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## "Goin' Round in Circles"... and Letting the Bad Loans Win: When Subprime Lending Fails Borrowers: The Need for Uniform Broker Regulation

Cassandra Jones Havard  
*University of Baltimore School of Law*

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# “Goin’ Round in Circles” . . . and Letting the Bad Loans Win<sup>1</sup>: When Subprime Lending Fails Borrowers: The Need for Uniform Broker Regulation

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\* Associate Professor of Law, University of Baltimore School of Law. B. A., Bennett College; J.D., University of Pennsylvania School of Law. I am grateful to Michelle Alexandre, Patience Crowder, Gilda Daniels, Audrey McFarlane and Odeana Neal for their comments on an earlier draft. Pratima Lele provided valuable research assistance.

1. The late Billy Preston made famous the song *Will It Go Round in Circles*. One of the verses is:

I’ve got a lil’ story ain’t got no moral  
Let the bad guy win every once in a while . . .

Chorus:

Will it go round in circles?  
Will it fly high like a bird up in the sky?

BILLY PRESTON, *Will it Go Round in Circles*, on *MUSIC IS MY LIFE* (A&M Records, Inc. 1972).

“Goin’ round in circles” is a reference to the circular argument that subprime borrowers are choosing the non-traditional mortgage products found in the market as informed market participants or rational buyers and therefore shoulder the total responsibility for their inability to repay the loans. This neoclassical economic argument obscures the fact that many products in today’s consumer mortgage market are designed to fail, which is inapposite to the consumer’s expectation to receive an affordable and sustainable mortgage loan product.

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## I. INTRODUCTION

Home ownership is an American dream. Yet, America faces a crisis in the residential housing market that threatens that dream for many. Approximately 2.2 million borrowers with home equity totaling \$164 billion or almost one-third of outstanding subprime mortgages will face foreclosure.<sup>2</sup> An even greater number of subprime home

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2. The Center for Responsible Lending (“CRL”) has estimated the percentage of foreclosures based on performance of the home mortgage loans over the life of the loan. ELLEN SCHLOEMER, WEI LI, KEITH ERNST, AND KATHLEEN KEEST, CTR. FOR RESPONSIBLE LENDING, *LOSING GROUND: FORECLOSURES IN THE SUBPRIME MARKET AND THEIR COST TO HOMEOWNERS 15–16* (2006) (hereinafter *LOSING GROUND*), available at <http://www.responsiblelending.org/pdfs/FC-paper-12-19-new-cover-1.pdf>.

These numbers are based on the fourth quarter of 2006. According to the Mortgage Bankers Association (“MBA”), this number represents an increase of 14 basis points from the third quarter of 2006. Press Release, The Mortgage Bankers Ass’n, *Delinquencies and Foreclosures Increase in Latest MBA National De-*

loans, 16.31% are delinquent, with 2.12% beginning foreclosure in the third quarter of 2007 and 6.89% of the delinquent subprime loans in foreclosure at the end of the third quarter.<sup>3</sup> Loans totaling \$164 billion are delinquent in monthly mortgage payments.<sup>4</sup> Ironically, these rising delinquency and foreclosure rates are due in large part to greater access to credit for homebuyers through the subprime lending market.<sup>5</sup> Though subprime lending<sup>6</sup> has filled a credit gap and addressed the problem of access to mortgage financing by creating a new

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- linquency Survey (Dec. 6, 2007), available at <http://www.mortgagebankers.org/NewsandMedia/PressCenter/58758.htm>. See also, Joint Econ. Comm., *The Subprime Lending Crisis: The Economic Impact on Wealth, Property Values and Tax Revenues, and How We Got Here*, S. Rep. No. 110-251 at 71-78 (2007) (estimating the number of foreclosures for the third quarter of 2007 through the end of 2009 to be around 1.66 million, and the related property loss around \$106 billion).
3. In the mortgage market, serious delinquencies are around 1% and foreclosures 0.2%. In the prime market, the delinquency rate is usually about .2%. Eight percent of subprime loans were seriously delinquent, meaning 90 days or more, during 2006 and the first half of 2007 as compared with 6% in 2005 and the first half of 2006. The foreclosure rate has climbed from 1.5% at the end of 2005 to 2.5%. During 2000-2002, serious delinquencies were about 12%, and foreclosures ranged from 2.5% to 3%. Press Release, *The Mortgage Bankers Ass'n, Delinquencies and Foreclosures Increase in Latest MBA National Delinquency Survey* (Dec. 6, 2007), available at <http://www.mortgagebankers.org/NewsandMedia/PressCenter/58758.htm>. See also, Joint Econ. Comm., *The Subprime Lending Crisis: The Economic Impact on Wealth, Property Values and Tax Revenues, and How We Got Here*, S. Rep. No. 110-251 at 71-78 (2007) (estimating the number of foreclosures for the third quarter of 2007 through the end of 2009 to be around 1.66 million, and the related property loss around \$106 billion.) The most recent estimate projected \$3 million in defaults this year and next leading ultimately to 2 million in lost homes. *The Growing Mortgage Foreclosure Crisis: Identifying Solutions and Dispelling Myths, Hearing Before the H. Subcomm. on Administrative and Commercial Law*, 110th Cong. 52 (2008) (statement of Mark M. Zandi, Ph.D., Chief Economist, Moody's Economy.com, Inc.).
  4. Numbers are based on the fourth quarter of 2006 on a seasonally adjusted basis. This number is up 28 basis points from the third quarter, and up 25 basis points from one year ago, according to MBA's National Delinquency Survey. Press Release, *The Mortgage Bankers Ass'n, Delinquencies and Foreclosures Increase in Latest MBA National Delinquency Survey* (Mar. 13, 2007), available at <http://www.mortgagebankers.org/NewsandMedia/PressCenter/50974.htm>.  
 In July 2007, Standard & Poor's changed the ratings on \$10 billion of debt from structured investment vehicles sponsored by Cheyne Capital Management from AAA to CCC. Eric Dash, *S. & P. Cuts British Firm's Debt Rating*, N.Y. TIMES, Aug. 29, 2007, at C1.
  5. The emergence of a subprime market for residential mortgages has closed a credit gap by making home ownership more affordable. In 1995, the subprime home loan market was valued at \$65 million. 1 INSIDE MORTGAGE FINANCE PUBLICATIONS, *THE 2007 MORTGAGE MARKET STATISTICAL ANNUAL* 222 (2007). By 2006, the total volume of subprime loans was \$600 billion, down from \$665 billion in 2005. Today, subprime mortgage originations constitute 23% of all mortgages. *Id.* at 209. The subprime market has also filled a market gap by allowing credit-impaired homeowners to borrow against the equity in their homes to meet a variety of needs. Cassandra Jones Havard, *Democratizing Credit: Examining the Structural Inequities of Subprime Lending*, 56 SYRACUSE L. REV. 233, 259 (2005).

market for home ownership, it has created more opportunities for abusive lending.<sup>7</sup> Borrowers have entered into financially detrimental and imprudent loans, often without being fully aware of or understanding the substance of their commitments. These often predatory loans are characterized by product terms and features such as interest-only, high loan-to-value (“LTV”) ratios, low start rates, and adjustable rates. Borrowers also have entered into mortgage agreements with high debt-to-income ratios; loans in which the monthly payment was large relative to the borrower’s income.<sup>8</sup> Many of these borrowers received loans without providing supporting documentation of their income or even providing a down payment.<sup>9</sup> The rising number of subprime mortgage foreclosures threatens to undermine the significant home ownership gains made over the past two decades.<sup>10</sup>

Some argue that the current crisis merely represents market failure.<sup>11</sup> The massive defaults in the subprime mortgage markets, the explanation goes, demonstrate that credit-impaired borrower markets are risky and have no place in the usually stable mortgage sector. This explanation supports the imperative that private, free market policies are the best solution to address both imperfections and inequality in the market and that the current subprime mortgage crisis is a neces-

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6. Virtually all predatory mortgages have subprime characteristics, though the vast majority of subprime mortgages cannot be characterized as predatory. See Kathleen C. Engel & Patricia A. McCoy, *A Tale of Three Markets: The Law and Economics of Predatory Lending*, 80 TEX. L. REV. 1255, 1260, n.6 (2002).
  7. “Because of innovations in the prime and subprime mortgage market, nearly 9 million new homeowners are now able to live in their own homes, improve their neighborhoods, and use their homes to build wealth.” Edward M. Gramlich, Governor, Fed. Reserve Bd., Address at the Financial Services Roundtable Annual Housing Policy Meeting, Chicago, Illinois (May 21, 2004).
  8. A Center for Responsible Lending Study projects that 1 out of 5 subprime borrowers will default on their mortgages over a 10 year period. SCHLOEMER, ET AL, *supra* note 2, at 19.
  9. There is no consensus on what constitutes predatory lending, but there are three common features, loan flipping, high fees, and pricing. David J. Weiner, *Assignee Liability in State Predatory Lending Laws: How Uncapped Punitive Damages Threaten the Secondary Mortgage Market*, 55 EMORY L.J. 535, 546–49 (2006).
  10. See generally Heather McCulloch, *Promoting Economic Security for Working Families: State Asset-Building Initiatives*, 7 Housing Facts and Findings, Vol. 2, at 3 (2005), available at [http://www.fanniemae.foundation.org/programs/hff/pdf/HFF\\_v7i2.pdf](http://www.fanniemae.foundation.org/programs/hff/pdf/HFF_v7i2.pdf); GWENDOLYN WRIGHT, *BUILDING THE DREAM: A SOCIAL HISTORY OF HOUSING IN THE UNITED STATES* (1981).
  11. *Subprime Lending: Defining the Market and Its Customers: J. Hearing Before the H. Subcomm. On housing and Community Opportunity and the H. Comm. on Financial Services*, 108th Cong. 73–76, 267–72 (statement of Anthony Yeazer, Professor of Economics, George Washington University). Cf. Athanasios Orphanides & John C. Williams, *Robust Monetary Policy with Imperfect Knowledge* (Fed. Res. Board Working Paper No. 33-2007), available at <http://www.federalreserve.gov/pubs/feds/2007/200733/200733pap.pdf>.

sary market correction.<sup>12</sup> Irrational borrowers, the line of reasoning continues, who accepted, rather than rejected, onerous loan terms must now bear the consequences of their actions.

To the contrary, the current crisis in the subprime mortgage sector is due to a market that has failed borrowers.<sup>13</sup> Mortgage market expansion should be seen as a means to address economic inequality with the expectation that the market operates in a manner consistent with borrower expectations.<sup>14</sup> Market-driven innovations, such as the subprime lending market, must be scrutinized for inequality in the treatment of vulnerable borrowers. Such inequality must be rooted out and rejected to ensure that the financially under-served receive their fair share of economic growth. In the context of subprime lending, that fair share is measured against policies and practices that cause marginalization and subordination.<sup>15</sup> Quite simply, this theory advocates that subprime lending policies must support mortgage sustainability.<sup>16</sup>

Mortgage sustainability, or affordable mortgage financing, is presently impacted negatively by the securitization of subprime loans. Securitization of loans is an underappreciated factor that paralleled the evolution of the subprime mortgage market.<sup>17</sup> Securitization has increased the availability of subprime mortgage credit and spawned a more significant function for mortgage brokers in the lending process.<sup>18</sup>

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12. See *infra* Part II.B.3 for a discussion of how subprime lending also addresses issues of inequality. For a discussion of the effects of privatization in another context see Michele Estrin Gilman, *Legal Accountability in an Era of Privatized Welfare*, 89 CAL. L. REV. 569 (2001).
  13. See generally Douglas G. Baird, *Discharge, Waiver, and the Behavioral Undercurrents of Debtor-Creditor Law*, 73 U. CHI LAW. REV. 16, (2007); Ian Ayres, *Menus Matter*, 73 U. CHI LAW. REV. 1 (2007).
  14. Affordable housing measures evaluate whether a buyer can qualify for the loan and afford the initial down payment as well as whether the homeowner is able to sustain the mortgage payments over time. Predatory loans conflict with housing affordability objectives by creating a pricing structure that which leads to the buyer defaulting on the loan.
  15. See Havard, *Democratizing Credit*, *supra* note 5, at 269–75.
  16. See Mark Wiranowski, Joint Center for Housing Studies of Harvard University, Neighborhood Reinvestment Corporation, *Sustaining Home Ownership Through Education and Counseling*, Oct. 2003, [http://www.jchs.harvard.edu/publications/homeownership/w03-7\\_wiranowski.pdf](http://www.jchs.harvard.edu/publications/homeownership/w03-7_wiranowski.pdf).
  17. The consolidation of the banking industry has resulted in the transformation of many sectors of the financial services industry. See generally Arthur E. Wilmarth, Jr., *The Transformation of the U.S. Financial Services Industry, 1975–2000: Competition, Consolidation, and Increased Risks*, 2002 U. ILL. L. REV. 215, 241–49 (2002) (arguing that bank profitability is declining as a result of competition and consolidation).
  18. As used in this Article, mortgage brokers means mortgage brokers, bankers, and lenders, all of which would be subject to the proposed regulations. See discussion *infra* Part III.

Mortgage brokers perform many of the tasks involved in loan origination.<sup>19</sup> They are also instrumental in identifying a broader market of lenders for potential borrowers. A mortgage broker's specialized knowledge and access to multiple lending sources is particularly helpful to borrowers who have been traditionally excluded from the market due to credit risks. When mortgage brokers function effectively and legitimately, they recommend loans with reasonable terms that are suited to the borrower's financial circumstance. But mortgage brokers' actions go largely unchecked and consequently some brokers recommend deceptive, unreasonable loan terms and unnecessarily high interest rates.<sup>20</sup> The combination of the effects of unscrupulous mortgage brokers and subprime lending has failed to fully protect credit-impaired borrowers, resulting in higher delinquency and foreclosure rates. Seventy percent of the now delinquent subprime loans were made by mortgage brokers.<sup>21</sup> Thus, the role of the mortgage broker in the subprime market requires critical examination.

The primary regulation of mortgage brokers currently resides with the states, with some states having little or no regulation.<sup>22</sup> Federal regulation of mortgage brokers offers an answer to the abuse that has accompanied the expanded access to subprime loans. This Article argues that the mortgage broker industry requires strengthened joint federal and state legislation because an unregulated industry poses a significant economic risk by confusing the interrelated issues of access with quality.

Part I of this Article discusses the structural framework of the mortgage broker industry. It describes the use and development of

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19. See generally Lloyd T. Wilson, Jr., *A Taxonomic Analysis of Mortgage Broker Licensing Statutes: Developing a Programmatic Response to Predatory Lending*, 36 N.M. L. REV. 297 (2006) (comparing and contrasting the the licensing statutes in four different states).

Mortgage brokers participate in more than 68% of home loans originations. The remaining 32% is retail done through the lenders retail channel, which means the lender does not go through a broker. See *Licensing and Registration in the Mortgage Industry: Licensing and Registration in the Mortgage Industry: Hearing Before the H. Subcomm. on Housing and Community Opportunity of the Comm. on Fin. Servs.*, 109th Cong. 70 (2005) (hereinafter *Licensing and Registration Hearing*) (statement of Joseph L. Falk, President, Irian Mortgage Servs., on behalf of the Nat'l Ass'n of Mortgage Brokers). The National Association of Mortgage Brokers estimates that "mortgage broker operations across the nation originate 65% of all residential loans in the U.S." *Id.*

20. See generally Lawrence Hansen, *In Brokers We Trust—Mortgage Licensing Statutes Address Predatory Lending Regulation*, 14 J. Affordable Housing & Community. Dev. 332 (2005); Lloyd T. Wilson, Jr., *Effecting Responsibility in the Mortgage Broker-Borrower Relationship: A Role for Agency Principles in Predatory Lending Regulation*, 73 U. CIN. L. REV. 1471 (2005).

21. Georgette C. Poindexter, *Subordinated Rolling Equity: Analyzing Real Estate Loan Default in the Era of Securitization*, 50 EMORY L.J. 519, 525 (2001).

22. See discussion *infra* Part II.

mortgage brokers and how some loans they endorse involve potentially reckless lending practices. These are loans designed to disadvantage borrowers because they are designed to fail. It then explains how these practices support abusive, predatory lending. Part I concludes by arguing that the societal costs of home ownership loss for a particularly vulnerable segment of borrowers justify a more comprehensive federal program.

Part II presents the corrective framework for the mortgage broker industry. Beginning with a discussion of the federalism debate in banking law, it briefly reviews the constitutional feasibility of any federal regulation in this area. It argues that the current legal framework is inadequate to address the potential economic risks that mortgage brokers impose. The private securitization of subprime loans creates a moral hazard thereby justifying the need for the imposition of a fiduciary duty.

Finally, Part III addresses why a federal approach is needed and explains what such a regime should address. Recognizing that all borrowers, not just subprime borrowers, will benefit from mortgage broker regulation, it argues for a comprehensive change in the regulatory structure and applies the standard to all mortgage finance participants. Adopting this standard replaces the existing ad hoc, *voluntary* acts that currently protect only *some* borrowers and will result in an appropriate level of mortgage finance regulation that offers greater protection to all mortgage borrowers.

## II. THE MORTGAGE BROKER INDUSTRY— THE STRUCTURAL FRAMEWORK

### A. Mortgage Brokers and Financial Intermediation

#### 1. *The Mortgage Broker Industry*

The mortgage origination process involves several different tasks. A loan officer interviews the potential borrower and gathers information about the borrower's finances, including their assets and liabilities, that are needed for processing the loan. The loan officer then assists the borrower in preparing an application. Assuming the borrower's income and debt ratio qualify for the loan, and following an appraisal of the property to ensure that the amount of the loan does not exceed the value of the property, the loan is funded. It then becomes the responsibility of the underwriter to determine whether the loan is eligible for the recommended mortgage product.<sup>23</sup>

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23. See discussion *infra* Part II.B.1 regarding underwriting and fiduciary duties.



