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Dangerous Loans: Consumer Challenges to Adjustable Rate Mortgages

Jo Carrillo†

ABSTRACT: As recently as the first quarter of 2007, home ownership rates were up across the board, including in low-income, fixed-income, and minority communities. By the fourth quarter of 2007, sales volume had flattened, housing prices had peaked or dropped, interest rates for consumers were uncertain, and mortgage lenders had tightened access to credit. Additionally, notices of default rose, as did forced (equity) sales, and completed foreclosures as measured by trustee deeds of sale filed.

This article analyzes the relationship between innovative mortgage products, like adjustable-rate mortgages, and the first wave of consumer legal challenges brought against those products under the Truth in Lending Act (TILA), 15 U.S.C. section 1601, et seq. (TILA). Legislation has been introduced to address the rise in mortgage distress among consumers, but much of that legislation is limited in application. Hence, by default, courts will continue to play an important role in resolving consumer claims against lenders, and many of the lawsuits will be brought as class actions. TILA explicitly allows class action lawsuits for damages under section 1640, but section 1635, which covers rescissions, is silent on the question of whether class-wide rescission claims are permissible. On the legal side, the answer will depend upon how courts interpret section 1635 in light of TILA's overall consumer protection purpose. On the economic side, the answer will depend upon how access-to-credit issues get framed in light of the expanding mortgage crisis.

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Dangerous Loans: Consumer Challenges to Adjustable Rate Mortgages

I. INTRODUCTION

Housing prices do not always rise, interest rates do not always fall, borrowers cannot always refinance, and physical shelter can be lost for mortgage nonpayment. Were cars as costly or dangerous as the newest mortgage products most recently on the market, the public would demand legal intervention in the form of legislation or court action; and indeed, that demand has occurred.

When the housing market was robust, lenders claimed that innovative lending products enhanced consumer access to credit, which of course they did. They cited credit availability as a reason for increased homeownership nationwide, which of course it was. And they maintained—against a growing body of evidence—that the new mortgage products, though untested in a weak market, were safe financial products for the ordinary consumer. By mid-2007, however, reality set in as consumers learned that the new mortgage products could be dangerous, if not ruinous, in a perfect financial storm.

This Article considers the current mortgage crisis as well as initial consumer legal responses to that crisis. Because this analysis was written as the mortgage crisis was first developing, its focus is on litigation, not on proposed legislation. Part I puts the current mortgage problem into a broad demographic context. Part II puts the specialty mortgage problem into a market context. Historically, lenders have argued that holding them legally liable for irregularities in lending will dry up public access to credit, particularly for the credit poor.1 On the theory that the legal fate of the low- and moderate-income borrower goes hand in hand with the fate of the financial institutions that lend money Part II thus draws a link between credit markets, lending institutions, and consumers.2 Part III offers a mini-primer on fixed rate mortgages (FRMs), adjustable-rate mortgages (ARMs), and negative amortization. Part IV

1. See, e.g., TERENCE A. SULLIVAN, ELIZABETH WARREN & JAY LAWRENCE WESTBROOK, THE FRAGILE MIDDLE CLASS: AMERICANS IN DEBT 254-56 (2000); cf., LENDOL CALDER, FINANCING THE AMERICAN DREAM: A CULTURAL HISTORY OF CONSUMER CREDIT 303 (1999) (arguing that lending and debt are regulators of income for middle-class Americans that lead not to excess, but to the "transform[ation of] consumer culture into a suitable province for more work").

discusses three class action rescission cases, each brought as an early collective consumer response to the emerging mortgage crisis, and each decided in the first quarter of 2007: LaLiberte v. Pacific Mercantile Bank, Andrews v. Chevy Chase Bank, and McKenna v. First Horizon Home Loan Corp.

II. THE PAINFUL ENDCGAME OF A CYCLE

Over the last half-decade, the United States has seen an historic rise in housing prices. One far-reaching social benefit of appreciating housing markets coupled with low interest mortgage loans is a rise in home ownership rates. Historically, low- and fixed-income consumers have been blocked from entering the housing market by lack of credit (for purchase or refinance), lack of capital, and lack of information about transaction costs. Thus the recent availability of specialty mortgage products, like adjustable-rate mortgages, low documentation loans, interest-only/negative amortization loans, CLTV>90% loans, home equity lines of credit, and 40- or 50-year fully amortized mortgages, has been one of the chief factors in improving home ownership rates. These lending products, which are discussed later in this Article, have made credit available for many consumers including those who might not otherwise be able to afford to purchase or refinance a home. Thus these products are responsible for the rise in home ownership rates from 66.2% in 2000 to 68.9% in 2006, according to U.S. Census figures.

3. 53 Cal. Rptr. 3d 745 (Cal. Ct. App. 2007).
4. 240 F.R.D. 612 (E.D. Wis. 2007).
5. 475 F.3d 418 (1st Cir. 2007).
7. Adjustable-rate mortgages (ARMs) first appeared in 1981, as authorized by the Federal Home Loan Bank Board (FHLLB) for federally chartered savings and loans institutions. Interest rates on ARMs are tied to one of four public cost of fund indices (see notes 115-118 infra). They relieve mortgage lenders of interest rate risk and entice borrowers with low initial interest rates that—like the other loans defined herein—make the difference for many borrowers between qualifying and not qualifying for a loan. Yet, these loans also expose borrowers to risk as they adjust upward from their initial interest rate and as interest rates rise. Low documentation loans allow borrowers to qualify for mortgage loans without fully documenting income or assets. Interest-only loans allow borrowers to pay a non-amortized interest-only payment for a specified period of time, at which point the loan adjusts upward to a fully amortized, and more expensive, payment. CLTV>90% loans provide borrowed funds for nearly all of, or in some cases more than, the market price of the asset that secures the loan. Forty- and fifty-year amortized mortgages work like the traditional thirty-year fully amortized mortgages, but extend the payment period significantly longer, thus lowering the monthly payments due. Home equity lines of credit (HELOCs) allow a borrower to charge purchases and cash advances against accumulated home equity. On the positive side, home equity loans are convenient. However, on the negative side, since the home equity loan is secured by real estate, if the borrower cannot meet the repayment terms of the loan, the borrower may lose his or her home.
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Home ownership rates, as compared to stock ownership, are an important indicator of financial comfort for the average household. Indeed between 2001 and 2004, stock ownership dropped sharply in direct contrast to home ownership, which rose. The median value of financial assets (e.g. stocks) held by the average family in 2006 was $23,000, while the median value of nonfinancial assets (e.g. primary residence and car) was $147,800.

A. Increased Homeownership Rates—Now Threatened

These recent gains in home ownership are now threatened. The housing market has cooled: housing prices and sales have flattened. For low- and

http://www.census.gov/hhes/www/housing/hvs/qtr406/q406press.pdf (discussing home ownership rates for the United States at 68.9%).

Home ownership rates are derived as follows:

Every housing unit in the United States is asked a limited number of basic demographic and housing questions such as race, age, marital status, housing value or rent (referred to as 100-percent questions). A sample of these housing units are asked more detailed questions such as income and housing costs in addition to the basic housing information (referred to as sample questions). Approximately one out of every six housing units in the nation is included in the census sample.


11. Id.

12. Id. at 295-305.

13. See, e.g., The Associated Press, Sales of Existing Homes Fall to Lowest Level in 4 Years, N.Y. TIMES, June 26, 2007, at C9 (citing sales of existing homes at their lowest level in four years, with the median home price dropping for a record 10th consecutive month and inventory levels of existing homes at the highest since 1992). See also March 2007 Report Charts, UCLA ANDERSON FORECAST at 71 ("California Existing Home Prices, 1986: 1Q to 2006: 4Q," "California Existing Home Sales Jan. 1995 to Jan. 2007," and "New One-Family Houses Sold Western Region Jan. 1995-Jan. 2007" showing a peak in home prices and a clear drop in home sales); September 2007 Report Charts, UCLA ANDERSON FORECAST at 70 (corresponding charts showing the same trend, namely a potential peak in home prices and a clear drop in home sales).
fixed-income borrowers (many of whom are persons of color), the dream of home ownership is stalling, if not fading altogether, as adjustable-rate mortgage payments reset and housing markets across the country take a downward turn.

In a strong market, a homeowner in mortgage default can refinance or sell her home to keep foreclosure at bay. In weaker markets, these transactional options are no longer certain. Additionally, the bankruptcy law amendments of 2005 have made it more difficult for borrowers to qualify for Chapter Seven “fresh start” bankruptcy proceedings. This has resulted in an increased likelihood that homes will directly go into foreclosure rather than bankruptcy, where they might have been exempt from the reach of creditors.

B. The Example of California

According to industry reports, California is “ground zero for much of the aggressive lending” of the past few years. Aggressive lending is different in degree from predatory lending, yet there can be overlap. Aggressive lending


15. 11 U.S.C. § 707(b)(1) (LEXIS through 2007 legislation) (providing that a debtor’s bankruptcy petition may be dismissed if the debtor fails to meet certain means tests, thus making it more difficult for consumers to discharge “consumer debts” (i.e. credit card debt) in bankruptcy than it was previously under 11 U.S.C. § 707 (2000)). See also TERESA A. SULLIVAN, ELIZABETH WARREN & JAY LAWRENCE WESTERBROOK, AS WE FORGIVE OUR DEBTORS: BANKRUPTCY AND CONSUMER CREDIT IN AMERICA (1989); Marianne B. Culhane & Michaela M. White, Creighton: Taking the New Consumer Bankruptcy Model for a Test Drive, 7 AM. BANKR. INST. L. REV. 27 (1999) (discussing how means testing is supported by the credit card industry and how it serves as a way to limit the number of debtors who can qualify for a fresh start); Lingling Wei, Bankruptcy May Not Save Homes – Filing Isn’t Helping Many Borrowers Avoid Foreclosures, WALL ST. J., Apr. 12, 2007, at D6 (citing a study released in March 2007 by Jay Guo, Credit Suisse Group, that assesses the risk to mortgage-bond investors as “high” given that “more subprime borrowers are turning to bankruptcy court to stave off foreclosure, as softening housing prices make it harder for them to sell their homes to repay debt”).

16. Culhane & White, supra note 15; Wei, supra note 15.

17. Scott Stoddard, Jobs, Not Subprime, Continue to Drive Foreclosure Rates, INVESTOR’S BUS. DAILY, Apr. 9, 2007 (quoting Mark Zandi, chief economist at Moody’s Economy.com, to note that California is home to the biggest mortgage lenders (Wells Fargo, Countrywide Financial, and WMC Mortgage being examples) and that California “tops the charts when it comes to risky loans”); see also Vikas Bajaj, More Trouble in Subprime Lending, N.Y. TIMES, June 15, 2007, C1, C7 (quoting Mark Zandi’s report that “we are seeing more loan modifications and foreclosures and once loans go through either of those processes, the loans go out of those [for example, default] databases... [but] they might come back. The recidivism on those loans is very high.”); Ryan Ratcliff, The California Report, UCLA ANDERSON FORECAST 51, 53-55 (Sept. 2007) [hereinafter Ratcliff I].

18. Ratcliff I, supra note 17, at 55-60.

19. Section 4970(b) of the California Financial Code limits predatory loans to those loans covered by the statute. CAL. FIN. CODE § 4970(b) (LEXIS through 2007 legislation). A “covered loan” is a consumer loan in which the original principal balance of the loan does not exceed the most current conforming loan limit for a single-family first mortgage loan established by the Federal National Mortgage Association in the case of a mortgage or deed of trust, and where one of the following conditions are met: (1) For a mortgage or deed of trust, the annual percentage rate at consummation of the transaction will exceed by more than eight percentage points the yield on treasury securities having
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often involves the marketing of loan products, like option ARMs or interest-only/negative amortization loans that are convenient at the start of the repayment period and onerous at the end. Predatory lending, depending upon how it is legislatively defined, implicates a comparatively narrower range of lender practices such as: loans made solely on the asset value of the collateral rather than on the borrower's ability to repay, loans whose margin rates exceed a certain high percentage, loan flipping (frequent refinancing that results in little or no economic benefit to the consumer), hidden costs, negative amortization issues, and inadequate disclosure of risks by the lender to the consumer.20

Default notices (NoDs) are the first step in the foreclosure process. In California the number of NoDs filed rose from 18,856 in the first quarter of 2006 to 46,760 in the first quarter of 2007, a 148% increase.21 These numbers are illustrative considering that the average number of NoDs filed per quarter from 1992, when DataQuick began collecting default statistics, to 2007 is 33,847.22

Indeed, 2006 was a defining year for the California housing market. The first quarter of 2006 saw low rates for NoDs filed at 18,856, but there was a surge upward from the first to the third quarters.23 By the third quarter of 2006, lending institutions had sent 26,705 NoDs to homeowners in California, up 28.3% from the second quarter of 2006 and up 111.8 % from the third quarter of 2005.24

For that same period, DataQuick reported that foreclosure commencements comparable periods of maturity on the 15th day of the month immediately preceding the month in which the application for the extension of credit is received by the creditor; (2) The total points and fees payable by the consumer at or before closing for a mortgage or deed of trust will exceed 6 percent of the total loan amount. See CAL. FIN. CODE § 4973 (LEXIS through 2007 legislation) (enumerating predatory acts in relation to covered loan products).


