’s erroneous disclosure. The reality that many borrowers do not read disclosure statements in their entirety means that they will be unable to establish the required causal link between the erroneous disclosure and their actual damages.

The federal statute that most directly addresses predatory lending is HOEPA, enacted in 1994 as an amendment to TILA to address concerns over reverse redlining in the mortgage industry. For mortgage loans that fall under the Act, HOEPA prohibits and restricts certain lending practices and loan terms that, while perhaps appropriate for some borrowers, are commonly considered predatory. These HOEPA provisions include prohibition of higher interest rates after borrower default, certain balloon payments, negative amortization, making more than two advance payments to borrowers from proceeds of the loan, and extending credit without regard to the payment ability of the consumer, as well as restrictions on prepayment penalties. HOEPA also addresses the often abusive practice of unnecessary refinancing by prohibiting refinancing a HOEPA loan within twelve months of closing, unless it is in the borrower’s best interest. To curb the practice of asset-based lending, in which a lender makes a loan based on the value of the home rather than the borrower’s repayment ability, a lender subject to HOEPA must document the borrower’s

75. Engel & McCoy, supra note 8, at 1269.
77. Seitz, supra note 60, at 769.
79. Reverse redlining refers to the practice of targeting vulnerable communities, particularly low-income and of color communities, for subprime and predatory loans. See sources cited supra note 19.
80. HOEPA prohibits balloon payments on any non-bridge loan with a maturity of less than five years. 15 U.S.C. § 1639(e).
81. Id. § 1639(c)-(h).
82. Asset-based lending is widely considered a predatory lending practice. See, e.g., Engel & McCoy, supra note 8, at 1262 (“These quintessential predatory loans often cause borrowers to suffer bankruptcy or lose their homes to foreclosure.”).
repayment ability, including “current and expected income, current obligations, and employment.”

HOEPA also adds specific disclosure requirements to those established by TILA. Significantly, HOEPA abrogates the “holder in due course” doctrine for loans that are covered by the Act. As explained in Part III.B infra, abrogation under HOEPA is significant because it preserves borrowers’ claims against mortgage assignees, unless the assignee can show that a “reasonable person” would not have realized the loan was regulated by HOEPA. HOEPA provides the TILA remedies of statutory and actual damages, as well as criminal liability.

Although HOEPA’s consumer protections appear powerful, the potential reach of its remedies is severely limited by the narrow scope of loans to which the Act applies. HOEPA restrictions only apply to “high-cost” home equity loans, and not to many of the most common types of mortgages, such as reverse mortgages, purchase money mortgages, or open lines of credit. More significantly, in order for HOEPA requirements to be triggered, the interest rates and total points and fees of home equity loans must exceed the minimum thresholds established by the Act. That the Act’s triggers are too

84. In addition to TILA disclosure requirements, lenders and brokers must disclose the annual percentage rate (APR) and the dollar amount of monthly payments in writing three business days before closing a HOEPA loan. For HOEPA-covered loans with adjustable interest rates, lenders and brokers must inform borrowers that the interest rate could increase and must disclose the maximum future monthly payment amount. Lenders and brokers also must disclose in writing the following: “You are not required to complete this agreement merely because you have received these disclosures or have signed a loan application,” and “If you obtain this loan, the lender will have a mortgage on your home. You could lose your home, and any money you have put into it, if you do not meet your obligations under the loan.” 15 U.S.C. § 1639(a)(1)(A), (B).
85. Id. § 1641(d).
86. Id.
87. Id. § 1640.
88. Id. § 1611.
89. Id. § 1640.
90. Id. supra note 55, at 1519.
91. With a reverse mortgage, a lender makes payments to the borrower from its home equity and subsequently recovers the loan principal plus interest upon the borrower’s sale of the home. About Reverse Mortgages for Seniors, U.S. Dep’t of Hous. & Urban Dev., http://www.hud.gov/offices/hsg/sfh/hecm/hecmabou.cfm (last updated Jan. 5, 2009).
92. A purchase money mortgage is “[a] mortgage executed to secure the purchase money or a part thereof by a purchaser of property, contemporaneously with the acquisition of the title thereto, or afterward, but as part of the same transaction.” Ballentine’s Law Dictionary 1027 (3d ed. 1969).
94. HOEPA requirements are triggered if the APR on the loan exceeds the yield on comparable Treasury securities by more than ten percentage points, or if total points and fees paid at or before closing exceed the greater of 8 percent of the total loan amount or $400. 15 U.S.C. § 1602(aa)(1) (2006). HOEPA applies to any creditor who originates two or more qualified mortgages in any twelve-month period, and to any creditor who originates one or more qualified
high to curb the bulk of predatory loans is made clear by Engel and McCoy's observation that HOEPA "has strong proscriptions but at best covers [only] the costliest five percent of subprime home loans."94 Although HOEPA grants the Federal Reserve Board authority to define "high-cost" loans that are subject to the Act's requirements, the Federal Reserve has not fully exercised this power to encompass a broader class of predatory loans.95 As a result, lenders have been able to continue issuing predatory loans without liability simply by avoiding prohibited terms and practices, while instead adding costs through loan terms that are not subject to HOEPA coverage.

The shortcomings of each of the federal disclosure laws (TILA, HOEPA, RESPA) and the proliferation of predatory lending practices since their enactment illustrate the limitations of the approach that federal anti-predatory lending statutes have taken to date. Namely, the prevailing approach of prohibiting certain loan characteristics and lending practices and mandating certain disclosures, which requires a type of line-drawing in the setting of thresholds that trigger legal protections, has proven too rigid and under-inclusive to prevent a worsening of the foreclosure crisis.96 Although the loan characteristics and practices these laws cover are problematic, lenders have and likely will continue to adapt to this type of statute by creating new, innovative products to exploit loopholes in any rigid regulatory scheme, while still originating risky mortgages unsuitable for borrowers. Further, disclosure provisions are effective only if those to whom the information is disclosed properly act on it, and thus place the onus of action on the borrower rather than the lender, whose familiarity with mortgage lending typically places her in a better position to determine the suitability of the mortgage to the borrower's means.

B. External Barriers to Existing Remedies: The "Do Equity" Requirement and the "Holder in Due Course" Doctrine

Borrowers who can make out a cause of action or defense to foreclosure under existing anti-predatory lending laws frequently are faced with practical barriers to suit, external to statutory requirements. When victims of predatory lending seek equitable relief from their loans during judicial foreclosure, their challenges frequently are thwarted by the requirement that they "do equity" by tendering the full amount of their debt before the court will hear their equitable challenge.97 Additionally, the background law governing negotiable...
instruments such as mortgages presents obstacles to borrowers' claims for predatory lending. In particular, many borrowers who seek to challenge their mortgage loans as predatory find that the "holder in due course" doctrine bars suit against the assignee who currently holds the mortgage note, and assignment of the mortgage precludes them from bringing suit against the mortgage originator. To effectively deter predatory lending and provide comprehensive remedies through a litigation-based private enforcement scheme, predatory lending laws must be buttressed by targeted abrogation of these external barriers that borrowers face when challenging predatory loans.

A fundamental maxim of equity jurisprudence is that "one who seeks equity must do equity." This "do equity" requirement applies in judicial foreclosure actions because they are equitable in nature. A court applying the "do equity" requirement can compel a borrower seeking equitable relief from foreclosure "to accommodate the equities favoring the [mortgage holder] by conditioning the plaintiff's relief upon the enforcement of those equities." In other words, a court of equity will not enjoin a foreclosure at the request of a borrower in default, unless the borrower tenders the full amount of the debt she owes to the holder of the mortgage. The rationale behind the "do equity" requirement is that "one who seeks to avoid the provisions of the written instrument must stand ready to discharge the implied obligation of repayment of the sum borrowed plus the lawful rate of interest." Repayment of the loan principal places the lender back in its original position, and repayment of interest at a legal rate compensates the lender for use of its funds. The "do equity" requirement applies in a judicial foreclosure so long as the "equitable rights favoring the [mortgage holder] arise from the same matter in controversy"—in this case the mortgage loan being foreclosed—and applies regardless of whether the borrower acted inequitably.

