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Pursuing Justice

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Is Wall Street Responsible for Destroying Main Street?

By Richard E. Gottlieb, Andrew J. McGuinness, and Theodore W. Seitz

You are the mayor of a blighted American city. After years of demanding that lenders adjust their underwriting standards to make loans available to inner-city borrowers, you watch in horror as those same borrowers default in record numbers and lose their homes. If you happen to be the mayor of Baltimore, Buffalo, or Cleveland, your next step is obvious: sue the same lenders for having the nerve to make all those bad loans.

These municipalities, along with several other cities, have brought highly publicized and politically charged lawsuits against mortgage lenders and other financial entities that purchased collateralized mortgage obligations. The lawsuits claim that irresponsible lending practices had the foreseeable results of escalating foreclosures, blighting whole urban neighborhoods, increasing criminal activity in vacant homes, and declining property values that cost the cities tens, if not hundreds, of millions of dollars in lost tax revenue.¹ The suits contain novel claims of “public nuisance,” as well as other creative theories of liability.

The Public Nuisance Cases

Public nuisance is the central claim of Cleveland’s complaint in *City of Cleveland v. Deutsche Bank Trust Co., et al.*² It is not against a single, predominant lender, but against an entire industry—frequently referred to as “Wall Street” in the complaint (notwithstanding the naming of several California and other non-New York-based defendants). Notably, the plaintiff almost entirely eschews use of the phrase “predatory lending,” instead launching a broad attack on the subprime mortgage industry writ large. Cleveland asserts that “[r]esponsibility for Cleveland’s plight rests principally with subprime’s so-called ‘securitizers’—investment banking firms from Wall Street and elsewhere that actually provided the cash used to make loans, regardless of the

(Continued on page 18)

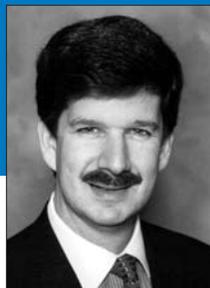
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Message from the Chairs

Foreclosure filings surpassed three million in 2008. This number represents an increase of 81 percent from the number of foreclosures filed in 2007. Banks repossessed more than 850,000 properties in 2008, as compared to approximately 404,000 properties in 2007. The value of the stock market has declined. The decline of global trade has adversely impacted the automobile industry and technology sector.

The ramifications of this economic turbulence and volatility on the legal profession are unknown. In past years when there was an economic downturn amid allegations of securities fraud, accounting scandals, and the like, litigators played the leading roles and courtrooms staged the setting for a resolution of these issues. However, because of the federal government's substantial involvement in this current economic crisis, the number and scope of private actions or lawsuits may be substantially limited. The situation we are currently witnessing in terms of the economic crisis and the government's involvement is quite similar to that involving the savings and loan crisis that took place two decades earlier, and led to the creation of the Resolution Trust Corporation.

This publication focuses on the impact of the subprime and mortgage industry collapse and the litigation that is taking place. Given the government's heavy participation in the litigation, many legal challenges in the mortgage finance industry may focus more on taxpayers than shareholders. Because most of the financial volatility and turbulence is viewed in light of past "irrational exuberance," and a tightening credit market as opposed to fraud, the role of the litigator in a lawsuit may become secondary to that of the government.

Bringing a private action to recover damages in this economic climate means an attorney must effectively and efficiently manage the case. Consequently, the best and most diverse legal team must be assembled to achieve reasonable client expectations before a jury.

The Business Torts Committee will serve as a valuable resource for all practitioners in these challenging times. The committee continually updates its website to rapidly disseminate information about new case decisions and legal developments. The committee publishes special issues such as this concerning the subprime and mortgage industry, rather than waiting until these events become past news. The committee has monthly telephone business conference calls. If you are

interested, please refer to our website for the scheduled date of the teleconference meetings.

Additionally, the Business Torts Committee provides for great networking opportunities. The greatest opportunities are generated by becoming involved in our committee's work and by attending business meetings and conference dinners.

We seek your assistance in enabling the committee to fulfill its mission of sponsoring insightful CLE programs and publishing web and journal articles. In exchange, you will have the opportunity to enhance or expand your business networking opportunities. ■

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Message from the Editors

Special Issue: Mortgage Industry Crisis

As we all are aware, our nation has been faced with severe financial concerns over the past year. In addition to the obvious impact on the overall economy, business litigators are now faced with the ensuing litigation. At the 2008 Annual Meeting in New York, our committee decided that these issues were important enough to deserve an entire special issue of the *Business Torts Journal*. The editors of the *Journal* would like to especially thank Michael Winston for his tireless efforts in recruiting leaders in this area of the law to provide the articles herein. Thanks also go to Lisa Darnley Cooper for her assistance with editing. The *Journal* is proud to provide this special issue focusing on several different aspects of the financial industry crisis and the resulting rash of foreclosures and related litigation.

Our first article describes the suits instituted by municipalities around the country against lenders for problems resulting from an increase in the foreclosure rate. While presenting the varying theories of the different cities, Richard E. Gottlieb, Andrew J. McGuinness, and Theodore W. Seitz describe the claims that lenders of all types now face. Any business litigator representing financial institutions must be aware of these new lawsuits. This article provides a thorough follow-up of the issues presented at our committee breakfast meeting at the ABA Annual Meeting in New York last August.

The next article discusses how the recent spike in residential foreclosures, combined with the current structure of the residential mortgage industry, has created additional concerns for lenders, servicers, and indentured trustees in bankruptcy proceedings. John R. Chiles, Reid S. Manley, Robert C. Folland, and Dale S. Smith analyze the manner in which bankruptcy

courts across the country have responded to unique and novel issues being litigated, and whether uniformity across bankruptcy jurisdictions is possible.

Ralph T. Wutscher analyzes two cases brought by the Massachusetts attorney general and the resulting court decisions that changed the way entire statutory schemes were enforced. While the law may only be applicable in Massachusetts, the author's analysis can help prepare litigators for similar decisions in their own jurisdictions.

In our final article, Benjamin M. Kahrl, Anna-Katrina S. Christakis, and Jeffrey D. Pilgrim explore whether grossly negligent mortgage underwriting practices can lead to title defects. The impact of this tortious behavior can result in extensive problems under title insurance policies.

We hope that you enjoy these articles and find them to be informative in this burgeoning area of the law. The *Journal* depends upon you to submit articles so that we can continue to offer a great publication to our members. Currently, articles have been submitted for the Summer issue on Tortious Interference, but the following issues are upcoming:

- Fall 2009** Unfair Trade Practices—articles due June 1
- Winter 2010** Fiduciary Duties—articles due September 1
- Spring 2010** Evidence—articles due December 1

If you would like to discuss an article for any of these issues, please contact us: Stu Glick, at sglick@sillscummis.com; Tom Dye, at TADye@CarltonFields.com; or Pierce Campbell, at pcampbell@turnerpadget.com. We are also accepting *Practice Pointer* columns for future issues. ■



The Subprime Meltdown: Trustees, Lenders, and Servicers of Residential Mortgages

By John R. Chiles, Reid S. Manley, Robert C. Folland, and Dale S. Smith

In the last couple of years, the phrase “subprime mortgage” has gone from a concept mostly confined to the financial industry to one known all too well within millions of American households. Subprime lending has given borrowers who otherwise would not have access to credit the opportunity for homeownership. The collective subprime loan industry, however, has experienced significant borrower defaults. Liberal lending and borrowing practices, excessive debt on the consumer and corporate levels, and the plummeting U.S. housing market have all played a significant role in the crisis resulting from subprime mortgages.

As a result of this crisis and a cyclical downturn in the U.S. economy, residential mortgage foreclosures have substantially increased in recent years. In 2007, over 405,000 American households lost their home.¹ This figure was up from slightly less than 270,000 in 2006.² This sharp increase in foreclosures has clogged the dockets of courts across the country. Litigation ancillary to foreclosure proceedings has also escalated as lenders, mortgage brokers, investment banks, credit rating agencies, and other mortgage players have become the targets of a myriad of actions brought by borrowers. In addition to straining state, and in some instances federal, court dockets, this surge in activity has also led to an upshot in consumer bankruptcy filings. In 2007, over 822,000 consumer bankruptcy cases were filed.³ This figure is up 38 percent from consumer filings in 2006. Due to continuing economic woes, rising gas prices, and credit card delinquencies, foreclosure numbers increased sharply again in early 2008. Foreclosure filing for the first quarter of 2008 increased 23 percent over the previous quarter, and 112 percent over the first quarter of 2007.⁴ It is difficult to predict how long this trend will continue. The considerable role mortgage-related disputes play in many of these bankruptcy filings has created new issues for mortgage lenders and servicers as well as their counsel.

Role of Bankruptcy Courts

When a party files for bankruptcy, all actions against that party and that party’s property are stayed, including foreclosure actions, execution of judgments, and pending sheriff’s sales.⁵ Nonetheless, the bankruptcy code provides mechanisms for secured lenders to get around this temporary injunction. Where a borrower has defaulted on mortgage payments and it appears unlikely that the borrower will continue to make mortgage payments or cure the arrearages in a reasonable time, bankruptcy courts will often grant a lienholder relief from the automatic stay to proceed with a foreclosure action outside the bankruptcy case.⁶

The Bankruptcy Code also enables a debtor to avoid foreclosure by developing a plan for curing amounts due and making regular monthly mortgage payments outside the bankruptcy plan.⁷ In this situation, the debtor submits a plan for repayment of all debts (including mortgage arrearages), subject to approval and confirmation by the bankruptcy court. The debtor has the opportunity to set forth a specific method for applying payments from the debtor or trustee to the underlying debts owed in the plan. When a confirmed plan sets forth a particular system for allocation of payments, creditors must comply with this system, or face damages or sanctions under the Bankruptcy Code.⁸

New Issues for Lenders and Servicers

Many new issues have surfaced as a result of significant restructuring of the residential mortgage market that has occurred in the last 20 years. Increasing interest rates in the late 1980s and early 1990s contributed to development of the market for securitized pools of residential mortgages. The benefit of the securitization model comes from spreading the default risk across a broad range of investors rather than one financial institution. Additionally, the pooling process ultimately reduces mortgage

servicing costs because the servicers are able to capitalize on economies of scale. Nonetheless, the complexities of this model have led to additional problems. The mass purchase and pooling of mortgages has increased the role of third-party originators, who often execute the closing of a loan and immediately transfer the note and mortgage. Based on their limited role in the process, third-party originators are not exposed to risk or accountability, which are instead allocated to the long-term holder.

Additionally, after securitization, the servicing rights for a mortgage pool are typically transferred to another third party, who collects payment from the borrowers and maintains the accounts. Because the servicer communicates directly with the borrowers, borrowers often believe that the servicer is the holder of the loan. This creates problems when some legal action, such as a foreclosure, is filed in the name of another party.

The Real Party in Interest Problem

The first of these problems is illustrated by Ohio Federal District Court Judge Christopher A. Boyko, in his opinion titled *In re Foreclosure Cases*.⁹ In this consolidated matter, Judge Boyko dismissed 14 foreclosure cases brought on behalf of investors, based on the investors' failures to establish themselves as the real parties in interest under Rule 17 of the Federal Rules of Civil Procedure. Judge Boyko ordered Deutsche Bank National Trust Company, trustee for a securitization pool, to file copies of recorded loan assignments showing ownership of the note and mortgage for each case as of the filing date. When the trustee failed to do so in a timely fashion, the court dismissed each action. This opinion, which has been widely cited and followed by other federal and state courts, illustrates what many critics of the securitization model believe to be its fundamental flaw.