When a mortgage broker originates a loan, the mortgage broker takes on specific tasks as the lender's agent.<sup>24</sup> A mortgage broker and lender agree that the broker will represent the lender in offering the lender's loan products to potential borrowers.<sup>25</sup> After interviewing the potential borrower and gathering personal information for processing the loan, the broker also evaluates the potential borrower's financial status, considering affordability and stated preferences, and may make recommendations regarding appropriate underwriting and the source for funding.<sup>26</sup>

Mortgage brokers have become an instrumental part of the lending process, and mortgage brokerage is big business. In 2004, mortgage origination totaled \$1.4 trillion dollars and 50% of loan originations loans were made through broker applications.<sup>27</sup> The mortgage brokerage industry has changed the distribution channels for loans, with banks relying on mortgage brokers to negotiate credit with borrowers and to develop and capture market share.<sup>28</sup>

## 2. *The Economics of the Mortgage Transaction*

### a. *Financial Intermediation*

Financial intermediation is the process of managing risk by bundling, distributing, and pricing it. Financing a mortgage loan involves a mortgage broker, who either funds or arranges funding for the bor-

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24. Brokers who are correspondent lenders do not have to disclose the fees that they receive from borrowers. Correspondent lenders choose an institutional lender based the mortgage products offered and may fund mortgages from their own funds or from the line of credit received from an institutional lender. Mortgages funded with correspondent loans are pre-arranged to be sold immediately to another lender. Brokers may become correspondent lender by building up capital and being able to fund mortgages out of those proceeds.

25. As used here, mortgage broker may mean either a broker, a mobile home dealer, or a home improvement contractor.

26. "Retail loan origination," may involve mortgage lenders and includes the advertising and solicitation of the loan product; receiving, by interviewing the potential borrower, the loan application; and performing some or all of the processing of the application information. The mortgage products offered to a borrower are also dictated by the lender's funding programs. Brokers may do a preliminary underwriting review in order to assist the consumer in choosing a lender and product. Typically, however, the broker neither performs the final underwriting nor makes the credit decision. Gary Rice, *Selected Issues Relating to Banking and the Internet*, 156 PLI/Corp 803, 843 (1999).

27. See The National Association of Mortgage Brokers, Industry Facts, [http://namb.org/namb/Industry\\_Facts.asp](http://namb.org/namb/Industry_Facts.asp) (last visited Jan. 15, 2008).

28. This is particularly true in the areas where banks have closed their retail branches. Banks must now rely on mortgage brokers to create their market share in these areas. See Orrice M. Williams, *U.S. Governmental Accountability Office, Alternative Mortgage Products: Impact on Defaults Remains Unclear, but Disclosure of Risks to Borrowers Could Be Improved*, Rep. No. GAO-06-1112T (2006).

rower, a lender that purchases the loan at the time of closing,<sup>29</sup> and an investment company that adds the individual loan to a pool of loans that are sold on the secondary market and in turn, sells secondary market bonds to individual or corporate investors.<sup>30</sup> Each of these sales is an important link in the cycle of financial intermediation and creates more financing for loans.<sup>31</sup>

Securitization is a byproduct of financial intermediation. By securitizing loans, an indirect source of funding is created.<sup>32</sup> The secondary mortgage market arguably makes subprime lending more efficient because it bridges the information gap for investors through uniformity.<sup>33</sup> Inefficiencies in the traditional governmental funding

29. A mortgage now can be:

- (1) originated by a mortgage broker who makes money only from origination;
- (2) serviced by a mortgage banker who did not originate the loan and may have bought the right to service the loan from another mortgage banker;
- (3) originated with the credit risk taken by one of the secondary market institutions, perhaps along with a mortgage insurance company; and
- (4) funded by a mortgage-backed security (MBS) sold into the capital markets, and the MBS can be packaged as a bundle of derivative securities that separate interest rate and prepayment risk among different investors.

David Reiss, *Subprime Standardization: How Rating Agencies Allow Predatory Lending to Flourish in the Secondary Mortgage Market*, 33 FLA. ST. U. L. REV. 985, 994 (2006). Mortgage loans may be furnished by an institutional lender who makes a loan to the broker or originator. Alternatively, a mortgage banking company often funds the loan using a warehousing line of credit. Warehouse lending involves an institutional lender and an originator, which may be a financial institution or a mortgage bank. The institutional lender makes a loan to the originator which in turn funds the mortgage for the borrower. The institutional lender is repaid with proceeds from the sale of loans to investors on the secondary market.

30. The transfer is from the mortgage banking subsidiary to the special purpose vehicle ("SPV"), to the underwriter and the investors. See Tamar Frankel, *Securitization: The Conflict Between Personal and Market Law (Contract and Property)*, 18 ANN. REV. BANKING L. 197, 211-17 (1999).
31. The most common mortgage funding options are table loans, correspondent loans and wholesale loans. In table financing, the originator sells the loans immediately after closing. The originator earns a profit by charging the borrower an origination fee, which is essentially payment for funding a lender. Leonard A. Bernstein, *Regulation of Mortgage Banking: a Pennsylvania Paradigm*, 116 BANKING L.J. 150, 161 (1999).
32. For example, secondary purchases require lenders to make representations that the borrowers were evaluated for their creditworthiness and that the property has been appraised using previously agreed upon appraisal standards. Henry T. Greely, *Contracts as Commodities: the Influence of Secondary Purchasers on the Form of Contracts*, 42 VAND. L. REV. 133 (1989) (discussing how standardization of contract terms creates efficiency).
33. See Joseph C. Shenker, *Asset Securitization: Evolution, Current Issues and New Frontiers*, 69 TEX. L. REV. 1369, 1383-90 (1991). Further, projected growth in the

sources created a need for private money in this particular economic sector.<sup>34</sup> As a financing structure, securitization has increased abusive mortgage lending.<sup>35</sup> Structured financing in the secondary subprime market requires a number of transfers and with each transfer the actual terms of the loan escapes scrutiny.<sup>36</sup> As will be discussed below, when the transfer is made to the rating agency prior to sale to the investors, there is little or no objectivity about the fairness of the transaction and whether it may be predatory.<sup>37</sup>

Intermediation facilitates the transfer of capital and risk between borrowers and lenders and is justified on two grounds: (1) borrowers hold superior information about their own financial condition than prospective lenders; and (2) the search and screening process matches borrowers and lenders and lowers search costs.<sup>38</sup> Mortgage brokerage became an essential component of the subprime mortgage origination market because brokers were able to reduce the costs of lending and facilitate intermediation. Brokers also perform services that both lenders and borrowers would find costly to do directly.<sup>39</sup> By reducing the information asymmetry and confirming that a borrower has the economic resources to repay a credit obligation, mortgage brokers

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housing market, again, underscored the concern that the present financing system was inadequate. *Id.* at 1388–92. See also Michael H. Schill, *Uniformity or Diversity: Residential Real Estate Finance Law in the 1990s and the Implications of Changing Financial Markets*, 64 S. CAL. L. REV. 1261 (1991) (proposing federal residential real estate finance laws as a way of creating integrated real estate finance markets).

34. The high interest rates of the late 1970s and early 1980s contributed to a significant decline in the private supply of credit for the housing mortgage market. When Senator Tower introduced the Secondary Mortgage Market Enhancement Act of 1984, Pub. L. No. 98-440, 98 Stat. 1689, he explained:

[N]ew sources for mortgage money must be found as more and more demands are placed on the credit market and mortgage lenders. Due to the magnitude of the demand for mortgage credit, the existing Federal agencies simply will be unable to provide all of the liquidity for mortgages that will be required during the coming decade.

Secondary Mortgage Market Enhancement Act: Hearing before the S. Subcomm. on Housing and Urban Affairs of the S. Comm. on Banking, Housing, and Urban Affairs, 98th Cong. 1 (1983).

35. See Evan M. Gilreath, *The Entrance of Banks into Subprime Lending: First Union and The Money Store*, 3 N.C. BANKING INST. 149, 152–53 (1999).
36. See Christopher L. Peterson, *Predatory Structured Finance*, 28 CARDOZO L. REV. 2185, 2215, n.182. (2007). Professor Peterson uses the term “structured financing” when discussing predatory or abusive lending.
37. Secondary market participants have only nominal incentives to deter predatory lending and therefore readily participate in the structured financing scheme. See discussion *infra* Part III.B.4.b.
38. John H. Langbein, *The Nonprobate Revolution and the Future of the Law of Succession*, 97 HARV. L. REV. 1108, 1118–19 (1984) (Financial intermediation connects “savers and borrowers, passive owners and active users of capital.”).
39. See generally Bruce Greenwald & Joseph E. Stiglitz, *Externalities in Economies with Imperfect Information and Incomplete Markets*, 101 Q. J. Econ. 229 (1986).

have helped to expand an emerging market that was initially difficult for banks to access.<sup>40</sup>

Recognizing the scope of the innovation in the consumer mortgage finance markets is critical to understanding the risks posed by financial intermediation.<sup>41</sup> Financial innovation has created mortgage products that unbundle risks, dividing investors according to their risk tolerance and, therefore, creating more liquidity. The trend now is for banks to serve as “equity bridges,” reducing their exposure to large loan risks. Regulated financial institutions now distribute rather than hold residual risks.<sup>42</sup> As a result, other financial intermediaries actually perform the functions that create, distribute, and hold risk and have changed the manner in which those risks are defined.<sup>43</sup> The “newer” financial intermediaries are not constrained by the same regulatory system that evaluates loan portfolios for safety and soundness.<sup>44</sup> Perhaps because there is no safety and soundness

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40. Banks and thrifts that hold subprime mortgages may face additional regulatory scrutiny. Beginning in 2001, the Federal Reserve Board increased the capital requirements for all institutions which held subprime mortgages that equaled or exceeded 25% of their tier one capital reserves. The Board required lending institutions to increase capital reserves held against subprime mortgages to one-and-one-half to three times greater than reserves held against prime mortgages. 2001 Guidance, 6 Fed. Banking L. Rep (CCH) ¶ 63-792, at 73,299-30.

41. Governor Kevin Warsh, of the Federal Reserve Board, describes the innovation in the consumer mortgage finance markets as an acceleration toward complete markets that have conflated the roles among financial intermediaries. Governor Kevin Warsh, Fed. Reserve Board, Remarks at the European Economics and Financial Centre, London, England (June 5, 2007), available at <http://www.federalreserve.gov/newsevents/speech/warsh20070605a.htm>.

42. W. Scott Frame, Diana Hancock & Wayne Passmore, *Federal Home Loan Bank Advances and Commercial Bank Portfolio Composition 6* (Fed. Res. Bank of Atlanta, Working Paper No. 2007-17, 2007), available at <http://www.frbatlanta.org/filelegacydoc/wp0717.pdf>.

43. Most products are now securitized. Lois R. Lupica, *Circumvention of the Bankruptcy Process: the Statutory Institutionalization of Securitization*, 33 CONN. L. REV. 199 (2000). Most consumer purchases are now securitized. See generally Thomas E. Plank, *The Security of Securitization and the Future of Security*, 25 CARDOZO L. REV. 1655 (2004).

44. The availability of a liquid market makes mortgage-backed securities attractive to investors and the diversification among the portfolio reduces risks. See Claire A. Hill, *Securitization: A Low-Cost Sweetener for Lemons*, 74 WASH. U. L. Q. 1061, 1073-75 (1996). The secondary market for mortgages makes capital accessible across the country. Some argue that mortgage-backed securities are useful in re-allocating capital by directing the loan funds into communities that are capital-starved. Mortgage-backed securities may represent an investment in the geographical areas that they fund. In low and moderate income areas, financing through mortgage-backed securities represents a way for investors to reduce risks of delinquencies and defaults. See generally Jo Anne Bradner, *The Secondary Mortgage Market and State Regulation of Real Estate Financing*, 36 EMORY L.J. 971 (1987); Carrie Stradley Lavargna, *Government-Sponsored Enterprises Are “Too Big to Fail”: Balancing Public and Private Interests*, 44 HASTINGS L.J. 991 (1993).

evaluation, they also have a higher tolerance for risk. By selling high risk loans to investors who are willing to accept that level of risk, investment firms are contributing to the myth of complete markets.<sup>45</sup> Changing the roles of regulated financial institutions in the intermediation process suspends their need to screen out borrowers who might perform poorly or even to require strong covenants or monitor loan performance.<sup>46</sup> This structured finance scheme does not identify abusive loans, however, because the investors who purchase the lower-rated tranches (bundles of loans) do not demand scrutiny of the actual loan terms at origination.<sup>47</sup>

Market innovation has closed a financing gap leading to market growth. The presumption among some economists is that this flow of liquidity indicates that markets are more or less complete.<sup>48</sup> Other economists question whether there can ever be a costless transaction—or one in which there is no asymmetric information or transaction costs.<sup>49</sup> While innovative financial intermediation in the subprime market has created competitive advantages that made lending to credit-impaired borrowers less risky for lenders, it also may have created informational disadvantages for those borrowers.<sup>50</sup>

### b. *The Market Imperfections*

Market imperfections, or incomplete information that raises costs and trades, affects whether individuals will enter into a transaction.<sup>51</sup> Knowing what those costs are is critical to the decision of whether the

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45. See Kathleen C. Engel & Patricia A. McCoy, *Turning a Blind Eye: Wall Street Finance of Predatory Lending*, 75 *FORDHAM L. REV.* 2039, 2040–41 (2007) (discussing Wall Street's practice of securitizing and selling loan pools without investigating their predatory lending characteristics).
  46. Failure to demand scrutiny means that as the loans are sold they are freely assignable and the borrower loses the rights to challenge the original transaction. See, e.g., Kurt Eggert, *Held Up in Due Course: Predatory Lending, Securitization, and the Holder in Due Course Doctrine*, 35 *CREIGHTON L. REV.* 503, 511–13 (2002).
  47. Petersen, *supra* note 36, at 2204 (describing how subprime mortgage tranches are tailored to meet the investors's needs).
  48. The concept of complete markets means that risks are priced and traded without significant diminution in value. See generally Kenneth J. Arrow & Gerard Debreu, *Existence of Equilibrium for a Competitive Economy*, 22 *Econometrica* 265 (1954).
  49. See, e.g., Greenwald & Stiglitz, *supra* note 39. See generally Joseph E. Stiglitz *Federalism in Securities Regulation: An Economist's Perspective*, 40 *U.S.F. L. REV.* 805 (2006).
  50. See generally Franco Modigliani & Merton H. Miller, *The Cost of Capital, Corporation Finance and the Theory of Investment*, 48 *AM. ECON. REV.* 261 (1958) (debating the relevance of these costs in determining the value of a small business).
  51. Ramon P. DeGennaro, *Market Imperfections* 3–4 (Fed. Res. Bank of Atlanta, Working Paper No. 2005-12, 2005), available at <http://www.frbatlanta.org/filelegacydocs/wp0512.pdf>.

transaction is cost-efficient from the borrower's perspective. Reducing the high cost of imperfect information is also essential to the lender who would otherwise use adverse selection to screen out a borrower, but who, if the costs are reduced, might find lending profitable.

*i. Transaction Costs*

One cost of lending is transaction cost. Financial intermediation reduces search costs by pairing borrowers with lenders.<sup>52</sup> Lenders and investors are served when intermediaries assist in diversifying risk and providing liquidity. Finding investors is costly and borrowers who have to do so on their own find it difficult. Securitization is helpful in reducing the transaction costs of lending precisely because strictly private investment is difficult for the individual borrower to arrange.

Brokers also provide market access for lenders. A broker's loan recommendation, however, begins a series of transactions that may affect loan sustainability (whether the borrower can afford the loan). Mortgage brokers are essentially sellers of loan products and receive compensation based on those sales. Competition among lenders can be fierce for certain broker client bases and markets resulting in increased compensation. As an industry, mortgage brokerage has developed indiscriminately with varying obligations and rules at the state level.<sup>53</sup>

Mortgage brokers play a distinct role in reducing the lender's financing costs and thus the overall costs of the loan.<sup>54</sup> For the lender, a mortgage broker is the first evaluator of information. They may offer advice and information to a potential borrower that increases the borrower's creditworthiness. Mortgage brokers also presumably make the lender's market more competitive by identifying a broader market

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52. Ichiro Kobayashi, *Private Contracting and Business Models of Electronic Commerce*, 13 U. MIAMI BUS. L. REV. 161, 176-180 (2005).

53. The United States is not alone in recognizing that the failure to have barriers to entry for mortgage brokers disadvantages borrowers. Australia has studied the problem of abusive mortgage broker behavior and instituted reforms. See Consumer Credit Legal Centre, A Report to the ASIC on Finance and Mortgage Broker Industry (2003) [http://www.asic.gov.au/asic/pdf/lib.nsf/LookupByFileName/Finance\\_mortgagebrokers\\_report.pdf/\\$file/Finance\\_mortgagebrokersreport.pdf](http://www.asic.gov.au/asic/pdf/lib.nsf/LookupByFileName/Finance_mortgagebrokers_report.pdf/$file/Finance_mortgagebrokersreport.pdf) (identifying problems when consumers have been exploited by borrowers).

54. The "retailing" of loans requires not only the time of lender personnel, but also the bearing of the cost of real estate ownership or rental, *i.e.*, the "bricks and mortar," as well as the expense of payroll and benefits, business machines, supplies, insurance and other costs necessary to maintain a retail branch. Cf. Sidhartha Venkatesan, *Abrogating the Holder in Due Course Doctrine in Subprime Mortgage Transactions to More Effectively Police Predatory Lending*, 7 N.Y.U. J. LEGIS. & PUB. POL'Y 177 (2004) (discussing the FTC's abrogation of the holder in due course doctrine in consumer retail lending).

of potential borrowers.<sup>55</sup> They are often key in identifying and reaching customer bases which because of geography, or a lack of contact or knowledge, might otherwise have never accessed the lender's products, thereby increasing competition.<sup>56</sup>

Borrowers have come to expect a mortgage broker's assistance in loan preparation. In many cases that assistance is critical to a determination that a borrower is creditworthy.<sup>57</sup> The borrower's transaction costs are significantly reduced when there is a ready market for subprime loans because of the liquidity of the underlying loan. The borrower pays less for credit review and documentation. Any apparent reduction in transaction costs helps to provide more access to credit for the marginal borrower.