As a practical matter, the "do equity" requirement will prevent most borrowers in foreclosure from bringing equitable challenges to their mortgage loans, and should not apply where the foreclosure the borrower seeks to
challenge is on a predatory loan. The requirement itself calls for payment in full of outstanding debt principal and interest, which is onerous if not impossible for most homeowners. Borrowers facing foreclosure almost certainly cannot tender their full debt or they would not have defaulted on their mortgage payments initially. Although some borrowers are able to “do equity” by refinancing their mortgage with a new loan, refinancing is a limited and risky means of doing equity. Borrowers who are already in foreclosure proceedings likely face great difficulty in finding a lender willing to refinance their loan with terms that will be affordable to them going forward. Additionally, borrowers seeking to refinance risk falling prey to yet another predatory lender, particularly because their credit has been tarnished by their current foreclosure. This concern is heightened by indications that many brokers in the burgeoning loan-modification industry are former subprime brokers who originated the “exotic mortgages that have proved most prone to sliding into foreclosure.” As such, the “do equity” requirement precludes equitable challenges to predatory loans for many borrowers who otherwise would have a viable defense to foreclosure.

Another major obstacle borrowers face in seeking relief at foreclosure is the difficulty of identifying an entity to hold liable for predatory lending practices. The widespread securitization of home mortgages creates a “horizontally segmented lending process in which the tasks of funding, originating, serving, and holding mortgage loans are performed by legally unrelated business entities.” Securitization is the process by which revenue-producing assets such as mortgages are pooled together, and interests in the pool are sold to investors. These interests are termed “mortgage-backed securities.” The pooling of large numbers of mortgages minimizes the risk to the investor of individual borrower default, and transforms an illiquid asset (the individual mortgage) into a liquid asset for the seller of the mortgage and a low-risk cash flow for the investor. Securitization requires assignment of the mortgage to another entity after origination, and as such, mortgage loans are almost universally assigned.

Assignment of home mortgages triggers the application of the “holder in due course” doctrine. This doctrine, which applies to negotiable instruments

equitable avoidance of a usurious mortgage, borrower must “do equity by tendering the unpaid balance due plus interest at a legal rate”).

106. Telephone Interview with Katherine Porter, Visiting Assoc. Professor of Law, Univ. of Cal., Berkeley, Sch. of Law (Nov. 22, 2009).


108. Hauser, supra note 55, at 1516.

109. Id.

110. Id.

111. Id. at 1528.

112. A holder in due course is “(1) a holder (2) of a negotiable instrument,” such as a
including mortgages, shields the assignee (here, the current mortgage holder) from most liability associated with the mortgage origination. Thus, it precludes many borrowers from bringing a cause of action against the assignee to enforce federal or state anti-predatory lending laws. State contract law generally provides that the assignee of a contract stands in the place of the assignor, which precludes the other party to the contract from seeking redress directly from the assignor. The “holder in due course” doctrine creates an exception to this rule by “shielding the assignee of a negotiable instrument from most claims and defenses to payment that a borrower could assert against the assignor.” Mortgages are negotiable instruments subject to the “holder in due course” doctrine, and therefore mortgage assignees are shielded from liability for the originator’s violations of federal and state anti-predatory lending laws, unless the assignee knew of the borrower’s claims and defenses when the mortgage was assigned. Assignees may typically assert the “holder in due course” doctrine as a defense to borrowers’ claims.

As a practical matter, the inability to bring claims against the assignee who currently holds the mortgage often can negate a borrower’s remedies. Borrowers who seek to bring claims against their mortgage originator under federal anti-predatory lending laws may find that the originator, typically a non-bank institution, has vanished or is insolvent by the time they assert their claim. Because the “holder in due course” doctrine prevents recovery from the assignee, borrowers in these situations are left without legal recourse. The “holder in due course” doctrine similarly operates to negate many borrowers’ state law claims, such as fraud or deceptive business practices. As a result, even when borrowers are theoretically able to utilize existing anti-predatory lending laws, the interaction between these laws and the background of negotiable instrument law may preclude them from obtaining relief.

Although state courts have been reluctant to abrogate the “holder in due course” doctrine to extend liability to mortgage assignees, Congress and the FTC both have acted to negate the assignee’s “holder defense” in certain contexts. As discussed in Part II.A supra, Congress abrogated the “holder in due course” doctrine for mortgages that fall under HOEPA. As a result of this

mortgage, “who took it (3) for value (4) in good faith” and “(5) without notice of certain problems with the instrument.” WHITE & SUMMERS, supra note 55, at 509; see U.C.C. § 3-302(a) (2002).

114. Id. at 1527.
115. Id.
116. Id.
117. Id.
118. See, e.g., Civils & Gongloff, supra note 57; FACTBOX: Subprime Lenders Sold, Closed, or Bankrupt, supra note 57.
119. See, e.g., Melton v. Family First Mortgage Corp., 576 S.E.2d 365 (N.C. App. 2003) (declining to create an exception to the “holder in due course” doctrine to impose assignee liability for mortgagee conduct that amounts to unfair and deceptive trade practices under North Carolina law).
statutory abrogation, borrowers who have a HOEPA claim may bring claims against both the mortgage originator and the assignee for the originator’s violations. However, the effect of HOEPA’s abrogation of the “holder in due course” doctrine, like HOEPA coverage, is limited to only 5 percent of the most costly mortgage loans, because the minimum threshold interest rates and total points and fees required to trigger HOEPA coverage are set fairly high. In short, HOEPA’s abrogation of assignees’ “holder defense” is too limited in scope to ensure that all borrowers victimized by predatory lending are able to seek legal recourse when claims against their originators are not viable.

In the 1970s, the FTC abrogated the “holder in due course” doctrine in the sale of most consumer goods and services, except in contracts for the sale of real property. Where this abrogation does apply, the FTC’s Holder in Due Course Regulations provides that any assignee takes the instrument subject to all of the borrower’s claims and defenses. However, the “holder in due course” doctrine continues to preclude assignee liability for an originator’s predatory lending as a result of the exception for real estate sales contracts. In Part III.B infra, I assert that there is no principled reason for excluding real property sales from the FTC regulation. To the contrary, the mortgage sales context is particularly appropriate for the doctrine’s abrogation, because pooled mortgage securitization in combination with the “holder in due course” doctrine creates perverse incentives for brokers to issue large volumes of loans without sufficient assurance of borrowers’ repayment abilities.

III. CRAFTING A LITIGATION-BASED PRIVATE ENFORCEMENT SCHEME TO EXPAND RELIEF FROM PREDATORY LOANS AND DETER PREDATORY LENDING

As discussed in Part II, the prohibitions contained in the federal anti-predatory lending laws are too inflexible and under-inclusive to deter and prevent predatory lending practices or to permit all aggrieved borrowers to challenge their predatory loans at foreclosure. Further, borrowers are frequently unable to access remedies under these laws, because their mortgage originator is insolvent and claims against their current mortgage holder are precluded by the “holder in due course” doctrine, or because they cannot tender the balance due on their loan to “do equity.” To address these shortcomings in existing federal law, I propose four congressional and agency actions to effectuate a litigation-based private enforcement scheme. First, Congress should place upon mortgage brokers and lenders a fiduciary duty to ensure that the mortgages they sell are suitable to the borrower’s financial situation. A lender suitability duty of care, which has been proposed in various forms by scholars and has inspired

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120. See Engel & McCoy, supra note 94, at 2069.
121. Hauser, supra note 55, at 1517.
122. 16 C.F.R. § 433.2 (2010); U.C.C. § 3-106(d) (2002).
state anti-predatory lending legislation, would serve as a more flexible liability standard for determining when lenders have engaged in abusive practices.

Second, Congress must pass targeted legislation that proscribes application of the "do equity" requirement when borrowers make a threshold showing that the mortgage loan they are challenging in judicial foreclosure is predatory. Third, the FTC must abrogate the "holder in due course" doctrine in all mortgage sales. This will make remedies against mortgage assignees available to all borrowers with federal and state predatory lending claims, not just to those borrowers with HOEPA claims. Finally, to complement the deterrent and remedial impact of private litigation with a backdrop of regulatory oversight, Congress must extend coverage of the Community Reinvestment Act (CRA) to all mortgage lenders, not just depository institutions. Because the obligations imposed upon depository institutions by the CRA are correlated with lower rates of issuing high-cost loans, and because the increased availability of CRA loans could help "steer" borrowers susceptible to predatory lenders to safer mortgages, expansion of CRA coverage to all mortgage lenders would help reduce predatory lending industry-wide. I discuss expanded CRA coverage in Part IV infra.