The opinion by Judge Boyko has been cited and followed in bankruptcy courts across the country. In *In re Maisel*, the Bankruptcy Court for the District of Massachusetts held that a party moving for relief from an automatic stay to proceed with a foreclosure action, which has not obtained an assignment from the original lender at the time the motion is filed, does not have standing to proceed.¹⁰ Citing Judge Boyko's decision, which was issued only two weeks prior, the court noted the increase in lenders who, in their rush to foreclose, "haphazardly fail to comply with even the most basic legal requirements of the bankruptcy system."¹¹ Additionally, the court acknowledged that for motions for relief brought by a loan servicer, the servicer must establish the rights of the holder and identify its own rights as authorized agent for the holder at the time the motion is filed.

Judge Pat Morgenstern-Clarren also imposed similar requirements in *In re Dimmings*.¹² Here, the court identified numerous flaws in multiple noncompliant motions for relief from stay, noting that "despite three chances, the movant failed to show that

it holds a perfected security interest in the debtors' residence that would allow the movant to foreclose on the property in state court."¹³ In identifying these deficiencies, the court cited a local standing order, which requires a party seeking relief from stay to provide evidence of critical components of the claim, including the origination, perfection of lien, transfers, nature of default, and the names of any other parties with interest in the collateral. The movant's total disregard for this order led to denial of the motion and prompted the court's observation that "[t]his case is a classic example of what happens when a motion for relief from stay is filed hastily and without adequate input from, and review by, an experienced attorney."¹⁴

Some members of the judiciary have a negative perspective towards the securitization model as a whole.

The opinions cited previously demonstrate the importance of strictly adhering to a court's procedural requirements. In *Nosek v. Ameriquest Mortgage Company*,¹⁵ the Bankruptcy Court for the District of Massachusetts showed how courts may respond to what they perceive to be a disregard of the court's requirements by lenders. The *Nosek* court issued a judgment with respect to an order to show cause, imposing \$650,000 in sanctions among Ameriquest (\$250,000), Wells Fargo (\$250,000), Ameriquest's national counsel (\$100,000), a local law firm (\$25,000), and one partner of the local law firm (\$25,000).¹⁶

The *Nosek* court based its order largely on the fact that throughout the course of proceedings, Ameriquest and its attorneys represented that Ameriquest was the holder of the note and mortgage. In reality, Ameriquest originated the note and mortgage in question, and five days later assigned the instruments to a predecessor of Wells Fargo, the trustee. The court found that Ameriquest, through its local and national counsel, made numerous misrepresentations to the debtor and the court between October 2002 and July 2006. Further, while Wells Fargo did not make any direct misrepresentations, the court would not permit Wells Fargo to escape liability, despite the fact that it was merely an indenture trustee without loan servicing responsibility. As the judge observed, "Wells Fargo and Ameriquest have attempted to jettison the obligation to be forthright

and diligent with the Court and Debtor,” while also noting that the assignment and pooling of notes and mortgages into a trust holding “is simply another example of the layers interposed between borrower and lender in today’s marketplace.”¹⁷

The securitization model for residential mortgages has modified a practice that rarely extended beyond local boundaries and elevated it to a nationwide system.

While this opinion further demonstrates the importance of identifying and establishing the real party in interest, it also displays the potential liability for trustees of the securitized pool who contract their responsibilities to third parties, as well as the negative perspective some members of the judiciary have towards the securitization model as a whole. In addition, it highlights the importance of maintaining open lines of communication among lenders, trustees, servicers, and counsel.

Compliance with Plan and Confirmation Order

Lenders face a different set of issues when dealing with borrowers in default who elect to keep real property and cure arrearages through the bankruptcy plan. Under section 1322(b)(2), a debtor cannot modify the rights of a claim secured by the debtor’s principal residence.¹⁸ The debtor can, however, cure defaults on a long-term debt, including mortgage arrearages, through the bankruptcy plan.¹⁹ Thus, a borrower can stretch repayment of the default amounts over a period of three to five years. This provision allows the debtor to specify a method and procedure for applying payments made to cure arrearages. Further, willful failure by a lender or servicer to credit default accounts under the terms of the plan constitutes violation of the discharge injunction, and can result in damages.²⁰

This problem is illustrated in a recent opinion issued by the First Circuit in *In re Nosek*.²¹ In this case, the debtor filed an adversary proceeding against the lender for violations of 11 U.S.C. § 1322(b) and 11 U.S.C. § 524(i), based on the lender’s accounting practices for applying the debtor’s payment of prepetition arrearages. The lender created a “suspense account” for funds paid directly from the debtor that were not sufficient to make a full mortgage payment.²² This mechanism, according to the lender, allowed it to accept partial payments

that otherwise would not be returned to the debtor for non-compliance with her contractual obligations. The Bankruptcy Court for the District of Massachusetts had determined that the lender was in violation, and awarded the debtor \$250,000 in emotional distress damages and \$500,000 in punitive damages, under 11 U.S.C. § 105(a).²³ The Massachusetts District Court affirmed the bankruptcy court judgment, and affirmed an amended plan that reflected such damages award.²⁴

The lender appealed the judgment and confirmation of the amended plan to the First Circuit Court of Appeals. The lender argued that 11 U.S.C. § 1322(b) does not, by itself, impose any specific duties on a lender, but instead that provision merely offers the debtor an opportunity to include specific elements in the plan. The First Circuit, in reversing the lower courts’ rulings, agreed. The court noted that, “[b]ecause § 1322(b) merely provides optional elements that a debtor may incorporate into her Chapter 13 plan, the provision has no meaning separate and apart from the choices the debtor makes and incorporates into her Chapter 13 plan.”²⁵ In this case, the plan specified the period of repayment and amount of payment each month, but included no further instruction pertaining to application of payments and the lender’s requirements for accounting for prepetition or postpetition payments, in the event that payments were short, late, or not made at all. Additionally, the payment history provided no evidence that the debtor was entitled to recovery.

While the damages award was ultimately reversed and the lender avoided liability, this case would have likely turned out differently if the debtor had set forth specific instruction for application of incoming payments in the plan. The opinion and result shows the importance of affording personal attention to each individual borrower in Chapter 13 bankruptcy, and closely monitoring the plan and confirmation orders. Additionally, this highlights the importance of maintaining open communication between servicers and local bankruptcy counsel to ensure the servicers’ practices are consistent with the plan.

Another line of cases highlights recent measures taken by debtors to prevent mortgagees and servicers from adding postpetition fees to a debtor’s account without approval. In *Padilla v. GMAC Mortgage Corporation*, the Bankruptcy Court for the Eastern District of Pennsylvania, after analyzing sections 506(b) or 1322(b) of the Bankruptcy Code, ultimately held that a mortgagee had no obligation to give a debtor notice, or obtain court approval, of postpetition legal expenses to which it was owed under a loan agreement.²⁶ In this case, the debtor initiated an adversary proceeding against the lender after discharge to dispute certain charges related to the bankruptcy proceeding imposed by the lender. The debtor argued that inclusion of such charges constituted a violation of 11 U.S.C. § 1327(a).²⁷ The opinion noted that the confirmed plan imposed no obligations on the lender to give notice or make demand for expenses incurred during the pendency of the case. The lender retained its right, without violating the confirmed plan, to seek payment

of legal expenses incurred during the pendency of the bankruptcy case that the lender was contractually allowed to assess against the debtor's mortgage account.

In a similar opinion, the Bankruptcy Court for the Northern District of Iowa recently held that Chapter 13 plans that impose restrictions on postpetition, pre-discharge fees set forth in the initial loan agreement are not confirmable.²⁸ In this matter, which came before the court jointly upon Wells Fargo's objections to two proposed Chapter 13 confirmation plans, the debtors attempted to include language in the plans requiring Wells Fargo to receive court approval under Bankruptcy Rule 2016(a), after notice and hearing, for any charges added to the debtors' accounts while the bankruptcy case was pending.²⁹ Additionally, the debtors included language stating that any violation of such provision would be deemed a willful violation under 11 U.S.C. § 524(i).

Wells Fargo objected to the plan language, arguing that imposing a reasonableness requirement on postpetition charges improperly modified the rights of a holder of a security interest in the debtor's primary residence in violation of 11 U.S.C. § 1322(b)(2). In its analysis, the court cited *Padilla* for the proposition that Rule 2016(a) does not apply to a lender's contractual fees and charges arising post-confirmation. The court agreed with *Padilla* and Wells Fargo's arguments, holding that

controls inserted into a plan to prevent abuse must be authorized by the Bankruptcy Code and Rules. . . . Plan provisions that attempt to modify the underlying contract agreement are inappropriate. Confirming such plans would constitute a revision of bankruptcy law, which is the prerogative of Congress and not the courts.³⁰

In response to the issues raised in these cases, a committee of 20 Chapter 13 trustees from the National Association of Chapter 13 Trustees and more than 30 mortgage servicers have joined forces to develop a list of *Best Practices for Trustees and Mortgage Servicers* to combat the problems that result in failed bankruptcies and complex bankruptcy litigation.³¹ This aspirational list includes 25 initiatives for servicers or mortgagees to follow for borrowers in Chapter 13 bankruptcy. This group includes a measure for servicers to clearly identify attorney fees allocated to a borrower for pursuing relief from stay; a request for servicers to track prepetition payments to prepetition arrears and postpetition payments to ongoing mortgage payments; and a measure for mortgagees to review the trustee's website at the discharge of the bankruptcy case for discrepancies with their system. The Bankruptcy Court for the District of Kansas has adopted certain practices from this list, and now requires lenders and servicers to comply.³²

Additionally, this list sets forth measures for Chapter 13 trustees, including requesting that trustees initiate communication with mortgagees when questions arise in a review of

postpetition escrow analysis. While this initiative has no binding legal authority, Chapter 13 trustees and industry representatives are optimistic that it will be widely followed by servicers and mortgagees, and will ultimately lead to a reduction in bankruptcy litigation surrounding residential mortgages, and, ultimately, to more efficient adjudication of Chapter 13 cases.

Some courts have balked at these consumer-friendly holdings and, citing equitable principles, declined to extend TILA to protect consumers in bankruptcy.

The Effect of Bankruptcy on a Borrower's Tender Obligation

Secured lenders face another bankruptcy hurdle when forced to rescind a loan due to a compliance failure under the Truth-in-Lending Act (TILA).³³ Under TILA, if a court holds that a borrower's rescission claim is valid, the lender must first terminate its security interest on the borrower's property, and return all money or property to the borrower to reflect termination of the interest.³⁴ Once the lender terminates its security interest, then and only then does the borrower have to tender any money or property delivered to the borrower during the transaction.³⁵ This creates a tenuous situation for a secured lender who is left without either the money paid to the borrower to purchase the property or its security interest in the borrower's property.

The situation becomes even graver when a borrower has filed for bankruptcy. Some courts have held that the policies of TILA are better served when a borrower is released from his or her obligation to tender, and the lender is instead treated as an unsecured creditor.³⁶ As justification for treating the lender as an unsecured creditor, federal courts have stated "that the TILA was passed primarily to aid the unsophisticated consumer," and that it was "intended to balance scales thought to be weighted in favor of lenders . . . to be liberally construed in favor of borrowers."³⁷ Courts fear that if a secured lender is not treated as an unsecured creditor, rescission would impose an obligation upon the debtor from which the debtor had been legally freed by bankruptcy.³⁸ The borrower would then be forced to choose between filing for bankruptcy and enforcing his rights under TILA. These judicial policies can prove extremely costly for unsuspecting lenders, leading to high penalties for potentially

minor violations of TILA. Without a secured claim, a lender is forced to divide any proceeds from the sale of the previously secured property with other unsecured creditors, despite the fact that the property was initially purchased with funds procured from the lender.