20. See Howard, supra note 19.

21. California Foreclosure Activity Jumps Again, DQNEWS.COM, April 16, 2007, http://www.dqnews.com/RRFor0407.s.htm (last visited November 29, 2007) [hereinafter Activity Jumps Again] (DataQuick, a subsidiary of Vancouver-based MacDonald Dettwiler and Associates, monitors real estate activity nationwide and provides information to consumers, educational institutions—including the UCLA Anderson Forecast—public agencies, lending institutions, title companies and industry analysts. DataQuick provides online access to property information, including default notices. Notices of Default, recorded at county recorders offices, mark the first step of the formal foreclosure process.).


23. Steep Increase, supra note 22.

24. Id.
were most likely to occur on a loan-by-loan basis in the counties of Fresno, Merced and Riverside, all inland counties with near majority Latino/Hispanic representation. Foreclosure commencements were least likely in Marin, Napa and San Francisco, all coastal counties with comparatively lower minority representation.

By the first quarter of 2007, foreclosures were most likely to commence on a loan-by-loan basis in Sacramento, Riverside, and San Joaquin counties, again all inland counties with near majority Latino/Hispanic representation. The
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difference in these counties, of course, is not a racial one so much as it is an economic one with racial and ethnic dimensions. Per capita income in 2005 in the San Francisco Bay Area, one of the areas of the state where foreclosures were least likely to occur, was $48,322, well above the national average of $34,495.\textsuperscript{35} Likewise, per capita income in the coastal areas of California (the Los Angeles Basin at $33,907 and the San Diego Region at $38,268) was near or above the national average. By contrast, per capita income in the inland regions (Sacramento at $33,866, San Joaquin Valley at $24,951, and Rest of State at $32,720), where foreclosure rates were higher, was near or below the national average.\textsuperscript{36}

Similarly, household income in 2005, as reported by the U.S. Census Bureau, was above the national average of $46,242 for all California regions with the exception of the San Joaquin Valley.\textsuperscript{37} Household income in 2005 in the San Francisco Bay Area, for example, was $67,440, well above the national average, while household income in California as a whole was $53,629, a figure exceeding the national average by 16%.\textsuperscript{38} In California, only the San
Joaquin Valley, at $43,423, fell behind the national household income figures. Nonetheless, even areas with high per capita and household income saw steep increases in NoDs. Buyers in coastal Marin County, with a per capita income in 2005 of $52,941 and a median household income of $78,919 (a figure exceeding the national household income figure by 23%), saw a 55.3% increase in NoDs from first quarter of 2006 to the first quarter of 2007. Other counties, including the high-density San Francisco Bay Area counties of Contra Costa and Solano, topped the 200% increase in the number of NoDs sent by lending institutions from 2006 as compared to 2007. The highest default areas in California were inland Yolo County, which saw a 310.4% increase in NoDs, inland El Dorado County, which registered a 305.6% increase, coastal Contra Costa County (up 225.5%), inland Yuba County (up 214.6%), and coastal Solano County (up 210.9%). The income data tracks the foreclosure data. This analysis focuses on the first quarter of 2007, but by the third quarter of 2007 – when the pattern of increased foreclosures was clear – foreclosure data showed that counties with the highest number of foreclosure sales were also the counties with high ARM usage in 2005 and with the most modest median home prices relative to other areas in the state, suggesting that families in those areas were stretching beyond their means to pay their mortgages.

41. See Activity Jumps Again, supra note 21.
43. See Activity Jumps Again, supra note 21; see also Ryan Ratcliff, The California Report: A Different Strain of March Madness, UCLA ANDERSON FORECAST, March 2007, at California-54 [hereinafter Ratcliff II] (charting DataQuick notices of default on a county-by-county basis).
44. Ratcliff II, supra note 43, at California-60 (clarifying that personal defaults led to investor defaults in California, identifying San Joaquin, Riverside, Yuba, Sacramento, Stanislaus, and Merced
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At the same time, March 2007 saw affordability collapse nationwide, but particularly in California, which has somewhere in the range of eight to eleven million housing units. Although household income in California exceeded the national average, Californians nevertheless felt the burden of high housing costs: DataQuick reported that the median price of a house in California was $484,000 in March 2007, up from $472,000 in February 2007, $470,000 in March 2006, and $211,500 in 2000. The California Association of Realtors calculated the median price of a house in California at $590,070 as of March 2007. The "typical mortgage payment" a buyer assumed in March 2007 was $2,230 per month, up from a median of $1,912 in 2005 and $1,478 in 2000. Even if one were to disagree on the exact median price ($470,000 or $590,070) or on the exact number of default notices sent, the trend in California was clear as of the first quarter of 2007. Housing prices were high but flattening. Consumer mortgage debt was high and rising, as were mortgage defaults. In California, these trends were especially apparent in inland counties like San Joaquin, Riverside, Yuba, and Sacramento where

Counties as those counties with high foreclosure rates, high ARM usage and relatively low median home prices compared to other counties in the state, thus concluding that "the combination strongly suggests that families [were] stretching beyond their means to realize the dream of home ownership").


47. March 2007 Home Sales, supra note 45.


49. March 2007 Home Sales, supra note 45 (the "typical mortgage payment" was quoted at $2,230, up from $2,196 in February 2007 and down from $2,235 in March 2006. The peak was $2,372 in June 2007); see also U.S. CENSUS BUREAU, 2000 CENSUS OF POPULATION AND HOUSING, TABLE 31. MORTGAGE AND RENTAL COST CHARACTERISTICS: 2000, SUMMARY SOCIAL, ECONOMIC, AND HOUSING CHARACTERISTICS, PHC-2-6, CALIFORNIA 9 (2003), available at http://www.census.gov/prod/cen2000/phc-2-6.pdf (quoting the median price of a house in California in 2000 at $211,500, and median mortgage at $1,478, with only 20% of mortgages in 2000 in the $2,000 or above range).


52. See supra note 13.

53. FEDERAL RESERVE, CONSUMER CREDIT OUTSTANDING, Mar. 2007, available at http://www.federalreserve.gov/releases/g19/20070507/ (placing consumer credit at a total of 2,425.5 billion (up 6.7% from February 2007), 888.2 billion for revolving (up 9.2% from February 2007), and 1,537.3 billion nonrevolving (up 5.2% from February 2007)).
median housing prices were deemed affordable.\textsuperscript{54}

Foreclosure trends were confirmed by year's end. Where jobs lagged, mortgage delinquency rates were even higher than they were in California, leaving economists tentatively optimistic about the California housing market despite its adherence to the general trend.\textsuperscript{55} Mortgage delinquency rates in California at the start of 2007 stood at 10.9\% as compared to 13.33\% nationally, 16.35\% in Ohio, and 21.08\% in Michigan, two states that suffered deep cuts in manufacturing jobs.\textsuperscript{56} In all but the poorest areas of Detroit, for example, subprime loans exceeded 50\% in 2006.\textsuperscript{57} According to economists from real estate, investment, and consumer protection sectors, two factors promised to save California from the knot of rising interest rates, rising unemployment rates, and falling home prices that the Midwest experienced at the start of 2007.\textsuperscript{58} Those two factors were double-digit gains in property values and a strong jobs picture.\textsuperscript{59}

By the first quarter of 2007, the loans that went into default in California mostly originated between April 2005 and May 2006 (peaking in August 2005), with the median age of the loans at 15 months.\textsuperscript{60} The use of innovative (and complicated) lending products like adjustable-rate mortgages\textsuperscript{61} peaked in May 2005, with DataQuick reporting that adjustable-rate mortgages comprised 77.8\% of all loan originations in that peak period alone.\textsuperscript{62} At the end of 2006, adjustable-rate mortgages reportedly made up 22\% of California's $256.8 billion total mortgage debt outstanding as opposed to approximately

\begin{itemize}
\item \textsuperscript{54} See, e.g., Ratcliff II, supra note 43, at California-53 (illustrating the percentage change in notices of default from 2005Q4 to 2006Q4 by percentage increase); REAL ESTATE AND CONSTRUCTION REPORT FIRST QUARTER 2007, REAL ESTATE RESEARCH COUNCIL OF SOUTHERN CAL. (2007) (providing employment, housing, and county recorder data by county); see also Ratcliff I, supra note 17 (for the explanation); Ratcliff I, supra note 17, at 58 (noting that San Joaquin, Riverside, Yuba, Sacramento, Stanislaus, and Merced Counties (in descending order) had the highest number of trustee deeds of sale filed per 10,000 households in California).
\item \textsuperscript{55} Stoddard, supra note 17; cf. Dean Treftz, Where Home Prices Are Hot Now, WALL. ST. J., May 9, 2007.
\item \textsuperscript{56} Stoddard, supra note 17 (quoting Leslie Appleton-Young, chief economist at the California Association of Realtors, Laura Armstrong, Vice President of Public Relations for the Mortgage Bankers Association, Mark Zandi, chief economist at Moody's Economy.com and the nonprofit Center for Responsible Lending in Oakland, California).
\item \textsuperscript{59} Stoddard, supra note 17. See, e.g., Ryan Ratcliff, The California Report: Are We There Yet?, UCLA ANDERSON FORECAST, 53, 61 (June 2007) [hereinafter Ratcliff III].
\item \textsuperscript{60} See Activity Jumps Again, supra note 21.
\item \textsuperscript{61} THOMAS J. NOTO, III, ANNUAL PERCENTAGE RATES, TRUTH IN LENDING (2000) (explaining the difficulty of predicting APR for adjustable-rate mortgages, which the author characterizes as complicated lending products).
\item \textsuperscript{62} See Activity Jumps Again, supra note 21.
\end{itemize}
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10% of Florida’s total and approximately 6% of New York’s total.\(^63\)

Race and ethnicity are part of the mix as well. In a 2006 study of 50,000 subprime loans originating in California, the Center for Responsible Lending in Oakland, California concluded that African American borrowers were “6 to 34% more likely to receive a higher-rate loan than if they had been white borrowers with similar qualifications,” while Latino borrowers were “29 to 142% more likely to receive a higher-rate loan than if they had been non-Latino and white . . . .”\(^64\) Additionally, the study reported that racial disparities in access to credit occurred in these ways: African American borrowers were more likely than their white counterparts to be hindered with prepayment penalties while Latino/Hispanic borrowers were more likely to be hindered with subprime adjustable-rate mortgages. Lenders steered borrowers into these products using a yield spread premium,\(^65\) a practice by which lenders pay brokers an undisclosed amount to “advise” (steer) borrowers into higher-interest rate, higher-risk mortgage loans.\(^66\) Minorities were susceptible to this kind of steering for at least two reasons: they tended to establish credit histories on credit card debt rather than on mortgage debt, and their credit scores were more vulnerable in light of those histories.\(^67\)

By April of 2007, in California, in cases where NoDs were filed, homeowners were a median of five months behind on their primary mortgage payments, and they owed a median of $10,784 on a median mortgage of $331,200.\(^68\) On home equity lines of credit, California homeowners in default were a median six months behind on their payments, owing a median of $3,880 on a median credit line of $60,000.\(^69\) While homeowners may have purchased luxury items, it was also evident that they tapped home equity, dubbed the


65. Wolksi v. Fremont Inv. & Loan, 25 Cal. Rptr. 3d 500 (Cal. Ct. App. 2005) (defining yield spread premiums (YSP) and holding that they do not fall within the definition of points and fees for purposes of identifying a covered loan under the California predatory lending law, section 4970 of the California Financial Code, and under section 17200 of the California Business and Professional Code even where the use of a YSP results in a higher interest rate for the borrower).

66. Bocian, Ernst & Li, supra note 64.

67. Id.; see also AMERICAN INCOMES, supra note 10, at 308 (noting that credit card balances were at 46% for both “Non-Hispanic White” householders and “Nonwhite or Hispanic” householders (46.7%), with most credit card balances being reported by householders in the 35-44 age range, followed closely by householders in the 45-54 age range, while debt secured by a primary residence was considerably higher in the “Non-Hispanic White” category (51.9%) than it was in the “Non-white or Hispanic” category (37.4%), suggesting that credit scores for minority householders are a greater function of credit card and other installment loan histories than of mortgage histories).

68. See Activity Jumps Again, supra note 21.

69. Id.
homeowner's piggy bank, to fund ordinary expenses as well.  

C. Personal and Social Consequences of Default

Once the foreclosure process begins, a homeowner can bring his or her payments current by refinance or sale. But as housing markets flatten these transactional options are no longer certain to ease a borrower's debt obligations. In the first quarter of 2007, for example, 40% of California homeowners in default actually lost their homes to foreclosure, up 9% from the fourth quarter of 2006. Trustee deeds of sale recorded, a signal of the loss of a house to foreclosure, totaled 11,033 during the first quarter of 2007 up from 6,078 for the fourth quarter of 2006, and a sharp increase from the 637 such deeds filed in the second quarter of 2005. Again, while a different database might record different particulars, the trend toward housing and debt stress have become indisputable: NoDs are at historic highs, the housing market has cooled considerably, and in some areas, where the market no longer provides relief to overburdened consumers, NoDs, foreclosures, and deficiency judgments are on the rise as Chapter Seven “fresh start” bankruptcy options become restricted by a new focus on means testing.

For the individual consumer, the most obvious results of foreclosure are loss of physical shelter, loss of financial stability (including a further compromised credit score) loss of retirement security (from accumulated home equity), and loss of the social and tax benefits of home ownership. This harm is exacerbated for those borrowers of color who learn after loan origination that they have paid a hidden or higher cost for credit because their race or ethnicity was used as a predictor of risk by their lender.

70. Floyd Norris, Signs of Lean Times for Home Equity, The American Piggy Bank, N.Y. TIMES, Dec. 9, 2006 at B3 (presenting data to show that during the best 2 ½ years of the real estate boom—ending March 2006—“the value of home equity in American rose at a very impressive annual rate of 11.8[ percent]. But the total amount of mortgages outstanding rose at a rate of 13.5[ percent],” thus raising a “paradox: the more homes are worth, the more many owners owe ...” due to higher prices, refinances, and increased willingness to use home equity lines of credit).