A. Adopting a Flexible Anti-Predatory Lending Standard Through a Lender Suitability Duty of Care

As discussed in Part II supra, existing federal laws have not effectively eliminated predatory lending largely because the prohibition of specific loan terms and practices, as well as rigid thresholds for statutory coverage, allow lenders to circumvent easily the law's purview by placing costs on borrowers in unrestricted ways. Abrogating the "do equity" requirement for predatory lending victims and eliminating the "holder in due course" doctrine in mortgage sales would allow a broader class of borrowers to obtain relief under existing laws. However, even assuming the removal of these barriers, lenders likely would continue to sell mortgages with unfavorable terms that would not give rise to a cause of action under existing law, but nonetheless would be unsuitable to the borrower's financial situation.

To provide a flexible standard for determining lender misconduct in home mortgage lending, Congress should establish a federal lender "suitability duty of care" (or "suitability duty") modeled after the suitability doctrine in securities law. Several scholars have proposed applying the suitability doctrine in this way as a means of more directly addressing the harms of predatory lending, and several states have adopted variations on suitability to address predatory lending. 123 Further, the suitability duty's flexible liability standard is

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123. For example, North Carolina's anti-predatory lending law prohibits lending based solely on collateral rather than a borrower's repayment ability, and the New York Banking Board provides for revocation of mortgage brokers' and lenders' licenses for "unfair, deceptive or
an integral part of the litigation-based private enforcement scheme I advocate, because it would permit aggrieved borrowers to seek relief at foreclosure from a broader class of predatory loans than recognized under current law. By broadening the class of exploitative loans borrowers may avoid during foreclosure, the suitability duty, in combination with the other proposals herein, will help to stem the current tide of mortgage foreclosures.

To explore these ideas, I first introduce the basic concepts of the suitability doctrine in the securities context. Second, I explore two existing proposals for applying the suitability duty to mortgage lenders, and make recommendations about how the duty should be applied. Third, I discuss options for remedies that would be available for violations of the suitability duty, including existing proposals and additional recommendations. Finally, I discuss the proposed Mortgage Reform and Anti-Predatory Lending Act of 2009, which purports to adopt a more effective liability standard for predatory lending, and the bill's shortcomings.

1. The Suitability Doctrine in Securities Law

Applying the suitability doctrine to the mortgage lending industry would place upon mortgage lenders a fiduciary duty to borrowers similar to the duty owed by other financial professionals to their clients, namely that of broker-dealer to investor. In the context of the buying and selling of securities, "broker-dealers have a duty to deal fairly with their customers and to provide investment advice that is suitable to the needs of the investor."124 Applied to the mortgage lending context, this lender suitability duty would serve as a federal anti-predatory lending standard flexible enough to respond to innovative mortgage products designed to circumvent anti-predatory lending laws. At the same time, the suitability duty would permit lenders to sell to some borrowers mortgage products commonly considered risky or predatory, but nonetheless suitable for the individual borrower's financial situation—thus preserving borrowers' free choice in selecting financial products.

The suitability doctrine initially developed in securities law as a doctrine requiring broker-dealers to ensure that their customers could cover their trades.125 Today, the suitability doctrine in securities law has "evolved into a doctrine to protect investors from having broker-dealers either make or persuade investors to make inappropriate investments."126 In the securities context, the suitability doctrine also has gained acceptance in the insurance industry—particularly in the sale of insurance products with investment unconscionable practices in the course of advertising, brokering or making high cost home loans." Engel & McCoy, supra note 8, at 1319–20; see also Ehrenberg, supra note 32, at 120.
124. Ehrenberg, supra note 32, at 120.
125. See id.
126. Id.
features, such as variable annuity policies and variable life insurance.\textsuperscript{127} Significantly, several states and the federal government already have adopted variations on suitability requirements in their efforts to curb predatory lending through regulation of high-cost loans.\textsuperscript{128}

When brokers breach their duty under the suitability doctrine in the securities context, investors may bring claims against them under one of two theories of recovery. Both theories have the antifraud requirement of scienter,\textsuperscript{129} involving intentional or reckless conduct on the part of the broker in selling an investment that he knows is unsuitable for the investor's financial situation.\textsuperscript{130} Under the misstatement-omission theory, broker-dealers misrepresent that the recommended security is suitable for their client, or they fail to inform the client that the recommended security is unsuitable for their financial means and needs.\textsuperscript{131} Under the fraudulent conduct theory, aggrieved investors assert their broker acted fraudulently in recommending or engaging in a transaction based on a security unsuitable for the investor.\textsuperscript{132}

The suitability of an investment for a particular customer in the federal securities context is determined case-by-case based on a general reasonableness standard, rather than a set of particularized conduct rules such as those that currently characterize federal anti-predatory lending laws.\textsuperscript{133} This general standard for defining suitability has been described as imposing a duty on the broker to have "a reasonable basis for recommending a security or investment strategy."\textsuperscript{134} For example, the Securities and Exchange Commission (SEC), in its adjudicatory decisions, has established the overarching requirement that broker-dealers shall not "recommend a security unless there is an adequate and reasonable basis for such recommendation."\textsuperscript{135} To establish a reasonable basis, a broker-dealer must conduct a reasonable investigation into the customer's financial circumstances, base the recommendation on this investigation, and

\textsuperscript{127.} Engel & McCoy, supra note 8, at 1329-34.
\textsuperscript{128.} Id. at 1319-20. For example, HOEPA prohibits lenders from making high-cost loans without regard to the borrower's repayment ability; regulations implementing this provision require lenders to consider the borrower's current and expected income, current financial obligations, and employment in order to make this determination. 12 C.F.R. § 226.34(a)(4) (2010). North Carolina's anti-predatory lending law similarly requires lenders to assess borrowers' repayment ability; the standard is presumptively met when the borrower's total monthly debts, including the high-cost loan at issue, is equal to or less than 50 percent of their gross monthly income, which must be verified. N.C. GEN. STAT. § 24-1.1E(c)(2) (2009).
\textsuperscript{129.} In this context, scienter is a "mental state consisting in an intent to deceive, manipulate, or defraud." BLACK'S LAW DICTIONARY 1463 (9th ed. 2009).
\textsuperscript{130.} Ehrenberg, supra note 32, at 120.
\textsuperscript{131.} Id.
\textsuperscript{132.} Id.
\textsuperscript{133.} Engel & McCoy, supra note 8, at 1342.
\textsuperscript{134.} Id. (quoting Mark J. Astarita, Brokers Have to Be Their Own Judge, RES. MAG. (Mar. 1997), available at http://www.seclaw.com/docs/397.htm).
\textsuperscript{135.} Hanly v. Sec. & Exch. Comm'n, 415 F.2d 589, 597 (2d Cir. 1969).
take into account the customer’s risk threshold.\textsuperscript{136} Similarly, the National Association of Securities Dealers (NASD) requires its members to learn the essential facts relative to their customers and to understand their customers’ financial situation and investment needs; failure to do so results in unsuitable transactions and constitutes a violation of the Self-Regulatory Organization (SRO) broker-dealer code of conduct.\textsuperscript{137} Significantly, broker-dealers are not liable for securities that performed poorly, but were suitable at the time of purchase.\textsuperscript{138}

2. Existing Proposals for a Lender Suitability Duty and Further Recommendations

Given the similarities between the roles of investment broker and mortgage broker in selling financial products to consumers, the doctrine lends itself to adaptation in the mortgage lending context. As such, several scholars have crafted proposals for applying a suitability duty to mortgage lenders to deter predatory lending.

Daniel Ehrenberg, former Deputy General Counsel of the Neighborhood Reinvestment Corporation, has suggested the following elements to prove a cause of action for predatory lending based upon the suitability doctrine in the securities context:

(1) that the loan made with the borrower was unsuited to the borrower’s financial circumstances, needs, and objectives; (2) that the defendant knew or reasonably believed that the loan was unsuited to the borrower’s financial circumstances, needs, and objectives; (3) that the defendant made the unsuitable loan with the borrower anyway; (4) that, with scienter, the defendant made material misrepresentations (or failed to disclose material information) relating to the suitability of the loan; and (5) that the borrower justifiably relied to its detriment on the defendant’s conduct.\textsuperscript{139}

In his formulation, a lender suitability duty would require lenders to make a reasonable inquiry into the borrower’s financial circumstances, needs, and

\textsuperscript{136} Id.