Some courts have balked at these consumer-friendly holdings and, citing equitable principles, declined to extend TILA to protect consumers in bankruptcy. In *Clay v. Johnson*,³⁹ the Northern District of Illinois held that a plaintiff who was awarded rescission after filing for Chapter 13 bankruptcy protection was required to tender the proceeds from the transaction. The court conditioned the rescission upon repayment of the contract amount by the borrower, allowing the borrower to make incremental payments. Courts have justified this equitable authority to alter the normal TILA rescission process by relying on Section 1635(b) of TILA, which, after stating that a mortgagee must rescind a loan within 20 days upon valid notice of rescission, provides: “[t]he procedures prescribed by this subsection shall apply except when otherwise ordered by a court.”⁴⁰ This provision has been read as an enabling device giving courts the authority “to condition rescission upon some affirmative act of the debtor.”⁴¹

Similarly, other courts have refused to honor a rescission if the debtor is in bankruptcy and shows no intent to ever tender the proceeds of a loan. In *In re Cox*,⁴² the court refused to order rescission because “the debtors never intended to comply with § 1635(b) and restore the status quo ante.”⁴³ The court stated that the debtors only wanted to “keep the residence, void the mortgage, obtain a refund of all charges or interest, and not repay the loan by discharging it as an unsecured debt.”⁴⁴ The debtors’ approach was described by the court as “one based on greed and manipulation . . . [as they were] attempting to keep the residence without paying for it.”⁴⁵

Conclusion

The securitization model for residential mortgages has modified a practice that, historically, rarely extended beyond local boundaries and elevated it to a nationwide system. Changes to this model have created new and complex problems for the mortgage servicing industry. To confront these problems, lenders must be certain to take additional measures when dealing with loans for borrowers in bankruptcy. All loan assignments should be properly recorded, and foreclosure actions and corresponding relief from stay motions filed in the name of the proper party in interest. Additionally, it is important for lenders and servicers to work with competent local counsel familiar with jurisdictional requirements and experienced in working with the local Chapter 13 trustee. Finally, lenders should look to adopt internal compliance measures, such as those set forth in the *Best Practices for Trustees and Mortgage Servicers*, as a guideline for servicing loans for borrowers in bankruptcy. ■

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Endnotes

1. See Foreclosures up 75% in 2007, Les Christie, available at http://money.cnn.com/2008/01/29/real_estate/foreclosure_filings_2007.

2. *Id.*

3. Bankruptcy Filings Rise 38% in 2007: What Does That Mean For 2008, Carmen Dellutri (Apr. 16, 2008), available at <http://www.bankruptcylawnetwork.com/2008/04/16/bankruptcy-filings-rise-38-in-2007-what-does-that-mean-for-2008>.

4. See U.S. Foreclosure Activity Increases 23 Percent in First Quarter (courtesy RealtyTrac Staff) (Apr. 29, 2008), available at <http://www.realtytrac.com/ContentManagement/pressrelease.aspx?ChannelID=9&ItemID=4566&acct=64847>.

5. 11 U.S.C. § 362(a).

6. 11 U.S.C. § 362(d).

7. 11 U.S.C. § 1322(a).

8. 11 U.S.C. § 524(i).

9. 2007 WL 3232430 (N.D. Ohio, Oct. 31, 2007).

10. 378 B.R. 19, 22 (Bankr. D. Mass. 2007).

11. *Id.* at 20–21.

12. 386 B.R. 199 (Bankr. N.D. Ohio 2008).

13. *Id.* at 200.

14. *Id.*

15. 386 B.R. 374 (Bankr. D. Mass. 2008).

16. *Id.* at 385–86.

17. *Id.* at 385.

18. 11 U.S.C. § 1322(b)(2).

19. 11 U.S.C. § 1322(b)(5).

20. 11 U.S.C. § 524(i).

21. *Ameriquest Mortgage Co. v. Nosek (In re Nosek)*, 544 F.3d 34 (1st Cir. 2008). Other recent opinions highlighting the importance of complying with confirmation orders include *Rodriguez v. Countrywide Home Loans, Inc. (In re Rodriguez)*, Adv. Proc. No. 08-01004 (Bankr. S.D. Tex., Sept. 18, 2008) (finding that lender violated plan confirmation order by applying payments in a manner inconsistent with the plan and by collecting for unreasonable fees where the contract between parties only provided for collection of reasonable amounts); *Payne v. Mortgage Electronic Registration Systems, Inc. (In re Payne)*, Adv. Proc. No. 04-06078 (Bankr. D. Kan., May 6, 2008) (holding that lender violated plan by failing to properly apply payments and failing to perform a timely escrow analysis); *In re Taylor*, Case No. 04-1451 (Bankr. M.D. Fla., Nov. 9, 2007) (holding that contractual provisions that did not conflict with, or were not addressed by, the confirmed plan remained valid and enforceable postconfirmation).

22. *In re Nosek*, 544 F.3d at 39.

23. 11 U.S.C. § 105(a) gives a bankruptcy court authority to issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of the bankruptcy code.

24. *In re Nosek*, 544 F.3d at 42.

25. *Id.*

26. *Padilla v. GMAC Mortgage Corp.*, 389 B.R. 409, 444 (Bankr. E.D. Pa. 2008). Section 506(b) allows a secured claimant to include interest, fees, costs, and charges provided for under an agreement to its claim to the extent that the claim is secured by the property.

27. 11 U.S.C. § 1327(a) states: "The provisions of a confirmed plan bind the debtor and each creditor, whether or not the claim of such creditor is provided for by the plan, and whether or not such creditor has objected to, has accepted, or has rejected the plan."

28. *See In re Aldrich and In re Votroubek* (joint opinion), 2008 WL 4185989 (Bankr. N.D. Iowa Sept. 4, 2008).

29. *Id.* at * 1. Bankruptcy Rule 2016(a) of the Bankruptcy Rules of Procedure set forth a procedure for an entity seeking compensation for services or reimbursement for expenses from the estate.

30. *Id.* at *4.

31. For a comprehensive list of these initiatives, *see* <http://www.nactt.com/infocenter/MortgageServicersChapter13.pdf>.

32. *See* Standing Order 08-04, United States Bankruptcy Court for the District of Kansas (Nov. 1, 2008).

33. *See* 15 U.S.C. § 1635.

34. 15 U.S.C. § 1635(a)–(b).

35. 15 U.S.C. § 1635(b).

36. *See In re Jaaskelainen*, 391 B.R. 627, 645 (Bankr. D. Mass. 2008) ("Bankruptcy . . . relieves the debtor from his obligation to pay the creditor upon rescission.") (quoting *In re Piercy*, 18 B.R. 1004, 1007–08 (Bankr. W.D. Ky. 1982)).

37. *In re Whitley*, 177 B.R. 142, 153 (Bankr. D. Mass. 1995) (quoting *Aquino v. Public Fin. Consumer Discount Co.*, 606 F. Supp. 504 (E. D. Pa. 1985); *see also Bizier v. Globe Financial Services, Inc.*, 654 F.2d 1, 3 (1st Cir. 1981)).

38. *See In re Myers*, 175 B.R. 122, 128–29 (Bankr. D. Mass. 1994) (quoting *In re Piercy*).

39. 77 F. Supp. 2d 879 (N.D. Ill. 1999).

40. 15 U.S.C. § 1635(b).

41. *Personius v. Homeamerican Credit, Inc.*, 234 F. Supp. 2d 817, 819 (N.D. Ill. 2002).

42. 162 B.R. 191 (Bankr. C.D. Ill. 1993).

43. *Id.* at 197.

44. *Id.*

45. *Id.*

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The Perils of Judicial Activism: “Unfairness” in the Massachusetts Attorney General Litigation

By Ralph T. Wutscher

The Superior Court of Massachusetts for Suffolk County issued two unprecedented preliminary injunction orders against two residential mortgage lenders, Fremont Investment & Loan and Option One Mortgage Corporation,¹ which have sent shock-waves through Massachusetts and beyond. Both orders retroactively apply novel and highly specific standards for “unfairness” to mortgage lending activities, suddenly making illegal thousands of mortgage loans that had been perfectly legal when they were made.

The Fremont Decision

In *Commonwealth v. Fremont Investment & Loan, et al.*, the attorney general of Massachusetts brought an action in the Superior Court of Massachusetts, Suffolk County, against Fremont Investment & Loan (Fremont), alleging that Fremont had engaged in unfair and deceptive acts and practices, in supposed violation of the state unfair and deceptive practices statute in its origination and servicing of subprime loans in Massachusetts.² The Commonwealth moved for a preliminary injunction barring Fremont, during the pendency of the action, from initiating or advancing any foreclosure on its residential mortgages in Massachusetts, without the written consent of the attorney general’s office.

On February 25, 2008, the court granted a preliminary injunction in favor of the attorney general, finding that the attorney general would likely prevail in proving that many of the subprime mortgage loans issued by Fremont, which were secured by the borrower’s primary residence, were presumptively unfair because Fremont supposedly knew or reasonably should have expected that these loans were unduly vulnerable to foreclosure. Consequently, the court enjoined Fremont from initiating or advancing foreclosures on such loans, except under certain prescribed conditions.

According to the court, a mortgage loan is “presumptively unfair” if it possesses the following characteristics:

- (a) The loan is an adjustable rate mortgage with an introductory period of three years or less;
- (b) The loan has an introductory interest rate that is at least 3 percent lower than the fully-indexed rate;
- (c) The borrower has a debt-to-income ratio that would have exceeded 50 percent (not based on stated-income

- application representations, but upon other evidence of income), calculated using the fully-indexed rate; and
- (d) Fremont extended 100 percent financing or the loan has a substantial prepayment penalty or penalty that lasts beyond the introductory period.³

The court further held:

for loans with these four characteristics, the lender reasonably should have recognized that, after the introductory period, the borrower would be unlikely to make the scheduled mortgage payments and the loan was doomed to foreclosure unless the fair market value of the property had increased, thereby enabling the borrower to refinance the loan and obtain a new “teaser” rate for the introductory period. Given the fluctuations in the housing market and the inherent uncertainties as to how that market will fluctuate over time, this Court finds that it is unfair for a lender to issue a home mortgage loan secured by the borrower’s principal dwelling that the lender reasonably expects will fall into default once the introductory period ends unless the fair market value of the home has increased at the close of the introductory period.⁴

Under the terms of the injunction, Fremont must provide the attorney general’s office with at least a 30-day notice of all foreclosures it intends to initiate for the loans that Fremont still owns and services, and allow the attorney general an opportunity to object to the foreclosure going forward. If Fremont issues a loan that is considered “presumptively unfair,” and the borrower occupies the property as his or her principal dwelling, the attorney general has 45 days to object to the foreclosure.

The court further held that Fremont may only proceed with a foreclosure to which the attorney general objects if Fremont files a request with the court, and the court reviews the matter and agrees that a foreclosure is appropriate. In considering whether to allow the foreclosure, the court stated it will consider, among other factors, whether the loan is unfair and whether Fremont has taken reasonable steps to work out the loan and avoid foreclosure. The preliminary injunction does not release borrowers from their monthly mortgage obligations.