71. Simon I., supra note 14; cf Julie Creswell, Web Help for Getting a Mortgage the Criminal Way, N.Y. TIMES, June 16, 2007(detailed websites that have developed to “make insolvent home shoppers look more attractive to lenders”).

72. See Activity Jumps Again, supra note 21.

73. Id.; see also Ratcliff II, supra note 43.

74. March 2007 Home Sales, supra note 45; see also James R. Hagerty, Supply of Homes Grows as Sales Remain Weak, WALL ST. J., May 9, 2007, at D3 (noting relationship between weakness of sales and high change in available inventory of single-family homes, condos, and town houses in the period of March 2007 to April 2007 for the San Francisco Bay Area (inventory up 19%), Orange County (up 15%), Sacramento (up 12%), and San Diego (up 9%)).


76. See Bocian, Ernst & Li, supra note 64.

77. See id.; see also BANKS AND BANKING, 12 U.S.C. § 1818 (2000) (terminating status as insured depository institution for violation of “an applicable law ... in connection with the approval of any
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D. The Credit Score as Property

Additionally, a long-term view confirms that a borrower’s relationship with credit in the past affects that borrower’s access to credit in the future. In 1964, in a law review article titled The New Property, Charles Reich defined “new property” as conditionally granted intangibles like income and benefits, jobs, occupational licenses, franchises, contracts, subsidies, and the use of public property distributed by government to create wealth. These assets together comprise the property of the poor (government entitlements), the property of the middle class (licenses, pensions, and other subsidies), and the property of the affluent (real estate and capital investments). By the end of the twentieth century, Reich’s “valuables dispensed by government” to the poor came under fire. Meanwhile, credit—today called the poor person’s capital or the “ultimate market-based social welfare program”—pushed to the fore. A borrower’s personal credit history (proprietarily packaged into a credit score) fits within Reich’s conception of the new property, especially as that credit score gets further protected by government intervention meant to protect consumers from lender overreaching.

application or other request” by the lender); EQUAL CREDIT OPPORTUNITY ACT, 15 U.S.C. § 1691 (2000) (prohibiting discrimination in mortgage lending on the basis of “race, color, religion, national origin, sex or marital status, or age”); FAIR HOUSING ACT, 42 U.S.C. § 3601 (2000) (stating that “it is the policy of the United States to provide, within constitutional limitations, for fair housing throughout the United States”); CIVIL RIGHTS ACT, 42 U.S.C. § 1983 (2000); Policy Statement on Discrimination in Lending, 59 F.R. 18266, 18269 (1994) (The statement provided that “if a lender has apparently treated similar applicants differently on the basis of a prohibited factor, it must provide an explanation for the difference in treatment. If the lender is unable to provide a credible and legitimate nondiscriminatory explanation, the agency may infer that the lender discriminated.”).


79. Charles A. Reich, The New Property, 73 YALE L.J. 733, 733-737, 758 (1964) (opening with the idea that “[t]he institution called property guards the troubled boundary between individual man and the state”).

80. Id. at 738, 758.

81. Id. at 733.

82. EMILY CARD, STAYING SOLVENT: A COMPREHENSIVE GUIDE TO EQUAL CREDIT FOR WOMEN 2, 15-47 (1985) (discussing the necessity of credit for generating capital).

83. SULLIVAN, WARREN & WESTBROOK, supra note 1, at 138.

84. Reich, supra note 79, at 774 (“Reduced to simplest terms, ‘the public interest’ has usually meant this: government largess may be denied or taken away if this will serve some legitimate public policy); see, e.g., Cavin v. Home Loan Ctr. Inc., 469 F. Supp. 2d 561, 564 (N.D. Ill. 2007) (holding that a lender can access private financial information without prior permission from any borrower to whom the lender makes a firm but contingent credit offer, and thus illustrating and expanding upon Reich’s idea that the contingent nature of intangible property, even if initially distributed by a private entity, later gets protected by government action); see also Reich, supra note 79, at 785 (arguing that some forms of largess, particularly those “closely linked to status” must eventually be “governed by a system of regulation plus civil or criminal sanctions, rather than a system based upon denial, suspension and revocation); White v. E-Loan Inc., 409 F. Supp. 2d 1183 (N.D. Cal. 2006) (certifying a class of 100,000 consumers who received a pre-screened credit solicitation based on consumer data harvested without prior permission).
which a lender forecasts a borrower's likelihood of meeting a debt obligation over time) lenders can theoretically hedge perceived risk at the contract phase of the lender/borrower relationship. A credit score is important to consumer well-being as it is itself a kind of property, the lack of which leads to a kind of poverty, as measured by algorithmically derived factors.

Historically, the acquisition and cost of credit were a function of social class. Today, the derivation of the personal credit score is a function of the market, as the credit score is a product that provides every consumer with a rank that determines his or her "earned" access to and cost of credit. Credit scores are fluid and improvable over time, but a low credit score at any point represents heightened risk for the lender. So, when low-score/high-risk "subprime" consumers get access to credit, even in amounts substantial enough to purchase a house, lenders expect to extract an upfront payback to hedge the risk that such borrowers pose.

The upfront payback comes in various forms. Today, higher coupon and/or margin rates are used to hedge risk. But such rates can still presume a transaction that requires a buyer to produce a substantial percentage of capital (cash) relative to the market value of the asset he is purchasing. This, of course, is capital that a low-scoring, credit-dependent borrower might not have or be able to access. Due to the overlap between subprime borrowers and cash poor borrowers, lenders have engineered other ways to hedge risk.

For subprime borrowers (the credit poor) and alt-A borrowers (the credit blemished), attractive loan products can take one of several forms, some overlapping, that promise lenders return even when loaning to high-risk borrowers. Examples include: option adjustable-rate mortgages (option ARMs); low documentation/no asset loans; interest-only loans; loans that near or exceed the cost of the property they are secured by; and, in California, forty- or fifty-year mortgages. These types of products tap potentially lucrative subprime and alternative-A credit markets and can be discounted with "teaser rates" to lure customers in, two factors that ensure volume (and thus profit) for lenders, while at the same time hedging risk.

85. 15 U.S.C. § 1681g(f)(2)(A) (2000 ed., Supp. IV) (defining a "credit score" as "a numerical value or a categorization derived from a statistical tool or modeling system used by a person who makes or arranges a loan to predict the likelihood of certain credit behaviors, including default"); see also Debt Markets: To Close for Comfort?, 38:458 EUROMONEY 76 (June 2007).

86. See, e.g., Safeco Ins. Co. v. Charles Burr; Geico General Ins. Co. v. Ajene Edo, 127 S. Ct. 2201 (2007) (holding that the Fair Credit Reporting Act allows for a credit score to be used in setting insurance rates for consumers).

87. CALDER, supra note 1, at 37-73.

88. See, e.g., DAVID S. EVANS & RICHARD SCHMALENSEE, PAYING WITH PLASTIC: THE DIGITAL REVOLUTION IN BUYING AND BORROWING 85, 87-91 (2005); CALDER, supra note 1, at 37-73.

89. For a classic study of court records of debt entanglement in the late 1960s, see DAVID CAPLOVITZ, CONSUMERS IN TROUBLE: A STUDY OF DEBTORS IN DEFAULT (1974); See also SULLIVAN, WARREN & WESTBROOK, supra note 1, at 41-50 (placing studies in broader context of research literature and summarizing theses about race/ethnicity in the studies).
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Devices, like the prepayment penalty, or the yield spread premium also can be engineered into a loan to make the final product profitable for the lender regardless of whether the consumer keeps the loan, refinances, or goes into default. In theory, all lender bases are covered, so long as accounting practices are solid. If a consumer defaults, the traditional remedy for covering the lender's risk is the security interest taken on the property purchased. But in recent years, as mortgage backed securities have become popular, home finance has become less about servicing buyers in the purchase of an appropriate loan and more about national and global investment. Thus, when mortgages are sold to serial assignees, the concept of the one-dimensional security interest must itself morph into something significantly more dynamic than it was previously. How this new complication will define what legal remedies are ultimately available for consumers is an open question.

E. Legal Options

Before the housing boom, low- and fixed-income buyers often lacked access to mortgage credit. During the boom, a rising market coupled with the extensive marketing and use of complicated lending products (like option ARMs) made it possible for previously credit poor or cash poor buyers to secure even more credit to purchase or refinance of a house.

Unfortunately, as the housing market turns downward, these low- to mid-income buyers are as or more vulnerable economically than they were before. Their inclusion in the American dream, to paraphrase Langston Hughes, is again deferred. Their critics characterize them as a class not capable of understanding the nature of credit. They are blamed for making obligations that they could not keep, or accused of perpetrating fraud on lending institutions by overstating income or assets. There is worry that the threat of lawsuit will

90. See, e.g., David Shulman, A Near Recession Experience, UCLA ANDERSON FORECAST, September 2007, at Nation-12 ("Indeed, the financial markets discovered that subprime mortgages or more likely collateralized debt obligations (CDOs) backed by subprime loans were held all over the world, especially by financial conduits that issue commercial paper.").

91. Shulman, supra note 63, at Nation-12; Laurie A. Burlingame, A Pro-Consumer Approach to Predatory Lending: Enhanced Protection through Federal Legislation and New Approaches to Education, 60 CONSUMER FIN. L. Q. REP. 460, 461-464, 480 (connecting the growth of the subprime market to state-imposed usury statutes, a series of congressional actions, and behavioral finance theory); SULLIVAN, WARREN & WESTBROOK, supra note 1, at 206-216; CALDER, supra note 1, at 262-290 (arguing that the economic difficulties of the Great Depression did not kill credit lending so much as it led to enhanced innovations in the credit industry).

92. Norris, supra note 70; see also FEDERAL RESERVE, supra note 53 (placing consumer credit at a total of $2,425.5 billion (up 6.7% from February 2007), $888.2 billion for revolving (up 9.2% from February 2007) and $1,537.3 billion nonrevolving (up 5.2% from February 2007)); Shulman, supra note 63, at Nation-12.


95. See, e.g., Steven Morris, Letter to the Editor, The Burden of Debt, N.Y. TIMES, Mar. 31, 2007, at 14; see also CALDER, supra note 1, at 93 (explaining the origins of the perceived cultural difference
“choke off” access to credit for others.\textsuperscript{96}

Those who support low- to mid-income buyers defend the buyers’ right to affordable credit,\textsuperscript{97} detail the factors that lead to bankruptcy,\textsuperscript{98} and call for more regulation of mortgage lending.\textsuperscript{99} These allies identify the class and race issues otherwise hidden in stories about the expanding mortgage crisis, thus giving rise to the disturbing hypothesis that in the U.S. today, credit is more expensive for people of color—of all socio-economic classes—than it is for their white counterparts.\textsuperscript{100} The arguments differ, but most of them turn on access to credit issues. Only a handful of arguments delve into why it is that the so-called democratization of credit must turn on products that put consumers of modest means at such serious financial risk.\textsuperscript{101}

Clearly there is a mortgage undertow, if not a full-blown crisis at hand. But what is a useful legal response to this crisis? What disparities in lending, if any, have been identified thus far? How have these new and complicated lending products been explained to consumers? Is it a minor error on the lender’s part to confuse a teaser rate with an interest rate, or to fail to disclose that race was used as an additional proxy for risk?\textsuperscript{102} If not, are borrowers’ remedies exclusively individual? Might not a broader remedy be called for? A remedy that holds lenders liable for the financial risk that their complicated loan products exposed borrowers to, especially in a falling real estate/ rising interest rate market?

The door is still open for aggrieved borrowers to litigate these questions. Under the Truth in Lending Act (TILA), individual borrowers can sue lenders for irregularities in disclosure.\textsuperscript{103} TILA requires creditors to make specific disclosures about the mortgage contract upon pain of damages or rescission.\textsuperscript{104} These include disclosures related to the cost of credit (the time series properties explained above) and to the extension of credit.\textsuperscript{105} TILA’s

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\textsuperscript{96} Daniel J. Morgan, The Right of Rescission, Still Controversial After All These Years, 49 CONSUMER FIN. L.Q. REP. 177, 177-178, (1995).


\textsuperscript{98} SULLIVAN, WARREN & WESTBROOK, supra note 1, at 214-220.

\textsuperscript{99} Id. at 250, 252-261.

\textsuperscript{100} VINCENT J. ROSCIGNO, THE FACE OF DISCRIMINATION: HOW RACE AND GENDER IMPACT WORK AND HOME LIVES 175-76 (2007); STEPHEN L. ROSS & JOHN YINGER, THE COLOR OF CREDIT: MORTGAGE DISCRIMINATION, RESEARCH METHODOLOGY, AND FAIR LENDING ENFORCEMENT (2002); see also Bocian, Ernst & Li, supra note 64; Syphax, supra note 97.


\textsuperscript{102} Morgan, supra note 96, at 177-178 (calling claims based on document errors neo-Rodash claims, based on Rodash v. AIB Mortg. Co., 16 F.3d 1142 (11th Cir. 1994), a case later overruled by subsequent TILA amendments in 1995).