\textsuperscript{137} Ehrenberg, supra note 32, at 121–22 n.31 (noting the “New York Stock Exchange leaves it up to the judgment of the broker-dealer to determine what facts are essential, based upon the specific circumstances of the account [but] does suggest a number of factors that a broker-dealer should consider examining”).

\textsuperscript{138} Engel & McCoy, supra note 8, at 1324.

\textsuperscript{139} Ehrenberg, supra note 32, at 125–26. Ehrenberg proposes several factors from the securities context to establish detrimental reliance. Specifically, the courts would evaluate:

(1) the sophistication and expertise of the plaintiff in financial matters; (2) the existence of a long-standing business or personal relationship; (3) access to relevant information; (4) the existence of an explicit fiduciary relationship; (5) concealment of the fraud; (6) the opportunity to detect the fraud; (7) whether the plaintiff sought out the lender and hastened to expedite the consummation of the loan; and (8) generality or specificity of the misrepresentations and disclosures.

Id. at 126.
objectives; to make an informed, good-faith judgment that the loan terms match the borrower’s financial circumstances, needs, and objectives based upon the information the lender obtains from this inquiry and the lender’s knowledge of mortgage products; to disclose truthfully to the borrower all loan terms and conditions; and to assist the borrower in understanding how the loan meets the borrower’s financial circumstances, needs, and objectives. Ehrenberg’s proposed suitability duty adheres to the general reasonableness standard of securities law, and would be applied by courts on a case-by-case basis by assessing the lender’s actions and the borrower’s circumstances and needs at the time of mortgage origination.

Professors Engel and McCoy have formulated a detailed proposal for application of the suitability doctrine to subprime mortgage lending based on securities law, but with notable differences in how “suitability” would be defined and by whom. First, Engel and McCoy propose a “multiple gatekeeper system” analogous to that in the securities context, in which the suitability duty may be enforced by the industry, the government (through a single federal regulatory agency), and private individuals. Second, they propose voluntary industry self-regulation. This would be effected by a legislative requirement that all brokers and lenders form and join a national exchange or SRO, approved by the federal government, which would in turn be required to “adopt rules obligating its members to refrain from deceptive or exploitative lending practices,” to promote “just and equitable principles of trade,” and to adopt a suitability requirement. Third, they advocate a new federal cause of action for breach of a suitability duty, either by legislating a freestanding requirement or by amending an existing statute such as the FTC Act or HOEPA.

In defining suitability, Engel and McCoy propose a departure from what they consider the “remarkably vague standard” applied in the securities context and recommend that an authorized federal agency establish rule-based definitions of suitability, rather than courts on a case-by-case basis. Engel and McCoy argue that for subprime lending, particularized suitability rules are preferable to the broad reasonableness standard from securities. This is because suitability in securities cases addresses only the risk posed by an
investment that the customer has already purchased, and neither the customer’s ability to pay nor the purchase terms are at issue.\textsuperscript{149} In contrast, suitability determinations in subprime lending would require examination of “an array of loan terms and the borrower’s ability to meet those terms, rather than the reasonableness of assessments about the future performance of an investment.”\textsuperscript{150} This suitability analysis, they posit, is inherently more difficult in the lending context and could degenerate into general price regulation.\textsuperscript{151}

Instead of a general reasonableness standard, Engel and McCoy propose reducing the suitability duty to specific rules.\textsuperscript{152} To first establish baseline regulation of loan-pricing terms and practices in the subprime market, they propose the following rules for lenders and brokers: (1) prohibit “selling subprime loans that borrowers cannot repay out of current income, based on reasonable investigation and the consideration of all material facts known to the brokers or lenders at the inception of the loans”;\textsuperscript{153} (2) require that all loan fees and charges “be transparent and conform to legitimate pricing functions, as defined by the [federal] implementing agency”;\textsuperscript{154} (3) require that loan refinancing have an economic rationale for borrowers, to eliminate loan flipping and refinancing at higher interest rates without benefit to borrowers;\textsuperscript{155} and (4) prohibit selling subprime loans to borrowers who qualify for prime loans.\textsuperscript{156}

Engel and McCoy also depart from the securities application of suitability in their recommendation for who should establish the particularized rules for defining suitability. Because case-by-case determinations of suitability by the courts could result in price regulation, and because courts lack expertise in economic analysis and cannot solicit public input, they recommend that Congress authorize a federal regulatory agency to define specific terms and practices that are unsuitable, subject to formal rulemaking procedures.\textsuperscript{157} Under this regime, courts would lack the ability to find certain loan terms and practices unsuitable for a particular borrower’s circumstances at the time of origination unless such terms or practices were specifically prohibited by the federal agency.\textsuperscript{158}

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149. Id.
150. Id.
151. Id. at 1343.
152. Id.
153. Id. This rule would prohibit asset-based lending on owner-occupied properties and require lending according to underwriting guidelines. Id.
154. Id. at 1343. For example, lenders would be required to document that “points assessed represent a tradeoff for interest, as is true in the prime market.” Id.
155. Id.
156. Id.
157. Id. at 1345.
158. Id.
\end{flushright}
In recommending a suitability duty for the private enforcement scheme that I advocate, I borrow from and build upon both Engel and McCoy’s and Ehrenberg’s proposals to broaden most effectively the class of aggrieved borrowers who may seek relief from their predatory loans at foreclosure, thereby maximizing the ameliorative impact of private enforcement on the current foreclosure crisis. Implementation of a lender suitability duty requires federal legislation. In the securities context, private enforcement of unsuitability claims is brought under the antifraud provisions of the Securities Exchange Act of 1934. Congress can most readily place this duty upon mortgage lenders by amending existing anti-predatory lending statutes to incorporate a “suitability duty of care,” which would then serve as a flexible standard for determining mortgage lenders’ liability to borrowers for predatory lending. Borrowers should be able to enforce the duty through a private right of action, and the duty should not replace the existing federal prohibitions or federal agency regulation of the mortgage lending industry. Rather, the lender suitability duty I propose would allow courts to make a determination of predatory lending on a case-by-case basis under a flexible liability standard, while preserving separate claims for loan terms and lending practices prohibited by RESPA, TILA, and HOEPA, discussed in Part II.A supra. By avoiding the line-drawing that currently characterizes these federal statutes and enables unscrupulous lenders to avoid easily the law’s purview, this suitability standard would allow courts to address the heart of predatory lending: “whether a mismatch exists between the borrower’s financial circumstances, needs, and objectives and the loan that the professional lender offers.”

While Engel and McCoy persuasively argue that a general reasonableness standard for suitability could lead to general price regulation, and that federal agencies are better positioned to engage in economic analyses of lending practices than the courts, judicial determination of suitability on a case-by-case basis may nonetheless be a desirable and viable option. Engel and McCoy

159. For the reasons set forth by Engel and McCoy, it is also desirable for Congress to effectuate industry self-regulation and a “multiple-gatekeeper system” in which suitability violations also may be enforced by industry and a federal oversight agency. Id. at 1337, 1341, 1338–39. However, because my proposal focuses on reducing foreclosures by enabling a broader class of aggrieved borrowers to seek relief from predatory loans, I will not explore these propositions in depth.


161. Engel & McCoy, supra note 8, at 126.

162. The relevant federal regulating agencies include the Office of the Comptroller of the Currency, Treasury (OCC); Board of Governors of the Federal Reserve System (Board); Federal Deposit Insurance Corporation (FDIC); Office of Thrift Supervision, Treasury (OTS); and National Credit Union Administration (NCUA). Federal Bank Regulatory Agencies, Commonwealth of Massachusetts Office of Consumer Affairs & Business Regulation, http://www.mass.gov/?pagelD=ocamodulechunk&L=4&L0=Home&L1=Consumer&L2=Banks+%26+Banking&L3=Selecting+Banks+%26+Credit+Unions&sid=Eoca&b=terminalcontent&f=dob_feds&csid=Eoca (last visited Oct. 25, 2010).