Arguably, broker participation in the origination process has dramatically reduced the transaction costs of origination.<sup>58</sup> In a complex residential finance market with numerous options, borrowers benefit from mortgage brokers' assistance in selecting and arranging financing. While a potential borrower seeks access to the most competitive lending opportunities, it is the mortgage broker who has easy access to lenders and is aware of the guidelines and incentives. In the vast majority of cases, however, the broker will have developed relationships with various lenders, and will serve as the "retailer" of the lenders' loan products to consumers. In that role, the broker serves as an agent to both the borrower and the lender.<sup>59</sup> In such instances, the broker/lender relationship is non-exclusive, and the broker is under no obligation whatsoever to submit any borrower's loan application to any particular lender for approval and funding. Brokers are thus free

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55. Lenders not only pay mortgage brokers a commission when the mortgage loan is made but may also pay a third party for identifying customers. Craig Steven Delsack, *The Mortgage Contingency Clause: A Trap for the Residential Real Estate Purchaser Using a Mortgage Broker*, 17 CARDOZO L. REV. 299, 307-310 (1995).
  56. Jessica Fogel, *State Consumer Protection Statutes: An Alternative Approach to Solving the Problem of Predatory Mortgage Lending*, 28 SEATTLE U. L. REV. 435, 438-440 (describing the subprime market as one without much competition and thus much leeway for brokers).
  57. Harold L. Levine, *A Real Estate Focus a Day in the Life of a Residential Mortgage Defendant*, 36 J. MARSHALL L. REV. 687, 706 (2003).
  58. If loans are over-priced, ultimately borrowers pay. The mortgage broker industry also posits that broker participation has increased the sheer number of eligible borrowers due to broker's ability to expertly navigate through the complex array of financial products. The question is whether these brokers have contributed to the high default and foreclosure rates. See generally Howell E. Jackson & Laurie Burlingame, *Kickbacks or Compensation: The Case of Yield Spread Premiums*, 12 STAN. J.L. BUS. & FIN. 289 (2007) (endorsing penalties against mortgage brokers who receive the primary part of their compensation from yield spread premiums).
  59. See Wilson, *Effecting Responsibility*, *supra* note 19, at 1507-08 (discussing borrower's expectations in the mortgage broker relationship).

to choose any one of several wholesale lenders' products for a particular borrower.<sup>60</sup>

*ii. Information Costs*

Lenders also price loans according to information costs. Credit rationing is attributed to asymmetrical information costs. Asymmetrical information is defined as the borrower having superior knowledge about his or her ability to repay the loan obligation as compared to the lender. Lenders often choose between making loans at high interest rates or declining to extend credit. Adverse selection contributes to this dilemma. Adverse selection means that only a few borrowers will be offered loans at a higher interest rate in order to control the risk of the loan portfolio and to assure that the lender meets its net profit goals.<sup>61</sup>

Mortgage brokers have oddly both eased adverse selection and begun advantageous selection. Because mortgage brokers are willing to gather more information about high-risk borrowers, they are better at screening and assessing the risks. Mortgage brokers exercise a significant informational advantage over lenders who, because of search costs and regulatory restrictions, have more difficulty qualifying credit-impaired borrowers. The current regulatory rules enforce the informational asymmetries between credit-impaired borrowers and regulated financial institutions.<sup>62</sup> Mortgage brokers have also "increased" adverse selection in that they have consistently identified a prototype subprime borrower, oftentimes seeking them out and allegedly steering them to higher risk loan products.<sup>63</sup> The growth of the subprime market demonstrates that credit rationing is reduced under certain circumstances.<sup>64</sup>

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60. Borrowers' remedies are extremely limited. Subprime mortgage servicers are usually outside the scope of the Unfair Deceptive Acts and Practice Laws ("UDAP"), and borrowers face difficult burdens of proof and persuasion. Ronald H. Silverman, *Toward Curing Predatory Lending*, 122 *BANKING L.J.* 483, 518 (2005). Furthermore, the federal statutes designed to protect borrowers in mortgage transactions are insufficient because these loans do not fall within the scope of these statutes.
61. Loretta J. Mester, Leonard I. Nakamura, & Micheline Renault, *Transactions Accounts and Loan Monitoring* (Rev. of Fin. Stud., Working Paper No. 05-14, 2005), available at <http://www.philadelphiafed.org/files/wps/2005/wp05-14.pdf> (positing that transactions accounts held with financial intermediaries provide extremely effective monitoring of borrower's behavior).
62. See Azmy Baher, *Squaring the Predatory Lending Circle: A Case for States as Laboratories of Experimentation*, 7 *FLA. L. REV.* 295, 316-18, (2005).
63. Cecil J. Hunt, II, *In the Racial Crosshair: Reconsidering Racially Targeted Predatory Lending Under a New Theory of Economic Hate Crime*, 35 *U. TOL. L. REV.* 211, 313 (2003) (arguing that a substantial amount of predatory lending is "racialized").
64. See generally Larry T. Garvin, *Credit, Information, and Trust in the Law of Sales: The Credit Seller's Right of Reclamation*, 44 *UCLA L. REV.* 247, 282-93 (1996).



*iii. Agency Costs*

Lenders rely on the mortgage broker to screen loan applicants and assess their ability to repay. Brokers then assume a dual agency role, with both the lender and the borrower expecting the broker to act in each of their best interests. Because lenders place total reliance on the mortgage broker in screening the borrower and may do so without imposing conditions on the broker's assessment, some of the loans made by brokers are designed to fail, unbeknownst to the lender.<sup>65</sup> Borrowers, who with more careful analysis could have been screened out because their credit history indicates either inability or unwillingness to repay, are not. When lenders actually held the mortgage loans that they funded in their loan portfolios, they were able to monitor those loans and develop information that proved useful in evaluating similar transactions. With lender monitoring now unnecessary, that informational base is lost.<sup>66</sup>

Again financial innovation has created a market imperfection and the lender should be held accountable for the agent's conduct. Otherwise, there is little or no incentive for the mortgage broker to behave fairly towards the borrower, creating moral hazard. Only by monitoring the behavior of mortgage brokers are lenders or even secondary market investors actually able to control the brokers' conduct.

The lender has a disincentive to monitor the mortgage broker because monitoring is costly. Securitizing the loan provides a further disincentive for monitoring because once sold and the interest assigned to another buyer the borrower loses all defense to the original transaction.<sup>67</sup> Because the risk of default is transferred from both the lender and the broker to the investors, the loss is borne by the borrowers. Similarly, as borrowers' risks increase and performance becomes more difficult, borrowers have little incentive to perform creating moral hazard.<sup>68</sup>

*iv. Moral Hazard*

Inappropriate behavior in the face of risk is the crux of moral hazard.<sup>69</sup> The opportunity to have some of the loss of the risky behavior

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65. See discussion *infra* Part III.B.3.

66. In the small business lending context, it appears that information asymmetries are actually lessened by lenders' monitoring but this information is usually not readily disseminated. See Amy C. Bushaw, *Small Business Loans Pools: Testing the Waters*, 2 J. SMALL & EMERGING BUS. L. 197, 209-10 (1998).

67. Eggert, *supra* note 46, at 552.

68. Moral hazard is common in most economic transactions. Moral hazard arises when an individual or firm is insulated from the economic consequences of their actions. Insurance is a typical example because it removes the financial risk of property ownership from the individual.

69. See generally Seth J. Chandler, *Visualizing Moral Hazard*, 1 CONN. INS. L.J. 97 (1994).

absorbed by another party creates an incentive to ignore the worst consequences of risky decision-making. Moral hazard occurs with borrowers who have an inability or unwillingness to pay and, consequently, default on their mortgage obligations. Moral hazard results often if there is some type of insurance fund that bails out borrowers or allows them to restructure their debt.<sup>70</sup> Mortgage brokers bridge the information gap for borrowers who appear unable to repay but who can actually afford the debt.<sup>71</sup>

The “other side” of moral hazard in subprime lending also has to do with the asymmetrical information between the mortgage broker and the borrower. In this regard the mortgage broker becomes an agent of the borrower, acting on the borrower’s behalf. As discussed below, this creates a fiduciary duty on the part of the mortgage broker.<sup>72</sup> The breach of this duty occurs when the agent exercises what might seem like a natural incentive to act in the agent’s own interest. In mortgage origination, this translates into the broker offering the borrower a loan that is not the “best rate” but which may instead yield the broker a higher commission from a lender.<sup>73</sup> The breach, when viewed from the borrower’s perspective, happens because of information asymmetry given the mortgage broker’s access to lender’s rates and products and the borrower’s inability to have access to that same information. It is the borrower’s inability to monitor the broker that creates this particular moral hazard leading to the market imperfection.

The effect of a mortgage broker’s moral hazard is that borrowers end up with riskier loan products than they qualify for and the mortgage broker bears no responsibility for those risks. Mortgage brokers who breach their duty to disclose do not bear the consequences of their poor advice. They receive a “financial bail-out” when the loan is sold on the secondary market and the consequences of their breach of duty

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70. See George F. Will, *Folly and the Fed*, WASH. POST, Aug. 16, 2007, at A15 (arguing against government intervention in the subprime mortgage market by restructuring the loans of defaulting homeowners); Irwin Stelzer, *Bernanke to the Rescue With a Surgical Strike*, SUNDAY TIMES (London), August 19, 2007, available at <http://business.timesonline.co.uk/tol/business/columnists/article2283092.ece> (discussing Federal Reserve Chairman Bernanke’s decision to lower the interest rate at the Federal Reserve’s discount window).

71. Oftentimes these borrowers appear unable to pay because they own a business, or participate in a cash business for which it is difficult to verify the receipt of income.

72. See discussion *infra* Part III.B.

73. One study of the consumer mortgage finance market argues that subprime lenders have a monopoly that allows them an informational advantage and deters competition by restricting entry into prime markets. Because of the market structure, subprime lenders have developed a pricing strategy that segments subprime borrowers and charges them a risk-based monopoly rate. See Jie Gan & Timothy J. Riddiough, *Monopoly and Information Advantage in the Residential Mortgage Market*, THE REV. OF FIN. STUD. (forthcoming 2008) (on file with author).

are left with the borrower. Having received commissions from the borrower and, most likely, the lending institution, brokers are not required to disgorge their profits if the loan performs poorly or fails. Most importantly, the borrower suffers the greatest loss. If the loan performs well, there has been a loss of equity because of the high costs of the loan. If the borrower defaults on the loan, the property goes into foreclosure. In both instances, moral hazard has disadvantaged the borrower, while the mortgage broker is protected.<sup>74</sup>

The market imperfections that cause opportunistic broker behavior can be corrected by providing borrowers with more information. By failing to address the imperfect costs of which borrowers are unaware, the market unfairly passes those costs on to borrowers through increases in closing costs and interest rates over the life of the loan. The question becomes what should the regulatory and supervisory response be given these changes in financial intermediation. A measured response evaluates risk and market infrastructure.<sup>75</sup> As will be discussed in Part II, the evaluation of infrastructure leads to the conclusion that there should be accountability at each level of intermediary involvement whether originators, lenders, or investors.

## B. Reckless Lending

For an individual, owning a home provides access to quality education and promotes job stability.<sup>76</sup> Owning a home is also a path to

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74. Robert E. Martin & David J. Smyth, *Adverse Selection and Moral Hazard Effects in the Mortgage Market: An Empirical Analysis*, 57 S. ECON. J., 1071, 1073-1075 (1991).

75. Governor Kevin Warsh, Fed. Reserve Board, Address at the Institute of International Bankers Annual Washington Conference, Washington D.C., Market Liquidity: Definitions and Implications (Mar. 5, 2007), available at [www.federalreserve.gov/newsevents/speech/warsh20071107a.htm](http://www.federalreserve.gov/newsevents/speech/warsh20071107a.htm).

76. The current crisis in the housing market disproportionately affects minority homeowners and consequently the minority community. Blacks and Latinos accounted for 49% of the increase in home ownership rates of the last decade. Souphala Chomsisengphet, and Anthony Pennington-Cross, *Subprime Refinancing: Equity Extraction and Mortgage Termination*, (Fed. Reserve Bank of St. Louis, Working Paper No. 06-23, 2006), available at <http://research.stlouisfed.org/wp/2006/2006-023.pdf>. See also Robert B. Avery, Kenneth P. Brevoort, and Glenn B. Canner, *The 2006 HMDA Data*, 93 FED. RES. BULL. A73, A99 (2007), available at <http://www.federalreserve.gov/pubs/bulletin/2007/pdf/hmda06final.pdf> (describing the rise in home-ownership rates among black and hispanic Americans).

Sustainable home ownership produces a financial safety net for home buyers and provides a foundation for a stable financial future. See *Ending Mortgage Abuse, Safeguarding Homeowners: Hearing Before the S. Subcomm on Housing, Transportation, and Community Development and the S. Comm. on Banking, Housing, and Urban Affairs*, 110th Cong. 909 (2007) (testimony of Wade Henderson, President & CEO, Leadership Conference on Civil Rights); DEBBUE GRUENSTEIN BOCIAN, KEITH S. ERNEST, & WEI LI, CTR. FOR RESPONSIBLE LENDING, THE EFFECT OF RACE AND ETHNICITY ON THE PRICE OF SUBPRIME MORTGAGES (2006),

wealth and asset accumulation for families and their future generations.<sup>77</sup> For society, home ownership stabilizes neighborhoods.<sup>78</sup> Home ownership also represents an investment in local economies and, thereby, contributes to the country's economic growth.<sup>79</sup>

Structural inequality, financial discrimination, and rampant greed have combined to produce the greatest loss of home ownership equity in this country.<sup>80</sup> To suggest that the foreclosure crisis is a market failure is to ignore the absence of regulatory discipline that bars access to a fair and equal system of credit. Given the peculiar market framework in which this lending is allowed to operate, an examination of the factors that contribute to this market's tolerance is essential.

### 1. *Underwriting Inefficiency and the Subprime Market*

The housing market is a critical part of the country's economy, as well as its social policy.<sup>81</sup> Critical to the housing finance market is the secondary mortgage market. By selling loans to investors, the secondary market facilitates more cash for loans by providing a market for quick liquidation of a lender's mortgage portfolio. This in turn generates cash to make more mortgages.<sup>82</sup> The country's need for a robust mortgage market has fueled much of the disregard about the harmful

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available at [http://www.responsiblelending.org/pdfs/r011-Unfair\\_Lending-0506.pdf](http://www.responsiblelending.org/pdfs/r011-Unfair_Lending-0506.pdf).

77. THOMAS P. BOEHM & ALAN M. SCHLOTTMANN, JOINT CTR. FOR HOUS. STUDIES OF HARVARD UNIV., *HOUSING AND WEALTH ACCUMULATION: INTERGENERATIONAL IMPACTS* 16 (2001) (explaining that lower income households receive substantial wealth accumulation benefits from home ownership including higher educational attainments for children in these households).
78. Predatory lending practices result in reverse redlining, a practice that Congress outlawed in the Community Reinvestment Act, 12 U.S.C. §§ 2901–2809. The root of reverse red-lining is the same as redlining—the absence of regulated lenders in financially underserved communities. See generally Cassandra Jones Havard, *To Lend or Not to Lend: What The CRA Ought to Say About Predatory Lending*, 7 Fla. Coastal Law Review 1 (2005).
79. Duncan Kennedy, *The Limited Equity Coop as a Vehicle for Affordable Housing in a Race and Class Divided Society*, 46 How. L.J. 85, 92 (2002).
80. Richard W. Stevenson, *Spending It: Focus on Home Equity Loans-Predatory Lending; How Serial Refinancings Can Rob Equity*, N.Y. TIMES, Mar. 22, 1998, § 3 (Magazine), at 10.
81. See generally Tim Iglesias, *A Place to Call Home?* 42 WAKE FOREST L. REV. 511 (2007); Xavier de Souza Briggs & Margery Austin Turner, *Assisted Housing Mobility and the Success of Low-income Minority Families: Lessons for Policy, Practice, and Future Research*, 1 NW J. L. & SOC. POL'Y 25 (2006) (examining whether housing policies that require the relocation of low-income persons are effective).
82. Robin Paul Malloy, *The Secondary Mortgage Market—A Catalyst for Change in Real Estate Transactions*, 39 Sw. L.J. 991, 1013 (1986) (describing the secondary mortgage market as reducing the costs of home financing and increasing a local market's economic stability).

effects of the subprime secondary mortgage market.<sup>83</sup> Home mortgages are now complex products, produced through multiple channels and an array of secondary market processes. Many mortgage lenders, especially in the subprime market, have tailored their practices and policies to place most of the risks of these complex products on the borrower.

A predominant flaw in the subprime market is the way that rating agencies provide ratings for mortgage-backed securities.<sup>84</sup> Rating agencies evaluate four key aspects of a securitization transaction: (1) frequency of default, (2) severity of loss given default, (3) pool characteristics, and (4) credit enhancement and the structure of the security. The evaluation of the four key aspects require an analysis of four additional factors: (1) qualitative, (2) quantitative, (3) servicing, and (4) legal risk.<sup>85</sup> It is the lack of oversight over this evaluative process that indeed creates a problematic pricing structure for subprime loans.<sup>86</sup>

Investors use the ratings to assess the probability that the underlying mortgages will be re-paid timely. In this regard, the agencies reduce the common information asymmetry thereby making the securities more marketable. Use of the rating system is endorsed by federal regulations.<sup>87</sup> Although there are numerous complaints that the rating system is based on inaccurate information, the rating systems do not have an incentive to be sensitive to anything other than inves-

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83. See Julia Patterson Forrester, *Mortgaging the American Dream: A Critical Evaluation of the Federal Government's Promotion of Home Equity Financing*, 69 TUL. L. REV. 373, 393-94 (1994).