Importantly, the court stated that the evidence showed that Fremont was the victim of misrepresentations on stated-income loan applications, and did not encourage or tolerate such misrepresentations.⁵ Specifically, there was no evidence that (1) Fremont knew of any of the alleged misrepresentations of income on the 50 or 60 stated-income loans at issue; or (2) Fremont recklessly supervised its brokers by continuing to do business with them after Fremont learned that the brokers had a pattern or practice of inflating the borrower's income on loan applications. Likewise, the court also found no evidence that Fremont had ever misrepresented the terms of the loan to any borrower.

Fremont and High-Cost Loan Act

In addition, there was no indication that any of the loans were "high-cost mortgage loans" under the Massachusetts "predatory lending" statute,⁶ properly known as the 2004 Predatory Home Loan Practices Act (High-Cost Loan Act).⁷ Nonetheless, the court found that the attorney general's theory of "unfairness" fell under the "penumbra" of the interests sought to be protected under the High-Cost Loan Act.⁸ A violation of the High-Cost Loan Act is also a violation of Massachusetts's unfair and deceptive practices statute, G. L. c. 93A.⁹ Significantly, this new "penumbra" approach effectively rewrote the High-Cost Loan Act, which, among other things, prohibits a lender from making a "high-cost home mortgage loan"¹⁰ unless the lender reasonably believes at the time the loan is made that the borrower will be able to make the scheduled payments to repay the home loan, based upon a consideration of the borrower's current and expected income, current and expected obligations, employment status, and other financial resources, then the borrower's equity in the dwelling secures the repayment of the loan.¹¹

Now, by virtue of the court's action, the High-Cost Loan Act has been expanded to include all loans, not just high-cost mortgage loans. More importantly, it also retroactively applied this new standard to the inception date of the High-Cost Loan Act, November 7, 2004, thereby subjecting Fremont to untold liability for money damages under G. L. c. 93A, which includes both statutory damages and treble damages.¹²

In support of this unprecedented decision, the court concluded, based on its own analysis, that it was expanding the High-Cost Loan Act to include all loans because it did not believe the Massachusetts state legislature intended to limit the proscriptions of the High-Cost Loan Act to high-cost mortgage loans alone.¹³ The court opined the following:

The Legislature, equally plainly, was disturbed by the mortgage foreclosures of the borrower's principal dwelling, and thought it unfair for a lender to issue a mortgage loan that the lender reasonably believes will result in foreclosure of the borrower's home, even if the high cost of the loan fairly reflects the risk of the loan.¹⁴

Moreover, the court further opined that circumstances had changed since the Massachusetts legislature had promulgated the High-Cost Loan Act, with "the increasing prevalence of mortgage-backed securities, which enabled lenders, such as Fremont, to assign large quantities of their high risk mortgages, take a quick profit, and avoid the risks inherent in the loan."¹⁵ Yet, when the Massachusetts legislature enacted the High-Cost Loan Act in 2004, it is well documented that mortgage-backed securities were already prevalent, and loans such as those at issue were commonplace, and were already under state and federal regulatory supervision.

In fact, the court acknowledged that the lender's conduct it deemed unfair was generally recognized in the industry to be fair at the time the loans were made. Nevertheless, the court stated it was not inappropriate to find Fremont's conduct to be unfair, for three reasons. First, the court held that the meaning of unfairness is forever evolving and adapting to changing circumstances. Second, the court opined that Fremont had constructive notice of the Interagency Guidance on High LTV Residential Lending (1999)¹⁶ that had warned, among other things, that mortgage loans with high loan-to-value ratios had not been tested during an economic downturn when defaults and losses may increase.¹⁷ Third, the court noted that federal agencies now recognize loans bearing the four listed characteristics are imprudent and present an unacceptable risk of foreclosure.

Although the concept of unfairness may be ever-changing under Massachusetts law, this is hardly support for the wide-scale retroactive application of a standard of unfairness that was previously unknown. Moreover, the court's reference to the Interagency Guidance is misguided, as it pertains to the safety and soundness of the lending institution and risk of loss to the institution, and says nothing about unfairness to consumers. Likewise, a 1997 Massachusetts banking regulatory announcement that compliance with banking-specific laws and regulations was not sufficient to prevent a finding of "unfair and deceptive practices" under G.L. c. 93A, did not present or apply any underwriting or other standards of the sort now enforced by the court.¹⁸ The fact that federal and state regulators now deride the imprudence of certain loan characteristics does not support the retroactive application of a standard they did not previously acknowledge or apply.

On May 2, 2008, the lower court decision was affirmed by the Massachusetts Appeals Court.¹⁹ The lower court decision in *Fremont* was affirmed by the Supreme Judicial Court of Massachusetts on December 9, 2008.²⁰

The Option One Decision

On June 3, 2008, the Massachusetts attorney general brought a similar action against Option One Mortgage Corporation and its affiliates.²¹ The same court granted the attorney general's motion for a preliminary injunction against Option One, referencing its earlier *Fremont* decision as follows:

In this Court's *Fremont* Decision, the Court found that it is an unfair act in violation of G. L. c. 93 A, section 2 for lender to issue an adjustable rate home mortgage loan secured by the borrower's principal dwelling that the lender reasonably should expect the borrower would be unable to afford to pay or be able to refinance once the introductory period ends unless the fair market value of the home has increased at the close of the introductory period. In that decision, the Court characterized this as structural unfairness. In this decision, this Court characterizes it as reckless disregard of the risk of foreclosure.²²

The *Fremont* decision contained language indicating it might apply to mortgage loans "originated by Fremont," including potentially those that had or would be sold and assigned to a different entity.²³ In fact, the court in *Option One* refused to dismiss a subsequent purchaser as to the equitable relief that might be afforded under its ruling.²⁴

However, in its *Option One* decision, the court changed the criteria for structural unfairness. Here, the court lowered the introductory rate criterion from 3 percent to 2 percent, explaining the revision as follows:

In blunter terms, most mortgage loans that fell into delinquency were so carelessly underwritten that the borrower could not afford them even before the payment shock kicked in. Therefore, this Court will revise the second criterion by including all loans with an introductory or "teaser" rate for the initial period that is at least 2 percent lower than the fully indexed rate, and will eliminate this criterion entirely for all loans with a debt-to-income ratio of 55 percent or above.²⁵

The court also lowered the loan-to-value criterion from 100 percent to 97 percent, with the following explanation:

for all practical purposes, a loan meeting the other three criteria with a loan-to-value ratio of 97 percent will only be able to be refinanced by a loan with a loan-to-value ratio equal to or greater than 100 percent, which will almost certainly not be available to a lender with a 50 percent debt-to-income ratio. Therefore, this Court provides the fourth criterion to require a loan-to-value ratio of 97 percent or a substantial prepayment penalty or a prepayment penalty that extends beyond the introductory period.²⁶

As with *Fremont*, the court did not find any evidence of pervasive deception or other wrongdoing on the part of the defendants in the *Option One* litigation, but did find that the attorney general was likely to prevail at trial on the issue of structural unfairness, and granted the motion for a preliminary injunction imposing the same review procedure as in *Fremont*.

Apparently, the court revised the criteria set forth in the *Fremont* decision upon being informed that only a very small fraction of loans in dispute would have met all four of the criteria imposed against Fremont. The court felt compelled to change the criteria in the manner discussed previously in order to enjoin the foreclosure of a greater population of loans.

The Perils of Judicial Activism

Residential mortgage lending is a highly regulated activity. The Massachusetts legislature and the federal government have enacted numerous statutes that restrict mortgage lending, including numerous limitations on loan features and fees. The Massachusetts Commissioner of Banks has published extensive regulations and guidance, including guidance on so-called "subprime" and adjustable rate mortgages, as well as other mortgage lending products and practices that are at issue in these cases. Moreover, the Massachusetts Division of Banks has conducted extensive examinations of licensed mortgage brokers and mortgage lenders—including so-called subprime mortgage lenders—for years, and has yet to publish a finding that any category of loans is presumptively unfair.

Notwithstanding all of these laws and regulations, the court engaged in its own speculative analysis of real estate market economics to support its arbitrary selection of four criteria that, so the court postulates, make mortgage loans presumptively unfair, a move that causes alarm in many circles. By imposing its novel notion of mortgage lending "unfairness," the court has insinuated that once-valid mortgage loans may easily become invalid and unenforceable at the stroke of a pen.

Due to the court's willingness to retroactively impose specific and wholly unprecedented lending standards, without even hearing any expert testimony, the mortgage lending industry now has two inconsistent decisions that set out different criteria for the novel presumption of structural unfairness in mortgage lending. The lack of consistency and predictability in applicable legal standards engendered by these decisions is likely to cause further chaos in the mortgage lending and related financial markets.

Unintended Consequences

The court's orders create a precedent that casts a specter of doubt over the value and enforceability of billions of dollars of Massachusetts loans. The liability exposure both from putative class actions and individual lawsuits could increase significantly. Lenders that are otherwise compliant with Massachusetts law could face incalculable repurchase or indemnification liability under investor purchase agreements because G.L. c. 93A provides for statutory damages, treble damages, attorney fees, and costs for each violation.

Perhaps more importantly, lenders may face the risk that a court could retroactively apply a current-day concept of unfairness to new loan activity and products that were not then

considered to be unfair when the loan was made. Accurate risk assessment, which is a critical component of the safety and soundness of any business, will be virtually impossible. Such pervasive inability to accurately assess the risk of default and enforceability of subprime mortgage loans is a major cause of the current global financial crisis.

Lenders that attempt to comply with the law will find it difficult to do so with any degree of certainty. The risk of invalidity and unenforceability of future loans will deter both lenders and investors from making or purchasing Massachusetts loans. Ironically, the very consumers the court seeks to protect—financially distressed borrowers—could find it more difficult to obtain relief if fewer loans are made.

When the risk of liability for mortgage lenders and purchasers is unknown, creditors have reacted by increasing credit costs or exiting the marketplace, as was the case with high-cost loan laws in Georgia, New Jersey, Washington D.C., and Ohio earlier in this decade. Lenders returned to these markets, and the cost of credit became more affordable only after the objectionable laws and regulations were amended to eliminate the uncertainty. These lessons were no doubt fresh in the minds of the Massachusetts legislators when they enacted the High-Cost Loan Act, which provisions are strictly limited to high-cost loans only.

Legislative Efforts to Stem Foreclosures

Given the potential for catastrophic consequences, distressed borrowers are best served by leaving foreclosure relief to the legislators and policy makers. In fact, significant progress has been made to stem the tide of foreclosures.

Massachusetts legislators and regulators have played a formative role in assuaging the foreclosure crisis. The Massachusetts Division of Banks essentially adopted the Joint Guidance on Nontraditional Mortgage Products and Joint Guidance on Subprime Lending issued by the federal banking agencies.²⁷ Massachusetts recently enacted the Act Preserving and Protecting Home Ownership,²⁸ which provides substantial protections to distressed borrowers.

Likewise, the federal government has taken aggressive action to stem the tide of foreclosures. For example, Congress recently enacted the Housing and Economic Recovery Act of 2008, which provides substantive assistance to homeowners in danger of foreclosure.²⁹ Federal banking agencies have urged federally regulated lenders to work with borrowers in distress. The Department of Treasury and Department of Housing and Urban Development have forged the HOPE NOW alliance of mortgage servicers and Wall Street firms to modify mortgages and provide other loan workout services to distressed borrowers. These and other similar efforts have significantly reduced the number of foreclosures in Massachusetts as well as the nation at large.