163. Ehrenberg, supra note 32, at 130.
recognize that the rule-based system they advocate is “substantially more prone to evasion [by lenders] than an open-ended suitability standard,” but conclude that their concerns, as well as the need for lender certainty and public input through notice and comment, outweigh the danger of lenders evading a rule-based approach. However, although a federal regulatory agency could amend suitability rules to include new and innovative predatory practices as they arise, there would necessarily be a lag time between when lenders craft new, exploitative mortgage products and when the regulatory agency identifies the new practices as abusive. In that time, borrowers may purchase—and even enter foreclosure on—unregulated, but nonetheless unsuitable, predatory loans. Further, because the priorities of federal regulatory agencies change along with the presidential administration, the agency may not consistently employ a consumer-protective approach.

Also, judicial determination of suitability on a case-by-case basis could result in inconsistent standards between and within jurisdictions. Although this concern suggests that the agency definition of suitability through defined rules may be preferable, the judicial definition based on a reasonableness standard may nonetheless be viable. In most cases, it likely will be fairly straightforward to determine whether the loan was unsuitable at the time the lender sold it, based on whether the lender made a “reasonable inquiry into the borrower’s financial circumstances, needs and objectives.” Based on this inquiry and the lender’s knowledge of mortgage products, a court should be able to determine whether the lender made “a good-faith and informed judgment” that they matched the loan terms. To guide the court in determining whether the lender made a reasonable inquiry, Ehrenberg suggests that courts evaluate whether the lender inquired into the borrower’s

age, occupation, estimated income, working status, assets and net worth, marital status, number of dependents, credit references and history, condition, appraised value and equity of the property to be mortgaged, repayment ability, other debts of the borrower and the borrower’s family, need for and use of loan proceeds, sophistication in financial matters, number of mortgages and refinancings that borrower has obtained, [and the] proposed objective of the loan.

In the absence of industry standards for subprime lending, courts can use expert testimony from other lenders to determine whether the defendant’s recommendation in these circumstances constituted an informed, good-faith judgment. Similarly, it will typically be straightforward to determine whether the lender “truthfully disclose[d] all of the terms and conditions of the loan to the borrower” and assisted “the borrower in understanding how [the] loan

164. Engel & McCoy, supra note 8, at 1344.
165. Ehrenberg, supra note 32, at 126.
166. Id.
167. Id.
meets the borrower’s financial circumstances, needs, and objectives,” based on
the loan disclosure documents and the parties’ testimony. In cases where
these determinations are more difficult to make, courts may analogize to
precedent from predatory lending cases brought under state and federal law, or
even from suitability cases in the securities context.

Whether Congress legislates a rules-based suitability definition
determined by federal regulators, or a general reasonableness definition
determined by the courts based on the specific borrower’s circumstances, a
borrower may prove a suitability violation using the five elements adapted by
Ehrenberg from the securities context, listed above. The lender’s actions in
recommending the loan would have to be intentional or reckless, and as in
the securities context, lenders would not be liable for loans that were suitable at
the time of origination but later became unaffordable for reasons beyond the
lender’s control.

To impact the current mortgage foreclosure crisis, legislation enacting the
suitability duty would apply retroactively, such that borrowers who received
unsuitable loans prior to enactment that did not fall under the limited
prohibitions of existing federal law nonetheless would be able to seek relief
from an unsuitable loan at foreclosure. Although this proposition likely would
face staunch opposition from the lending industry, retroactive application is
justified by the current and predicted scope of foreclosures and the
substantial evidence that lenders have exploited information asymmetries to
originate abusive subprime loans, which have caused a disproportionate share
of foreclosures.

3. Potential Remedies for Violations of the Suitability Duty

Scholars and commentators have made a variety of recommendations for
remedies available to borrowers for lenders’ violations of the suitability duty.
Ehrenberg has suggested that the borrower be enabled to have the unsuitable
loan “unwound by the court,” to have the interest rate and other unsuitable
terms reduced or refunded, and to recover damages, possibly even treble
damages and attorney’s fees. Engel and McCoy suggest that a lender
suitability duty be enforceable by allowing both the federal government and
aggrieved borrowers to sue for loan reformation, disgorgement, and damages—
thus forcing predatory lenders to internalize their costs. The proliferation of
predatory lending practices and the scope of the current foreclosure crisis

168. Id.
169. See id. at 125–26.
170. Id.
171. See Engel & McCoy, supra note 8, at 1325.
172. See supra notes 1–6.
173. Ehrenberg, supra note 32, at 128.
174. Engel & McCoy, supra note 8, at 1319.
suggestion that a combination of these remedies should be available both to make predatory lending victims whole and to effectively deter lenders from marketing loans unsuitable for consumers.

For the suitability cause of action to help ameliorate the ongoing foreclosure crisis, borrowers who establish a suitability violation must be able to avoid the unsuitable loan at foreclosure. Loan rescission, a remedy already available to borrowers under federal law, should also be available to borrowers who establish a suitability claim. As proposed by Engel and McCoy, a lender’s suitability violation should be an absolute defense to foreclosure.

4. The Mortgage Reform and Anti-Predatory Lending Act of 2009

Members of Congress have considered some type of duty for mortgage lenders. The Mortgage Reform and Anti-Predatory Lending Act, an amendment to TILA passed by the House and referred to the Senate Committee on Banking, Housing, and Urban Affairs in May 2009, included anti-predatory lending provisions and would have established a federal duty of care for mortgage originators. In establishing this duty of care, the bill would have required that mortgage originators (1) be qualified, registered, and licensed as a mortgage originator; (2) “diligently work to present the consumer with a range of residential mortgage loan products for which the consumer likely qualifies and which are appropriate to the consumer’s existing circumstances, based on information known by, or obtained in good faith by, the originator”; (3) make full disclosures to consumers; (4) certify to creditors that the lender has complied with all mortgage origination requirements; and (5) include on all loan documents the lender’s unique identifier “provided by the Nationwide Mortgage Licensing System and Registry.” A mortgage loan would be presumed appropriate for a borrower if “the mortgage originator determines in good faith, based on then existing information and without undergoing a full underwriting process, that the consumer has a reasonable ability to repay and, in the case of a refinancing of an existing residential mortgage loan, receives a net tangible benefit” and “the loan does not have predatory characteristics or effects (such as equity stripping and excessive fees and abusive terms).” The bill explicitly stated it would not create a fiduciary duty between mortgage originator and borrower, but the bill would eliminate compensation that incentivizes mortgage originators to “steer” applicants to higher-cost

175. See Part II.A supra.
176. Engel & McCoy, supra note 8, at 1352.
178. Id. § 102.
179. Id. (emphasis added).
180. Id. (emphasis added).
181. Id.
mortgages, such as yield spread premiums discussed in Part I supra.182

While the bill’s introduction of a lender duty of care is promising, it falls short of imposing a flexible anti-predatory lending standard comparable to the suitability doctrine. First, although the bill would require that lenders “diligently work to present the consumer” with options “appropriate to the consumer’s existing circumstances, based on information known by, or obtained in good faith by, the originator,” the use of “appropriate” rather than “suitable” suggests a conscious decision not to adopt the suitability doctrine. Further, the bill expressly disclaimed creation of a fiduciary duty between lender and borrower, which confirmed that the term “appropriate to the consumer’s existing circumstances” is not equivalent to a suitability standard.

Second, the requirement that mortgage loans “not have predatory characteristics or effects” appears to adhere to the approach taken in existing anti-predatory lending laws of identifying and prohibiting certain loan terms and lending practices. While such regulations are a crucial part of preventing predatory lending, a more complete solution would adopt a suitability duty to allow case-by-case assessments of the appropriateness of the loan to the borrower’s needs and abilities. Further, the suitability duty would place the burden of proving the legitimacy of the lending practice squarely and definitively on lenders, whose financial expertise generally makes them more capable of determining the suitability of loans to borrowers’ needs.

B. Eliminating Practical Barriers to Suit: Targeted Abrogation of the “Do Equity” Requirement and “Holder in Due Course” Doctrine

For the prospect of litigation and damages to deter lenders from issuing loans unsuitable for borrowers, Congress and the FTC must eliminate two key barriers to suit presented by the “do equity” requirement and the “holder in due course” doctrine, discussed in Part II.B supra. The rationales underlying each doctrine and their impact on aggrieved borrowers reveal that their application in the context of challenges to predatory loans is unwarranted and contrary to public policy.