84. Standard & Poor's, Moody's Investors Services, and Fitch Ratings are the three major bond and securities rating agencies that rate mortgage-backed securities. All three rating agencies have rating guidelines that prohibit favorable ratings for any securities that are governed by state predatory lending statutes. Freddie Mae and Fannie Mac also have policy guidelines that do not allow either entity to purchase any loans that have predatory lending features.

85. Reiss, *supra* note 29, at 1013-14. Mortgage-backed securities are divided into tranches, or Collateralized Debt Obligations ("CDOs"). The CDOs are classified according to risk, equity (high risk), mezzanine (middle risk) and the much sought-after investment grade bonds (low risk). *Id.*

86. See Claire A. Hill, *Regulating the Rating Agencies*, 82 WASH. U. L.Q. 43, 46-64 (2004); Frank Partnoy, *The Siskel and Ebert of Financial Markets?: Two Thumbs Down for the Credit Rating Agencies*, 77 WASH. U. L.Q. 619, 627-54 (1999); Steven L. Schwarcz, *Private Ordering of Public Markets: The Rating Agency Paradox*, 2002 U. ILL. L. REV. 1, 15; see also Arthur Pinto, *Control and Responsibility of Credit Rating Agencies in the United States*, 54 AM. J. COMP. L. SUPP. 341(2006) (highlighting the lack of control and oversight over credit rating agencies in the United States).

87. The rating agencies use a self-determination process. There are proposed rules for deeper scrutiny, but under the present system of regulation, the SEC makes a case by case determination regarding Nationally Recognized Statistical Rating Organizations ("NRSROs") for recognition. See Definition of Nationally Recognized Statistical Rating Organization, 17 C.F.R. § 240.3b-10 (2007).

tor interest.<sup>88</sup> The assigned ratings make the mortgage pools sold in the capital markets valuable or invaluable, depending on what they are.<sup>89</sup>

Investment banks can create a proportion of highly marketable bonds out of a package of low-quality mortgages. They do this by separately ranking the tranches. The equity portion of a subprime loan is classified at the highest risk level because of the probability that the loan will not be re-paid by the borrower. This is also the tranche that receives the highest profit, but receives loss first if the loan becomes non-performing. The mezzanine tranche also has a fairly good prospect of non-payment. The lowest tranche, the investment-grade bond, has a chance of re-payment, which is why the ratings agencies give the lowest-risk tranche a credit rating high enough to qualify for the critical investment grade rating.<sup>90</sup> It is fairly standard, for example, to convert a large package of mortgage-backed securities into perhaps 80% investment-grade bonds, 10% mezzanine, and 10% equity.<sup>91</sup> But, this is a matter of discretion among the firms.

The rating agencies do not issue consistent ratings and are not required to use the same information to create them. It is difficult therefore to know whether the information used is even appropriate.<sup>92</sup> Some evidence suggests that the agencies are becoming more conservative and may be biased against financial innovation.<sup>93</sup> While the

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88. Gretchen Morgenson, *Wanted: Credit Ratings. Objective Ones, Please*, N.Y. TIMES, Feb. 6, 2005, at D1 (reviewing criticism of privileged rater oligopoly); *The Credit Rating Agency Duopoly Relief Act of 2005: Hearing on H.R. 2990 Before the H. Comm. On Fin. Servs.*, 109th Cong. 31 (2005) (statement of Sean J. Egan, Managing Director, Egan-Jones Ratings Company) (“[A]dditional competition should encourage the issuance of timely, accurate ratings.”). SEC representatives have argued, however, that market forces may keep the number of NRSROs down, whatever the application process. See Hill, *supra* note 86, at 57–59.

89. Federally regulated financial institutions cannot purchase asset-backed securities that do not have the requisite rating. Specifically OTS and OCC regulations require that the purchase must satisfy applicable regulatory requirements, investment guidelines, covenant restrictions, or internal policies. Investment Securities, 12 C.F.R. §§ 1, 7 (2007).

90. The majority of the higher-yield securities are in the form of collateralized debt obligations (CDOs) backed by “synthetic” high-rated tranches of securitized subprime mortgages, which have been losing market value due to the defaults in the subprime-mortgage market. Paul Tustain, *Subprime Mortgage Collapse: Why Bear Stearns Is Just the Start*, MONEYWEEK, May 7, 2007, available at <http://www.moneyweek.com/file/31699/subprime-mortgage-collapse-why-bear-stearns-is-just-the-start.html>.

91. *Id.*

92. See, e.g., Larry G. Perry, *The Effect of Bond Rating Agencies on Bond Rating Models*, 8 J. FIN. RES. 307, 313 (1985) (citing the frequency of disagreement between S & P and Moody’s at 58%).

93. See Hill, *supra* note 86, at 64; see also Schwarcz, *supra* note 85, at 22 (“[T]he rating agency system, as presently constituted, is conservatively biased against innovation.”).

rating agencies perform a much needed function, they exert tremendous influence on the risk ratings and thus, the subprime loan market. This raises the issue of whether the rating agencies favor states that do not regulate predatory lending.<sup>94</sup> By giving less favorable ratings to loans that are not subject to state anti-predatory lending rules, the rating agencies actually protect investors to the detriment of borrowers who must purchase loans from lenders who are not policed for their abusive practices.

The critical nature of the role that the rating agencies play argues against market efficiency.<sup>95</sup> While many have touted the subprime market as efficient, others have questioned the market's profit-making strategies.<sup>96</sup> The infrastructure, which is based on financing loans where there is an expected poor performance by the borrower, a principal balance that is not repaid, and yet investors who continue to receive returns, undercuts the notion of rationality.

It is more difficult to renegotiate loans that have been securitized because they have been divided into different tranches. For this reason, secondary market investors do not seriously police predatory lending activity. The investors' concern about the risk of the investment results in the rating agencies imposing conditions that make the pool of loans more expensive. Thus, moral hazard pushes financial asset prices to artificially high levels, which prove to be unsustainable.

## 2. *Tolerating Default and Reckless Lending*

There is a perverse incentive in the operation of subprime mortgage markets: Lenders identify and solicit borrowers who have a good chance of not repaying the obligation.<sup>97</sup> In fact, the profitability of the

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94. See Baher, *supra* note 62, at 316–18.

95. See Stephen Choi, *Market Lessons for Gatekeepers*, 92 Nw. U. L. REV. 916, 934 (1998).

96. See Howard Lax, et al., *Subprime Lending: An Investigation of Economic Efficiency*, 15 HOUSING POLY DEBATE 533, 556–569 (2004) (concluding that subprime lending is inefficient compared to prime lending by evaluating the role of the risk, borrower satisfaction with mortgage product and interest rate comparison); Vikas Bajaj, *Prospering in an Implosion; Subprime Market's Fall Plays to the Strengths of a Bold Contrarian*, NY TIMES, Apr. 12, 2007, at C1. See also Alan M. White & Cathy Lesser Mansfield, *Literacy and Contract*, 13 STAN. L. & POLY REV. 233 (2002) (recommending policy changes to the contract principle—the duty to read).

97. See, e.g., Lawrence M. Ausubel, *Credit Card Defaults, Credit Card Profits, and Bankruptcy*, 71 AM. BANKR. L.J. 249, 257–260, 264 (1997) (drawing a correlation between a lender's tolerance of increasing default rate and the lender's profitability). This phenomenon was even recognized by the bankruptcy courts in the United States. See, e.g., *In re American Home Patient, Inc.*, 420 F.3d 559, 569–570 (6th Cir. 2005) (invalidating interest rate because it would result in a windfall to the lender); *Till v. SCS Credit Corp.*, 541 U.S. 465 (2004) (cramdown

loan portfolio depends on defaulting borrowers. In a competitive market, it is rational for lenders to have a portfolio of non-performing, high-interest rates loans. Lending to borrowers who are likely to default can go beyond equilibrium and extend to a profitable transaction so long as the fees received by the lender exceed the cost of writing off the principal.<sup>98</sup>

Lenders are well aware that the loans that they make are both excessive, meaning the borrower does not have the ability to repay, and reckless, meaning that the lender is conscious of but disregards the financial consequences to the borrower when the loan is made. Borrower behavior and literacy are not at the crux of these problems nor should solutions be predicated on them.<sup>99</sup>

The repayment plan of the mortgages indicates that they are improperly made. Instead of the principal reducing, it increases. The high rate of foreclosure also indicates that mortgage loans have not been properly made. Receiving a subprime loan with certain features, especially predatory ones, portends delinquency, with the likelihood of foreclosure increasing over time.<sup>100</sup>

Foreclosure involves negative externalities.<sup>101</sup> As in personal bankruptcy, foreclosure is not a 'fully isolated' internalized occurrence

interest rate should be based on an efficient market); *In re Hernandez*, 208 B.R. 872, 879 (Bankr. W.D. Tex. 1997) (discussing Sears payment plan that calculated finance charges for non-payment as profitable).

98. This unorthodox business principal called the "sweatbox," refers to identifying customers who will be unable to pay debt and allowing them to 'sweat-out' their inability to pay until they finally default. See Ronald J. Mann, *Bankruptcy Reform and the "Sweat Box" of Credit Card Debt*, 2007 U. ILL. L. REV. 375. With payment of interest, late fee payments, penalty interest fees and re-financing, non-performing loans can be maintained to a "break-even" period.
99. John A. E. Pottow, *Private Liability for Reckless Consumer Lending*, 2007 U. ILL. L. REV. 405, 407 (proposing an affirmative legal defense of "reckless credit" for bankruptcy debtors to assert against undesirable loan contracts in response to bankruptcy reform legislation that is too onerous on borrowers). Most scholars are critical of the actual impact financial literacy education can cause. See, e.g., Susan Block-Lieb, *Net Mandatory Protections as Veiled Punishments: Debtor Education in H.R. 975, The Bankruptcy Abuse and Prevention Act of 2003*, 69 BROOK. L. REV. 425 (2004); Creola Johnson, *Maxed out College Students: A Call To Limit Credit Card Solicitations on College Campuses*, 8 N.Y.U. J. LEGIS. & PUB. POL'Y 191 (2005); Nathalie Martin & Ocean Tama y Sweet, *Mind Games: Rethinking BAPCPA's Debtor Education Provisions*, 31 S. ILL. U. L.J. 517 (2007).
100. See U.S. GEN. ACCOUNTING OFFICE, No. 04-280, CONSUMER PROTECTION: FEDERAL AND STATE AGENCIES FACE CHALLENGES IN COMBATING PREDATORY LENDING, REPORT TO THE CHAIRMAN AND RANKING MINORITY MEMBER 254 (2004) (statement of Scott Harshbarger, Att'y Gen., Commonwealth of Massachusetts) (Predatory lending practices targeting low-income neighborhoods may result in "the social fabric of many inner-city urban neighborhoods [being] torn apart and communities destabilized."), available at <http://www.gao.gov/new.items/d04280.pdf>.
101. Externalities generally refer to third party factors that effect outcomes. A negative externality in social economics terms is an outcome that is not socially opti-



between a home buyer and a lender. Bankruptcy scholars identify two factors which make up the “knock-on effect.”<sup>102</sup> Both factors capture the psychological costs of debt in monetizable costs.<sup>103</sup> One factor evaluates the effect of bankruptcy debt on the debtors family and friends and the other on society and the debtor’s inefficiency at work while under financial strain.<sup>104</sup>

Two troubling attributes of the subprime market contribute to borrower irrationally and may lead to foreclosure. The first is the borrower’s cognitive bias for risk underestimation.<sup>105</sup> Generally, borrower behavior has been characterized as irrational when the end-cost of the loan seems unreasonably high.<sup>106</sup> Brokers’ selection of irrational borrowers in turn fuels the foreclosure rates in the subprime mortgages. Borrowers irrationally agree to repay unserviceable levels of debt simply because they cannot appreciate the nature of the obligation. We are witness to the fall-out of this now as borrowers are no longer able to refinance and lenders go under.<sup>107</sup>

The second troubling attribute that compounds borrowing irrationally is the lender’s credit risk assessment, or ability to repay. The pricing structure of many subprime loans is complex with variable terms. Lenders find themselves in an advantageous position because even if the loans default, lenders have received a profitable return of interest charges and fees prior to default. The lack of price transparency precludes all but the most financially astute of borrowers from making an accurate assessment of the costs of a loan.

This incentive that lenders have to lend money to borrowers who may end up defaulting on their loans is an aberration of the conven-

mal. See generally Kathleen C. Engel, *Do Cities Have Standing? Redressing the Externalities of Predatory Lending*, 38 CONN. L. REV. 355 (2006).

102. See Pottow, *supra* note 99, at 411.

103. Bankruptcy scholars describe these as “intrahousehold” costs. Robert B. Chapman, *Missing Persons: Social Science and Accounting for Race, Gender, Class, and Marriage in Bankruptcy*, 76 AM. BANKR. L.J. 347 (2002).

104. For example, bankrupt debtors are distracted from working at their highest and best-use level of productivity because they are trying to cope with financial ruin. See Mechelle Dickersen, *Bankruptcy and Mortgage Lending: The Homeowner Dilemma*, 38 J. MARSHALL L. REV. 19, 49 (2004).

105. In the credit card industry, “irrational discounting myopia” makes it easy for borrowers to be seduced by plastic. See Pottow, *supra* note 99, at 413. For a general overview, see Christine Jolls, Cass Sunstein, & Richard Thaler, *A Behavioral Approach to Law and Economics*, 50 STAN. L. REV. 1471 (1998); Oren Bar-Gill, *Seduction by Plastic*, 98 NW. U. L. REV. 1373, 1396–99 (2004) (discussing credit cards).

106. See generally Richard A. Epstein, *Behavioral Economics: Human Errors and Market Corrections*, 73 U. CHI. L. REV. 111 (2006).

107. Many subprime loans require frequent re-financing in order for borrowers to meet the monthly payments. Michael J. Pyle, Policy Comment, *A “Flip” Look at Predatory Lending: Will the Fed’s Revised Regulation Z End Abusive Refinancing Practices?*, 112 YALE L.J. 1919, 1923–24 (2003).

tional paradigm of credit risk assessment. What is most significant about the financing of subprime loans is the locus of the long-term lending obligation. Traditionally, lending institutions have an interest in the performance of the loan because it remains a part of the institution's portfolio. By contrast, the current business model of selling the loan creates a disincentive at the time of origination and encourages recklessness on the part of lenders.

The rationale of perfect information would dictate that the borrower make a decision not to accept the loan because it would be apparent that its terms would lead to default.<sup>108</sup> What happens, especially in the adjustable rate mortgage ("ARM") market, is a practice that Professor Pottow describes as the "sweat box" in the consumer lending market. In this practice,

[L]enders lure debtors into their sweatbox . . . by preying upon their underestimation and optimism biases. "Shrouding" the terms of their contracts through moving price terms, the lenders attract borrowers—"manipulating" them, in the assessment of some psycho-economic observers—who likely cannot repay their debts and hence will be the most likely to sweat. The sweatbox is actually a two-stage model that entices all borrowers at the outset with low rates, but then cranks up the heat through late payment fees and penalty rates for the "sweaters."<sup>109</sup>

In essence, the costs of excessive credit is borne entirely by borrowers who may or may not be financially literate, but who are surely confused and sometimes manipulated.<sup>110</sup> A market response that eliminates subprime lending completely is inappropriate because there are legitimate needs.<sup>111</sup> A market response that ignores the reckless actors, is irresponsible to the extent that it relies solely on market assumptions about the borrower rationality and information.

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108. Economist Kenneth Arrow identified five criteria that any social choice should meet. The criteria were: (i) transitivity; (ii) unrestricted domain; (iii) the Pareto principle; (iv) independence of irrelevant alternatives; and (v) non-dictatorship. See KENNETH ARROW, *SOCIAL CHOICE AND INDIVIDUAL VALUES* (1963).
109. Pottow, *supra* note 99 at 417. Social efficiency from a positivist perspective evaluates desirability or undesirability of a phenomenon by evaluating data according to the established criteria. For a general discussion of positivist economic theory see AMARTYA K. SEN, *COLLECTIVE CHOICE AND SOCIAL WELFARE* 56 (K. Arrow, et al., eds. 1970); W. J. BAUMOL, *WELFARE ECONOMICS AND THE THEORY OF THE STATE* (1952); J. Baumol, *Community Indifference*, 14 *REV. ECON. STUD.* 44, 47 (1947).
110. Regina Austin, *Of Predatory Lending and the Democratization of Credit: Preserving the Social Safety Net of Informality in Small-loan Transactions*, 53 *AM. U. L. REV.* 1217, 1253–57 (2004) (discussing how the informal economy affects minority borrower behavior and advocating that credit democratization, particularly efforts to curb predatory lending take into account the cultural background of borrowers).
111. Joseph A. Smith, Jr., *The Federal Banking Agencies' Guidance on Subprime Lending: Regulation with a Divided Mind*, 6 *N.C. BANKING INST.* 73 (2002) (discussing the banking regulatory agencies' efforts to define responsible subprime lending).

A transparent and priceable credit product that will allow consumers to make informed choices about their credit levels—and, thus, only use “good,” economy-growing credit—is needed.<sup>112</sup>

A more comprehensive regulatory scheme of mortgage brokers serves as a deterrence to “bad” conduct. It also corrects a structural market defect in the way that mortgages are presently originated. In this context, establishing a mortgage brokers’ fiduciary duty to a borrower places the liability on the party who benefits from an abusive extension of credit and therefore ought to bear responsibility for the borrower’s injury.<sup>113</sup>

### 3. *The Market as a Social Actor: A Symbiotic Synthesis*

An unusually high foreclosure rate in the subprime market and the loss of home ownership for first-time homeowners represents an institutional change to the pattern of increased home ownership. It also destroys the beginnings of financial foundations for wealth accumulation.