\textsuperscript{105} 15 U.S.C. § 1631 (2000); see also, H.R. 3915, 110\textsuperscript{th} Congress 1\textsuperscript{st} Session (Oct. 22, 2007)
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language clearly allows class action lawsuits for damages and individual claims for rescission, but TILA is silent on the issue of class-wide rescission. TILA's statutory silence has sparked a debate among the federal circuits over whether a class of borrowers can sue a lender for what turns out to be a potentially ruinous mortgage product. On one hand, if economic and social gains have flowed to subprime borrowers from increased home ownership, then perhaps courts should shield the lending institutions that violated TILA to preserve access to credit, at least until other legal safety-nets can be initiated. On the other hand, the dangerous nature of the loans themselves should weigh strongly in favor of allowing the use of TILA to strike a legal blow to those lenders who inserted dangerous financial products into the marketplace without full disclosure to consumers of the risk and true cost of those products.

III. SELLING ARMS: VOLUME, PROFITS, AND DISCOUNTS

Reports of a mortgage-lending problem began surfacing in the fall of 2006. By early March of 2007, financial newspapers like the Investor's Business Daily and the Financial Times (U.S.A.) were reporting on the issue. By the end of March, 2007 and into June, 2007, the Wall Street Journal and the New York Times were devoting extensive front-page coverage to what was first called a mortgage-lending problem and later a mortgage undertow, a mortgage meltdown, a mortgage cloud, and finally a mortgage crisis. Specifically, the press reported about the financial problem adjustable-rate mortgages posed for consumers as loans reset, and for markets as consumer defaults increased. (inserting new minimum standards of disclosure for all residential mortgage loans).

106. See, e.g., supra note 101 (warning in general terms that adjustable-rate mortgages are dangerous and should be regulated); H.R. 3915, 109th Congress 1st Session (Oct. 22, 2007) (addressing disclosure problems that made the cost of innovative mortgage products unpredictable for consumers).


107. Syphax, supra note 97 (arguing for lowering the rating for subprime loans that do not require the borrowers to complete pre-home ownership education and counseling programs, thus making that set of loans attractive to secondary markets, and for implementing 24-month mortgage payment protection insurance to help borrowers guard against divorce, job loss, illness, and disability, which are "among the biggest contributors to mortgage default"); see also NEHEMIAH CORPORATION OF AMERICA, EXPANDING AFFORDABLE HOME OWNERSHIP WITH PRIVATE CAPITAL: A STUDY OF THE NEHEMIAH DOWN PAYMENT ASSISTANCE PROGRAM, http://www.nehemiahcorp.org/milkenreport (last visited June 10, 2007).


111. See, e.g., Whitehouse, supra note 57.

112. See, e.g., Fahim & Nixon, supra note 93.

113. See supra notes 109-112; see also CALDER, supra note 1, at 292-294 (identifying the "stock analysis" used to explaining the rise in consumer debt/credit).
Option ARMs, subprime loans, alternative-A (alt-A) loans, interest-only loans and the like are common ways of referring to the mortgage products that are on the market today. "Subprime" generally refers to borrowers with marred credit histories. Alternative-A (or alt-A) refers to borrowers with blemished credit histories. Prime refers to borrowers with strong credit histories. These labels refer to consumer qualifications, but they can also refer categorically to types of loan products. Many of the new products, unlike the fixed-rate products of old, adjust in various ways, and indeed because of this feature, these products can fill the needs of many a cash-strapped borrower.

An option adjustable-rate mortgage, for example, is a specific kind of mortgage product that uses two or (usually) more arithmetical time series properties to determine interest rate dynamics. A contractually set market index and a formula of time series properties determine whether and when an adjustable-rate mortgage will reset (adjust) and by how much. The variables of market index and time also determine the length and cost of the loan. Any given option ARM can use a different market index to measure the underlying rate of interest that a borrower will pay at any given point in the life of the loan. However, four indices dominate the market: (1) the one-year constant maturity Treasury yield; (2) the one-year LIBOR; (3) the Federal Housing Finance Board (FHFB) national average contract interest rate; and (4) the Eleventh District Cost-of-Funds Index (EDCOFI).

In theory, an option ARM gives a borrower choice. As a fixed payment product, for instance, the option ARM contract allows for multiple payment options. But if a borrower elects the fixed payment option—an economic

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114. See, e.g., Shulman, supra note 63, at Nation-12. A mortgage can be used to purchase or to refinance a home. A home equity loan is a closed-end product and a home equity line of credit is akin to revolving credit because it is open-ended. See 15 U.S.C. § 1602 (2000) (defining "creditor," "consumer," "open end credit plan," and "residential mortgage transaction").

115. Published by the Federal Reserve Board in its H-15 statistical release, this index is computed as a weekly average. See also THE FEDERAL RESERVE BOARD, CONSUMER HANDBOOK ON ADJUSTABLE RATE MORTGAGES 1 (2006), http://www.federalreserve.gov/pubs/arms/arms_english.htm (last visited June 22, 2007) (providing one-sentence explanations of how adjustable-rate mortgages work and the risk they carry to consumers).

116. Reported by the Board of Governors of the Federal Reserve and major financial papers, the one-year London Interbank Offered Rate is a daily quote by five London banks that are averaged and rounded to the nearest 1/16th to arrive at the index rate. See, e.g., Bankrate.com, 1 Year LIBOR Rate, Sept. 26, 2007, http://www.bankrate.com/brm/ratewatch/1yr-libor.asp (last visited June 12, 2007) (stating consumer information on 1-year LIBOR).

117. This Federal Housing Finance Board Index is a monthly report of the average of initial mortgage interest rates paid by home buyers for loans originated during the first five business days of every month. See Federal Housing Finance Board, http://www.fhfb.gov (last visited June 12, 2007).

necessity for many borrowers—negative amortization (what lenders call "deferred interest") results. Mathematically, negative amortization works like positive compounding, but in the opposite way; negative amortization is the compounding of interest owed to the lender by the consumer, rather than the compounding of principal earned by the consumer from a bank or investment. Over time, if interest rates rise and if so-called "deferred interest" accrues, then any borrower who elects to pay only the fixed minimum payment will eventually owe more than was originally borrowed.119 Termed "calculating interest by the actuarial method," negative amortization is a legally acceptable (and profitable) way for a lender to engineer a lending product so that once a borrower falls behind, he or she is eventually liable for continuously accruing interest owed.120

As a discounted product, the option ARM contract uses a low "teaser rate" (an initial interest discount) at the outset of the mortgage contract to lure the consumer with the promise of low monthly payments. Briefly, the coupon rate on a loan is the amount promised as return per dollar to a lender or investor.121 Option ARMs of the recent housing boom commonly had no or low initial coupon rates. Practically, this meant that a borrower would pay less than the contractually determined fully indexed rate plus a percentage margin,122 at the start of the loan. At a contractually determined time, the cost of the loan would reset to a fully indexed annual percentage rate, identified by the index rate plus the agreed upon margin rate. This is the legal concept of the annual percentage rate, or APR, which is not a method to calculate interest so much as it is a uniform way for consumers to price competing loan products.123 The fully indexed rate plus the margin thus becomes the non-discounted rate that the buyer is liable for after the teaser rate expires. To be sure, deep discounts diminish lender return on a single loan, but they also attract borrowers in already credit-saturated markets. At the high mark of the housing boom, not only were option ARMs attractive to subprime borrowers they were also

120. See, e.g., Cavin, 469 F. Supp. 2d at 564.
122. See, e.g., Cavin, 469 F. Supp. 2d at 563 (quoting a margin of 2.10% as added to the Monthly Treasury Average Index).
123. 15 U.S.C. § 1606 (2000) (stating that the annual percentage rate "shall be determined in accordance with the regulations of the [Federal Reserve] Board").
profitable to lending institutions, especially when originated in high volume.

**A. Innovative Lending Products, Real Estate Markets and Capital Markets**

Before 2006, interest rates were at historic lows and home prices were rising at a record pace in many areas of the country. These market alignments gave lenders a keen incentive to originate mortgages in volume. Indeed, despite any engineered hedges that might increase the cost of credit for an individual consumer, credit was widely available across the board. The economic environment so amplified the housing market that consumers, lenders, and policy analysts agreed, despite their diverging interests, that innovative (new and often risky) mortgage products made home-ownership available to more consumers than had been possible with traditional fixed rate (FRM) mortgages. In the early 1960s, the Census Bureau recorded home ownership rates for the U.S. at the 62% mark. By 2006, this number had risen to nearly 69% for the U.S. overall, with the highest increase in the South and Midwest.

As discussed previously, specialty products comprised a high percentage of mortgage originations during the housing boom. The traditional house buying formula of a fully amortized fixed rate mortgage, supplemented by a 20% cash down payment, gave way to the widespread use of an adjustable rate lending product with little or no cash down payment. The investment group Lehman Brothers analyzed the change in mortgage products nationally from 2001 to 2006. It found these changes: use of “subprime” mortgages increased from 6.3% in 2000 to 14.6% in 2006; use of “interest only/negative-amortization” products increased from 2.0% in 2000 to 26.0% in 2006; use of “cost to loan total value >90%” products increased from 4.8% in 2000 to 14.7% in 2006; and “limited documentation” products increased from 7.0% in 2000 to 20.0% in 2006.

Nationally, subprime loans accounted for “fully 20% of the flow and 15% of the stock of the $8 trillion securitized mortgage market at the end of 2006” whereas “California accounted for 38% of the $1.2 trillion subprime loans held in securitized pools.” One early industry source estimated that ARMs comprised at least 22% of California’s total mortgage debt, if not more. While lender analyses tended to cluster around the claim that “foreclosures are simply a well-functioning market punishing investors in a

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126. *Callis & Cavanaugh, supra* note 8, at 6 (discussing home ownership rates for the United States and specific regions); see also *supra* note 8.

127. *See supra* note 62; *supra* note 63.


129. *Id.*

130. *See supra* note 63.
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high stakes game of musical chairs," consumer advocates blamed aggressive and predatory lending for the crisis.131 Either way, the use of complicated lending products and adjustable-rate mortgages was so extensive that HSBC's Chief Executive Michael Geoghegan warned that the mortgage lending crisis was not one of "trailer park lending," but one of "Main Street America."132

Option ARMs, alt-A loans, interest-only/negative amortization loans, and 40- or 50-year mortgage products (available in California) first appeared in the subprime lending market, a market made up of thinly capitalized consumers with poor credit scores, and high credit dependency. In California, subprime vectors crossed with immigrant, minority, and low-, fixed-, and middle-income sectors of the population, sectors for which home ownership rates were historically low.133 Housing and Urban Development (HUD) Office figures for late 1994 to 2001 show that minority home ownership rates were over 25 percentage points lower than white home ownership rates in that period.134 As the housing boom neared its end in 2005, however, the gap had narrowed slightly, suggesting that minority consumers, despite lower household incomes generally, were making the move to home ownership.135

In one sense the loosening of credit in the form of complicated lending products evidenced a "democratization" of the American dream,136 as lack of capital for down payment and closing costs had been one of the historic barriers to home ownership.137 These new products, despite serious allegations of discriminatory practices, did increase access to credit and possibly capital.138 In any given transaction, option ARMs could be stacked with adjustable rate home-equity lines of credit to fully fund a purchase.139 In this way, one or more

131. See, e.g., Ratcliff I, supra note 17, at 56 (summarizing and analyzing how the data supports the competing "efficient market" versus "predatory lending" theories for the current mortgage picture).
132. Scholtes, Larsen & White, supra note 110. At year-end 2006, HSBC Finance was the second-largest subprime lender. See, e.g., Shulman, supra note 63; cf. Bajaj, supra note 17 (noting that California has been hit hard, but then incorrectly defining this as a "subprime" problem that is confined to a small slice of less able borrowers).
133. See, e.g., American Fin. Servs. Ass'n v. City of Oakland, 34 Cal. 4th 1239 (2005) (holding that Oakland Municipal Code section 5.33, which was meant to address predatory subprime mortgage lending in the Oakland housing market, was preempted by California Financial Code Sections 4970-4979.8).
134. Dep't of Housing & Urban Dev., supra note 6.
135. See, e.g., RACIAL AND ETHNIC DIVERSITY: ASIANS, BLACKS, HISPANICS, NATIVE AMERICANS, AND WHITES 315, 327 (5th ed. 2006) (citing "Hispanic Homeownership Rate" from 1994 to 2004, citing median income for Latino households from 1990 to 2003, and specifying that in 2003, the median income of total households was $43,318, whereas for Hispanic households it was $32,997); see also id. at 214 (citing "Black Homeownership Rate" from 1994 to 2004, citing median income for Black households from 1990 to 2003, and specifying that in 2003, the median income of total households was $43,318, whereas for Black households it was $29,689).
136. See, e.g., CALDER, supra note 1, at 37-73; EVANS & SCHMALENSEE, supra note 88, at 45-50; NEHEMIAH CORPORATION OF AMERICA, supra note 107.
137. Dep't of Housing & Urban Dev., supra note 6.
138. Bocian, Ernst & Li, supra note 64.
139. Shulman, supra note 63, at Nation-12 (noting that data for home equity lines of credit are sketchy at this time).
loans often provided otherwise cash- and credit-poor buyers with enough capital to purchase, furnish, and even renovate a house. Additionally, these products could be used to refinance original mortgage debt and thus tap available home equity in a rising market.