Conclusion

Today, we are confronted with a global financial crisis of unprecedented proportions. Foreclosures are at an all-time high. Property values are declining as never before. Many homeowners are unable to obtain credit to refinance their mortgages or sell their homes. The last thing the business and financial markets need is more risk and uncertainty.

Given the potential for catastrophic consequences, borrowers are best served by leaving foreclosure relief to the legislators and policy makers.

Lenders and businesses must be able to determine in advance whether their conduct is compliant with G.L. c. 93A in Massachusetts and similar statutes in other jurisdictions. It is manifestly unfair to all if a court can retroactively apply a current concept of unfairness to earlier conduct that was then considered to be fair. If anything is to be learned from the *Fremont* and *Option One* decisions, it is that the legislature's process of careful consideration, hearings, and a vote is better suited for legislating than a court of law. Solutions to this financial crisis are best left to the legislature, which has the time, resources, and expertise to effectuate practicable solutions for the benefit of all. ■

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Endnotes

1. Commonwealth of Mass. v. H&R Block, Inc., et al., No. 08-2474-BLS1 (Mass. Super. Nov. 10, 2008) (Gants, J.) (*Option One*); Commonwealth of Mass. v. Fremont Investment & Loan, No. 07-4373-BLS1, 2008 WL 517279 (Mass. Super. Feb. 28, 2008) (Gants, J.) (*Fremont*) *aff'd* Commonwealth v. Fremont Investment & Loan, __N.E.2d __, 452 Mass. 733 (Mass. 2008).
2. *Fremont*, 2008 WL 517279 at *1.
3. *Id.* at *11.
4. *Id.* at *10.
5. *Id.* at *7.
6. *Id.* at *9.
7. MASS. GEN. LAWS ch. 183C, § 2 (2004).
8. *Fremont*, 2008 WL 517279 at *9-10.

(Continued on page 17)



Can Reckless Mortgage Underwriting Practices Constitute a Defect in Title?

By Benjamin M. Kahrl, Anna-Katrina S. Christakis, and Jeffrey D. Pilgrim

Mortgage lenders and title insurers have no shortage of horror stories to share in the midst of the current crisis in the real estate and subprime markets. But a recent title dispute in Chicago presents a morbid fact pattern worthy of an Alfred Hitchcock thriller. How the Illinois trial court ultimately rules on the novel coverage issue presented in the litigation will truly leave either lenders or insurers with a nightmare scenario for the foreseeable future.

On January 9, 2008, Thomas Jacobs, the successful bidder of a single family home sold at a foreclosure auction, took possession of his new property in the Kenwood neighborhood of Chicago. When Mr. Jacobs toured the three-story house for the first time, he discovered the clothed mummified remains of Randy Johnson, the son of a prior owner of the house. According to a newspaper report, “Sitting upright in the corner of a bedroom off the kitchen was a human skeleton in a red tracksuit, and next to him was a dead dog.”¹

Mr. Johnson, who was known as a recluse to his neighbors, had lived in the house his entire life. The property had belonged to his mother, Arrellia Johnson, who died in 2001. In 2006, one of Mr. Johnson’s neighbors, who hadn’t seen him in weeks, called social services to ask for a well-being check. The house was searched, but Mr. Johnson was not found. His death is still a mystery and remains under investigation.²

In the period of time since that well-being check in 2006, ownership of the house changed hands three times. First, in October 2006, a deed dating back to 1996 was filed with the county recorder’s office, transferring title from Arrellia Johnson to Rhonda Evans. The deed was notarized by Mae Evans, Rhonda Evans’s mother, and drawn up on the official stationery of Cook County Recorder Eugene Moore, who did not take office until 1999—three years after the deed was supposedly executed.³

Three months later, the house changed hands for the second time when Rhonda Evans sold the house to Donald Franklin for \$450,000, in January 2007. Mr. Franklin paid \$500 in earnest money and financed 100 percent of the purchase with two mortgages through Countrywide Home Loans.⁴ The loan was brokered by E&I Funding Corporation, a company owned by Rhonda Evans’s brother, Edwin Evans.⁵ Franklin’s loan application indicated that he was a single 28-year old who rented an

apartment in Harvey, Illinois, for \$1,900 a month. The application further showed that Franklin earned over \$142,000 a year as an excavator for Class Act Construction, a company also owned by Edwin Evans.⁶ Countrywide’s underwriting report noted that Franklin’s credit was “acceptable” and that the loan had been approved on a “reduced documentation” basis, subject only to satisfaction of a few conditions on an underwriting checklist, such as verbal verification of his employment, confirmation of his employer’s 411 listing, and identification of the source of \$14,500 that had been deposited in his savings account in the months preceding the loan application.⁷ It does not appear that Countrywide ever received the two-year employment verification its underwriting report required.⁸

Ticor Title Insurance Co. v. Countrywide Home Loans, Inc.

In preparation for closing, Countrywide retained the services of Ticor Title Insurance to perform a title search of the property. Ticor subcontracted the title search to Tri-Star Title, whose report showed that title was “clean.”⁹

Franklin never moved into the house and never made a single payment on either mortgage.¹⁰ On May 29, 2007, Countrywide filed for foreclosure. Franklin was never located and, therefore, never served with papers.¹¹ Seven months later, Countrywide auctioned off the property to Mr. Jacobs for \$93,000—an amount Countrywide ultimately refunded after the discovery of the corpse.

On January 31, 2008, the Cook County Public Administrator—who is charged with representing the interests of people who die intestate—filed a motion on behalf of the Estate of Arrellia Johnson to intervene in the foreclosure action, seeking to have ownership of the property restored to Arrellia Johnson’s heirs. Four days later, Countrywide tendered the motion to Ticor and sought indemnity for defects in the title under its insurance policy.

Ticor declined coverage and filed suit in Cook County Circuit Court, seeking a declaration that it has no duty to defend or indemnify Countrywide for any losses related to the subject property because any “defects, liens, encumbrances, adverse claims, or other matters [were] created, suffered, assumed, or agreed to by the insured claimant.”¹² In this regard, the suit alleges that as a result of “the explosive growth in subprime

mortgage lending,” Countrywide adopted a “pattern of grossly negligent underwriting” practices in lieu of its traditional underwriting protocols. According to the complaint, examples of these “grossly negligent” practices include:

- Failing to require full documentation on an application for 100 percent financing of a \$450,000 mortgage to a first-time home buyer
- Accepting a loan based on a sale price of \$450,000 where the buyer deposited only \$500 in earnest money, and where the seller agreed to pay up to 5 percent of the buyer’s closing costs
- Failing to obtain verification of Franklin’s employment and salary
- Failing to obtain written documentation of the nearly \$15,000 in increased savings.¹³

Ticor further alleges that because Countrywide deliberately chose to employ the “reckless and grossly negligent practices” that resulted in the “abandonment of any meaningful underwriting standards,” “fraudulent conduct like the ‘straw man’ scheme alleged to have occurred [in connection with the Franklin mortgage] went undetected.”¹⁴ Consequently, because the title insurance policy excludes from coverage defects, claims, and other matters that arise because of the intentional conduct of the insured, Ticor claims that it is under no obligation to defend or indemnify Countrywide.¹⁵

“Created, Suffered, Assumed, or Agreed To”

The “created or suffered by the insured” language upon which Ticor relies for its denial of Countrywide’s claim is a standard exclusion used by title insurance companies all over the country.¹⁶ It is a frequently litigated provision that, until this lawsuit, had not been applied to mortgage underwriting practices. A question raised by this case is whether a claim of “grossly negligent” mortgage underwriting bars coverage under a title insurance policy for a defect in title. In other words, can a lender “create” or “suffer” loss without intending to do so simply by having inadequate underwriting processes? Or put another way, should the phrase “created, suffered, assumed, or agreed to” be interpreted to include negligent or grossly negligent acts, or only intentional ones?

Courts interpreting the “created, suffered, assumed, or agreed to” exclusion have typically held that it applies only to knowing and intentional conduct by the insured.¹⁷ The common understanding is that “the insurer can escape liability only if it is established that the defect, lien, or encumbrance resulted from some intentional misconduct or inequitable dealings by the insured or the insured either expressly or impliedly assumed or agreed to the defects or encumbrances.”¹⁸ In addition, for the exclusion to apply, the title defect must be caused by the insured’s conduct (such as fraudulently

inducing the loan transaction, ignoring the seller’s contract to sell the property to a third party, or failing to pay tax liens that the insured agreed would be its responsibility), rather than by some other force.¹⁹ Accordingly, “courts have not permitted the insurer to avoid liability if the insured was innocent of any conduct causing the loss or was simply negligent in bringing about the loss.”²⁰

Each of the specific terms used in the exclusion has been interpreted to require that the insured either intentionally created the adverse lien, or expressly or impliedly agreed to the defects. “Created” has been interpreted to mean deliberate, rather than inadvertent, action.²¹ “Suffered” is commonly understood to mean “consent with the intent that ‘what is done is to be done’” and has been “deemed synonymous with ‘permit,’ which implies the power to prohibit or prevent the claim from arising.”²² “Assume” is commonly understood to require that the insured had knowledge of the specific title defect assumed, while the term “agreed to” has been understood to carry “connotations of ‘contracted,’ requiring full knowledge by the insured of the extent and amount of the claim against the insured’s title.”²³

Should the phrase “created, suffered, assumed, or agreed to” be interpreted to include negligent or grossly negligent acts, or only intentional ones?

Ticor does not allege that Countrywide had knowledge of the defective chain of title its borrower caused by the apparent forgery of the deed from the deceased Arrellia Johnson to Rhonda Evans. Nor can it be said that Countrywide would have knowingly “assumed” or “agreed to” the defects in title, or that Countrywide acquiesced in, or “suffered,” the forged deed. It is safe to conclude that if Countrywide knew about the defective chain of title or the rotting corpse of Ms. Johnson’s heir in the guest room, the loan would never have been made.

Because negligence would be insufficient to defeat the title claim, and there being no proof of Countrywide’s knowledge of or involvement with the hostile interest in the property claimed by the Estate of Arrellia Johnson, Ticor’s claim instead relies on a novel theory of gross negligence.

Implications of Ticor Claim

The Ticor claim is unique in two respects. First, the alleged gross negligence did not create the Estate's hostile claim or the defect in the chain of title. Rather, Ticor asserts that Countrywide's overall business practices constituted gross negligence in obtaining Countrywide's lien interests, regardless of Countrywide's knowledge of or role in the existence of any other lien on the property.²⁴

Ticor's claim is also unique in that it is unclear whether gross negligence of any kind, as opposed to intentional conduct or actual knowledge, is sufficient to make the exclusion apply. A New Jersey court posed the same question in a decision over 30 years ago, stating "We must examine plaintiff's actions closely to see if they amount to gross negligence and, if so, whether gross negligence can be equated with the intentional, illegal, and fraudulent acts found in the cases cited above to bring plaintiff within the 'suffered or created' conditions of the policy."²⁵ Unfortunately for Ticor's purposes, the court in that case held that the insured's conduct did not constitute gross negligence, and so the court never answered whether gross negligence could be equated with intentional conduct so as to trigger the exclusion.²⁶

Ultimately, a victory for Ticor would pose a burden for mortgage lenders seeking title coverage for losses stemming from defective loans around the country. For the first time, an insured could be barred from coverage when it had no role in the existence of the claim that was hostile to its own insured lien, even though the insured had not misrepresented or willfully concealed the defects in title for which it sought coverage. The focus of future litigation would then be on the general lending practices of the insured rather than the hostile lien presenting the title claim. In response, the mortgage lending community is likely to argue that the facts of this case present precisely the type of scenario for which purchasers and lenders acquire title insurance. Moreover, lenders will argue that it is the title insurer's agent at the closing who is primarily responsible for locating conflicting chains of title in the public record.