Viewing the harm of mortgage foreclosure, or even delinquency, from the perspective of the borrower is consistent with a social institutions economic theory. This perspective challenges the neoclassical economic notions of the market as being based on a universal model of rational behavior.<sup>114</sup> Instead the question becomes how this economic sector should provide for human needs.<sup>115</sup> A social institution analysis evaluates the different components of the market to address the current issue: What is an acceptable rate of foreclosure in the subprime market<sup>116</sup> and who should bear the costs of growth and pros-

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112. Again, there are parallels from Professor Mann’s work on consumer credit-card debt. See RONALD J. MANN, CHARGING AHEAD: THE GROWTH AND REGULATION OF PAYMENT CARD MARKETS AROUND THE WORLD 80–81 (2006).

113. The structural inequity of subprime lending becomes even more evident when bankruptcy is the only option for subprime borrowers. The bankruptcy consequences for subprime residential mortgages can differ than for prime mortgages. The result is again a loss of equity. See generally R. Stephen Painter Jr., *Subprime Lending, Suboptimal Bankruptcy: A Proposal to Amend §§ 522(f)(1)(B) and 548(a)(1)(B) of the Bankruptcy Code to Protect Subprime Mortgage Borrowers and Their Unsecured Creditors*, 38 LOY. U. CHI. L.J. 81 (2006) (arguing in favor of amendments to the bankruptcy code that will give subprime borrowers the same “fresh start” as prime borrowers).

114. See Peter J. Boettke, *Where Did Economics Go Wrong? Modern Economics as a Flight from Reality*, 11 CRITICAL REV. 11, 16 (1997).

115. This theory of economic social institutions has its roots in Karl Polanyi, an economist who studied the effect of social relationships and institutions. See generally KARL POLANYI, *THE GREAT TRANSFORMATION* (1944).

116. Analysis of what an acceptable foreclosure rate should be is outside the scope of this paper. What is most significant in evaluating foreclosure statistics in the subprime market is that what seems like a low foreclosure rate 2.65%, represents an increase of 80% over a similar reporting period in 2006. See Press Release, Mortgage Bankers Ass’n, *Delinquencies and Foreclosures in Latest MBA Na-*

perity of this particular financial innovation. From the borrower's perspective, democratization of credit argues for participation in a robust economy by attaining exclusive property rights through home ownership.<sup>117</sup> Yet, that perspective also argues for a dramatically smaller foreclosure rate than is presently projected.

Social institutions theory as applied in an economic context categorizes and orders social interactions based on "non-economic" relationships and institutions.<sup>118</sup> As a result, decisions are social actions and not solely classical economic ones. Similarly, economic institutions are social forms. The relationships and intersections of the institutional players are examined to see how change is effected.<sup>119</sup>

Social economic institutions theory can translate into a concept of economic democracy. As such, there is a recognition of the economic rights of all who participate in the economy. Socio-economic decision making, based on equitable factors that fairly distribute control, discounts the notion of property rights as being exclusive.<sup>120</sup> In particular, the tangible economic interests represented by economic property rights directly relates to the distribution of property.<sup>121</sup> The market,

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tional Delinquency Survey (Dec. 6, 2007), available at <http://www.mortgagebankers.org/NewsandMedia/PressCenter/58758.htm>.

Social choice or social institutions economic theory has four predominate factors: 1) encourages and facilitates cooperation; 2) defines entitlements or property interests that may be the subjects of exchange; 3) protects participants against predation, including from the state and 4) imposes accountability. William K. Jones, *A Theory of Social Norms*, 1994 U. ILL. L. REV. 545 (1994).

117. See Robert P. Merges, *A Transactional View of Property Rights*, 20 BERKELEY TECH. L. J. 1477, 1481 (2005) (describing connection between property and economic rights).
118. See generally Peter J. Hammer, *Arrow's Analysis of Social Institutions: Entering the Marketplace with Giving Hands?*, 26 J. HEALTH POL. POL'Y & L. 1081 (2001) (discussing Kenneth Arrow's theory on the role of social institutions in economic theory).
119. Philosopher John Rawls is instructive on this point. Rawls posits that distributive justice requires that society maximize the life prospects of its least advantaged class. See generally JOHN RAWLS, *POLITICAL LIBERALISM* (1993).
120. Professor Stiglitz has teamed up with several economists and presents several different theorems that are relevant to this discussion. The Sappington-Stiglitz theorem "establishes that an ideal government could do better running an enterprise itself than it could through privatization. See David E. M. Sappington & Joseph E. Stiglitz, *Privitization, Information and Incentives*, 6 J. POL'Y ANALYSIS & MGMT. 567, 579-80 (1986). The Greenwald-Stiglitz theorem posits market failure as the norm, establishing "that government could potentially almost always improve upon the market's resource allocation." Bruce C. Greenwald & Joseph E. Stiglitz, *Examining Alternative Macroeconomic Theories*, 1988 BROOKINGS PAPERS ON ECON. ACTIVITY 207, 211-34.
121. KENNETH J. ARROW, *The Organization of Economic Activity: Issues Pertinent to the Choice of Market versus Nonmarket Allocation*, in 2 COLLECTED PAPERS OF KENNETH J.—GENERAL EQUILIBRIUM 133, 149 (1983) (discussing Arrow's well-know examples of opportunistic behavior such as "adverse selection" and "moral hazard").

therefore, does not operate outside the context of the individuals who participate in it. To do otherwise is to subordinate the interests of some of the market participants.<sup>122</sup>

The subprime mortgage market, and the predatory mortgage market, in particular, represent a market transformation.<sup>123</sup> A critique of the organizational arrangement in which the subprime market operates shows that it is devoid of adequate oversight and regulatory authority.<sup>124</sup> It is chaotic in some respects.<sup>125</sup> Given that the subprime housing market operates solely to serve credit-impaired borrowers, it is inconceivable to allow it to operate without protections. The advent of subprime lending for home finance occurred without significant study of the impact of institutions on patterns of behavior and habit. It also developed with merely indirect governmental support and oversight.<sup>126</sup> The justifications for home ownership in this industry merit the same incentives and support as in the prime markets.

As a by-product of the transformed institution, the evaluation of borrower behavior must be measured against the market's pricing strategies. By necessity, that evaluation focuses scrutiny on the behavior of the brokers, lenders, and the rating agencies and begs, as a matter of equity, for more regulatory oversight. The absence of sufficient regulatory involvement and authority abdicates the spirit, if not the letter, of the law. A uniform standard must apply across the entire home mortgage industry. While the market should not be overregulated, presently there is an absence of regulation. It is contrary to public interest to rely on the voluntary acts of brokers, lenders, and the rating agencies alone to achieve a market correction. An intervention is necessary to address the issues that are keeping the industry from working efficiently and fairly.<sup>127</sup> That intervention requires evaluating the federalism issues unique to banking law.

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122. See generally CHRISTOPHER L. PETERSON, TAMING THE SHARKS: TOWARDS A CURE FOR THE HIGH-COST CREDIT MARKET 205-14 (2004) (arguing that high-cost lending has adverse spill-over effects on the economy).
  123. Jane B. Baron & Jeffrey Dunoff, *Against Market Rationality: Moral Critiques of Economic Analysis in Legal Theory*, 17 CARDOZO L. REV. 431 (1996).
  124. See, e.g., Peter J. Hammer, *Questioning Traditional Antitrust Presumptions: Price and Non-Price Competition in Hospital Markets*, 32 MICH. J. L. REFORM 727 (1999) (identifying market imperfections and legitimate professional goals in regulating trade restraints in healthcare).
  125. Chaos theory is described as a system that goes from predictable to unpredictable behavior. See Thomas Earl Geu, *Chaos, Complexity, and Co-Evolution: The Web of Law, Management Theory, and Law Related Services at the Millennium*, 66 TENN. L. REV. 137, 268 (1998).
  126. See generally Richard Scott Carnell, *Handling the Failure of a Government-sponsored Enterprise*, 80 WASH. L. REV. 565 (2005) (criticizing the federal policies and statutes that regulate government-sponsored enterprises as providing for no accountability).
  127. David K. Musto & Nicholas Souleles, *A Portfolio View of Consumer Credit* (Fed. Reserve Bank of Philadelphia, Working Paper No. 05-25, 2005) (examining risk-

### III. MORTGAGE BROKERS—THE CORRECTIVE FRAMEWORK

Most states regulate mortgage brokers.<sup>128</sup> However, most of these statutes are not effective in eliminating subprime lending abuse because they do not impose an affirmative duty on the mortgage broker.<sup>129</sup> Fiduciary obligations to the borrowers, and not just the lenders, should be imposed upon the mortgage brokers.

The question of equity in regulation raises issues about the interplay of the state and federal governments. That question came more to the forefront after the Supreme Court's decision in *Watters v. Wachovia*.<sup>130</sup> By upholding the Office of the Comptroller of Currency's ("OCC") preemption of state consumer laws, the Supreme Court's ruling contributed to an ongoing debate about banking and federalism. This section provides the corrective framework for *Watters*, first by discussing federalism's three chief tenets—preemption, dual federalism and cooperative federalism—and concludes by recommending cooperative federalism as an approach that strikes the appropriate balance between federal oversight of an issue of national importance and state regulation of an issue that "quintessentially belongs to the states."<sup>131</sup>

This section then examines fiduciary duties and argues that they are at the crux of the current problem of regulating the misbehavior of mortgage brokers. It discusses the dual agency situation that mortgage brokers find themselves in, representing the interest of both borrowers and lenders. It also examines how the standard mortgage broker agreement waives the mortgage broker's fiduciary duty to the borrower and the implied duty of good faith is insufficient to protect borrowers. It ends by proposing a federal approach for regulating mortgage brokers that balances state and federal interests and serves as a control on the opportunistic behavior of mortgage brokers.

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adjusted consumer credit), available at <http://www.phil.frb.org/files/wps/2005/wp05-25.pdf>.

128. Although forty-nine states require mortgage brokers and mortgage brokerage institutions to have licenses, other requirements are minimal. See Wilson, *supra* note 19, at 301.

129. Only Minnesota and North Carolina a statutory fiduciary duty on mortgage brokers. See, e.g., Lawrence Hansen, *In Brokers We Trust—Mortgage Licensing Statutes Address Predatory Lending*, 14 A.B.A.J. AFFORDABLE HOUSING & COMMUNITY DEV. L. 332 (2004) (discussing the mortgage broker license statutes in New York, Georgia, and Illinois).

130. *Watters v. Wachovia*, 127 S.Ct. 1559 (2007).

131. *Id.* at 1573 (Stevens, J., dissenting).

## A. Banking Law and Federalism

Dual federalism separates the power and authority of the state and federal government.<sup>132</sup> The Nation's banking system was envisioned as a system in which federal and state regulation would operate separately.<sup>133</sup> In theory, state and federal banking regulators operate in distinct spheres. In practice, federal and state banking regulation co-exist with cooperation between the regulators.<sup>134</sup> States have the authority to enact laws in certain subject areas that federally-chartered institutions must follow.<sup>135</sup> Yet, federalism in banking law raises the unique issue of whether the federal regulator's policy of expanding banking powers deregulates federally chartered institutions, thus making it difficult for state-chartered institutions to remain competitive.<sup>136</sup> In particular, the issue evolves to ask whether this expansion of powers for national banks and the federal doctrine of preemption

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132. The U.S. Supreme Court first expressed the doctrine of dual federalism in *Texas v. White*, 74 U.S. (1 Wall) 700, 725 (1869), *overruled in part by Morgan v. United States*, 113 U.S. 476 (1885). The doctrine has three related principles:

(1) the federal government and the state governments exercise exclusive and nonoverlapping authority; (2) the allocation of authority between the national government and the states rests on functional premises, with the national government regulating certain kinds of matters and the state governments regulating different matters; and (3) the courts play an important and distinctive role in maintaining the boundary between the states and the national government.

Robert A. Schapiro, *Interactive Federalism: Filling the Gaps? From Dualist Federalism to Interactive Federalism*, 56 EMORY L.J. 1, 4 (2006); see also Ernest A. Young, *Dual Federalism, Concurrent Jurisdiction, and the Foreign Affairs Exception*, 69 GEO. WASH. L. REV. 139, 144 (2001) (defining dual federalism as a sub-species of dual sovereignty with state and federal governments having different jurisdictional spheres).

133. See generally Stephen J. Friedman & Connie M. Friesen, *A New Paradigm for Financial Regulation: Getting from Here to There*, 43 MD L. REV. 413 (1984) (discussing the history of banking regulation).

134. Arthur E. Wilmarth, Jr., *The Expansion of State Bank Powers, the Federal Response, and the Case for Preserving the Dual Banking System*, 58 FORDHAM L. REV. 1133, 1159–1161 (1990). Cf. Elizabeth F. Brown, *E Pluribus Unum—Out of Many, One: Why the United States Needs a Single Financial Services Agency*, 14 U. MIAMI BUS. L. REV. 1 (2005). Federalism concerns arise in most areas of law, including commercial law. See generally E. Hunter Taylor, Jr., *Forward, Federalism or Uniformity of Commercial Law*, 11 RUTGERS L.J. 527 (1980); Neil B. Cohen & Barry L. Zaretsky, *Drafting Commercial Law for the New Millennium: Will the Current Process Suffice?* 26 LOY. L.A. L. REV. 551 (1993).

135. See, e.g., Larry D. Kramer, *Putting the Politics Back Into the Political Safeguards of Federalism*, 100 COLUM. L. REV. 215, 220 (2000) (posits that contract law is an area of state law-making); William J. Woodard, Jr., *Constraining Opt-Outs: Shielding Local Law and Those it Protects From Adhesive Choice of Law Clauses*, 40 LOY. L.A. L. REV. 9 (2006).

136. Christian A. Johnson, *Wild Card Statutes, Parity, and National Banks—the Renaissance of State Banking Powers*, 26 LOY. U. CHI. L.J. 351 (1995) (advocating that state legislatures expand state banking powers in order to make state banks more competitive with national banks).

facilitates the gaps in the current regulatory structure that have allowed subprime lending to both proliferate and become harmful.<sup>137</sup>

### 1. Federal Preemption

The Supremacy Clause of the U.S. Constitution grants Congress the power to preempt any state law within its constitutionally delegated powers.<sup>138</sup> Congress' intent to preempt state law may be either implied or express.<sup>139</sup> Moreover, Congress may delegate to administrative agencies the power to enact regulations that preempt state law as well.<sup>140</sup>

Express preemption requires an examination of both Congress' specific intention as well as the scope of the statute.<sup>141</sup> When the language is clear, Congress' intent is straightforward. Rarely, is the statute unambiguous and the scope precise. Instead, the court must reconcile the specific statutory language with the legislative history and surrounding circumstances. More often than not, a court will acknowledge the law's varying interpretations and will have to deter-

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137. This Article does not describe the current state and federal law and regulations that may apply to subprime lending because there are many excellent articles that do so. See, e.g., Christopher L. Peterson, *Federalism and Predatory Lending: Unmasking the Deregulatory Agenda*, 78 TEMP. L. REV. 1, 4 (2005).

There are 10 federal laws and five federal agencies that have some type of jurisdiction over consumer lending. The FTC has brought nineteen actions alleging deceptive and/or illegal practices on the part of mortgage lenders from 1983-2000 under Truth in Lending Act ("TILA"). TILA was the first major Congressional effort at regulating consumer credit transactions. TILA requires the creditor to disclose the amount financed, the annual percentage rate, the finance charge, and the total number of payments to be made, including a payment schedule. Most of these cases resulted in settlement and concession and promissory obligation from the offending lenders. See Donald C. Lampe, *Predatory Lending Initiatives, Legislation and Litigation: Federal Regulation, State Law and Preemption*, 56 CONSUMER FIN. L.Q. REP. 78 (2002).

138. U.S. CONST. art. VI, cl. 2. See *McCulloch v. Maryland*, 17 U.S. (4 Wheat.) 316, 451 U.S. at 746 (1819).

139. Karen A. Jordan, *The Shifting Preemption Paradigm: Conceptual and Interpretive Issues*, 51 VAND. L. REV. 1149, 1165 (1998). See also Nina A. Mendelson, *Chevron and Preemption*, 102 Mich L. Rev. 737 (2004) (discussing the role of federal administrative agencies and preemption of state law).