The American Dream seemed to be alive and well.\textsuperscript{140} Specialty mortgage products seemingly represented a real gain to buyers who would otherwise have been excluded from the housing market, but that gain now appears to be receding as housing prices fall. In any case, it has come at a steep financial, social, and personal cost to consumers.\textsuperscript{141} The specialty ARMs, alt-A loans, and interest-only loans in the portfolios of a great many of the poor and undercapitalized, are today regarded as the high-cost, if not predatory, spur of the sort that has fueled historic speculative bubbles in gold, lead, silver, and land.\textsuperscript{142}

In coastal areas of the country, the use of adjustable-rate mortgage loans have also spread to traditionally defined luxury markets.\textsuperscript{143} Low teaser rates, convenient but not often necessary to well-capitalized buyers, proved useful in the purchase of a vacation or luxury home.\textsuperscript{144} In the San Francisco Bay Area,

\textsuperscript{140} See, e.g., About Fannie Mae, FANNIE MAE, http://www.fanniemae.com/aboutfm/index.jhtml? p=About+Fannie+Mae (last visited on December 17, 2007) (on June 12, 2007, the website stated that “[o]ur public mission, and our defining goal, is to help more families achieve the American Dream of home ownership” but that language was replaced with language detailing Fannie Mae’s “American Dream Commitment . . . whose purpose is to help people qualify for a mortgage and build equity wealth”); see also Freddie Mac in the News: Helping Families “Catch the Dream,” FREDDIE MAC, http://www.freddiemac.com/news/in_the_news/whitehouse_1016.htm.


\textsuperscript{142} See, e.g., American Fin. Services Ass’n, 34 Cal. 4th 1239.


\textsuperscript{144} For example, the median price for a house in Q1 2007 in Marin County, California was over $900,000; in Q2 2007, the median price of a home in Marin County broke the $1,000,000 mark; in Q3 2007 it dipped back to $925,000. See Gary Klien, Home Prices Slip Below $1 Million Threshold: Median Figure for May Dips to $925,000, MARIN I.J., June 15, 2007, at A1 (citing Bay Area Home Sales Drop, Prices Up, DQNEWS.COM, May 16, 2007, http://www.dqnews.com/RRBay0507.shtm (last visited November 30, 2007)).

\textsuperscript{145} See, e.g., Elizabeth Harris, Luxury Real Estate Investment, WORTH, Apr. 2007, at 74 (citing a 2006 study sponsored by the Research Institute for Housing America, a Washington D.C.-based nonprofit, concluding that mortgages comprise only 4% of all mortgage activity in the vacation-home/investor market); Matt Purdue, Home Security, WORTH, Apr. 2007, at 8; Matt Purdue, Stubborn Slump, WORTH, July 2007, at 8 (noting that “once trendy vacation regions in Florida and California saw home prices fall by as much as 40 percent in 2006”); Russ Alan Prince & Hannah Shaw Grove, What Bubble? Despite Agitation in the Real Estate Market, Very Affluent Homeowners Continue to Buy, Sell, and Remodel, WORTH, July 2007, at 56 (concluding from a first quarter 2007 update of a 2003 survey of homeowners with net assets of $1 to $10 million, $10 to $20 million, and over $20 million that only
where the median price of a house rose to levels at or well above the Office of Federal Housing Enterprise Oversight (OFHEO) conforming loan limits of $417,000 in 2006—a limit that remained unchanged in 2007—what might have appeared on paper to be a luxury purchase (or refinance) was in fact the tentative purchase of a modest abode.

Still, the OFHEO conforming loan limit is an important marker. It determines the maximum size of a mortgage that Fannie Mae and Freddie Mac can buy or guarantee. It also sets the line between lower interest "conforming" loans and higher-interest/risk "jumbo" loans. Further, in California the OFHEO conforming loan limit is part of the definition of a covered loan under the predatory lending statute. Given San Francisco Bay Area prices, even buyers who purchased or refinanced the most modest of homes likely funded their credit transaction with a jumbo loan over $417,000, which is above the OFHEO limit. According to California Association of Realtors President, Colleen Badagliacco, "the median price of a home [in California] exceed[ed] the national median by 79%," yet California was not recognized by the OFHEO as a "high-cost" state, as were Alaska, Hawaii, Guam, and the U.S. Virgin Islands.

The media presented many human-interest stories to put a face on the buyers who used adjustable mortgage products. In California, for example, predatory lending is narrowly applicable to covered loans. Thus in the first quarter of 2007, the Wall Street Journal reported the story of Mr. Felipe Duluna of Watsonville, California, who apparently purchased a $729,000 house using a jumbo adjustable mortgage product on an annual income of $27,000.

On the numbers alone, Mr. Duluna’s loan might seem predatory since by any mathematical model a $27,000 income cannot fund, much less support, the purchase of a $729,000 house. But under California’s predatory lending law, Mr. Duluna’s loan probably would not qualify as a covered loan if it exceeds "the most current conforming loan limit of $417,000 for a single-family first

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147. 2007 Conforming Loan Limits Unchanged, CALIFORNIA REAL ESTATE, Jan./Feb. 2007, at 11 [hereinafter Conforming Loan Limits Unchanged].
148. CAL. FIN. CODE §§ 4970(a)-(b)(2) (LEXIS through 2007 legislation).
149. Conforming Loan Limits Unchanged, supra note 147, at 10.
150. Fahim & Nixon, supra note 93.
153. See, e.g., Howard, supra note 19, at 88.
mortgage loan."\textsuperscript{154} Thus, if a loan is not a covered loan under the predatory lending statute, the issue of whether the lender originated the loan without regard to Mr. Duluna's ability to repay would not arise under California law, nor for the same reason would it arise under TILA.\textsuperscript{155}

\textit{New York Times} reporters Kareem Fahim and Ron Nixon gave an extensive report on how borrowers were struggling to pay adjustable rate loans in the heavily minority city of Newark, New Jersey.\textsuperscript{156} In Detroit, on the 5100 block of West Outer Drive—previously "the model of middle-class home ownership" and "part of an urban enclave of well-kept Colonial residence and manicured laws"—seven of the twenty-six households on the block reportedly took out "subprime" mortgage loans. Of those seven borrowers, four used the loans to extract equity from their homes, while three used the loans to purchase homes. Of the four refinancing borrowers, two are now on the verge of eviction. Of the three who used the loans to purchase a home, one is in foreclosure.\textsuperscript{157} Stephanie Moore, a Bay Area writer in retreat from the high prices of the California real estate market, wrote of how she moved to the southern United States in order to buy an affordable home only to discover how easy it was for her to fall into default on her adjustable-rate mortgage.\textsuperscript{158}

Low- and fixed-income buyers, who predictably could not accommodate significant increases in housing and maintenance costs, were routinely given access to more risky and costly specialty ARMs.\textsuperscript{159} To ensure volume, lenders debased standards by moving from the traditional 2.5 standard to the newer standards like the 28/36 standard.\textsuperscript{160} Under the 2.5 standard, a mortgage loan should not exceed 2.5 years of income, while under the 28/36 standard a mortgage payment should not exceed 28% of the borrower's income and all debt payments should not exceed 36% of the borrower's income. This shift from measuring the buyer's ability to repay the principal balance of the loan itself (the 2.5 rule) to measuring her ability to make the payments (the 28/36 rule) is significant and will likely be further investigated by scholars. One unanswered legal question, of course, is whether loans should have originated

\begin{footnotesize}
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  \item \textsuperscript{154} See notes 146 to 148 \textit{supra}.
  \item \textsuperscript{155} CAL. FIN. CODE §§ 4970 (a)-(b)(2) (LEXIS through 2007 legislation) (defining a covered loan for purposes of predatory lending under California law); 15 U.S.C. § 1639 (2000); \textsc{Home Ownership Equity Protection Act}, 12 C.F.R. § 226.34(4) (2007) (defining a covered loan for purposes of predatory lending under federal law). See CAL. FIN. CODE § 4973(f)(1) (LEXIS through 2007 legislation) (defining lender obligations as to covered loans with a special emphasis on criteria that may legitimately be used to evaluate the borrower's ability to repay the loan); 15 U.S.C. § 1639(h) (2000) (providing that "a creditor shall not engage in a pattern or practice of extending credit to consumers under mortgages . . . based on consumers' collateral without regard to the consumers' repayment ability, including the consumers' current and expected income, current obligations, and employment").
  \item \textsuperscript{156} Fahim & Nixon, \textit{supra} note 93.
  \item \textsuperscript{157} Whitehouse, \textit{supra} note 57.
  \item \textsuperscript{158} Moore, \textit{supra} note 141.
  \item \textsuperscript{159} \textit{Id}.
  \item \textsuperscript{160} \textsc{Shiller}, \textit{supra} note 143, at 211.
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\end{footnotesize}
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at all in cases where borrowers met the 28/36 standard for a heavily discounted loan product, but not for that same product as it reset upward. \(^{161}\)

Nevertheless, as housing prices rose, arguments in favor of adjustable-rate mortgages were heard from all sides. Analysts took pride in the fact that home ownership rates were higher than they had ever been, particularly in low-income, fixed-income, and minority communities. \(^{162}\) Lenders argued that the cost inherent to specialty loans was necessary to offset the risk of servicing the subprime and alt-A markets. \(^{163}\) Realtors proposed that a rising housing market would keep consumers afloat no matter their financial circumstance. \(^{164}\) And consumers (the group that will ultimately bear the first and most personal cost of the mortgage crisis) incorrectly believed that housing prices would continue to rise, that refinancing options would be readily available, and that mortgage brokers were part of a real estate/title advisory team whose legal duty it was to match buyers with loans appropriate to their financial situation. \(^{165}\)

Indeed, brokers and money managers had notice as of 2006 that subprime lending was becoming more risky for both buyers and investors. In September 2006, Freddie Mac announced that it would stop buying alt-A “no income-no assets,” mortgages, low documentation mortgages that could not be easily verifiable, and certain kinds of mortgages that were offered at discount with teaser interest rates like options ARMs. \(^{166}\) On March 6, 2007 and again on March 13, 2007, the DOW Jones Industrial Average, the S&P, and the NASDAQ fell sharply on heavy trading. \(^{167}\) Lehman Brothers downgraded the mortgage leader Countrywide, citing the subprime “undertow.” \(^{168}\) Countrywide share prices fell 5%. Stifel Nicolaus cut NovaStar, Accredited Home Lenders, and New Century to sell, citing an industry in a “downward spiral.” \(^{169}\) Shares of NovaStar\(^{170}\) stock fell 41% and shares of Accredited fell 21%. New Century fell 69%, down 91% from its fifty-two week high before it collapsed due to market and accounting problems. \(^{171}\) H&R Block’s mortgage unit reported big losses and warned investors that rising defaults could be “problematic.” \(^{172}\) As the source of its woes, H&R Block blamed “shaky borrowers as higher rates

\(^{161}\) See also CAL FIN. CODE § 4973(f)(1) (LEXIS through 2007 legislation) (determining criteria for whether a borrower can repay a loan); 15 U.S.C. § 1639(h) (2000).

\(^{162}\) See, e.g., Syphax, supra note 97.

\(^{163}\) See, e.g., Ratcliff III, supra note 59.

\(^{164}\) See, e.g., Fahim & Nixon, supra note 93.

\(^{165}\) Simon II, supra note 152 (reporting on story of Felipe Duluna).

\(^{166}\) Richard Beales & Saskia Scholtes, Freddie Mac Refuses Some Subprime Loans, FIN. TIMES (U.S.A.), Feb. 27, 2007, at 20.


\(^{168}\) Shinkle, supra note 109.

\(^{169}\) Id.

\(^{170}\) Id.

\(^{171}\) Id.

and flat home prices” took hold.\textsuperscript{173}

Capital markets and the financial newspapers that report on them regarded subprime lending as a problem that went far beyond the neighborhoods of the poor. In fact, in places like California, where housing prices are steep, all areas saw the use of complicated mortgage products. And with mortgage-backed securities gaining clout, the mortgage problem/cloud/crisis had become a phenomenon that reached well into both the investing and the affluent classes, either directly (through the use of jumbo loans) or indirectly (through stock and bond investments).\textsuperscript{174} Indeed, many an institutional and individual retirement fund met sharp volatility in the first quarter of 2007 as capital markets retreated over subprime lending fears.

The mortgage-lending problem has expanded from the homebuyer to the investor, where it has retraced its steps from the deep recesses of international financial papers to the front pages of the \textit{New York Times} and regional papers like the \textit{San Jose Mercury News}. It has moved from the subprime to the alt-A to the prime and, to a lesser degree, to luxury and second-home markets.\textsuperscript{175} Housing markets are responding to the mortgage crisis. With the exception of a few, highly unique and affluent markets where housing-stock is finite or a few so-called retreat markets,\textsuperscript{176} housing prices are flattening nationwide, and even falling from their market highs. When mortgage money flowed freely and housing prices soared upward Robert J. Shiller seemed the lone voice sounding the alarm at the home equity party that “things happen during a speculative bubble that can ruin people’s lives.”\textsuperscript{177} Now reporters and politicians are joining in to explain what has occurred. Yet, it is lawyers, who deal with individuals and their claims, who will be the first to see the financial wreck that option ARM mortgages have made of once “middle class” lives.\textsuperscript{178}

\section*{IV. THE NEW NORMAL: A MINI PRIMER ON FRMs, ARMs, AND NEGATIVE AMORTIZATION}

Adjustable-rate mortgages (ARMs) are different in function and risk than fixed-rate mortgages (FRMs), though both are collateralized by security. With a FRM, a buyer can finance a portion of a purchase at a fixed interest and fixed

\begin{footnotesize} 
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\item Id. 
\item \textit{See. e.g.,} Prince & Grove, supra note 145 (concluding that homeowners with over $20 million of assets are not concerned about the downturn in the real estate market, but they are watchful of capital market investments). 
\item \textit{See. e.g.,} Harris, supra note 145, at 73; see also Prince & Grove, supra note 145. 
\item Treftz, supra note 55. 
\item Shiller, supra note 143, at 211. 
\end{enumerate} 
\end{footnotesize}
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payment rate. With a FRM the buyer typically finances 80% of a house purchase. Payments on FRMs are amortized from the first payment to the last, and interest rates on FRMs do not adjust over time. In theory, FRMs are marketed to buyers who are capitalized and creditworthy enough to be mortgage-risk averse and who are stable enough (in theory) to stay in a property for longer than seven years.