On the other hand, Ticor's lawsuit does present the interesting question as to whether a lender can systematically cast a blind eye to the risks it takes in its lending decisions. Title

insurance companies are inundated with title claims these days, and they are likely to feel that they are unduly shouldering the consequences of the loose lending standards preceding the subprime meltdown. Title insurers could argue that they would have been reluctant to insure lending transactions had they known that there had been an alleged decline in underwriting standards in recent years.

Conclusion

Ultimately, the lending and insurance industries must adapt to the burden shifting that the court will perform in evaluating the legal merits of Ticor's claim. Lenders will have an even

greater incentive to exercise due diligence in their origination and underwriting processes. Insurers may need to alter the language in future policies to specifically exclude instances of gross negligence in those processes. Both parties should make sure someone has searched the premises for dead bodies.

But in the short term, how the Cook County Circuit Court rules will impact similar skirmishes between lenders and insurers will play out across the country. The court may not be able to conclude how Randy Johnson and his faithful dog ended up dying in that house, or how their skeletons went undetected for years. But the court's decision will determine whether title

companies will be haunted with the increasing number of troubled loans, or whether coverage can be defeated by unearthing skeletons in lenders' closets. ■

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"TITLE INSURER v. LENDER AMIDST THE FORECLOSURE CRISIS."

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Endnotes

1. Susan Chandler, *This House Was a Steal*, CHI. TRIB., Feb. 24, 2008, available at http://www.chicagotribune.com/news/chi-sun_fraud_0224feb24,0,5031285.story.
2. *Id.*
3. According to newspaper reports, Mae Evans was also the

mother of Edwin Evans, a convicted rapist and armed robber who was indicted on mortgage fraud in September 2007. *Id.*

4. Complaint filed in Tigor Title Insurance Co. v. Countrywide Home Loans, Inc., 08 CH 25938 (Cook. Co. Cir. Ct.) (*Tigor* Complaint) ¶¶ 24, 34.

5. Susan Chandler, *Title Firm Ready to Do Battle*, CHI. TRIB., Aug. 17, 2008, available at <http://archives.chicagotribune.com/2008/aug/17/business/chi-sun-title-insurance-fraud-aug17>.

6. *Tigor* Complaint ¶ 25; Susan Chandler, *Title Firm Ready to Do Battle*, CHI. TRIB., Aug. 17, 2008, available at <http://archives.chicagotribune.com/2008/aug/17/business/chi-sun-title-insurance-fraud-aug17>.

7. *Tigor* Complaint ¶¶ 29–30, 32.

8. *Tigor* Complaint ¶ 32.

9. Susan Chandler, *Title Firm Ready to Do Battle*, CHI. TRIB., Aug. 17, 2008, available at <http://archives.chicagotribune.com/2008/aug/17/business/chi-sun-title-insurance-fraud-aug17>. According to the Tribune, Tri-Star is currently defunct and under investigation for mortgage fraud.

10. See Complaint ¶ 35; Susan Chandler, *This House Was a Steal*, CHI. TRIB., Feb. 24, 2008, available at http://www.chicagotribune.com/news/chi-sun_fraud_0224feb24,0,5031285.story.

11. Susan Chandler, *Title Firm Ready to Do Battle*, CHI. TRIB., Aug. 17, 2008, available at <http://archives.chicagotribune.com/2008/aug/17/business/chi-sun-title-insurance-fraud-aug17>.

12. *Tigor* Complaint at ¶ 43.

13. *Tigor* Complaint at ¶ 44.

14. *Tigor* Complaint at ¶¶ 45, 47.

15. *Tigor* Complaint at ¶¶ 47, 51.

16. See Standard Conditions and Stipulations, 1992 American Land Title Association Policy of Title Insurance.

17. See, e.g., *American Title Ins. Co. v. East West Financial*, 16 F.3d 449, 455 (1st Cir. 1994); *American Sav. & Loan Ass'n v. Lawyers Title Ins. Corp.*, 793 F.2d 780, 784 (6th Cir. 1986); *Brown v. St. Paul Ins. Corp.*, 634 F.2d 1103, 1008 (8th Cir. 1980); *Tigor Title Ins. Co. v. FFCA/IIP 1988 Prop. Co.*, 898 F. Supp. 633, 640 (N.D. Ind. 1995); *Stevens v. United Gen. Ins. Co.*, 801 A.2d 61, 69 (D.C. 2002). See generally, Joel E. Smith, Annotation, *Title Insurance: Exclusion of Liability for Defects, Liens, or Encumbrance Created, Suffered, Assumed, or Agreed to by the Insured*, 87 A.L.R.3d 515 (1978).

18. *Brown*, 634 F.2d at 1107–08 n.8.

19. *Resolute Trust Corp. v. Ford Mall Assocs. Ltd. P'ship*, 819 F. Supp. 826, 840 (D. Minn. 1991) (citations omitted).

20. *Brown*, 634 F.2d at 1107–08 n.8.

21. *American Sav. & Loan*, 793 F.2d at 784.

22. *Id.* (quoting *First Nat. Bank & Trust Co. v. N.Y. Title Ins. Co.*, 12 N.Y.S.2d 703, 709 (N.Y. Sup. Ct. 1939)); *Arizona Title Ins. Co. v. Smith*, 519 P.2d 860, 863 (Ariz. Ct. App. 1974).

23. *American Sav. & Loan*, 793 F.2d at 784.

24. *Tigor* Complaint ¶¶ 44–47.

25. *Keown v. West Jersey Title and Guaranty Co.*, 371 A.2d 370, 378 (N.J. Super. 1977), *rev'd on other grounds*, 390 A.2d 715 (N.J. App. 1978).

26. *Id.* at 379.

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9. MASS. GEN. LAWS ch. 183C, § 18(a) (2004).

10. A “high-cost home mortgage loan” is specifically defined in MASS. GEN. LAWS ch. 183C, § 2 (2004) as a loan securing the borrower’s principal dwelling and that either exceeds by more than eight percentage points (for first mortgage) the yield on Treasury securities with a comparable maturity period, or features total points and fees that exceed the greater of 5 percent of the total loan or \$400.

11. MASS. GEN. LAWS ch. 183C, § 4 (2004).

12. MASS. GEN. LAWS ch. 93A, § 9(3A) (2004).

13. *Fremont*, 2008 WL 517279 at *9, *11.

14. *Id.* at *9.

15. *Id.* at *11.

16. *Interagency Guidance on Subprime Lending*, issued by the United States Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve Board, the Federal Deposit Insurance Corporation, and the Office of Thrift Supervision (March 1, 1999), 71 Fed. Reg. 58609.

17. *Fremont*, 2008 WL 517279 at *12–*13.

18. Consumer Affairs and Business Regulation Massachusetts Division of Banks, Subprime Lending (Dec. 10, 1997).

19. *Fremont*, No. 08-J-118, 2008 WL 2312648 (Mass. App. Ct.) (May 2, 2008).

20. *Id.*, __N.E.2d __, 452 Mass. 733 (Mass. 2008).

21. *Option One*, No. 08-2474-BLS1 at p. 1.

22. *Id.* at pp. 41–42.

23. *Fremont*, 2008 WL 517279 at *15.

24. *Option One*, No. 08-2474-BLS1 at p. 52.

25. *Id.* at p. 46.

26. *Id.* at p. 47.

27. Regulatory Bulletin 5.1-103, “Guidance on Nontraditional Mortgage Product Risks” (Mass. Div. of Banks) (Jan. 8, 2007).

28. Chapter 206 of the Acts of 2007 (Mass.), available at <http://www.mass.gov/legis/laws/seslaw07/sl070206.htm>.

29. Pub.L. 110-289, 122 Stat. 2654 (2008).

WALL STREET AND MAIN STREET

(Continued from page 1)

lender or broker nominally involved in the transactions.”³ Cleveland also bemoans the “astronomical fees” and the “voracious appetite” of the mortgage-backed security industry.⁴ In so many words, Cleveland accuses the banks of shoving money at the originators and thereby fostering their misdeeds, a practice it labels “the phenomenon of money-seeking borrowers.”⁵

In contrast, the City of Buffalo’s claim against 36 financial institutions seeking reimbursement of demolition costs and other damages is not expressly a subprime mortgage case on its face.⁶ The complaint does, however, contain specific allegations of 3,000 foreclosure filings in Buffalo in the past two years, and of 10,000 vacant properties in the city, and painstakingly references details on numerous properties allegedly tied to the lender defendants. Moreover, the *City of Buffalo* Complaint includes both an individual count for public nuisance, and a further public nuisance count asking that defendants be held liable “jointly and severally” for the costs of abatement, including demolition at an average cost of \$16,000 per dwelling.⁷ Whether considered a subprime mortgage case or not, one could interpret the Buffalo lawsuit as a strategy to put pressure on banks to think twice about foreclosing on any subprime mortgage loans in that city.

These pending municipal lawsuits raise the issue of whether subprime lending—even “predatory” lending—can ever be a public nuisance. Indeed, attempts to hold subprime lenders broadly accountable under a public nuisance theory may well be subjected to greater scrutiny because (1) the law seldom deems lawful conduct (however misguided or unfortunate in retrospect) to be adequate grounds for declaring a public nuisance; (2) as a matter of public policy, the courts may well resist public nuisance theories in favor of legislative regulation because such attacks might harm borrowers by drying up funding sources that have long permitted millions with blemished credit histories to purchase or maintain their homes; and (3) the causation and damages complexities in public nuisance litigation of this type may well be deemed overwhelming.

The Public Nuisance Concept

A “public nuisance” is not easy to define. According to the restatement, “a public nuisance is an unreasonable interference with a right common to the general public.”⁸ A public nuisance, unlike a private nuisance, does not necessarily involve an interference with the use and enjoyment of land, or an invasion of another’s interest in the private use and enjoyment of land, but encompasses any unreasonable interference with a right common to the general public.⁹

Central to public nuisance claims is the question of a public right. At English common law, the list of public rights that

would support a public nuisance claim were limited to the following: the right to walk safely along a public way; the right to breathe unpolluted air; the right to be free from disturbances from rowdy crowds; and the right to be free from the spread of infectious disease.¹⁰ While Parliament could declare an activity a public nuisance, it could also authorize an activity and thereby exempt that activity from common law public nuisance claims, such as in the case of railroads.¹¹

Since the emergence of the industrial era, the courts have not been quick to find a public right where the challenged conduct comports with law, particularly where the activity is heavily regulated.¹² Moreover, the courts have been understandably reluctant to declare what is and is not a public right in such instances for fear of being accused of judicial activism.¹³

Defenses to the Public Nuisance Claims

The Cleveland and Buffalo public nuisance claims face a number of defenses and raise numerous legal and policy issues. Each case raises obvious issues of standing, whether or not there is a “public right” to be free from aggressive or predatory lending practices, whether the type of detriments alleged constitutes an “unreasonable interference” that has an ongoing and “significant effect” on a public right, whether the defendants’ conduct is the proximate cause of the city’s ills,¹⁴ and whether the cities have alleged cognizable damages.¹⁵

Buffalo seeks to recover damages based on a public nuisance theory, and also based on ordinance violations by owners, even though the mortgagees did not technically have title to the vacant or distressed properties at issue. Buffalo argues in its complaint that the lenders “permitted, suffered, and allowed the aforesaid building(s) . . . [to] become so dilapidated, deteriorated, abandoned, and/or decayed so as to present a danger to the health, safety, and welfare of the public. . . .”¹⁶

As previously noted, the public right issue is a thorny one that is laced with “slippery slope” considerations. For example, when faced with this question, the Illinois Supreme Court worried that if it recognized a public right to be safe, then the alcohol industry might be sued for public nuisance because of the illegal acts of drunk drivers.¹⁷ On the question of unreasonable interference, the Cleveland defendants will likely point to the fact that their product (subprime loans) is legal, and that they have complied with all applicable government regulations. Defendants in all cases will probably also argue that the diminution of the city’s tax base and other claimed damages are too remote and speculative to support a claim.