As discussed in Part II.B supra, borrowers who seek equitable relief from their mortgages during judicial foreclosure are required to “do equity” by paying what they owe on their mortgage before the court will consider an equitable challenge. Because this is usually an insurmountable obstacle, the “do equity” requirement precludes many predatory lending victims from seeking relief from their loans at foreclosure. However, because “do equity” is an equitable doctrine, its application arguably should be conditioned on the terms of the challenged loan being equitable to the borrower. In cases where the borrower challenges the defaulted loan as predatory, the premise of the “do equity” requirement—that the borrower is fulfilling an equity by paying what is

182. Id. § 103.
owed on the note—does not apply because the terms of the mortgage are themselves inequitable to the borrower.183 Further, because this requirement effectively bars many aggrieved borrowers from seeking relief to which they otherwise would be entitled, its application is contrary to the public policy of providing meaningful remedies to predatory lending victims, as embodied in the federal anti-predatory lending laws discussed in Part II.A supra.

Despite the obvious injustice to predatory lending victims done by the “do equity” requirement, there is little case law supporting the proposition that the requirement should not apply when the foreclosure is occurring on a predatory loan.184 Targeted legislation is needed to eliminate the requirement that borrowers facing foreclosure “do equity” before they may challenge their mortgage loan on equitable grounds, where the borrower makes a threshold showing that the loan being foreclosed is predatory. Because the “do equity” requirement serves as a barrier to borrowers’ equitable relief from predatory loans during judicial foreclosure in all but the most exceptional of cases, its elimination in equitable challenges to foreclosures on predatory loans is a necessary complement to effective anti-predatory lending legislation.

Additionally, the FTC must abrogate the “holder in due course” doctrine in the home mortgage context, as has been done in other consumer credit settings, in order to provide all consumers with meaningful legal recourse under federal anti-predatory lending laws,185 regardless of whether their mortgage loan falls under HOEPA protections. The FTC excepted mortgage transactions from its abrogation of the holder doctrine likely due, at least partly, to opposition from the mortgage lending industry, which has profited considerably from the reduced risk to investors in mortgage-backed securities enabled by the holder doctrine. I examine below the rationale for the doctrine’s abrogation in other consumer contexts and several anticipated objections to the doctrine’s abrogation, and conclude that there is no principled reason to maintain the “holder in due course” doctrine in the sale of mortgages.

The “holder in due course” doctrine originally developed to increase access to capital by making negotiable instruments, including mortgages, freely transferable through assignment to another entity.186 Today, however, consumer credit has become easily accessible, and therefore this rationale for the holder doctrine has become “obsolete in the consumer context.”187 It was

184. See id. (partnership case suggesting that the requirement of “doing equity” is not absolute).
185. For the reasons discussed above, abrogation of the holder doctrine in the real estate context would also facilitate borrowers’ recovery in state law claims, which are not the focus of this Comment.
186. Hauser, supra note 55, at 1517. The idea was that purchasers of securities will be drawn to low-risk investments, and mortgage-backed securities were thought to decrease risk of default to the investor by pooling together large numbers of mortgages for division and purchase.
187. Id. at 1516–17.
recognition of the doctrine's obsolescence in the consumer context that prompted the FTC to abrogate the doctrine in the sale of most consumer goods in the 1970s. At first blush, it may appear that the contraction of the subprime mortgage credit market, as a result of the current foreclosure crisis, leaves a role for the holder doctrine in mortgage sales, given the doctrine's original purpose of making consumer credit easily available. However, it is unknown whether the holder doctrine has played any legitimate role in preserving consumer mortgage credit, and several academics have commented that "on balance the world is better off with abolition of the holder in due course doctrine in consumer transactions." Moreover, as discussed below, application of the holder doctrine to mortgage sales has created perverse incentives for brokers to issue mortgages without regard to borrowers' repayment abilities, resulting in high rates of borrower default on subprime loans. The social costs of the resulting foreclosures should be given at least as much weight as promoting subprime consumer mortgage credit through preservation of the holder doctrine.

Opponents of abrogation would argue that extending liability to mortgage assignees would make investment in mortgage-backed securities riskier to investors (and thus less lucrative for brokers who sell or assign mortgages for securitization), ultimately drying up the mortgage market. However, preservation of the low-risk mortgage-backed securities market cannot justify continuation of the holder doctrine, because the doctrine incentivizes brokers to sell large volumes of mortgages without sufficient attention to borrowers' repayment abilities. The widespread assignment of mortgages for the sale of mortgage-backed securities allows originators to profit whether or not borrowers repay their loans, and as such has largely removed the incentive for originators to verify borrowers' repayment abilities. As such, the holder doctrine has enabled the mortgage-backed securities market to flourish with very little risk to investors of liability for predatory lending, but at the expense of financially unsophisticated borrowers who find themselves unable to afford their mortgages in the long-run.

Abrogation of the holder doctrine would allow borrowers to bring predatory lending claims against the assignee-holder, which would in turn prompt assignees and investors to seek greater assurances that the mortgages

188. Id. at 1517.
189. See, e.g., Civils & Gongloff, supra note 57; FACTBOX: Subprime Lenders Sold, Closed, or Bankrupt, supra note 57; see also Scott Horsley, Big Subprime Lender Files for Bankruptcy, (National Public Radio broadcast Apr. 3, 2007), available at http://www.npr.org/templates/story/story.php?storyId=9307852 (quoting David Olson, Home Equity Industry Analyst, Wholesale Access, referring to "disintegration of [subprime mortgage] industry").
191. It may also be suggested that this would particularly diminish mortgage credit opportunities for those consumers most likely to qualify only for subprime loans.
backing their securities are not likely to result in default. Along the same lines, abrogation may prompt assignees to demand from assignor-originators contract terms requiring originators to indemnify assignees for violations of federal anti-predatory lending laws. Both of these results would in turn incentivize originators to ensure the suitability of mortgage loans to borrowers’ financial means and would greatly reduce the number of unaffordable loans brokers sell. In sum, abrogation of the holder doctrine would require predatory mortgage originators, who are generally more financially savvy than the borrowers they target, to internalize the costs of predatory lending.

Further, it is not at all clear that incentivizing brokers in this way—to ensure borrowers’ repayment abilities and refrain from marketing predatory loans—would dry up the mortgage market for people with less-than-perfect credit records. As discussed in Part IV infra, the Community Reinvestment Act (CRA) has spurred depository institutions covered by the Act to expand greatly their mortgage lending to communities and individuals who historically have been denied mortgage credit opportunities, while simultaneously and significantly lowering rates of high-cost loans more likely to result in borrower default. As such, mortgage lending under CRA terms is a more appropriate vehicle for providing mortgage credit to consumers who cannot qualify for prime loans.

The mortgage lending industry also would likely oppose abrogation of the doctrine on the grounds that assignees have not received notice of the terms of origination, and thus should not be held liable for the originator’s violations of federal law. Under the doctrine, “holder in due course” is defined as someone who did not have notice of certain problems with the instrument; in this case, the assigned mortgage sold on the secondary market. However, the notice problem easily can be addressed by including in the mortgage assignment contract certain provisions giving the assignee (who is later the borrower’s mortgage holder) recourse against the assignor-originator for violations of federal or state law. Many mortgage assignment contracts already include provisions that give the holder recourse against the originator if the borrower defaults on the mortgage. The inclusion of similar contract provisions

193. Engel and McCoy have documented that predatory lenders market their loans to borrowers who are disconnected from the credit economy and thus are unable to engage in meaningful comparison shopping for loans. Their target markets are most likely to be “communities of color.” Engel & McCoy, supra note 8, at 1294. Further, traditional lenders, the banks and thrifts, “do not have a significant presence in [low- and moderate-income] neighborhoods.” Id. at 1295. In this way predatory lenders are able to exploit “information asymmetries” between brokers, lenders, secondary-market participants, and borrowers. Id. at 1280–81.

194. See Part IV infra and accompanying footnotes.

195. See U.C.C. § 3-302(a) (2002).

196. See WHITE & SUMMERS, supra note 55.

providing assignees with indemnification from assignors for their violations of predatory lending laws would discourage lenders from marketing predatory loans.