ARMs, on the other hand, were marketed to buyers as a way to stay in a property for a short-term period. In actuality, they were also heavily marketed to buyers who could not afford (i.e., qualify for) FRMs because of lack of access to capital or credit. The risk inherent to ARMs is that they adjust in tandem with a measurable market interest rate index. Some indices adjust more quickly than others and thus may be more expensive for the consumer over time. Therefore, it seems that the comparative differences in indices should be fully disclosed to a borrower. ARMs have the advantage of carrying a lower interest rate and lower monthly payments in the early years. But since the ARM rate is adjustable and since interest rates are (still) at relative historic lows, it is more likely, that the ARM rates will go up for a given mortgage, despite what loan marketing information so often implied. Lower interest rates are remotely possible; higher interest rates are probable to certain.

Additionally, though ARMs are adjustable in terms of interest rates, they can be fixed in terms of the required minimum payment. This means that borrowers have payment and prepayment options (the "option" aspect of the ARM) that can affect the speed with which the loan gets repaid. Once a loan adjusts to a higher interest level, a larger percentage of the payment goes to accrued interest while a smaller percentage is credited toward principal. When a borrower elects to pay the minimum payment due, eventually, the entirety of

179. See CALDER, supra note 1, at 64-69 (detailing how the purchase of homes in the late 19th century, like today, was typically made with borrowed funds).


181. This percentage avoids the additional cost to a borrower of private mortgage insurance (PMI). See, e.g., id.

182. Stanton & Wallace, supra note 121, at 62 (concluding that the interest rate sensitivity of an ARM "depends significantly on three key factors: 'contract terms, the dynamics of the index underlying the mortgage, and on the prepayment behavior of the mortgage holders,'" and that "ignoring any of these interacting factors will lead to significant errors in measuring and hedging the interest rate risk of these mortgages"). See also supra notes 115 to 118.


the loan payment goes to pay accrued interest. At this point, negative amortization, termed deferred interest by lenders, occurs. Gravity works reliably, and so too does negative amortization, but while gravity democratizes weight, negative amortization works exclusively in favor of the lender.

V. FIRST QUARTER 2007 CLASS ACTION RESCISSION CASES

The first quarter of 2007 saw the beginning of consumer legal challenges to the marketing, use, and effect of new and risky mortgage lending products. These challenges came in several forms, but this article focuses on the challenges that were brought under the federal Truth in Lending Act (TILA), which requires lenders to provide consumers with clear, conspicuous, and reasonably understandable disclosures about the cost of credit. TILA does not “govern charges for consumer credit” or otherwise set the cost of credit. Market factors like indices, margins and coupon rates set those costs. Neither does TILA regulate the substantive rights and remedies of parties to a contract, except insofar as it gives consumers the substantive right to damages and the substantive “right to cancel certain credit transactions that involve a lien on a consumer’s principal dwelling.” TILA’s purpose is remedial, yet it does not limit the possibility for profit in the business of

185. Negative amortization refers to unpaid accrued interest, what lenders called “deferred interest.” See, e.g., Andrews, 240 F.R.D. at 620 (challenging a lender’s use of the term “deferred interest” when “negative amortization” was what the lender intended to communicate to the consumer); see also 12 C.F.R. § 226.22(a)(1) (LEXIS through 2007 legislation) (identifying two methods for measuring an exact annual percentage rate, the actuarial method, and the United States Rule Method (U.S. Rule)). These two methods yield the same annual percentage rate, but differ in their treatment of unpaid accrued interest.

Under the actuarial method, if no payment is made or if a payment made is insufficient to pay the accumulated finance charge, the unpaid accrued interest for that period is capitalized, meaning it is added to the amount financed. Because interest is owed on the amount financed, the net mathematical result is a negative compounding of deferred interest.12 C.F.R. §§ 226.22(a)(1)-(2) (LEXIS through 2007 legislation); see 12 C.F.R. § 226 app J (LEXIS through 2007 legislation) (showing examples on how to calculate the annual percentage rate using the actuarial method).

The U.S. Rule allows unpaid accrued interest to accumulate separately so that no compounding of interest occurs. Additionally, under the U.S. Rule, no interest calculation is made until a payment is received. 12 C.F.R. § 226.2(a)(3) (LEXIS through 2007 legislation).

186. To illustrate how negative amortization can occur mathematically, see, for example, Mortgage Calculators, www.mtgprofessor.com/calculators.htm (last visited June 12, 2007), which is a calculator often referred to in the financial press.


188. 12 C.F.R. § 226.1(b) (LEXIS through 2007 legislation); see also James v. Home Constr. Co. of Mobile, Inc., 621 F.2d 727, 730 (5th Cir. 1980) (clarifying that “what is mandated [under TILA] are not conditions of credit, but only disclosures,” citing Smith v. No. 2 Galesburg Crown Finance Corp., 615 F.2d 407, 414 (7th Cir. 1980)).


190. 12 C.F.R. § 226.1(b) (LEXIS through 2007 legislation); § 226.23(3) (LEXIS through 2007 legislation) (interpreting 15 U.S.C. § 1635(a) (2000), which provides a post-consummation, 3-day cooling-off period).
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lending.191

TILA has been amended several times in an effort to simplify and update the Act, since credit transactions "because of their complexity and variety . . . defy exhaustive regulation by a single statute."192 Originally passed in 1968, TILA was amended in 1980 with the TIL Simplification and Reform Act of 1980 (Simplification Act) and again in 1995 as a way of overruling Rodash, a case that held a lender liable for a minor violation of TILA.193 Despite attempts to simplify TILA, it remains an extensive, complicated, and multifaceted disclosure statute that applies to both closed-end and open-end credit transactions. TILA is further complicated by the fact that it must be read alongside Regulation Z, which was implemented in 1981 by the Federal Reserve Board of Governors.194

TILA is sometimes mischaracterized as a statute that requires lenders to use a certain font and type size in a disclosure. It is, of course, much more than that. TILA obligates a creditor to disclose all material elements that go toward the cost of credit. If the creditor fails to meet its TILA obligations, then the three-day cooling-off period extends to a three-year period in which for cause rescission is permitted.195 Conversely, if a creditor meets its TILA disclosure obligations, a consumer has three business days to rescind a credit contract, for any reason, even if that contract is fully consummated.196

Whether TILA applies to any given transaction can be a complicated factual issue, but generally disclosure under TILA is required whenever a creditor takes a security interest in a consumer’s principal dwelling.197 TILA requires disclosure in residential mortgages and even allows for damages when disclosure obligations are not met, but it does not allow rescission for residential mortgages used to purchase or construct a home.198 However, if that

191. 12 C.F.R. § 226.1(b) (LEXIS through 2007 legislation).
193. Rodash, 16 F.3d 1142.
197. 12 C.F.R. § 226.1(b) (LEXIS through 2007 legislation) (“[T]he regulation also gives consumers the right to cancel certain credit transactions that involve a lien on a consumer’s principal dwelling. . . .”); § 226.23 (LEXIS through 2007 legislation) (giving consumers a right to rescind a credit transaction if “a security interest is or will be retained or acquired in [the] consumer’s principal dwelling”); § 226(2)(a)(11) (LEXIS through 2007 legislation) (defining a consumer as “any natural person whose ownership interest in his or her principal dwelling is subject to the risk of loss”).
198. 15 U.S.C. § 1602(w) (2000) (“The term ‘residential mortgage transaction’ means a transaction in which a mortgage, deed of trust, purchase money security interest arising under an installment sales contract, or equivalent consensual security interest is created or retained against the consumer’s dwelling to finance the acquisition or initial construction of such dwelling.”); 12 C.F.R. § 226.23(f)(1) (LEXIS through 2007 legislation) (excluding residential mortgages).
same purchase/construction loan is later refinanced—a secondary credit transaction involving the consumer's primary residence—TILA gives the consumer damages and full rescission remedies on the secondary transaction.\textsuperscript{199}

Given the seriousness of placing one's primary residence at risk, TILA provides clear remedies whenever creditors intentionally or unintentionally fail to meet their disclosure obligations. Chief among these remedies are section 1640 (monetary damages) and section 1635 (rescission). TILA section 1640 expressly permits class-action lawsuits and monetary damages where creditors have failed to meet TILA mandated disclosure requirements, but it caps these class-action lawsuits at "the lesser of $500,000 or 1% of the net worth of the creditor."\textsuperscript{200} Section 1635 allows for rescission,\textsuperscript{201} but it is silent on the issues of whether class-wide rescission claims are permissible and, if so, capped.\textsuperscript{202}

As a remedy, rescission is a considerably more complicated untangling of legal interests than is a claim for damages. Rescission creates mutual obligations, which makes it a controversial remedy for legal, economic, and administrative reasons.\textsuperscript{203} If rescission is agreed to, TILA gives a creditor twenty days after receiving a notice of rescission to release its security interest in the consumer's primary residence and to return all fees, costs, and interest payments that it collected from the consumer. This becomes a difficult maneuver if the mortgage has been assigned once or twice over and bundled for global capital investors.\textsuperscript{204} Afterwards and in exchange, the consumer must return to the creditor any principal funds that were loaned, yet another potentially difficult feat unless the consumer has successfully refinanced the loan with a subsequent lender.\textsuperscript{205}

Rescission is time-sensitive. After consummating a loan, a consumer has a statutory three-day cooling off period that can be extended to three years if there is an irregularity in the lender's disclosures.\textsuperscript{206} A failure to disclose occurs either when the lender omits information or provides unclear

\textsuperscript{199.} 12 C.F.R. § 226.23(f)(2) (LEXIS through 2007 legislation) (excluding residential mortgages).
\textsuperscript{201.} 15 U.S.C. § 1635 (2000); 12 C.F.R. § 226.15 (LEXIS through 2007 legislation) (providing for right of rescission for open-ended credit); § 226.23 (LEXIS through 2007 legislation) (providing for right of rescission for close-ended credit); \textit{see also} SCHMELZER, D. EDWIN, \textit{THE RIGHT OF RESCISSION UNDER TRUTH IN LENDING, TRUTH IN LENDING} 597-655 (2000); Morgan, supra note 96, at 177-178 (noting, as of 1995, that "arguments for and against class certification of rescission cases continue to be perhaps the most important fundamental issues remaining unresolved concerning 1635").
\textsuperscript{202.} LaLiberte, 53 Cal. Rptr. 3d at 749 (noting that "class-actions seeking rescission were virtually nonexistent . . . in 1974 to 1976, when the [damages] cap was enacted").
\textsuperscript{203.} \textit{Id.}; \textit{see also} Morgan, supra note 96, at 195 (arguing against class action rescission cases on the ground that "each rescission [sic] case contains its peculiar legal DNA code based on such variables" related to consumer and creditor choices).
\textsuperscript{205.} \textit{Id.}
\textsuperscript{206.} \textit{Id.}
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information to the consumer.\textsuperscript{207} Information is deemed unclear for legal purposes when it is susceptible to more than one interpretation.\textsuperscript{208} The standard for determining whether information is susceptible to more than one interpretation is the ordinary consumer standard, which is an objective test.\textsuperscript{209}

Three cases were litigated in the first quarter of 2007 to test the applicability of class action claims to rescission under TILA. In \textit{LaLiberte v. Pacific Mercantile Bank} the question of rescission arose before the California Court of Appeal, which held that TILA prohibits class-wide rescission under section 1635.\textsuperscript{210} The Court of Appeal, First Circuit, in \textit{McKenna v. First Horizon Home Loan Corp.}, also disallowed a class action lawsuit for rescission on the ground that Congress did not intend for section 1635 to open the door to class action claimants.\textsuperscript{211} In \textit{Andrews v. Chevy Chase Bank}, while a federal district court certified a class action lawsuit for rescission, an appeal is expected.\textsuperscript{212}

\textbf{A. Hidden Closing Costs: \textit{LaLiberte et al v. Pacific Mercantile Bank}}

In the California case of \textit{LaLiberte et al v. Pacific Mercantile Bank}, plaintiffs took nearly six months to transform their individual claims into a class action rescission claim invoking section 1635.\textsuperscript{213} The class was defined as “all persons who obtained a closed-end loan from Pacific Mercantile Bank primarily for personal, family or household purposes secured by either real property or the borrower’s principal dwelling during the period from Nov. 21, 2002 to the present.”\textsuperscript{214} Plaintiffs alleged that defendant failed to disclose a $450 closing cost on loans of several hundreds of thousands of dollars.\textsuperscript{215} Plaintiffs sought rescission.

Defendant demurred to the class allegations. The trial court dismissed the plaintiffs’ complaint holding that a class action rescission claim was inappropriate under TILA. Plaintiffs appealed, arguing that the trial court erred in its conclusion and in its denial of leave to amend their complaint. For the plaintiffs, it was important to advance to the discovery phase of trial so that they could identify an adequate class representative and thus put to rest

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\textsuperscript{208} 15 U.S.C. § 1631 (2000); 12 C.F.R. § 226.6 (LEXIS through 2007 legislation); see also Smith v. Check-N-Go of Illinois, Inc., 200 F.3d 511 (7th Cir. 1999).

\textsuperscript{209} Andrews, 240 F.R.D. 612.

\textsuperscript{210} LaLiberte, 53 Cal. Rptr. 3d 745.

\textsuperscript{211} McKenna, 475 F.3d 418.