140. See *Fid. Fed. Sav. & Loan Ass'n v. de la Cuesta*, 458 U.S. 141, 162 (1982).

141. *Bates v. Dow Agro Sciences, Inc.*, 544 U.S. 431, 453-58 (2005). A majority of the Court decided that a federal statute did not preempt state tort law on labeling pesticides. Justice Stevens was particularly forceful in defining the limitations on the scope of preemption.



mine the scope or range of the statute.<sup>142</sup> The foundational question is always to what extent Congress intended to preempt state law.<sup>143</sup>

When courts cannot find express preemption, they will look for implied preemption.<sup>144</sup> Courts evaluating implied preemption evaluate whether the federal interest in the subject matter is of such significantly high interest that state regulation should be supplanted.<sup>145</sup> This calls for the court to make a more probing analysis of the statute's purpose and goals and then to balance the statute's objectives with the state laws on the subject matter.<sup>146</sup> Courts may also evaluate whether the state rule operates as an obstacle to federal occupation of a subject matter area. This examination evaluates the effect of a combined federal and state approach to see if it will be impossible to accommodate both.<sup>147</sup> The impediment of a state law to accomplishing the federal statutory objectives is also evaluated.<sup>148</sup>

Recognizing that both the state and federal governments operate on a delicate balancing of authority, the Supreme Court has carved out exclusive state authority on some issues. Absent a clear and manifest purpose by Congress, these issues are left to the states.<sup>149</sup> In the subprime lending context, preemption questions have arisen regarding whether the OCC's regulations on visitation and preemption pro-

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142. *Geier v. Am. Honda Motor Co.*, 529 U.S. 861, 894 (2000) (Stevens, J., dissenting). Justice Stevens dissented because the source of the federal government's preemptive authority was an administrative agency's interim rule.
  143. Robert R. Gasaway, *The Problem of Federal Preemption: Reformulating the Black Letter Rules*, 33 PEPP. L. REV. 25 (2005) (arguing that courts should interpret express preemption provisions very broadly).
  144. *Sprietsma v. Mercury Marine*, 537 U.S. 51, 65 (2002) ("Congress' inclusion of an express pre-emption clause 'does not bar the ordinary working of conflict preemption principles.'" (quoting *Geier*, 529 U.S. at 869)).
  145. M. Stuart Madden, *Federal Preemption of Inconsistent State Safety Obligations*, 21 PACE L. REV. 103, 106 (2000) ("Issues of express preemption are textual, while questions of implied preemption are contextual.").
  146. This is field preemption and applies in the cases between OCC and the states. See *Jones v. Rath Packing Co.*, 430 U.S. 519, 525 (1977).
  147. *Fla. Lime & Avocado Growers, Inc. v. Paul*, 373 U.S. 132, 142-43 (1963) (discussing impossibility and preemption); *Hines v. Davidowitz*, 312 U.S. 52, 67 (1941) (discussing obstacles and preemption).
  148. For example, HOEPA's prohibition against a higher interest rate on default in a HOEPA high-cost loan, "preempts state law to the extent that state law is more tolerant than the federal requirements for loans covered by HOEPA." Julia Patterson Forrester, *Still Mortgaging the American Dream: Predatory Lending, Preemption, and Federally Supported Lenders*, 74 U. CIN. L. REV. 1303, 1346 (2006).
  149. Only those state laws that conflict with the purpose of national banks or that impair the ability of national banks to execute their purpose are invalidated. See generally *First Nat'l Bank v. Missouri*, 263 U.S. 640, 656 (1924); *McClellan v. Chipman*, 164 U.S. 347, 357 (1896) (federal law prevails over state in the banking law arena when there is a conflict); *Davis v. Elmira Sav. Bank*, 161 U.S. 275, 283 (1896). An example is the statute which expressly preempts state usury laws, the Depository Institutions Deregulation and Monetary Control Act of 1980 ("DIDMCA"), 12 U.S.C. § 1735f-7a (2000).

hibit state regulation. Three circuit courts and the Supreme Court considered this issue and affirmed that the OCC properly exercised its authority.<sup>150</sup>

## 2. *Watters v. Wachovia*<sup>151</sup>

The dynamic between state and federal regulation was tested recently in the *Watters v. Wachovia* case. Whether federally chartered financial institutions are subject to the enforcement of state laws raises issues of federalism. In May 2007, the Supreme Court refused to uphold a Michigan law permitting state banking regulators to investigate consumer complaints about banking practices. The Court decided that federal banking regulations preempt a state's authority to regulate the lending activities of federally-chartered bank subsidiaries, such as mortgage companies. The ruling is but a single example of the kind of federal action that may thwart the efforts of states to protect consumers from abusive lending that may occur within their borders.<sup>152</sup>

In *Watters*, the Supreme Court upheld a regulation of the federal banking agency, the OCC, preempting state law regulatory authority over national banks and their subsidiaries.<sup>153</sup> Opponents of *Watters*, and more specifically of the OCC's preemption powers, argue that the Court's decision impermissibly threatens the dual banking system and fosters an uneven playing field between federal and state

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150. The Sixth, Ninth, and Second Circuit Courts of Appeals have held that the OCC, as an administrative agency, did not exceed its authority to exercise jurisdiction over operating subsidiaries. See *Wachovia Bank v. Watters*, 431 F.3d 556 (6th Cir. 2005); *Wells Fargo Bank N.A. v. Boutris*, 419 F.3d 949, 960 (9th Cir. 2005); *Wachovia Bank, N.A. v. Burke*, 414 F.3d 305, 321 (2d Cir. 2005). As one scholar has said, the question is not "whether the OCC is authorized to preempt state predatory lending statutes, but rather on the normative issue as to whether the OCC should preempt state predatory lending laws." Julia Patterson Forrester, *Still Mortgaging the American Dream: Predatory Lending, Preemption, and Federally Supported Lenders*, 74 U. CIN. L. REV. 1303, 1348-49 (2006).

151. 127 S.Ct. 1559 (2007).

152. For example, in Illinois where foreclosure filings totaled 72,445, increasing 55% in 2006, the state created a Predatory Lending Database that monitors unscrupulous lending practices. See 765 ILL. COMP. STAT. 77/70 (2007). The same legislation also regulates the conduct of mortgage brokers. The law limits the types of loans mortgage brokers may offer their clients by requiring a suitability-type test. The law requires that mortgage brokers verify the borrower's ability to repay not just the principle and interest, but also the insurance and taxes. Mortgage brokers are also under a duty to guide potential borrowers through loan comparisons. *Id.* Georgia has implemented a similar plan. Gary Whalen, *The Wealth Effects of OCC Preemption Announcements After the Passage of the Georgia Fair Lending Act*, (Office of the Comptroller of the Currency, Econ. & Pol'y Analysis Working Paper 2004-4, 2004).

153. *Watters*, 127 S.Ct. 1559.

chartered mortgage subsidiaries.<sup>154</sup> Additionally, as argued below, the Court's decision to uphold the OCC's regulations compromises consumer protection laws, which are usually enforced by the states.<sup>155</sup>

The issue was whether Michigan's mortgage licensing laws applied to national banks and their subsidiaries operating within the state of Michigan.<sup>156</sup> Specifically, Wachovia challenged the authority of the State of Michigan to regulate its operating subsidiary, which was chartered under state law.<sup>157</sup> The Michigan law at issue permitted the state to investigate a consumer complaint if federal regulators refused to investigate the complaint. It also imposed fees and required they register with the state. It required operating subsidiaries of national banks to register with the state regulators and gave the regulators the authority to "visit" and examine the national bank operating subsidiaries and bring enforcement actions, if necessary, for violations of state law.<sup>158</sup>

Wachovia successfully argued that preemption protects the character of national banks and a system of nationwide banking by shielding the banks from conflicting state laws that impede or interfere with their functioning. The Supreme Court also agreed with Wachovia that under the visitatorial powers, states may exercise jurisdiction in certain subject areas over national banks only when Congress by permission allows.<sup>159</sup> The OCC characterized its regulations as offering greater clarity to existing restrictions that limit a state's regulatory power over national banks and their operating subsidiaries.<sup>160</sup> The agency

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154. The Supreme Court's upholding of the OCC's broad interpretation of its authority fails to take into account the OCC's inherent conflict of interest. Professor Arthur Wilmarth has written the preeminent article discussing the conflict and the unfair advantage that the OCC's jurisdiction creates for subsidiaries of national banks. See Arthur E. Wilmarth, Jr., *The OCC's Preemption Rules Exceed the Agency's Authority and Present a Serious Threat to the Dual Banking System and Consumer Protection*, 23 ANN. REV. BANKING & FIN. L. 225 (2004).

155. See discussion *infra* Part III.A.3.

156. The Court's decision upheld the favorable decisions in other circuits. See *Wachovia Bank v. Watters*, 431 F.3d 556(6th Cir. 2005); *Wachovia Bank, N.A. v. Burke*, 414 F.3d 305 (2d Cir. 2005).

157. On Jan. 1, 2003, Wachovia Mortgage became a wholly-owned operating subsidiary of Wachovia Bank, a national bank. Chartered by the state, an operating subsidiary is a separate corporation from the national bank, but under federal law, it can engage in the same business practices, including mortgage lending. On April 3, 2003, after making mortgage loans in Michigan for nearly six years, Wachovia Mortgage notified the Michigan Office of Financial and Insurance Services ("OFIS") that it would continue to issue mortgages without registering with the OFIS, thereby violating Michigan's laws. *Watters*, 127 S.Ct. At 1565-66.

158. Two OCC regulations were at issue in *Watters*. They were (1) the preemption of state laws available to national banks and their operating subsidiaries and (2) the OCC's visitatorial powers over national banks and their operating subsidiaries.

159. *Id.* at 1571.

160. Bank Activities and Operations; Real Estate Lending and Appraisals, 68 Fed. Reg. 46119-02 (Aug. 2, 2003) (Codified at 12 C.F.R. pts. 7 & 34).

interpreted the passage of diverse local and state laws aimed at national banks as both interfering with the operations of national banks and imposing unnecessary costs and expenses. In formulating its preemption rule, the OCC used as a criterion whether the state law will “obstruct, impair, or condition” national banks and therefore impermissibly limit the exercise of federally authorized powers. The OCC based its exemptions on those laws which regulate the business of banking as compared with those laws which govern the conduct of banking business.<sup>161</sup> Consumer groups opposing the OCC’s regulations were concerned that the regulations exempted national banks from state and local laws against predatory lending. The OCC asserted its authority to determine predatory lending violations and to regulate such abusive conduct under its supervision and enforcement powers.<sup>162</sup>

These recent developments necessitate reform in the regulatory structure to protect responsible subprime lending. It is arguable whether the OCC has properly exercised either its preemptive or visitatorial powers. Even without preemption, states would have difficulty enforcing anti-predatory lending statutes because of OCC’s regulations on visitatorial powers. The real policy question is whether the OCC, which denies that its banks are involved in predatory lending, ought to preempt state predatory lending laws.

### 3. *Cooperative Federalism*

While both dual federalism and preemption serve their purpose in the various contexts,<sup>163</sup> there is an alternative middle ground of cooperative federalism. Cooperative federalism is more appropriate in this context because it advances the doctrine of state and local government autonomy but requires consistency and allows federal intervention when necessary.<sup>164</sup>

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161. *Watters*, 127 S.Ct. at 1569–71.

162. OCC’s new regulation did not change the obligation of national banks and their operating subsidiaries to be subject to applicable federal law prohibiting unfair or deceptive practices in lending activities under § 5 of the Federal Trade Commission Act (FTC Act). 12 C.F.R. §§ 7.4008(c) & 34.3 (2007).

163. Nestor M. Davidson, *Cooperative Localism: Federal-local Collaboration in an Era of State Sovereignty*, 93 VA. L. REV. 959, 964–68 (2007) (comparing preemption and cooperative federalism).

164. Cooperative federalism as a regulatory structure covers a wide terrain of fields including environmental programs, telecommunications regulation, health care programs and tobacco regulation. Its benefits, generally described as “democratic experimentalism” have four basic categories: (1) state interests and autonomy; (2) local participation and accountability in public policies; (3) local experimentation and interstate competition; and (4) using local, already established bureaucracy. Philip J. Weiser, *Chevron, Cooperative Federalism, and Telecommunications Reform*, 52 VAND. L. REV. 1, 31 (1999).

Cooperative federalism is characterized by a strong federal government with reliance on the state and local governments to work cooperatively to implement programs. It has two basic structures of operation. One is receipt of federal aid when conditions are met by non-federal bodies.<sup>165</sup> The other is conditional preemption by establishing a minimum federal standard that non-federal governments must meet in order to regulate a subject matter area reserved for the federal government. The most common cooperative federalism structure combines the two: Congress preempts an area of regulation and subsidizes state and local governments to implement the federal programs if they meet federal standards.<sup>166</sup>

As a regulatory tool, cooperative federalism melds the competing interests. It is a method of federal intervention that forces states to address their inconsistencies without requiring a homogeneous approach.<sup>167</sup> It also rejects exclusive reliance on federal courts and agencies by allowing states to become more autonomous as administrators of federal law.<sup>168</sup> In the area of economic regulation, the shared schematic provides a workable model that balances the goals of regulation with the concerns of business looking for the proper balance.<sup>169</sup> Unlike dual federalism, in which there are few or no constraints in state program frameworks, and preemption, in which

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165. Both state and local governments play a role in implementing federal standards. See generally Larry Kramer, *Understanding Federalism*, 47 VAND. L. REV. 1485, 1488 (1994) (discussing federalism as sharing power between state local and federal governments).
166. Roderick M. Hills, Jr., *Federalism in Constitutional Context*, 22 HARV. J.L. & PUB. POL'Y 181,185-86 (1998). Mills describes this as the "carrot and stick" approach of cooperative federalism. The "carrot" is when Congress in effect hires non-federal governmental bodies to implement federal government programs by giving them federal grants but the federal assistance is conditioned on the implementing entities meeting specific program requirements. The "stick" is conditional preemption. Using this approach, Congress creates a federal standard and allows state or local law that is consistent with the minimal federal threshold to replace the federal regulation. *Id.*
167. For example, in the area of welfare reform, which involves federal benefit and entitlement programs, state and local initiatives are needed. See Sheryll D. Cashin, *Federalism, Welfare Reform, and the Minority Poor: Accounting for the Tyranny of State Majorities*, 99 COLUM. L. REV. 552 (1999); Michele Estrin Gilman, *Poverty and Communitarism: Towards a Community-Based Welfare System*, 66, U. PITT. L. REV. 721 (2005).
168. Philip J. Weiser, *Federal Common Law, Cooperative Federalism, and the Enforcement of the Telecom Act*, 76 N.Y.U. L. REV. 1692, 1693 (2001).
169. The use of cooperative federalism in economic regulation is a very popular notion. See Reza Dibadj, *Weasel Numbers*, 27 CARDOZO L. REV. 1325 (2006); Jill E. Fisch, *The New Federal Regulation of Corporate Governance*, 28 HARV. J.L. & PUB. POL'Y 39 (2004); Jonathan R. Macey, *Wall Street in Turmoil: State-Federal Relations Post-Eliot Spitzer*, 70 BROOK. L. REV. 117 (2004); Jill E. Fisch, *Institutional Competition to Regulate Corporations: A Comment on Macey*, 55 CASE W. RES. L. REV. 617, 625 (2005); Renee M. Jones, *Dynamic Federalism: Competition, Cooperation and Securities Enforcement*, 11 CONN. INS. L.J. 107, 122 (2004).

there is a unitary uniform federal framework, there is what some might term a “healthy” separation of powers.<sup>170</sup>

Cooperative federalism envisions a sharing of regulatory authority between the federal government. States have the authority to regulate within a framework delineated by federal law.<sup>171</sup> State agencies may supervise regulatory programs that implement federal law.<sup>172</sup>

While the federal government has a broader constituency, greater resources, and a national perspective on social and economic concerns, states focus on local or regional concerns.<sup>173</sup> They also can experiment with innovations and may try ideas that can later be implemented nationally.<sup>174</sup> States may also implement programs that are too risky for the federal government to attempt initially. The shared functions create an appropriate tension and have proven to be an appropriate allocation of power and resources.<sup>175</sup>

This is very similar to what has been done in the area of environmental law. Congress sets parameters by passing environmental laws that apply to all of the states. States then have the flexibility to adopt programs that are more comprehensive with the EPA intervening only if the federal minimum standards are not met. The federal environmental goals are set through federal legislation requiring minimum federal standards. The programs are then delegated to the states, reflecting the “retention of the traditional notions of federalism.”<sup>176</sup> The national goal of providing fair lending throughout the home mortgage market can prove beneficial and balanced within federalist principles. The advantage of federal oversight is national uniformity and the ability to monitor abuse and non-compliance while also clarifying the federal priorities. The disadvantage of this approach is that there can be

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170. See Roderick M. Hills, Jr., *The Political Economy of Cooperative Federalism: Why State Autonomy Makes Sense and “Dual Sovereignty” Doesn’t*, 96 MICH. L. REV. 813, 852 (1998) (positing that the reality of state and federal authority being completely separate and distinct is a flawed premise).

171. See generally Michael S. Greve, *Against Cooperative Federalism*, 70 MISS. L.J. 557 (2000).

172. This period of burgeoning federal programs represented a significant change in state and federal government relations and required a greater deal of cooperation for program implementation. A 1938 Iowa Law Review Symposium chronicles this period of New Deal legislation and the developing relationship between the state and federal governments. See, e.g., *Symposium on Cooperative Federalism*, 23 IOWA L. REV. 455 (1938).

173. Ellen R. Zahren, Comment, *Overfiling Under Federalism: Federal Nipping at State Heels to Protect The Environment*, 49 EMORY L.J. 373, (2000).

174. Michael Abramowicz, *Speeding up the Crawl to the Top*, 20 YALE J. ON REG. 139, 157–59 (2003) (discussing the benefits of innovation in the corporate context).

175. Douglas L. Grant, *Interstate Water Allocation Compacts: When the Virtue of Permanence Becomes the Vice of Inflexibility*, 74 U. COLO. L. REV. 105, 151–53 (2003) (discussing allocation of state and federal authority within the context of the “law of the union doctrine”).