In sum, abrogation of the "holder in due course" doctrine in mortgage assignments is particularly appropriate because the doctrine incentivizes predatory lending. By eliminating assignee liability for illegal lending practices, the doctrine minimizes the risk of investing in mortgage-backed securities, while broker-originators profit from the sale of mortgage loans for securitization regardless of borrowers' ultimate repayment abilities. Given the FTC's abolition of the doctrine in other consumer contexts and the proven effectiveness of the CRA in creating a mortgage credit market for communities traditionally denied credit opportunities, as discussed in Part IV infra, there is no principled reason not to abrogate the doctrine's operation in home mortgage sales. In abrogating the doctrine for HOEPA-covered mortgages, Congress recognized that the doctrine unjustly precludes predatory lending victims from obtaining HOEPA remedies. By the same token, the FTC should abrogate the doctrine for all home mortgages to ensure that borrowers can avail themselves of federal anti-predatory lending protections even if their original lender is no longer available to make the borrower whole. As discussed in Part III.A supra, Congress can complete the picture by expanding the class of predatory mortgages for which borrowers can seek relief against abusive lenders. If Congress places a duty upon broker-lenders to sell only mortgages that brokers reasonably could determine are suited to borrowers' financial means, borrowers would be able to seek relief against both their mortgage originator and the current mortgage holder for lending practices that are predatory but do not fall under HOEPA's purview.

IV.
EXPANDING REGULATORY OVERSIGHT TO ALL MORTGAGE LENDERS UNDER THE COMMUNITY REINVESTMENT ACT

The proposals outlined in Part III supra will effectuate a litigation-based private enforcement scheme to allow a broader class of aggrieved borrowers to seek damages for predatory lending and relief from their predatory loans at foreclosure. The premise of this enforcement scheme is that mortgage lenders will be deterred from originating abusive loans if they stand to pay damages through litigation. The proposed statutory scheme differs from current law by imposing lender liability for the crux of predatory lending: knowingly selling unsuitable loans to borrowers. Further, eliminating the "do equity" requirement and "holder in due course" restrictions would deter lenders from selling abusive loans to the particular borrower and would allow victims of such loans to be made whole.

As a practical matter, however, the long-term deterrent effect of any litigation-based private enforcement scheme will be limited by the number of
aggrieved borrowers who bring suit. Because predatory lending victims often are ill-equipped to recognize the problem or afford legal representation, private litigation of predatory lending claims largely will be limited to class action and pro bono representation. Many subprime lenders, the majority of which are not subject to any federal or state regulatory oversight, may determine that the profits gleaned from predatory lending still outweigh potential damages pay-outs. For this reason, effective regulatory oversight of all mortgage lending institutions, as well as alternative sources of legitimate mortgage credit for potential borrowers in the subprime market, are necessary complements to the private enforcement scheme I advocate above.

In addition to the federal statutes addressing predatory lending directly—RESPA, TILA, and HOEPA—discussed in Part II.A supra—the CRA has played a role in preventing the federally insured depository institutions it covers from issuing high-cost subprime and predatory mortgage loans. The FDIC has observed that federally insured depository institutions have “a good record of avoiding involvement in predatory lending practices.” Recent studies of CRA lending have demonstrated that CRA-covered depository institutions have issued fewer high-cost loans—those most likely to be foreclosed—as a percentage of their total loan portfolios, than lending institutions not covered by the CRA, while simultaneously expanding legitimate mortgage credit opportunities in communities historically excluded from the prime mortgage lending market. Based on this research, discussed in more detail, I conclude that the CRA can serve as a regulatory complement to the proposed litigation enforcement scheme and help steer borrowers in the subprime market toward less-risky mortgage loans. Because the CRA currently applies only to depository institutions, such as banks and thrifts, Congress should amend the CRA to cover the non-depository lending

198. Engel and McCoy have noted that typical predatory lending victims are unsophisticated about their options for securing mortgage credit, often as a result of historic exclusion from the mortgage market due to discrimination and credit rationing. Engel & McCoy, supra note 8, at 1280.

199. Unlike banks, thrifts, and some credit unions, most subprime lenders are not subject to federal or state regulatory oversight. OFFICE OF INSPECTOR GEN., FED. DEPOSIT INS. CORP., supra note 30, at 9. In 2005, more than half of subprime loans were made by independent mortgage companies not subject to oversight by federal bank regulatory agencies, and 30 percent were made by affiliates of banks and thrifts that are not subject to CRA examination. Laderman & Reid, supra note 11, at 5.


203. OFFICE OF INSPECTOR GEN., FED. DEPOSIT INS. CORP., supra note 30, at 13.

204. The risk of foreclosure of subprime, or higher-cost, loans is 8.16 times higher than for non-subprime loans. Laderman & Reid, supra note 11, at 6.

institutions and bank and thrift affiliates that comprise the bulk of the predatory and subprime lending markets.

The Community Reinvestment Modernization Act of 2009, introduced in the House of Representatives in March 2009, would amend the CRA to extend its coverage and affirmative obligations to non-bank mortgage lenders. Although the fate of the bill is uncertain at the time of this Comment, a legislative extension of the CRA may be more politically viable than adoption of a federal lender suitability doctrine, discussed in Part III.A supra, which is strongly opposed by the mortgage lending industry.

Congress enacted the CRA in 1977 primarily to counteract the practices of “redlining,” in which banks refuse to make loans in minority and low-income communities, and “capital export,” in which banks accept local deposits while refusing to make loans in the same community. To end these practices, the CRA places upon banks and thrifts a “continuing and affirmative obligation to help meet the credit needs of the local communities in which they are chartered.” The federal bank regulatory agencies enforce this obligation by conducting periodic CRA examinations, which evaluate lenders’ records at meeting community credit needs and rate lenders based on their performance. To give CRA obligations “teeth,” the same federal agencies are required to consider depository institutions’ CRA records and ratings when approving or denying applications for expansions and mergers. Also, members of the general public are empowered to oppose expansion and merger applications based on a lender’s failure to meet community credit needs; indeed, such “CRA challenges” have generated trillions of dollars in bank lending to underserved communities.

Since its enactment, the CRA is estimated to have increased significantly the supply of credit available to low- and moderate-income (LMI) communities and communities of color, including the supply of mortgage credit. Between 1993 and 2000, CRA-covered lenders are estimated to have provided 336,000 more home mortgage loans to LMI borrowers than would otherwise have been

206. Many banks and thrifts have non-depository affiliates that may be excluded from the CRA evaluation process. See Richard Marsico, Introduction, Community Reinvestment Act Symposium Edition, 53 N.Y.L. Sch. L. Rev. 193, 199 (2008–2009). Banks and thrifts tend to exclude their affiliates from CRA examination if affiliates “engaged in risky lending or discriminatory policies.” Taylor & Silver, supra note 205, at 211.


208. Marsico, supra note 206, at 194.


210. These agencies are the Federal Reserve Board, which examines state-chartered banks; the Office of the Comptroller of the Currency, which examines nationally-chartered banks; the Office of Thrift Supervision, which examines federally-chartered thrifts; and the Federal Deposit Insurance Corporation, which examines state-chartered banks and thrifts. Taylor & Silver, supra note 205, at 204.

211. Id. at 206.

212. Marsico, supra note 206, at 196.
The Treasury Department has documented that between 1993 and 1998, "CRA-covered lenders increased home mortgage loans to LMI borrowers by 39%." Overall, banks and thrifts have issued more home loans to LMI borrowers in geographical areas where regulators conduct CRA exams than in those areas not subject to the CRA. Other studies support the link between CRA obligations and increased lending in communities of color with data that demonstrates "banks make a greater percentage of their loans to minorities and LMI borrowers than non-CRA covered mortgage companies and credit unions." Further, the CRA's proven effectiveness at increasing mortgage credit access in communities of color and LMI communities undermines the argument, addressed in Part III.B supra, that preserving the "holder in due course" doctrine is necessary to sustain a mortgage credit market for historically underserved borrowers.