\textsuperscript{212} Andrews, 240 F.R.D. 612.

\textsuperscript{213} LaLiberte, 53 Cal. Rptr. 3d at 746-47.

\textsuperscript{214} Id. at 747.

\textsuperscript{215} Id. at 746-47.

\end{footnotesize}
defendant’s attacks on the factual appropriateness of their claim.\textsuperscript{216}

The Court of Appeal denied plaintiffs’ appeal on the ground that TILA’s silence on the issue of class-wide rescission was a legislative oversight, not a grant of permission. The court also stressed that class-wide rescission under section 1635 was an issue of first impression in California and a matter of sharp debate among the federal circuits.\textsuperscript{217} As the court saw it, rescission was a personal remedy and as such not suitable for a class action lawsuit.\textsuperscript{218} Thus, it did not accept the plaintiffs’ view that section 1640, which permits class action damages claims, extends to section 1635, which explicitly permits individual rescission claims. Although the court did not speak directly to the broader social issue of access to credit, it did allude to the economic difficulties that a lender would face under a rescission process that requires a lender to take the first step in the rescission process—namely, refunding the borrower.\textsuperscript{219}

While the court’s holding was based on TILA, it has far-reaching practical implications. Relevant to the court’s decision was the difference between the undisclosed closing cost ($450) and the amount of principal borrowed (several hundreds of thousands of dollars).\textsuperscript{220} Also important was the fact that TILA requires lenders to take the first step, thus increasing the arithmetical possibility that the lender will face onerous, aggregate liability. The process of rescission is constant, but closing costs relative to loan balances are variable. For this reason, at its most practical, LaLiberte can be read to excuse lenders from TILA obligations in cases involving hidden closing costs that are small relative to the loans themselves.

In the first quarter of 2007, the California Court of Appeal also decided \textit{Pacific Shore Funding v. Lozo},\textsuperscript{221} a predatory lending case brought under TILA. In \textit{Pacific Shore Funding}, the plaintiff-borrowers sued one lender to rescind a loan that the consumer had already refinanced with a different lender. Defendant-lenders, citing \textit{King v. State of California},\textsuperscript{222} moved to dismiss plaintiff’s claim on the ground that refinancing a loan terminates a borrower’s otherwise timely rights to rescission. The California Court of Appeal held that buyers are not precluded from rescinding a loan “merely because they have already refinanced that loan.”\textsuperscript{223} Noting a split in the federal courts over the issue, the court chose to reject the rationale in \textit{King} and in so doing to side with

\begin{itemize}
\item \textsuperscript{216} Id. at 745-46.
\item \textsuperscript{217} Id. at 750.
\item \textsuperscript{218} LaLiberte, 53 Cal. Rptr. 3d at 750 (citing Gibbons v. Interbank Funding Group, 208 F.R.D. 278, 280-286 (N.D. Cal. 2002)).
\item \textsuperscript{219} Id. at 751 (noting that rescission requires the lender to terminate its security interest \textit{before} the debtor tenders the money borrowed).
\item \textsuperscript{220} Id. at 746, 752.
\item \textsuperscript{221} 42 Cal. Rptr. 3d 283 (Cal. Ct. App. 2006).
\item \textsuperscript{222} 784 F.2d 910 (9th Cir. 1986) (opening the door to class action rescission claims of loans that consumers have already refinanced).
\item \textsuperscript{223} Pac. Shore Funding, 42 Cal. Rptr. 3d at 285.
\end{itemize}
the majority view that rescission of a loan is available even after a loan has been refinanced. The theory behind the majority view is that refinancing is an incomplete rescission in which the borrower, not the lender, takes the first step of returning the borrowed funds. Rescission is finalized when the lender responds by returning all fees, costs, and interests to the borrower. Once both parties meet their obligations, the status quo ante is restored. By treating refinancing and rescission as distinct legal events, the California Court of Appeal held true to TILA's consumer protection mandate.

Pacific Shore Funding is important in relation to LaLiberte for three reasons. First, Pacific Shore Funding broadens by a wide margin the class of plaintiffs who might seek rescission of already refinanced loans should class actions for rescission eventually be permitted under California law. Rescission, according to Pacific Shore Funding, is a remedy that restores the status quo ante: it reimburses the borrowers for finance charges, loan costs, and fees, and it returns borrowed funds to the lender. In contrast, refinancing is a transaction, not a remedy, and it does not restore the status quo ante. Instead, refinancing repays the lender all amounts due (including costs, interest, and fees) without any reimbursement to the borrower. Second, Pacific Shore reads TILA against the backdrop of its consumer protection mandate, making clear that any reading of TILA that "would only benefit lenders at the expense of borrowers" does not comport with the congressional intent of the statute. Finally, the cases signal a split at the appellate level in California on the issue of how best to interpret TILA, with each case pointing to a distinct sub-split within the jurisdiction on the questions of whether class-wide rescission is allowable and, if so, whether it is available to borrowers who have already refinanced the loans they seek to rescind under section 1635.

B. Inaccurate Disclosures: McKenna v. First Horizon Home Loan Corporation

Another first quarter 2007 case to address the question of whether TILA allows class action rescission claims is McKenna v. First Horizon Home Loan Corp. In McKenna, 8,900 plaintiffs sued Horizon Home Loan Corp under TILA and the Massachusetts Consumer Credit Cost Disclosure Act (MCCCDA) for class-wide rescission related to the refinance of mortgages with option ARMs. Plaintiff-borrowers alleged that their lender inaccurately disclosed rescission related information and also failed to respond appropriately

224. Id. at 289 (identifying the split in authority and noting that "most courts have not followed" the view that refinancing a loan terminates otherwise timely rescission rights under TILA).
225. Pac. Shore Funding, 42 Cal. Rptr. 3d at 291.
226. Id. at 290.
227. McKenna, 475 F.3d 418.
228. MASS. ANN. LAWS ch. 140D, § 1 (LEXIS through 2007 legislation).
to plaintiffs' verbal requests for rescission.\(^{229}\)

As in \textit{LaLiberte}, the lender in \textit{McKenna} gave the court an estimate of the liability it would face should a class be certified. In \textit{LaLiberte} the defendant's estimate was $37,000,000; in \textit{McKenna} the estimate was $200,000,000.\(^{230}\) The \textit{McKenna} trial court certified the class.\(^{231}\) Defendant appealed. On appeal, defendant argued that rescission is not available for class action cases under TILA as a matter of law.\(^{232}\)

The issue of class-wide rescission in \textit{McKenna}, heard here by the First Circuit, was a matter of first impression just as in \textit{LaLiberte}.\(^{233}\) Persuaded by \textit{James v. Home Constr. Co. of Mobile, Inc.}, a Fifth Circuit case disallowing class-wide rescission, the court read TILA's rescission provision against the backdrop of its monetary damages provision to conclude that Congress intended rescission as a purely personal remedy—not as a broad social one.\(^{234}\) Additionally, the court expressed concern that rescission class action lawsuits might render creditors insolvent, not as in \textit{LaLiberte} because they had to go first in the rescission process, but because the numbers of aggrieved consumers were so large.\(^{235}\)

The court relied on the plain meaning of the statute as read against TILA's legislative history. It began with the premise that TILA is a consumer protection statute that "expressly acknowledges the potential for damages in class-actions by capping statutory damages for a single violation, repeated in multiple cases. . . ."\(^{236}\) In the court's analysis, the intention behind the cap in

\(^{229}\) McKenna, 475 F.3d at 420. This allegation tracks Rodash, 16 F.3d 1142, but it enhances it with the additional allegation that the defendant failed to respond to plaintiffs' rescission requests. \textit{See also} Morgan, supra note 96, at 195 (1995) (arguing strongly—prior to the rise of subprime and complicated lending products—that judges should "just say no to section 1635 class action certification" in cases like \textit{Rodash} that involve minor errors in disclosure).

\(^{230}\) \textit{Id.} at 424.


\(^{232}\) \textit{McKenna}, 475 F.3d at 421-422.


\(^{234}\) \textit{McKenna}, 475 F.3d at 423 (citing \textit{James}, 621 F.2d at 730, a case, widely-cited by federal circuits and state courts alike, that disallows rescission class action claims under TILA on the ground that (1) TILA's primary purpose as stated in Section 1601 is to assist individual consumers shop for credit, not to penalize lenders; (2) the remedies contemplated by TILA redress harms to individual consumers, not harms to the public; and (3) the remedy of rescission is purely personal to the consumer, not public. This analysis was important in defining TILA as a consumer protection statute rather than as a penal statute, and this definitional focus, which is consistent with TILA's purpose, is what has made the Fifth Circuit decision so influential.).

\(^{235}\) \textit{Id.} at 425 (citing the unsupported statements of Senator D'Amato to the effect that liability could threaten the housing financing system); \textit{Id.} at 424 (citing 141 Cong. Rec. S 14566-03 (Sept. 28, 1995) (discussing the unsupported statements of Senator Mack to the effect that liability could threaten the housing financial system)).

\(^{236}\) 15 U.S.C. § 1640(a)(2)(B) (2000); \textit{see also} McKenna, 475 F.3d at 425.
the TILA section 1640 monetary damages provision was to protect consumers, and the best way to protect consumers was to shield creditors from "crushing liability" so as to preserve access to credit.\textsuperscript{237} Hence, to strike a balance between creditor liability and creditor compliance with TILA, the \textit{McKenna} court came down on the side of consumer liability.\textsuperscript{238}

This is an odd twist of logic unless one accepts the deeply pro-creditor bias of the \textit{McKenna} rationale. According to that logic, when a court shields a creditor (a lending institution) from broad liability, that court is carrying out TILA's mandate to protect the consumer by keeping open the credit spigot. This is so even where the consumer did not know the true cost of the loan because of a TILA violation. In the abstract, this argument sounds plausible, and thus it no doubt will find proponents. But in the harsh light of data, the pro-lender bias of this reasoning is clear. The net result of \textit{McKenna} is that consumers, not lenders, will suffer the risks of dangerous mortgage products in this first down-market go-round, so that the corporate lenders who originated these products can be shielded from massive liability.

\textbf{C. Failure to Disclose Cost of Loan Information on an Option ARM: Andrews v. Chevy Chase Bank}

\textit{Andrews v. Chevy Chase Bank}, a third case involving the issue of class-wide rescission, rejected the \textit{McKenna} rationale.\textsuperscript{239} \textit{Andrews} is a more direct test of TILA than either \textit{McKenna} or \textit{LaLiberte}. In the latter cases, lenders arguably erred in minor ways. In \textit{Andrews}, the alleged TILA violation went to the heart of how the costs of the variable aspect of the option ARM product at issue were disclosed.

In June 2004, plaintiffs refinanced their home with a specialty option ARM mortgage product. The contract specified fixed minimum payments of $701.21 per month for five years. Plaintiffs used the option ARM product because they "believed that the payments and the interest rate were fixed for five years (at the teaser interest rate of 1.950\%) and became variable thereafter."\textsuperscript{240} Instead the teaser interest rate of 1.950\% applied only to the first monthly payment, after which the initial and variable 4.047\% APR applied. Only the monthly minimum payment was fixed. Everything else about the option ARM adjusted upward. As this happened, the minimum fixed payment of $701.21 became

\begin{footnotesize}
\textsuperscript{237} McKenna, 475 F.3d at 424 (citing Rodash, 16 F.3d 1142, which noted that the court holding defendant lending institution liable for "minor" irregularity in disclosure); \textit{id}. at 424 (citing Truth in Lending Class Action Relief Act of 1995, Pub. L. No. 104-12, \S\ 2, 109 Stat. 161 (codified as amended at 15 U.S.C. \S\ 1640 (2000)); amending Truth in Lending Act to forgive lenders liability for "minor" irregularities in disclosure).

\textsuperscript{238} \textit{id}. at 425.

\textsuperscript{239} Andrews, 240 F.R.D. at 621.

\textsuperscript{240} \textit{id}. at 615.
\end{footnotesize}
insufficient to cover the interest that was accruing on the loan.\textsuperscript{241} The plaintiff-borrowers had the option to pay more than the fixed monthly payment, but they either did not or could not afford to do so. In a class action claim for rescission plaintiffs alleged that the defendant failed to disclose TILA-required information about the true cost and variable nature of its option ARM product.\textsuperscript{242} The class included two thousand borrowers with mortgages originating from defendant Chevy Chase Bank.