176. See MARTIN H. REDISH, *THE CONSTITUTION AS POLITICAL STRUCTURE* 25 (1995).

tension between the state and federal governments, or that enforcement can interfere with cooperative federalism.<sup>177</sup> There is a legitimate concern that federal standards may be enforced inconsistently or become confused with the involvement of state courts. However, with most cooperative federalism schemes, implementation and enforcement are effective with the federal oversight.<sup>178</sup>

In operation, the federal banking agencies would retain enforcement jurisdiction. The agencies would approve practices and modify state authority when necessary. Challenges to the state's authority would be resolved in federal court.<sup>179</sup> It is important, therefore, that the federal statute have the proper scope and purpose.<sup>180</sup>

While both dual federalism and preemption serve their purpose in the various contexts,<sup>181</sup> the alternative middle of cooperation is appropriate in this context. The doctrine advances the doctrine of state and local government autonomy, requires consistency, and allows federal intervention when necessary.<sup>182</sup>

Central to the imposition of a federalist model under cooperative federalism is that the issue be one of national importance that justifies the establishment of federal policy goals.<sup>183</sup> The policy goals of federal regulation are paramount. The federal statute becomes important in establishing a threshold. By providing minimum standards for

177. Robert L. Fischman, *Cooperative Federalism and Natural Resources Law*, 14 N.Y.U. ENVTL. L.J. 179, 191–93, (2005) (discussing the roles of state in environmental enforcement).
178. See, e.g., Matthew D. Zinn, *Policing Environmental Regulatory Enforcement: Cooperation, Capture, and Citizen Suits*, 21 STAN. ENVTL. L.J. 81 (2002) (discussing sharing costs as a reason to adopt cooperative federalism standards); George A. Bermann, *Regulatory Cooperation with Counterpart Agencies Abroad: the FAA's Aircraft Certification Experience*, 24 L. & POL'Y INT'L BUS. 669 (discussing the FAA's international cooperative federalism scheme).
179. For example, in the environmental area, federal courts are called upon to determine the proper balance in the regulatory environment between the state and federal governments. Ellen R. Zahren, *Overfiling Under Federalism*, 49 EMORY L.J. 373, 391–393 (2000).
180. A federal court would review the challenges to agency authority using a *Chevron* analysis. See *Chevron U.S.A., Inc. v. Natural Res. Def. Council, Inc.* 467 U.S. 837, 842–45 (1984).
181. Nestor M. Davidson, *Cooperative Localism: Federal-local Collaboration in an Era of State Sovereignty*, 93 VA. L. REV. 959, 964–68 (2007) (comparing preemption and cooperative federalism).
182. Cooperative federalism as a regulatory structure covers a wide terrain of fields including environmental programs, telecommunications regulation, health care programs, and tobacco regulation. Its benefits, generally described as “democratic experimentalism” have four basic categories: (1) state interests and autonomy; (2) local participation and accountability in public policies; (3) local experimentation and interstate competition; and (4) using local, already established bureaucracies. See Weiser, *Chevron*, *supra* note 164, at 31.
183. Uniformity is needed to keep the playing field level and to avoid a “race to the bottom.”

fighting fraud and deceptive actions, a federal statute can also provide for both public enforcement and private rights of action.

Accommodating the interests of the state laws aimed at consumer protections is not at odds with this approach. Because this is an area that has traditionally been left to the states for regulation, the sharing of responsibility may produce the most efficient result for borrowers. States have long shown great responsibility and initiative in monitoring consumer activities and passing effective legislation. It is the unevenness in states' action to a national problem, however, that calls for a modified approach in this area. The problem in this particular area is that not all states have taken action. Second, federal preemption effectively minimizes a great deal of success that state laws have achieved in addressing abusive lending practices. Some state legislatures have shown a great deal of initiative in passing effective legislation. Likewise, state executives have used their resources to bring successful actions that halted unfair or deceptive practices and punished bad actors, and none of this has had a negative effect on the flow of capital in these jurisdictions. Yet, state laws have still been ineffective in their efforts to corral mortgage broker abuse for a number of reasons. For instance, the lack of comprehensive coverage has meant that the brokers simply avoid making loans in states where there is extensive regulation and potential liability.<sup>184</sup>

The new and innovative financial products of the consumer mortgage market require a balancing of how to expand access to subprime lending while also protecting borrowers from the abuses of a financial marketplace. By establishing a federal threshold of fiduciary duty to borrowers, minimum federal parameters are set that can be expanded as needed to provide enhanced protections.

## B. Fiduciary Duty

Fiduciary obligation is a context-bound legal obligation based on a formally established and recognized agency relationship.<sup>185</sup> Agency law is fairly simplistic in defining fiduciary duties when the agent has expressly decided to act for or on behalf of a principal.<sup>186</sup> Three gener-

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184. Neil J. Morse, *The Predatory Lending Obstacle Course*, MORTGAGE BANKING, Apr. 2002, at 53-59.

185. RESTATEMENT (SECOND) OF AGENCY § 1 (1958). Often a broadly defined concept, fiduciary duty has its origins in equity.

186. See generally *FDIC v. Canfield*, 763 F. Supp. 533 (D. Utah 1991) (bank directors held liable under standard of gross negligence for lending decisions) (rev'd on other grounds); *Arnott v. American Oil Co.*, 609 F.2d 873 (8th Cir. 1979) (finding that a fiduciary relationship existed between a service-station owner and an oil company that fraudulently induced the service station owner to enter into a lease); *Photovest Corp. v. Fotomat Corp.*, 606 F.2d 704 (7th Cir. 1979) (holding franchisor liable for violating fiduciary duties to its franchisee); Harold Brown, *Franchising-A Fiduciary Relationship*, 49 TEX. L. REV. 650 (1971) (discussing



ally recognized duties—the duty of care, the duty of loyalty, and the duty of good faith—are designed to control opportunistic and abusive conduct and are considered to be more than a mere implied contractual obligation.<sup>187</sup> The duty of care requires that the fiduciary consider the appropriate information in making decisions on behalf of the fiduciary.<sup>188</sup> The duty of loyalty requires that the fiduciary safeguard the principal's assets and specifically guard against misappropriation of assets that the fiduciary manages or supervises.<sup>189</sup> The fiduciary duty of good faith—which is distinguished from the implied contractual term—evaluates whether the fiduciary has taken actions that demonstrate a conscious and intentional disregard of risks to the principal.<sup>190</sup> A violation of any one of these duties requires the fiduciary to be held accountable. The situations in which the duties arise under common law may vary.<sup>191</sup>

Fiduciary duties are based on the structure of the relationship.<sup>192</sup> The likelihood of harm and the magnitude of the potential harm sup-

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franchisor liability for breach of fiduciary duties to franchisees). A discussion about the creation of specific fiduciary duties in the lending relationship is beyond the scope of this Article; therefore, the following discussion will focus solely on general fiduciary duties created by a court's determination that a mortgage broker becomes the agent of a borrower based solely upon her status as a "broker." For a thorough analysis of the creation of specific fiduciary duties within the lender-borrower relationship, see Cecil J. Hunt, II, *The Price of Trust: An Examination of Fiduciary Duty and the Lender-Borrower Relationship*, 29 WAKE FOREST L. REV. 719 (1994).

187. Victor Brudney, *Contract and Fiduciary Duty in Corporate Law*, 38 B.C. L. REV. 595, 635 (1997) ("[T]raditional fiduciary loyalty strictures more rigorously protect . . . against opportunistic behavior . . . than does classic contract doctrine.").
188. See *Smith v. Van Gorkham*, 488 A.2d 858, 872 (Del. 1985).
189. D. Gordon Smith, *The Critical Resource Theory of Fiduciary Duty*, 55 VAND. L. REV. 1399, 1490–91 (distinguishing contract duty of good faith from fiduciary duty by stating that "[t]he only material difference between the relationships is that contracting parties 'exercise . . . discretion in performance' whereas fiduciaries exercise discretion with respect to a critical resource." (quoting Steven J. Burton, *Breach of Contract and the Common Law Duty to Perform in Good Faith*, 94 HARV. L. REV. 369, 394 n.109 (1980))).
190. A fiduciary duty is typically more expansive than contractual duty. While a fiduciary duty is determined by the structure of the relationship, the obligation of good faith and fair dealing emanates from the terms of the contract. *Id.* at 1490–91; Frank H. Easterbrook & Daniel R. Fischel, *Contract & Fiduciary Duty*, 36 J.L. & Econ. 425, 438 (1993) ("When transactions costs reach a particularly high level, some persons start calling some contractual relations fiduciary, but this should not mask the continuum.").
191. Common law fiduciary obligations are derived from the need to control one person's discretion based on her relationship with another. See generally Kenneth B. Davis, Jr., *Judicial Review of Fiduciary Decisionmaking—Some Theoretical Perspectives*, 80 Nw. U.L. REV. 1 (1985) (explaining fiduciary duty in the context of private bargaining).
192. See *Pepper v. Litton*, 308 U.S. 295, 307 n.14 (1939) (citing *Twin-Lick Oil Co. v. Marbury*, 91 U.S. 587, 590 (1875)).

port the imposition of a duty. Thus, the principal's inability to control the fiduciary from acting in a self-serving and opportunistic manner creates a need to define a fiduciary duty as a "legal rule designed to limit [that] discretion."<sup>193</sup>

Fiduciary duties may be contractual because the parties have express or implied duties for defined behavior.<sup>194</sup> Recognizing that contracts are voluntary transactions, some argue that fiduciary duties ought not be reduced to a waivable contract term.<sup>195</sup> When contract law chooses to define fiduciary duties, it is within the parties' discretion to negotiate the scope of those duties. The parties, presumably equals, determine under what circumstances the fiduciary consents to serve. The pre-determined agreement conclusively fixes the fiduciary's duties.<sup>196</sup>

Fiduciary duties may also be relational. Courts are willing to imply fiduciary duties in certain circumstances—*i.e.*, attorneys, accountants, real estate agents, and other confidential relationships. In those instances, courts resolve relational fiduciary duties on a case-by-case basis.<sup>197</sup> Courts seem more likely to recognize a relational fiduciary duty when there is also some other egregious factor present.<sup>198</sup> The goal of fiduciary law is to reduce the principal's risk.<sup>199</sup> Its informality makes it readily available and not subject to the constraints of the

193. *Smith, supra* note 189, at 1490.

194. *Hunt, supra* note 186, at 765 (arguing that the presumption against finding a fiduciary duty in commercial transactions is fundamentally flawed and suggests that instead the inquiry should be whether a fiduciary duty has arisen with respect to a particular aspect of the transaction).

195. Reza Dibadj, *The Misguided Transformation of Loyalty into Contract*, 41 TULSA L. REV. 451, 458–59 (2006).

196. See Deborah A. DeMott, *Beyond Metaphor: An Analysis of Fiduciary Obligation*, 1988 DUKE L. J. 879, 879. Professor DeMott argues that, "[a]lthough one can identify common core principles of fiduciary obligation, these principles apply with greater or lesser force in different contexts involving different types of parties and relationships. [T]he law of fiduciary obligation is situation-specific." *Id.* See also Frankel, *Securitization, supra* note 30, at 822 (recognizing that court's will inquire into the nature of the fiduciary duty even when there is a specific waiver of the duty).

197. *Consol. Insured Benefits, Inc. v. Conseco Med. Ins. Co.*, No. 6:03-cv-03211-RBH, 2006 WL 3423891 (D. S.C. Nov. 27, 2006) (stating in dicta that such duties apply to attorneys); *Graefe v. Vaughn*, 972 P.2d 317 (Idaho Ct. App. 1999) (stating in dicta that such duties apply to accountants).

198. Courts look for factors such as "inequality, dependence, weakness of age, of mental strength, business intelligence, knowledge of the facts involved or other conditions giving to one an advantages over the other." *Yuster v. Keefe*, 90 N.E. 920, 922 (Ind. Ct. App. 1910); see also *Federal Deposit Ins. Corp. v. Fordham*, 130 B.R. 632, 649 (Bankr. D. Mass. 1991) ("fiduciary obligation often involves a party in a position of "inequality, inferiority, or other disadvantage").

199. See generally Robert Cooter & Bradley J. Freedman, *The Fiduciary Relationship: Its Economic Character and Legal Consequences*, 66 N.Y.U. L. REV. 1045 (1991); Deborah A. DeMott, *Disloyal Agents*, 58 ALA. L. REV. 1049 (2007).

bargaining process. But the real benefit is that fiduciary duties control behavior that is neither specifically identified nor addressed and gives the principal the right to justifiably rely on the actions of the agent.<sup>200</sup> The discussion below focuses on fiduciary duties in dual agency and independent contractor classification and how the duties may be implied in the context of contractual good faith.

1. *Fiduciary Duty—A Comparison of Dual Agency, Independent Contractor, and Implied Duty of Good Faith*

a. *Dual Agency*

As an instrumental part of the loan origination process, mortgage brokers assume a common law agency duty.<sup>201</sup> What the borrower does not know is that the typical representation contract allows the mortgage broker to be a dual agent.<sup>202</sup> The mortgage broker may already be an agent of one or more lenders. When the mortgage broker recommends a particular lender's mortgage product to the borrower, dual agency is created because the mortgage broker will represent

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200. See William W. Bratton, *Berle & Means Reconsidered at the Century's Turn*, 26 J. CORP. L. 737, 762 (2001); Stephen M. Bainbridge, *The Politics of Corporate Governance*, 18 HARV. J.L. & PUB. POL'Y, 671, 672 (1995).

201. See generally Wyatt v. Union Mortgage Co., 598 P.2d 45 (Cal. 1979) (holding mortgage broker liable for breach of fiduciary duty towards plaintiff as principles in connection with negotiation of a second mortgage when loan broker misrepresented the terms of the loan, including the extent of interest, late charges, and balloon payments); *Taborsky v. Mathews*, 121 So.2d 61, (Fla. Dist. Ct. App. 1960) (holding that parties may void real estate agreement where broker did not disclose dual nature of his agency to purchasers); *Spratlin, Harrington & Thomas, Inc. v. Hawn*, 156 S.E.2d 402 (Ga. Ct. App. 1967) (holding that dual agency prohibited if not disclosed); *Hughes v. Robbins*, 164 N.E.2d 469 (Ohio Com.Pl. 1959) (holding that a real estate broker who represents both parties to transaction, even if one of his principals were aware of such dual agency, cannot recover commission from either of his principals, unless both knew of and consented to or acquiesced in such double employment); *Lass v. Meinhardt*, 15 Ohio Law Abs. 272, 39 Ohio Law Rep. 37 (Ohio Ct. App. 1933) (holding that a real estate agent has the sole responsibility to disclose dual agency).

202. See *Godfrey v. Steinpress*, 128 Cal. App. 3d 154, 177-78, 180 Cal. Rptr. 95, 107 (Cal. Ct. App. 1982) (finding that dual agency was implied from the agent's conduct). Dual agency was at one point a particularly popular remedy in the real estate setting when a buyer challenged the lack of representation by a real estate broker that represented both the buyer and the seller in a transaction. Buyers challenged real estate brokers independence because the real estate broker represented both buyer and seller. Some courts attempted to make up for the lack of buyer representation by finding the cooperating broker to be an agent of the buyer as well as of the seller. See Nat'l Ass'n of Realtors, *Agency and Real Estate*, at 2-3 (November 1986) (citing *Grnadchamp v. Patzer*, 197 N.W.2d 537 (Mich. Ct. App. 1972)) (on file with author). One commentator criticizes dual agency as a solution to deterring the real estate broker's misconduct because it only allows the buyer a remedy after the transaction is complete. See Matthew M. Collette, *Sub-Agency in Residential Real Estate Brokerage: A Proposal to End the Struggle with Reality*, 61 S. CAL. L. REV. 399 (1988).

both the borrower and the lender in the same transaction. While this is a conflict of interest, it is resolved through disclosure to both borrower and lender, usually in the separate contracts that they have entered into with the mortgage broker. In this dual capacity, the mortgage broker has confidential information about the borrower's financial condition and the lender's pricing policies. The expected outcome is different as well. The borrower wants the lowest possible interest rate on the mortgage while the lender, as well as the mortgage broker, benefit when the interest rate is the highest. The question becomes whether the inherent conflict of interest can adequately be assuaged given the dramatic differences in the borrower's and lenders' interests.<sup>203</sup>

Courts resolve the issue most often against the borrower finding no distinction in the broker's obligations and holding in essence that contract terms waived the duty.<sup>204</sup> What these courts have failed to rec-

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203. Robert E. Kroll, *Dual Agency Problems in Residential Real Estate Brokerage: Conflict of Interest and Interests in Conflict*, 12 GOLDEN GATE U. L. REV. 379, 379 (1982).

204. See *Weinberger v. Kendrick*, 698 F.2d 61, 79 (2d Cir. 1982) (holding that a lender, who is on the opposite side of the negotiating table, does not act as a fiduciary); *Bank of Red Bay v. King*, 482 So. 2d 274, 285 (Ala. 1985) (holding that no fiduciary duty exists between the parties because the parties have equal bargaining power and the borrower did not request disclosure); *Dolton v. Capitol Fed. Sav. & Loan Ass'n*, 642 P.2d 21, 23 (Colo. Ct. App. 1981) (holding that only special circumstances justify fiduciary duty in a debtor and creditor relationship); *Cooper v. Burby*, No. 387563, 1992 WL 97044, at \*4-5 (Conn. Super. Ct. Apr. 29, 1992) (finding that the mortgage broker and borrower stand at arm's length"); *Mid-America Nat'l Bank v. First Sav. & Loan of South Holland*, 515 N.E.2d 176, 181 (Ill. App. Ct. 1987) (holding that a "conventional mortgagor-mortgage relationship . . . , standing alone, is insufficient" to impose a fiduciary relationship); *Vacinek v. First Nat'l Bank of Pine City*, 416 N.W.2d 795, 799 (Minn. Ct. App. 1987) (stating that a customer must tell the bank or the bank ought to know if its customer is placing confidence in the bank); *UT Communications Credit Corp. v. Resort Dev., Inc.*, 861 S.W.2d 699, 710 (Mo. Ct. App. 1993) (finding no relationship between a bank as lender and its customer as borrower); *Deist v. Wachholz*, 678 P.2d 188, 193 (Mont. 1984) (finding no fiduciary duty in a bank's debtor and creditor relationship); *Stone v. Davis*, 419 N.E.2d 1094, 1098 (Ohio 1981) (holding that a "mortgage loan is an arm's length transaction"); *Umbaugh Pole Bldg. Co., Inc. v. Scott*, 390 N.E.2d 320, 321 (Ohio 1979) (holding that an informal relationship creates a fiduciary duty only when special trust or confidence is known); *Production Credit Ass'n of Lancaster v. Croft*, 423 N.W.2d 544, 546 (Wis. Ct. App. 1988) (holding that a borrower-customer relationship does not create a fiduciary relationship).