In the *City of Buffalo* litigation, the lender defendants have raised several arguments in favor of dismissal that may repeat themselves in future actions. For example, the lenders have

attacked Buffalo's public nuisance claims on the basis that New York law requires "the plaintiff [to] allege conduct by the defendant that creates, maintains, or contributes to an interference with or injury to the public in the exercise of rights common to all,"¹⁸ and in this case, there is no conduct by the lenders to attack because these lenders never owned the property that became distressed. Moreover, the lenders argued that the complaint failed to plead (1) injury to a legally cognizable public right as part of its nuisance claim; (2) that the claimed nuisances are substantial or threaten to be substantial; and (3) that the claimed nuisance is an unreasonable interference with a public right, all of which are required elements for public nuisance under New York law.¹⁹ Finally, the lenders asserted that the public nuisance claim should be dismissed because money damages are not available to the city in a common law nuisance action because only injunctive relief and abatement are available.²⁰

Whether or not Buffalo's general allegations of public nuisance will survive early dispositive motions will certainly be resolved in the near future. The larger question is whether Buffalo's lawsuit—and similar copycat suits that may follow—can get past various requisite elements of public nuisance law, and whether the theory could more broadly be applied jointly and severally.

An initial public nuisance requirement, that the nuisance be substantial, is arguably the "first important limitation on nuisance actions imposed by the common law."²¹ In the Buffalo complaint, the city did not attempt to tie their broader allegations to any specific property. The lenders argued that the question whether a particular building is blighted or requires demolition does not mean that the building is a public nuisance, absent alleged facts establishing all the elements of such a claim. Moreover, the lenders further argued that the city neither pled nor was capable of pleading that the claimed nuisance is an unreasonable interference with a public right.²²

The most difficult hurdle for the City of Buffalo may be its attempt to hold—without any allegations of joint conduct—all defendants jointly and severally liable for the alleged instances of public nuisance, and in particular, the costs related to the abatement of the public nuisance for each property described in the complaint.²³ For example, the lenders argued that, under the City of Buffalo's theory, each mortgagee becomes liable for the costs associated with the abatement of nuisance for properties as to which it had no ownership interest, no mortgage lien, no right of possession, and no knowledge. As the lenders put it, "[i]n the [c]ity's apparent view, if a Buffalo borrower abandons his house after the mortgagee obtains a judgment of foreclosure, and the house then deteriorates, the mortgagee is somehow liable to remediate not just that property . . . but *all* deteriorated parcels alleged in the [c]omplaint."²⁴

Given its impact on the damages potentially payable by lender defendants, this may well be the critical matter for early resolution by the court. If any court allows a municipal public

nuisance claim based on joint and several liability to survive, it might theoretically tie together lienholders of one parcel of land with lienholders of other parcels of land, without any showing that these entities had anything to do with each other. The concept is a broad one, and appears to have no real support in New York law.²⁵ Another possibility is that courts will sever claims for public nuisance and other claims on the theory that the claims involve distinct properties, conduct, and alleged damages.²⁶ Severance might be appropriate if the city cannot provide a factual basis to identify a sufficient causal connection between its claims against the various lenders and the alleged wrongdoing.

The public right issue is a thorny one that is laced with "slippery slope" considerations.

Other Approaches by Municipalities

There are other approaches being pursued in the courts by municipalities. For example, the *City of Baltimore* Complaint is not technically a "public nuisance" suit, but likewise seeks broad-ranging remedies based on allegedly predatory conduct in inner-city Baltimore.²⁷ Baltimore claims that so-called predatory lending practices have had a disparate impact on minorities in that city, amounting to racial discrimination by defendant Wells Fargo Bank, described as the city's largest subprime lender. The City of Baltimore articulates particular practices, but frequently in conclusory terms: failing to "prudently" underwrite loan applications; extending mortgage loans on terms that the borrower "could not afford"; "stripping" equity through refinancing an existing loan; failing to underwrite loans based on "traditional underwriting criteria."²⁸ These allegations also arguably amount to a tautology: If a subprime loan defaults and the bank is forced to foreclose, then the underwriting was ipso facto "imprudent" or "irresponsible," and the loan it generated "unaffordable."

In addition, San Diego and Birmingham recently brought their own claims against lenders.²⁹ San Diego's lawsuits were brought under the California Business and Professions Code, but the suits have some of the same underpinnings as the Cleveland and Buffalo lawsuits. Similar to the City of Baltimore's lawsuit, Birmingham's complaint alleges racial discrimination in the foreclosure context, and alleges violations of the federal Fair Housing Act. Interestingly, both the San Diego and Birmingham lawsuits have been met with political

opposition from within their community, including the respective newly elected San Diego city attorney³⁰ and Birmingham mayor.³¹ At press time, it appeared possible that this internal opposition might lead to the dismissal of the lawsuits before they even needed to be actively defended. However, the Birmingham mayor was indicted on corruption-related charges shortly after the lawsuit was filed, and the lawsuit remains in place as of the date this article was submitted for publication.³²

The cities point to foreclosures and ask the court or jury to conclude that the banks acted improperly, even “unscrupulously.” The irony is, no bank wants a foreclosure.

Finally, the City of Minneapolis recently debated whether to bring similar litigation against the lending industry. As of December 2008, however, it had brought suit only against a single company.³³ The defendant is not a lender, but rather a firm, which purchased and then “flipped” 162 inner-city properties. Moreover, the suit is not for public nuisance, but rather one under both Minnesota’s Tenant Remedies Act³⁴ (for violation of housing codes) and under that state’s consumer fraud statute.³⁵ The lawsuit seeks monetary damages, the appointment of an administrator to manage the properties to remedy code violations and mitigate costs, and injunctive relief to prevent the defendant from continuing its allegedly fraudulent activities.

Paradoxical Arguments

One of the central paradoxes of these cases is that banks are being sued for increased foreclosures associated with loans that everyone, including the cities, recognized faced an increased rate of foreclosure at the time they were made. Another related paradox is that essential market-based features of these riskier loans that allowed them to materialize—including higher fees and interest rates to compensate for the increased risk of default—themselves increased the risk of default and foreclosure by making the loans less affordable in the longer term. Variable rate mortgages with “teaser” introductory rates are a perfect example of this, both in the subprime and prime markets.

Another conundrum is this: The cities are focused on increased foreclosures and the resulting vacancies. They point

to these foreclosures and ask the court or jury to conclude—based largely on the fact of the foreclosures themselves—that the banks acted improperly, even “unscrupulously” and “irresponsibly.” The irony is that no bank wants a foreclosure. A foreclosure represents a failed loan. This is even more manifestly the case when the foreclosed property remains vacant resulting in the alleged public nuisance. Every vacant home resulting from a foreclosure that a city claims is blighting its neighborhoods and leading to increased crime and other problems represents an unsuccessful foreclosure from a lender’s point of view; if the home could have been sold to repay the principal still owed on the underlying mortgage, it would have been successful. In other words, each vacant property represents a loss of substantial principal by the lender, or by the investors who purchased the collateralized mortgage obligations tied to that mortgage.

The question is whether the municipal subprime mortgage suits are examples of the cities wanting it both ways. The cities reject that argument, claiming instead that they are targeting particularized bad conduct by particular actors. This should come as no surprise to mortgage lenders, of course, because mortgage fraud lawsuits (frequently brought by lenders against shady originators, borrowers, and/or appraisers, for instance) are not a new phenomenon. Further, outright mortgage fraud is not the only “bad” conduct out there. But the types of systemic allegations of the sort made by the cities in their subprime mortgage lawsuits appear to be almost unprecedented.

Subprime lenders are likely to argue that their industry is heavily regulated, with everything from prepayment penalties, to disclosures, to closing practices prescribed by statutes and regulations. To the extent there is any public right in this context, the lenders may argue that it should be limited to having lenders follow those laws and rules. Because such laws typically have enforcement mechanisms, subprime lenders will likely argue that there is little need for the law of nuisance to step in and overlay a common law remedy.

A third possibility is that the cities will argue that there is a public right not to have foreclosed properties remain vacant. One might observe that government very rarely puts this type of affirmative obligation on property owners. In other words, laws frequently tell us what we cannot do with our property (e.g., pollute, violate zoning rules, etc.) but not what we have to do with it (occupy it). And such a right logically would interfere with the long-standing and long-recognized rights of mortgagees to obtain possession of real property securing a loan used to purchase that property, which for generations has not included any expectation by either party to the transaction that the mortgagee would occupy the property after obtaining possession of it. If this “right” were adopted legislatively and applied to existing mortgages, vendors may argue that such a law would violate the norm against ex post facto law, since it would appear to substantially interfere after-the-fact with contractual foreclosure rights.

It may be difficult for cities to point to a public right to high property values. It is not difficult to believe that foreclosures—particularly those where empty houses tend to remain vacant—have a negative effect on municipal tax revenues. But just because governmental units decide to finance their operations through taxes based on real estate value does not make the homeowner—much less his or her mortgagee—a guarantor of any particular value. There are at least two additional hurdles to this theory. First, one of the major criticisms of the subprime mortgage crisis is that real estate values were driven up in an overheated market fueled by easy money made available by loose lending practices. But if that is true, then the cities were (by the logic of their principal damages claim of lost tax revenues) the direct beneficiaries of that phenomenon. For them now to claim that there is a public right to maintain property values at artificially high levels would seem both unfair and contrary to traditional notions of free market economics.

Second, the prospect of a public right to high real estate values to support high tax revenues raises a concern about how far this theory might extend. Is there a similar public right to have workers earn higher wages to support higher income tax revenue, for example? The potential for undue judicial interference in market economics implicit in this approach is evident.

Credit is essential for most Americans to participate in current notions of what is considered a modern lifestyle—ownership of a home, a car, and other consumer goods. Loan defaults help virtually nobody. Banks lose, their investors lose, and other borrowers who do not default shoulder a portion of the burden in the higher rates they pay. The defaulted borrower pays an ongoing cost. With so much misery to go around, cities seeking to hold lenders additionally liable for their unsuccessful loans seem jurisprudentially misguided. It risks causing more harm than good to urban residents, and, while those residents are not the plaintiffs in these cases (the cities are suing for their own damages, and not to compensate homeowners), courts are not likely to ignore their interests in defining a new public right.

Issues with Causation and Quantification of Damages

Even assuming that one could confidently discern with hindsight which loans, when viewed prospectively, involved improper conduct, how could one reliably determine how any resulting foreclosure affected property values in a given neighborhood, much less the tax base of the city, going forward? Land values are complex phenomena, responding to broad economic factors and regional elements. How confident can one be of isolating the contribution of foreclosures solely related to improper loans from all other factors? After five houses on a block are foreclosed on, do lenders who foreclose on houses six, seven, and eight get a “pass” because market values have already tanked? Do defendants receive “credit” for any elevation of the tax base in these areas in the years when lending activity was high, and

foreclosures relatively low or stable? If foreclosed houses remain unsold, how many years out are lenders supposed to be held liable for the decreased real estate tax base? Forever?