In addition to increasing mortgage lending in LMI neighborhoods and communities of color, a growing body of research shows that CRA coverage is correlated with lower rates of foreclosure and subprime and predatory lending. This research undermines claims that the CRA caused the current foreclosure crisis by requiring depository institutions to lend to non-creditworthy borrowers. For example, Republican U.S. Representative Steve King of Iowa has introduced legislation to repeal the CRA, arguing that the CRA caused the current crisis by forcing banks to lend to people in poor areas who represented unjustified credit risks. Contrary to such allegations, Ben Bernanke, Chairman of the Federal Reserve Board, flatly rejected arguments that the CRA "contributed in any substantive way to . . . the current mortgage difficulties," and pointed to Federal Reserve findings that "CRA covered depository institutions have been able to lend profitably to lower-income households and communities and that the performance of these loans is comparable to other loan activity." Bernanke emphasized that a separate Federal Reserve analysis failed to reveal any evidence that the CRA caused high rates of default in the subprime market. John Dugan, the Comptroller of the Currency, also rejected any connection between the CRA and the subprime mortgage crisis, noting that

214. Taylor & Silver, supra note 205, at 207.
215. Id. at 208.
216. Id.
218. Id.
220. Id.
75 percent of subprime loans were made by non-CRA lenders.221 A 2008 study of California home purchase loans by the Federal Reserve Board of San Francisco demonstrated that loans originated by lenders covered by the CRA ("CRA loans") "were significantly less likely to be in foreclosure than those originated by [independent mortgage companies]," even after controlling for borrower and loan characteristics such as income, credit score, and whether the loan was high-priced.222 With regard to LMI neighborhoods in particular, the San Francisco Federal Reserve found that loans from CRA lenders performed as well as loans from non-CRA lenders; and when loan source was excluded as an explanatory variable, CRA loans were found to perform significantly better than non-CRA loans.223 From this research, the San Francisco Federal Reserve suggested that CRA oversight and obligations "helped to ensure responsible lending."224

In his 2008 comparison of the lending practices of CRA-covered banks and thrifts and non-CRA mortgage lenders, Warren Traiger showed that banks covered by the CRA "were substantially less likely than other lenders to make the kinds of risky home purchase loans that helped fuel the foreclosure crisis."225 Traiger's more specific findings supported the conclusion that CRA obligations deter risky lending practices:

1. CRA Banks were 66% less likely than other lenders to make a higher cost loan;
2. The average annual percentage rate (APR) on higher cost loans originated by CRA Banks was sixty-eight basis points226 lower than the average APR on higher cost loans originated by other lenders;

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222. Laderman & Reid, supra note 11, at 19. Further, loans that CRA-covered lenders made within their assessment areas were half as likely to be foreclosed than loans made by independent mortgage companies. Id.
223. Id. at 21.
224. Id. at 20. Some of the study's more specific findings add support to the proposition that CRA coverage discourages predatory lending. The San Francisco Federal Reserve found that 28 percent of loans made by CRA lenders in low-income areas within their assessment area were fixed-rate loans; in comparison, 18.2 percent of loans made by [independent mortgage companies] in low-income areas were fixed-rate. And only 12 percent of loans made by CRA lenders in low-income areas within their assessment areas were higher-priced, compared with 29 percent in low-income areas outside their assessment areas and with 52.4 percent of loans made by [independent mortgage companies] in low-income areas. Id.
225. Traiger, supra note 22, at 229.
226. A basis point is one-hundredth of a percentage point. U.S. Commodity Futures Trading Commission, CFTC Glossary, http://www.cftc.gov/ConsumerProtection/EducationCenter/CFTCGlossary/glossary_b.html (last visited Oct. 25, 2010). In other words, the average annual percentage rate on higher-cost loans issued by CRA-covered banks was 0.68 percent lower than the APR on the average high-cost loan issued by non-CRA institutions.
3. CRA Banks were more than twice as likely as other lenders to retain originated loans in their portfolio; and

4. Foreclosure rates were lower in MSAs [metropolitan statistical areas]\(^{227}\) with greater concentrations of bank branches.\(^{228}\)

A fair conclusion from the research described above is that the CRA-imposed obligation to “help meet the credit needs of the local communities in which they are chartered,”\(^{229}\) in combination with the CRA examination and enforcement regime, effectively deters depository lenders from issuing the risky and often abusive loans that have contributed to the current foreclosure crisis. The correlative, if not causal, relationship between CRA oversight and lower rates of risky lending and foreclosure suggests that amending the CRA to cover the non-depository lenders that issue the majority of subprime loans would significantly reduce predatory lending. As noted above, a backdrop of regulatory oversight is a desirable complement to a litigation-based private enforcement scheme, because many predatory lending victims will be unable to afford or recognize the need for legal representation. Regulatory oversight of all mortgage lenders under the CRA in particular is desirable because of growing evidence that CRA obligations and regulatory enforcement have a direct, deterrent impact on risky lending. Further, expanding CRA regulatory oversight to non-depository institutions likely would have the concomitant effect of increasing access to legitimate sources of mortgage credit for borrowers in the subprime market. Amending the CRA to cover the non-depository institutions responsible for most subprime loans likely will prompt these lenders to provide legitimate, lower-cost mortgage loans less likely to result in foreclosure. In this regard, amending the CRA to cover all mortgage lenders will help prevent predatory lending both by steering potential borrowers toward legitimate mortgage loans, which the newly-covered subprime lenders will be more likely to provide, and by directly deterring risky lending through federal agency oversight and examination.

CONCLUSION

The extent of the foreclosure crisis and the staggering scope of losses predicted over the next several years suggest that current federal law and oversight of the lending industry are insufficient to deter lenders from issuing the risky, high-cost loans most likely to be foreclosed. Existing anti-predatory lending laws employ rigid liability standards and thresholds for coverage that

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227. Metropolitan statistical areas (MSAs) are defined by the U.S. Census Bureau by their geographic delineation, or by a list of their geographic components at a particular point in time. For a current list of MSAs, see U.S. CENSUS BUREAU, CURRENT LISTS OF METROPOLITAN AND MICROPOLITAN STATISTICAL AREAS AND DEFINITIONS, available at http://www.census.gov/population/www/metroareas/metrodef.html.

228. Traiger, supra note 22, at 229.

unscrupulous lenders can easily avoid, while placing abusive costs on borrowers in unrestricted ways. Many borrowers who received predatory loans and otherwise could challenge their loans at foreclosure are unable to do so, because they cannot pay the amount they owe to "do equity," or because the "holder in due course" doctrine bars redress against their mortgage holder. Perhaps most egregious is the fact that the majority of subprime lenders are not subject to federal or state oversight, even though subprime loans, of which predatory loans are a subset, are foreclosed at a rate 8.16 times higher than non-subprime loans. This Comment has proposed legislative and agency actions to address these significant shortcomings in federal law, to broaden the class of predatory loans for which borrowers can seek relief at foreclosure, and to deter and prevent predatory lending and resulting foreclosures going forward.

To deter lenders from predatory practices and permit aggrieved borrowers to be made whole, I advocate a litigation-based private enforcement scheme that adopts a flexible standard for lender liability and eliminates two practical barriers to suit. Congress must amend HOEPA, TILA, and RESPA to impose liability for the core of predatory lending: knowingly selling financially unsuitable loans to the borrower. By shifting the focus of anti-predatory lending laws from specific predatory terms and practices to a flexible suitability standard, Congress would authorize remedies for a broader class of aggrieved borrowers, who may then defend a foreclosure action with a predatory lending claim, and more effectively disincentivize predatory lending in the long-run. Congress and the FTC also must eliminate external barriers to relief to ensure that borrowers facing foreclosure are able to access remedies for predatory lending even if they cannot "do equity" or if their mortgage originator is insolvent. To this end, Congress must eliminate the "do equity" requirement for borrowers who can show the challenged loan is predatory, and the FTC must abrogate the "holder in due course" doctrine in mortgage sales to permit redress against current mortgage holders. Abrogating the "holder doctrine" in all mortgage sales should incentivize lenders and assignees to ensure the borrower's repayment ability, thereby deterring predatory loans. Individuals who do not qualify for prime mortgages could continue to access mortgage credit from banks covered by the CRA, which has expanded legitimate mortgage credit opportunities for low- and moderate-income communities and communities of color.

Although the prospect of liability and damages may deter many lenders from selling predatory loans, the requirement of legal counsel for private lawsuits leaves a role for federal regulatory oversight of the entire mortgage lending industry. Because the obligations imposed by the CRA have prompted banks covered by the CRA to issue the high-cost mortgages that typically result in foreclosure at lower rates than non-covered lending institutions, extending

230. See Laderman and Reid, supra note 11, at 6.
the CRA’s coverage and regulatory oversight to all non-bank lending institutions is likely to curb predatory lending. Regulatory oversight of the entire mortgage lending industry, combined with the deterrent effect of private litigation, should help prevent predatory lending in the long-term and ameliorate the ongoing foreclosure crisis.