Under TILA, the standard for testing the clarity of a disclosure is the ordinary consumer standard, with the question being whether an ordinary consumer would find the disclosures reasonably understandable.\textsuperscript{243} The ordinary consumer standard is a strict objective standard; compliance with TILA rides upon the contents of the disclosure form, not upon how the form affects any particular reader.\textsuperscript{244} As Judge Adelman affirmed: “The sufficiency of TILA-mandated disclosures is to be viewed from the standpoint of an ordinary consumer, not the perspective of a Federal Reserve Board member, federal judge or English professor.”\textsuperscript{245} Under TILA, a disclosure is clear if it is subject to no more than one interpretation; it is unclear—and thus a violation of the statute—if it is subject to more than one interpretation from the standpoint of an ordinary consumer.\textsuperscript{246}

On January 16, 2007, Judge Lynn Adelman of the U.S. District Court for the Eastern District of Wisconsin certified the class. Defendant immediately challenged the judge’s certification, citing McKenna for the proposition that TILA section 1635 precludes class action rescission cases.\textsuperscript{247} In a separate opinion handed down on February 14, 2007, Judge Adelman held against defendant-lender again, relying on policy reasons and the absence of language in section 1635 prohibiting class certification. In the judge’s view, this was a case involving “public wrongs and widespread injuries.”\textsuperscript{248} The judge also pointed to the efficiency of certifying the class, namely that the “infirmity” plaintiffs sought to litigate appeared “in the [loan] documents,” which were “common to all members of the class.”\textsuperscript{249} For these reasons, Judge Adelman held in favor of the consumer-plaintiffs rather than “reward defendants who

\textsuperscript{241} Id.; see also 12 C.F.R. § 226.22(a)(2) (LEXIS through 2007 legislation).
\textsuperscript{242} Andrews, 240 F.R.D. at 615-16 (failure to disclose variable nature of loan’s payment schedule); id. at 617 (failure to disclose payment period); id. at 617-20 (conflicting information on discount interest rate versus annual percentage rate); id. at 619-21 (failure to disclose variable interest rate feature of the loan); id. at 620 (insufficient disclosure on negative amortization).
\textsuperscript{243} Id. at 616.
\textsuperscript{244} Check-N-Go, 200 F.3d at 515.
\textsuperscript{245} Andrews, 240 F.R.D. at 616 (citing Smith v. Cash Store Mgmt., 195 F.3d 325, 328 (7th Cir. 1999)) (internal quotation marks omitted).
\textsuperscript{246} Id.
\textsuperscript{247} McKenna, 475 F.3d at 425.
\textsuperscript{248} Andrews, 240 F.R.D. at 621.
\textsuperscript{249} Id.
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may have committed wrongs and leave victims who may have been wronged uncompensated."\textsuperscript{250}

The class of plaintiffs was broadly defined as borrowers with loans from the defendant’s bank.\textsuperscript{251} Under TILA section 1635, borrowers with improvement/construction loans, purchase loans, or loans that refinance with the same lender and secure the loan with the same collateral are not entitled to rescission.\textsuperscript{252} Thus, the defendant will likely appeal both on certification and class definition grounds. If the class action claim survives in \textit{Andrews}, the class will have to be narrowed to include only those borrowers who refinanced their original purchase/construction loans with a different lender or who refinanced those loans with the same lender but secured them with different collateral.\textsuperscript{253} Even so, the \textit{Andrews} class, which now stands at two thousand, will remain large. The class in \textit{McKenna}, now at 8,900 members, also remains large. In some areas of the country, even a class precisely and narrowly defined under the strictest reading of TILA will result in a large class, possibly placing mortgage rescission suits on a legal stage the size of mass tort litigation cases. Moreover, because of the specter of real estate fraud, mortgage rescission suits under TILA could potentially involve the attorneys general of various states.\textsuperscript{254}

\textit{Andrews} was stayed on the merits pending appeal of the class-wide rescission issue. As in \textit{LaLiberte} and \textit{McKenna}, the opinion in \textit{Andrews} stresses the existence of sharp disagreement among the federal circuits on this question. If the economic climate tips the rise in mortgage defaults toward the side of a full-fledged crisis, which seems likely at this date, the sharp difference of opinion in the federal circuits could push this issue to the U.S. Supreme Court. Additionally, in California, if a split in opinion at the court of appeal level ripens on this issue, or on the issue raised in \textit{Pacific Shore Funding} of whether refinancing a loan terminates a borrower’s rights to rescission, either or both issues could find their way to the California Supreme Court.

\textit{Andrews} is a significant test of whether a class of plaintiffs who allege substantial violations of TILA’s disclosure provisions can lower their individual legal costs and enhance their legal strength by seeking class-wide rescission under TILA section 1635.\textsuperscript{255} It also raises the issue of whether courts

\begin{itemize}
  \item \textsuperscript{250} \textit{Id.} at 621-22.
  \item \textsuperscript{251} \textit{Id.}
  \item \textsuperscript{252} 15 U.S.C. § 1635 (2000)
  \item \textsuperscript{253} 15 U.S.C. §§ 1635 (e)(1)-(2) (2000).
  \item \textsuperscript{255} Marc Galanter, \textit{Why the “Haves” Come Out Ahead: Speculations on the Limits of Legal Change}, 9 LAW & SOC’Y REV. 95-160 (1974) (hypothesizing about the importance of repeat player status in determining courtroom victories); see also Richard Lempert, \textit{A Classic at 25: Reflections on...
have the power in the words of Judge Adelman "to shield lenders from liability in ways that Congress has not."\textsuperscript{256}

VI. CONCLUSION

This Article is about ordinary consumer lending, a fair amount of which was aggressive but not necessarily predatory under state legislative definitions. It is about the kind of mortgage practices that lenders engaged in during this most recent housing boom to ostensibly democratize access to credit. Just as widespread access to credit once popularized the automobile,\textsuperscript{257} widespread access to mortgage loans has placed home ownership within the grasp of many who might not otherwise have been able to afford to enter the fold. However, gains in home ownership, if any, have come at a very high personal and financial cost to already financially strapped consumers. As one economist concluded "teaser rates and negative amortization gimmicks [can] only postpone the inevitable: eventually, sellers and lenders [will] have to confront the basic disconnect between incomes and mortgage payments."\textsuperscript{258} The legal dimension of this confrontation has already begun.

As sales volume and housing prices drop, as interest rates rise, as mortgage lenders necessarily tighten access to credit, and as the rate of notices of default goes up, the question of rescission will press hard on the courts. The widespread use of complicated mortgage products like option ARMs is itself a recent phenomenon. To be sure, option ARMs have been useful to consumers, but only in the double-edged way that credit cards can be. Despite their allure and benefit, two of the many risks-disguised-as-benefits that are engineered into option ARMs are the (1) buy-now-pay-later debt obligations that give way to (2) negative amortization.

Additionally, market indices adjust differently depending on three interacting factors: contract terms, the market dynamics of the underlying index rate, and the prepayment behavior of the mortgage holder.\textsuperscript{259} Specifically, this means that any given index will register a longer or shorter time lag between the rise of the index and the resetting (adjustment) of the ARM than another index might under the same conditions.\textsuperscript{260} These arithmetical dynamics of interacting time series properties have deep legal implications. They predict a potentially huge wave of delayed defaults with a corresponding delayed wave of litigation, resulting from loans that originated in the period between 2003 and 2006, when housing prices were at historic highs. Additionally, while

\textsuperscript{256} Galanter's Haves Article and Work It Has Inspired, 33 LAW & SOC’Y REV. 1099 (1999).
\textsuperscript{257} Andrews, 240 F.R.D. at 617.
\textsuperscript{258} CALDER, supra note 1, at 184-201.
\textsuperscript{259} Ratcliff II, supra note 43, at California-53.
\textsuperscript{260} Stanton & Wallace, supra note 12, at 59-60, 62.
option ARMs were widely used by the credit poor, a category comprised of low-income, fixed-income, and minority borrowers, they were also widely used by middle-class buyers in high cost states like California.\textsuperscript{261}

This Article has drawn a link between the rise in the use of innovative mortgage products and the initial wave of litigation brought by consumers to test TILA's consumer protection remedies. In doing so, it has analyzed the first round of cases to challenge the lending practices of recent times. While TILA allows class-wide damages, it is silent on the issue of class-wide rescission. Because of this silence, the legal acceptance of class-wide rescission as a remedy for widespread irregularities in mortgage disclosure invokes legal and economic policy questions. On the legal side, the issue will be whether Congress intended by its silence to disallow class-wide rescission in a statute whose declared main purpose is protecting the consumer. On the economic side, the question will be whether the use of courts to address recent lending practices will have the unwelcome effect of diminishing the public's access to credit.

In the context of these court challenges, lenders have the upper hand so far. Their main litigation tactic has been to estimate their potential liability. In one case the lender set its potential damages in the case at $37,000,000, in another at $200,000,000, both credible estimates.\textsuperscript{262} Each lender averred that if the consumer class action lawsuit against it were to proceed, the defendant lender would go broke and the credit supply would dry up as other lenders retreated from the market in reaction to the litigation. This is a traditional lender argument that has buttressed even the most aggressive of lender practices.\textsuperscript{263} According to its logic, courts and legislators must not hold particular lenders accountable because if they do lenders as a class (and their investors) will pull back on the credit supply. This argument, however, begs the question of why lenders would continue to pull back from lending once the housing market stabilizes. Nevertheless, the lender strategy is to appeal to courts to interpret federal law so that consumers who are in financial distress will be required to take their claims about irregularities in loan disclosures back on a loan-by-loan, consumer-by-consumer basis to the very lender that failed to

\textsuperscript{261} Allegations have been made that lenders used race and ethnicity as a proxy for risk. If evidence can be presented to support this contention, then minority borrowers who paid a higher price for credit because of their race could also constitute a large group of potential plaintiffs.

\textsuperscript{262} LaLiberte, 53 Cal. Rptr. 3d at 751 (taking note of lender generated estimates of $37,000,000 in potential liability to plaintiff class and citing Johnson v. West Suburban Bank, 225 F.3d 366, 372 (3rd Cir. 2000), on the point that Congress capped the TILA damages award so as to protect small business from catastrophic judgments); McKenna, 475 F.3d at 424 (taking note of lender generated estimates of $200,000,000 in potential liability to plaintiff class).

\textsuperscript{263} See, e.g., CALDER, supra note 1, at 141-142 (describing the lenders' defense of their business "as couched in the rhetoric" of "'social bonds'" . . . "'industry harmony' and 'the common good', the idea being that "all Americans . . . "were in the same boat—they all needed credit"); see also H.R. Conf. Rep. No. 93-1429 (1974).
disclose TILA-required information in the first place.

As I complete this Article in the second quarter of 2007, a mix of prominent headlines shout from the national press. Increased lender standards and tighter accounting practices have "whipsaw[ed] the value of mortgage-related assets," yet Lehman Brothers has "vaulted" over the problem with "record net income that surpassed analyst expectations." Foreclosure levels are at record highs with analysts warning that the peak is not yet in sight. Consumers are tapping what little retirement equity they might own earlier and earlier in life. New credit-score vendors are emerging to service homeowners who cannot qualify for new loans under new and tighter lending standards. Housing prices are in moderate decline, with a sharp future decline predicted.

Consumers face limited options, causing their personal version of the American Dream to dissolve. They can work harder to pay the debt that threatens to avalanche them. They can sneak their way into the underground cash market as economic nomads. Or, they can use the law to question why lenders sold mortgages that are significantly more expensive than the lenders disclosed or were able to disclose at the origination stage.

Many questions remain as yet unanswered. Even if these ordinary consumers signed on the bottom line, what did they agree to? Was the ordinary consumer fully informed of the time series properties of his or her option ARM loan? Did the ordinary consumer know that the market index listed in the actual mortgage contract might adjust differently than the other three indices he or she (in theory) might have negotiated for instead? Did the ordinary consumer understand the difference between an "interest rate," a "discount rate," and an


267. Shira Boss, *Nibbling Early at Nest Egg Is a High-Risk Diet*, N.Y. TIMES, June 16, 2006, at C1 (citing Richard W. Johnson, Gordon B.T. Mermin & Cori E. Uccello, *When the Nest Egg Cracks: Financial Consequences of Health Problems, Marital Status Changes, and Job Layoffs at Older Ages* (2005), which provides that last year, 2006, seven out of ten people, ages 51 to 61 in 1992, in the sample experienced a negative shock in the following decade, through a job loss, health problems, or loss of a spouse that resulted in diminished personal wealth, with divorce causing an average 44 percent decline in assets).

268. Creswell, supra note 71; see also Rose, supra note 58 (concluding that subprime lenders should "review and tighten their lending practices to ensure their borrowers... are not taking on more debt than they can handle... and that all information relevant to a borrower's ability to repay a loan is considered.").

269. See generally S&P/Case-Shiller Home Price Indices, http://www2.standardandpoors.com/portal/site/sp/en/us/page.topic/indices_csmahp/0/0,0,0,0,0,0,0,0,0,0,1,0,0,0,0,0,0,0.html ("The S&P/Case-Shiller Home Price Indices measures the residential housing market, tracking changes in the value of the residential real estate market in 20 metropolitan regions across the United States.").
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"APR?" Did the consumer who “chose” to pay only the fixed minimum payment understand that compound interest (what Einstein called the eighth wonder of the world) would work against him or her in the form of negative amortization? Did particular consumers pay more for a loan or get steered to a riskier loan product because they were African American or Latino? Was the possibility that a consumer’s race might inflate the cost of a mortgage disclosed or otherwise explained by the lender?

As consumers seek legal remedies other than bankruptcy, courts will be faced with how best to follow TILA’s consumer protection mandate. TILA obligates lenders to disclose the true cost of credit or else suffer the legal consequences. It is far too facile for a federal judge to opine that people of ordinary means should not use credit cards or mortgage loans. Credit is a fact of life; it has been for over a century. The question for most Americans is not whether or even when to use credit, but how to manage it wisely. Wise management, by necessity, requires full and accurate disclosure by lenders to consumers about the cost of the credit.

Therefore, just as other products must meet certain safety standards, so too should mortgage loans. Part of assessing a loan’s safety to a borrower involves having that borrower understand how the particular loan works, in good and bad economic times, at low- and high-interest rates. Legislators are proposing new rules to help qualifying consumers cope with their expanding mortgage debt. But this legislation, even if passed, will be available only to select borrowers. Thus, by default, litigation must continue to play a central role in defining and sorting out mortgage related disputes. Moreover, until courts require lenders to explain why their loan disclosures did not accurately predict the cost of credit, the parameters of what constitutes adequate safety standards on mortgage products cannot be clarified.

270. See, e.g., Home Equity Loan Consumer Protection Act (HELCPA), Pub. L. 100-709, 102 Stat. 4733.