With so much misery to go around, cities seeking to hold lenders additionally liable for their unsuccessful loans seems jurisprudentially misguided.

This rationale and the previous analysis of the legal standards, and their application to the circumstances of the municipal subprime mortgage public negligence cases, suggest that courts may well be reluctant to find a public right, an unreasonable interference, and sufficient proof of causation to support public nuisance claims based on legal lending practices, particularly if there is hope that an extra-judicial way can be found to abate future foreclosures. Such an effort is far more likely to be productive, partly because banks often do not do well by foreclosing on subprime mortgages. So far that effort appears to be centered in the legislatures, where the complex balance between attracting capital to poor neighborhoods while protecting residents in those communities can be hammered out.

Other cities are trying more direct ways to help residents facing foreclosure, including intervention to facilitate workouts of troubled loans, and even loans on favorable terms to homeowners facing foreclosure. Moreover, it seems that a new statute is enacted or a new regulation is proposed nearly every day to stave off foreclosures, to aid troubled borrowers in refinancing their mortgages, or to prop up the latest financial institution placed in jeopardy whose collapse is deemed too devastating to allow. In short, there is every reason to believe that if there is a legislative solution to the foreclosure epidemic, it is being aggressively pursued outside the courts.

Conclusion

It is entirely unclear whether municipal litigation is just a blip on the litigation screen or a long-term development. Only time will tell. Municipal suits against the lead paint, gun, and tobacco industries lasted for years. That said, many of the suits are based on tenuous legal theories, and legal standing remains problematic in some of the cases. While municipal litigation

against lenders and Wall Street presents numerous novel legal issues that may have implications far beyond the subprime mortgage crisis, it is by no means a foregone conclusion that cities will ever persuade the courts that they are worthy of the massive remedies they seek.

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Endnotes

1. See, e.g., *City of Cleveland v. JP Morgan Chase Bank, N.A.*, No. CV 08-668608 (Cuyahoga County, Ohio Court of Common Pleas, Complaint filed Aug. 22, 2008) (*City of Cleveland State Court Complaint*).

2. *City of Cleveland v. Deutsche Bank First Co., et al.*, Case No. 1:08-cv-00139 (N.D. Ohio) (Complaint filed Jan. 10, 2008) (*City of Cleveland Complaint*).

3. *City of Cleveland Complaint*, ¶ 1.

4. *Id.* at ¶¶ 3–5.

5. *Id.*

6. *City of Buffalo v. ABN AMRO Mortgage Group, et al.*, State of New York, Supreme Court, Erie County, Index No. 2008–2200 (filed Feb. 20, 2008). (*City of Buffalo Complaint*).

7. *Id.* at ¶¶ 16–28.

8. RESTATEMENT (SECOND) OF TORTS §821B (1979).

9. 58 Am. Jur. 2d *Nuisances* §31, at 592 (2002).

10. William L. Prosser, *Private Action for Public Nuisance*, 5 VA. L. REV. 977, 997–98 (1966).

11. See, generally, Comment: *Municipalities versus Gun Manufacturers: Why Public Nuisance Claims Just Do Not Work*, 31 U. BALT. L. REV. 273, 277 (2007).

12. See *International Paper Co. v. Ouellette*, 479 U.S. 481, 486 (1987).

13. See, e.g., *City of Philadelphia v. Beretta U.S.A. Corp.*, 277 F.3d 415, 420–21 (3rd Cir. 2002); *Camden County Bd. of Chosen Freeholders v. Beretta*, 273 F.3d 536, 541 (3rd Cir. 2001).

14. See, Jonathan L Entin & Shadya Y. Yazback, *City Governments and Predatory Lending*, 34 FORDHAM URB. L. J. 757, 762–770 (2007).

15. See, e.g., *City of Cincinnati v. Beretta U.S.A. Corp.*, 768 N.E.2d 1136, 1142 (Ohio 2002).

16. *City of Buffalo Complaint*, ¶ 142.

17. *City of Chicago v. Beretta U.S.A. Corp.*, 821 N.E.2d 1099, 1116 (Ill. 2004).

18. *People v. Sturm, Ruger & Co.*, 309 A.D.2d 91, 109 (1st Dep't 2003) (emphasis added) (citing *New York Trap Rock Corp. v. Town of Clarkstown*, 299 N.Y. 77, 80 (1949)).

19. Defendants' Joint Memorandum of Law In Support of Motions to Dismiss, *City of Buffalo Complaint*, Index No. 2008–2200, at 18.

20. *Id.*; see, e.g., *State v. Waterloo Stock Car Raceway, Inc.*, 409

N.Y.S.2d 40, 45 (N.Y. Sup. Ct. 1978).

21. Denise E. Antolini, *Modernizing Public Nuisance: Solving the Paradox of the Special Injury Rule*, 28 ECOLOGY LAW Q. 755, 771 (2001).

22. RESTATEMENT (SECOND) OF TORTS § 821B; *accord DeStefano v. Emergency Housing Group, Inc.*, 722 N.Y.S.2d 35, 37 (N.Y. App. Div. 2001); Denise E. Antolini, *Modernizing Public Nuisance: Solving the Paradox of the Special Injury Rule*, 28 ECOLOGY LAW Q. 755, 772 (2001); Robert Abrams and Val Washington, *The Misunderstood Law of Public Nuisance: A Comparison With Private Nuisance Twenty Years After Boomer*, 54 ALB. L. REV. 359, 374 (1990).

23. *City of Buffalo Complaint*, ¶ 34.

24. Defendants' Joint Memorandum Of Law In Support Of Motions To Dismiss, *City of Buffalo Complaint*, Index No. 2008–2200, at 18.

25. See, e.g., *Carrols Equities Corp. v. Villnave*, 76 Misc. 2d 205, 207 (N.Y. Sup. Ct. 1973), *aff'd*, 49 A.D.2d 672 (N.Y. App. Div.1975).

26. See N.Y. C.P.L.R. 603 (McKinney 2005) (“In furtherance of convenience or to avoid prejudice the court may order a severance of claims, or may order a separate trial of any claim, or of any separate issue.”).

27. *Mayor and City Council of Baltimore v. Wells Fargo Bank, N.A. et al.*, No. 1:08-cv-00062-BEL (D. Md. Jan. 8, 2008) (*City of Baltimore Complaint*), Complaint, ¶ 1.

28. *City of Baltimore Complaint*, ¶ 26; see also, e.g., *City of Cleveland State Court Complaint*, ¶¶ 3–5 (describing a purported litany of abusing lending practices).

29. See, e.g., *People of the State of California v. Countrywide Financial Corp., et al.*, Case No. 37-2008-00088176-CU-BT-CTL (Superior Court of California, San Diego County); *People of the State of California v. Washington Mutual, Inc.*, Case No. 08-0093736 (Superior Court of California, San Diego County); *City of Birmingham v. Argent Mortgage Company, LLC, et al.*, Case No. CV-2008-903691 (Jefferson County Circuit Court, Alabama).

30. See, e.g., A Message from City Attorney Jan Goldsmith, *available at* <http://www.sandiego.gov/cityattorney> (last visited December 29, 2008) (newly elected City Attorney Jan Goldsmith was inaugurated December 8, 2008, and promptly criticized the overly politicized actions of the former City Attorney).

31. See *Birmingham Mayor Opposes City Suit Against Lenders*, *available at* <http://www.montgomeryadvertiser.com/article/20081114/NEWS/8114035/1002/sports> (last visited November 14, 2008).

32. See *FBI Arrests Birmingham, Alabama Mayor*, *available at* <http://www.cnn.com/2008/CRIME/12/01/birmingham.mayor> (last visited December 1, 2008).

33. *City of Minneapolis v. TJ Waconia*, No. 27CV0887880 (Hennepin Co., Minn., Dist. Ct., Apr. 2, 2008).

34. MINN. STAT. § 504B.395 (2002).

35. MINN. STAT. § 3250D.44 (2002).

Practice Pointers



The “Alphabet Soup” of Lending Claims

By Michael Winston

With the rapid increase in foreclosure filings that most jurisdictions are experiencing, there has been an equally rapid rise in the appearance of what many practitioners refer to as the “alphabet soup” of federal lending claims. These claims, which go by various acronyms such as TILA, RESPA, HOEPA, ECOA, FIRREA, and NFIA, each have their own statutory language, their own body of interpretive case law, and sometimes even their own distinct language. While, as with any specialized area of the law, the unfamiliar practitioner should exercise great caution before jumping into one of these cases, there are several key issues to evaluate when the alphabet soup appears.

Unlike many statutes, the alphabet soup statutes have companion regulations known by titles such as Reg. X, Reg. Z, and Reg. B. These regulations, as well as their commentary, are extensive and detailed. As these regulations and commentaries are almost universally held to be controlling, they are far from surplusage. Therefore, it is essential that they be considered as part of the analysis of any claim.

The following are key points that should be initially considered when analyzing these types of claims:

What Type of Transaction or Borrower Does the Claim Involve?

The first step in evaluating an alphabet soup claim is determining the type of transaction involved and whether the borrower is a member of the class of persons intended to be protected. For example, most alphabet soup claims do not apply to investment properties; some apply only to refinance transactions; and many other provisions apply to a very limited number of loans that fall within a set of precise statutory definitions.

Are There any Pending Statutory Deadlines?

Another initial step is to identify and address statutory deadlines. For example, a TILA rescission request must be responded to within 20 days of receipt. Similarly, a RESPA qualified written request must be acknowledged within 20 days, and responded to within 60 days. Oftentimes, these requests are buried in court filings. Other times, these demands are sent directly to the client. Identifying these requests and determining whether they are valid is essential to avoiding a statutory damage claim.

Does the Statute Provide Private Civil Remedies?

Many alphabet soup claims, although seemingly imposing privately enforceable obligations, do not provide borrowers with a private right of action. For example, RESPA, FIRREA, and NFIA each have provisions that impose obligations on lenders. These obligations, however, are subject only to administrative enforcement. Other

provisions permit claims only for “material” violations, with nonmaterial violations resulting in lesser relief or no relief at all.

Does the Statute Address Assignee Liability?

In the world of modern lending, many mortgages have been sold and resold with many now being part of securitized trusts. Several of these alphabet soup laws have express provisions dealing with assignee liability for initial violations by the assignor. For example, TILA and ECOA have express provisions that discuss assignee liability. On the other hand, RESPA is silent on the issue resulting in divergent case law. Significantly, typical holder in due course rules do not always apply.

What Are the Statutes of Limitations at Issue?

Many alphabet soup provisions have a one-year limitations period, yet still permit out of time claims to be asserted defensively in setoff or recoupment. Other provisions have three-year statutes of repose for which no tolling, whether equitable or otherwise, is permitted. As cases interpreting these provisions can be inconsistent, even within a single jurisdiction, close attention must be paid to whether claims are time-barred.

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The above is a quick walk-through of a vast body of law. Other issues that can creep into analyzing alphabet soup claims include preemption of state law claims, National Bank Act or HOLA preemption, and the impact of reclusive doctrines such as *Rooker-Feldman*. Each of these issues must be carefully considered and addressed when bringing or defending alphabet soup claims.



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