*Cf. Munday v. Real Estate Advisors, Inc.*, No. C-95-20143-JW, 1995 WL 549015, at \*2-3 (N.D. Cal. Sept. 12, 1995) (holding that a mortgage broker breached its fiduciary duty to borrower by failing to disclose that the non-recording of certain documents is not the custom in the real estate industry); *Wyatt v. Union Mortgage Company*, 598 P.2d 45 (Cal. 1979) (finding a fiduciary duty between mortgage loan broker and mortgagor); *Mitchell v. Aames Home Loan Co.*, No. B021272, 1987 WL 13307, at \*5 (Cal. Ct. App. May 21, 1987) (stating in dicta that a mortgage broker may have a fiduciary duty); *UMET Trust v. Santa Monica*

ognize, however, is the triangular relationship of the broker, borrower, and lender.<sup>205</sup>

Courts are willing to concede that an agent can serve as a fiduciary to more than one principal in the same transaction.<sup>206</sup> In those circumstances, an agent must disclose the relationship with the other to both principals.<sup>207</sup> Courts rarely, however, inquire into the specific manner in which the disclosure is made in order to see if it was effective. This is problematic because it provides a limited basis for a court to examine the sufficiency of the disclosure. Commonly, the borrower and the mortgage broker enter into an agreement for services. It is in this agreement, a stock, form agreement drafted undoubtedly to best capture the interests of the mortgage broker, that the borrower agrees to dual representation. Assuming that such a signed agreement is sufficient to absolve a fiduciary from liability, it is hard to imagine that a court that relies solely on this agreement has made the critical examination of the scope of the agreement or of the surrounding circumstances.<sup>208</sup>

The circumstances surrounding the disclosure and an inquiry into the borrower's understanding regarding the dual agency seem germane. The fiduciary's disclosure in the representation agreement effect is the borrower's waiver. As such, the court must determine

Med. Inv. Co., 140 Cal. App. 3d 864, 873 (Cal. Ct. App. 1983) (holding that failing to disclose the negative legal consequences of sale leaseback financing is a breach of fiduciary duty); *Rushing v. Stephanus*, 393 P.2d 281 (Wash. 1964) (finding a fiduciary relationship between lender and borrower).

205. *Delsack v. Cumella*, 593 N.Y.S.2d 2 (N.Y. App. Div. 1993).

206. *Coldwell Banker Commercial Group, Inc. v. Nodvin*, 598 F.Supp. 853 (N.D.Ga. 1984) (holding that dual agency is not *per se* improper).

207. See, e.g., *John Conlon Coal Co. v. Westchester Fire Ins. Co. of New York*, 16 F.Supp. 93 (M.D. Pa. 1936) (stating that there must be notice of dual agency in order for it to be effective).

208. Linda S. Mullenix, *Choice of Forum, Another Choice of Law: Consensual Adjudicatory Procedure in Federal Court*, 57 *FORDHAM L. REV.* 291, 369-71 (1988). As Professor Mullenix argued,

[T]he ultimate inquiry must be whether the application of contract principles to civil law waivers adequately balances the dangers of waiver with the value-enhancing dimension of consent. The cases suggest that it does not. If a waiver represents an "alternative, informal interaction that the state encourages by its enforcement of the waiver," then it is incumbent that "courts should strive to translate the fairness of the plenary interaction into the informal setting of the abbreviated one." Therefore, a party waiving a right should be assured the functional equivalent of that right in the setting in which the right is foregone. As a practical matter, it is the court's task to "determine the nature of the right that has been waived, identify the kind of protection that the right provides, and then require that an informal version of those same protections be provided."

*Id.* at 371 (quoting Edward L. Rubin, *Towards a General Theory of Waiver*, 28 *UCLA L. REV.* 478, 537 (1981)).

whether the waiver was “knowingly and intelligently” made.<sup>209</sup> Specifically, there should be an explicit inquiry into whether the borrower understands the entire scope of the mortgage broker’s duties as an agent and whether the borrower understands that the dual agency relationship may inure to the lender’s material benefit and the borrower’s detriment. Absent this type of searching inquiry, the court cannot determine whether the borrower is truly relinquishing her right or the mortgage broker is asserting the right to be a dual agent and by default is limiting or eliminating the borrower’s right to make an informed choice.

*b. Independent Contractor*

Many mortgage brokers have decided to eliminate the borrower’s fiduciary claims by determining that they are independent contractors. Independent contractors do not work under the direct control of a principal.<sup>210</sup> Instead, the principal delegates a duty to the contractor and may define the scope of the work, but then leaves the independent contractor to determine the specifics of performing the task. In these situations, the principal will be found liable only if the delegated duty is a non-delegable one.<sup>211</sup>

Courts usually examine several factors when deciding what type of relationship the fiduciary has with the principal. Those factors include looking at issues as varied as whether the principal furnishes the essentials to perform the work, to the principal’s ability to furnish details about the kind and character of the work, to who pays the employees and has the right to discharge them.<sup>212</sup> The policy justifications also relate to the principal’s lack of control. Specifically, those

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209. *Aetna Casualty and Surety Co. v. L. K. Comstock & Co., Inc.*, 488 F.Supp. 732, 737 (D.Nev. 1980) (“[W]aiver is the voluntary relinquishment of a known legal right.”).

210. See generally J. A. Jolowicz, *Liability for Independent Contractors in the English Common Law—A Suggestion*, 9 STAN. L. REV. 690 (1957).

211. Nondelegable duties are those which are so dangerous that the principal must take responsibility for them. Given that these loan products are often designed to fail, it is a significant policy decision that all lenders, regardless of their defined relationship status with the broker, will be held responsible. See discussion *infra* at Part I.B.1.c.

212. In *Kisner v. Jackson*, 132 So. 90, 91 (Miss. 1931), the court looked at several factors, including:

- 1) Does the principal have the power to terminate the contract at will;
- 2) Can the principal fix the price in payment for the work, or vitally controls the manner and time of payment;
- 3) Does the principal furnish the means and appliances for the work;
- 4) Does the principal control the premises;
- 5) Does the principal furnish the materials upon which the work is done and receives the output thereof;
- 6) Does the independent contractor deal only with the principal concerning output;

policies presume that the fiduciary has adopted the work as her own and must therefore prevent any risks. They also presume that the fiduciary has charged the principal an amount commensurate with that risk. There will be liability for the principal when she is negligent in selecting the independent contractor.<sup>213</sup>

When the mortgage broker is not an employee of the lender, the lender is unable to control the broker's actions and or decisions. Also the relationship typically is not exclusive to a single lender, which seems to further separate the mortgage broker relationship from that of a fiduciary.<sup>214</sup> The mortgage broker is "for hire" and receives compensation from the lender for her services. The question becomes whether the mortgage broker is merely serving as a facilitator by bringing the borrower to the lender or as a negotiator by stepping in to the lender's shoes to negotiate the actual loans terms.

The mortgage broker is responsible for presenting one or several lenders' criteria for approval of a loan to the buyer. Maintaining independent contractor status requires the broker to take care not to interfere in the borrower's discretion in choosing the loan products or risk liability. Interestingly, the lender bears some responsibility under this theory for the broker's conduct and should not escape liability if the lender has knowledge that the offered products are irresponsible or abusive.<sup>215</sup> Indeed, by offering mortgage brokers predatory loan products or failing to require the broker to certify or independently investigate the broker's actions, the lender is in effect retaining supervisory control over the mortgage broker with the broker acting in a manner that the lender authorizes. Furthermore, the lender's failure to request pertinent borrower information from the mortgage broker that would adjust loan terms for the benefit of the borrower raises an

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7) Does the principal have the right to prescribe and furnish the details of the kind and character of work to be done;

8) Does the principal have the right to supervise and inspect the work during the course of employment;

9) Does the principal have the right to direct the details of the manner in which the work is to be done;

10) Does the principal have the right to employ and discharge the sub-employees and to fix their compensation;

11) Is he obliged to pay the wages of said employees?

213. Under *Restatement (Second) of Torts* § 411 (1965), a principal is liable when she "fails to take action upon noticing the careless performance of the contractor."

214. See generally Delsack, *supra* note 55, at 323 (criticizing the New York courts' failure to interpret a state statute as making a mortgage broker an agent for both the purchaser and the institutional lender).

215. Imposing such a rule would be similar to the rules imposing liability in inherently dangerous tort situations. See *RESTATEMENT (SECOND) OF TORTS* § 410 (1965); James B. McHugh, *Risk Administration in the Market Place: A Reappraisal of the Independent Contractor Rule*, 40 U. CHI. L. REV. 661, 662-65 (1973).

issue of imputed knowledge from which the lender should not be able to escape by claiming independent contractor status.<sup>216</sup>

*c. The Duty of Good Faith*

The duty of good faith is also used to prevent opportunistic behavior. There is a contractual duty of due care and fair dealing. Implied within every contract, the duty requires good faith in contract performance.<sup>217</sup>

A good faith duty has a similar purpose to a fiduciary duty of care in that it establishes a standard of conduct. It is distinguishable from a fiduciary duty in the manner in which the duty attaches and in its remedy.<sup>218</sup> A contractual duty does not exist until the contract is created and is not the typical vehicle for dealing with imbalance of bargaining powers in contract negotiations.<sup>219</sup> It is therefore more limited in the way in which it remedies the harm—essentially requiring a *post hac* determination of damages instead of deterring misbehavior.

However, the distinction is more than a procedural one. As a substantive duty, a fiduciary duty requires a fiduciary to adhere to the duty throughout the fiduciary's action on behalf of the principal. In that regard, there is a continual deterrence from misbehavior. A contract, because it is bargained for, usually constricts duties and obligations that the parties might ordinarily have. This is especially true in the fiduciary context. The duty of good faith imposes no obligation on the fiduciary to advance the principal's interests or even to act without self-interest.<sup>220</sup> Thus, it is not proper to characterize it as a fiduciary duty.<sup>221</sup>

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216. See RESTATEMENT (SECOND) OF AGENCY § 392 (1958).

217. The duty of good faith and fair dealing is implied in every contract. E. Allan Farnsworth, *Good Faith Performance and Commercial Reasonableness Under the Uniform Commercial Code*, 30 U. CHI. L. REV. 666, 669 (1963) (“[T]he inclusion of an obligation of good faith performance in the Code revives an ancient, although largely forgotten, principle.”).

218. Eileen A. Scallen, *Promises Broken Vs. Promises Betrayed: Metaphor, Analogy, and the New Fiduciary Principle*, 1993 U. ILL. L. REV. 897.

219. Blake D. Morant, *The Salience of Power in the Regulation of Bargains: Procedural Unconscionability and The Importance of Context*, 2006 MICH. ST. L. REV. 925 (discussing disproportional power and procedural unconscionability's procedural element, which lends itself to scrutiny of the imbalance of power).

220. See generally Tamar Frankel, *Fiduciary Duties as Default Rules*, 74 OR. L. REV. 1209, 1225–26 (1995).

221. See Smith, *supra* note 189, at 1448 (stating that fiduciaries owe more stringent obligations than mere contracting parties).



## 2. *Fiduciary Duty and Economic Risks*

Fiduciary duty is a high standard for imposing liability and must be affirmed in this context for several reasons. As discussed above, the mortgage broker's disclosure serves as the borrower's potentially unknowing waiver of fiduciary duty. Furthermore, the seriousness of the financial obligation raises the issue of whether this is a waiver that the law should so willingly allow a party to include as a standard contact term.

The mortgage broker acts as an agent of both the lending institution and the borrower and enters into two separate contracts.<sup>222</sup> The mortgage broker contracts with the borrower to provide a service. Not only does the agreement authorize the mortgage broker to make applications on behalf of the borrower, it also identifies the fees that the borrower must pay the broker.<sup>223</sup> This service is particularly useful for borrowers who have complex financial circumstances or may have difficulty obtaining particular loans.

The mortgage broker also has a contractual obligation with the lending institution to gather all pertinent information from the potential purchaser. The mortgage broker assumes the costly and time consuming task of taking the mortgage application, collecting the relevant financial information, preparing the credit reports, and arranging for the property appraisals.<sup>224</sup> The broker then earns a commission from the lender for performing these tasks. In both agency capacities, the mortgage broker absorbs the transaction costs of the deal. However, this assumption of transaction costs operates to achieve different results for the borrower and the lending institution.

### a. *Mortgage Brokers as Market Monitors*

Mortgage brokers increase the availability and affordability of residential mortgages because they help make borrowers more financially literate by explaining different loan products to them. They also make the mortgage markets more competitive for borrowers. Mortgage brokers increase awareness of and access to an array of lenders' loan products and offerings. Their acquired expertise is unmatched by that of the average borrower.

Yet, herein lies the conflict. The justification for mortgage brokers as market monitors posits that mortgage brokers owe a fiduciary duty

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222. See discussion *infra* Part III.C.2.

223. See generally Peter J. Hong, *Hidden Costs to Homeowners: the Prevalent Non-disclosure of Yield Spread Premiums in Mortgage Loan Transactions*, 18 *LOX. CONSUMER L. REV.* 131 (2005).

224. Delsack, *supra* note 55, at 309.

to the borrower and not to the lending institution.<sup>225</sup> This is a flawed presumption that supports the vague and ambiguous definitions of the mortgage broker's duties and responsibilities. Instead, what needs to be done is to align the brokers' duties and responsibilities with the economic costs of the mortgage transaction. Doing so recognizes that the mortgage broker receives adequate compensation for the rights inherent in representing the borrower and that the borrower has paid the mortgage broker to absorb the risks of the transaction and has a legitimate expectation that both the transaction and the relationship will have a material benefit.<sup>226</sup>

The duty requires the agent to act in the best interests of the principal in carrying out the assigned duties. Failure to do so requires the agent to prove that an action or transaction in conflict with the fiduciary duty is in the best interests of the principal.<sup>227</sup>

Unfortunately, once a borrower discovers how economically disadvantageous the loan is, she realizes that the broker has implicitly or explicitly given her poor advice. Upon learning that the circumstance may be actionable, the borrower learns that the available remedies are ineffective and costly.<sup>228</sup> The unstated expectation of the consumer is that the mortgage broker reviews the borrower's credit file

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225. See Niels B. Schaumann, *The Lender as Unconventional Fiduciary*, 23 SETON HALL L. REV. 21, 26 (1992). See also Theodore H. Hellmuth, *Lender Liability and Fiduciary Obligation: Dentures for a "Toothless Lion,"* 3 PROB. & PROP. 20, 22 (Aug. 1989) ("The lender who acts as a fiduciary to the borrower is liable for almost anything; the lender who does not is liable for almost nothing. This is not simply hyperbole. The average borrower must fend for himself or herself when negotiating the average loan. To the contrary, when a lender who is a fiduciary gains an advantage over the borrower, there is a presumption of unfairness").

226. See generally 1 JOHN N. POMEROY & SPENCER W. SYMONS, A TREATISE ON EQUITY JURISPRUDENCE §§ 151, 157 (5th ed. 1941); DAN B. DOBBS, REMEDIES: DAMAGES—EQUITY—RESTITUTION § 2.3 (1973).

227. See Tamar Frankel, *Fiduciary Law*, 71 CAL. L. REV. 795, 797–804 (1983). The common law duty of agency has protected borrowers in only a few situations—and there is a recognized conflict among the states. Minnesota imposes a statutory duty. See MINN. STAT. §§ 58.16(1), 58.02(3), (14), (19), (23) (2007) (mortgage broker defined as mortgage originator). The California Supreme Court used a statute and common law agency principles to impose a duty in *Wyatt v. Union Mortgage Co.*, 598 P.2d 45, 50 (Cal. 1979) (a mortgage broker's duty to borrower was recognized under state agency law and California real estate law). A Pennsylvania court used common law agency principles in *McGlaw v. Pennsylvania Human Relations Comm'n*, 891 A.2d 757, 769 (Pa. Commw. Ct. 2006). A federal district court in Illinois permitted the inference of a fiduciary duty between mortgage broker and borrower using agency law principles in *Epps v. Money Store, Inc.*, No. 6-C-2703, 1997 U.S. District LEXIS 17964 at \*20 (N.D. Ill. Sept. 30, 1997). Finally, a bankruptcy court in Pennsylvania also imposed a fiduciary duty protecting the borrower. In re *Barker v. Altegra Credit Company*, 251 B.R. 250, 259 Bankr. E.D. Pa. 2000). By contrast, a federal district court in Washington refused to recognize a fiduciary relationship between broker and borrower. *Brazier v. Sec. Pac. Mortgage*, 245 F. Supp. 2d 1136, 1143 (W.D. Wash. 2003).

228. See discussion *infra* Part II.A.2.b.iv.

extensively and will make recommendations based on that review. In actuality, unbeknownst to the average borrower, what the broker is doing is much narrower. The average broker views her role as providing financing for a certain amount. Brokers will readily admit that they have access to many products and knowledge about the market, but they do not perceive that their duty is to provide financing that is appropriate.<sup>229</sup> In theory and practice, there is little or no consensus on what the broker should do. The duties range from advising the borrower on a broad range of products given the borrower's personal circumstances to presenting a range of options for the borrower without express or implied recommendations for the borrower to make a decision to facilitating a sale on behalf of the lender as the lender's agent.

Given this range of services among mortgage brokers, borrowers face substantial risks in their dealings with them. Essentially, borrowers are unaware, unless the mortgage broker's duties are prescribed by state law, of the nature of the broker's duties and functions. Unless specifically discussed with them, borrowers do not know what services they are to receive.<sup>230</sup> To the extent that borrowers place reliance on the mortgage brokers' expertise, the borrower implicitly admits not having the expertise to make loan comparisons. Taking away the fiduciary duty imposes tremendous costs on the borrower—economic as well as social. The borrower needs germane information to assess the potentially detrimental features of the loan as well as the knowledge base to assess whether the loan fits her financial situation.

### *b. Mortgage Brokers and Transaction Costs*

Analyzing the structure of the mortgage broker's relationship to the borrower leads to the conclusion that imposing fiduciary duties, in this context, would reduce the economic costs associated with conducting complex commercial transactions.<sup>231</sup> By indirectly supervising conduct, the imposition of fiduciary duties deters bad actors. They differ from express contractual obligations because of the absence of a

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229. *Preserving the American Dream: Predatory Lending Practices and Home Foreclosures, Before the S. Banking and Urban Affairs Comm.*, 110th Cong. 17 (2007) (statement of Harry Dinham, President of the National Association of Mortgage Brokers), available at <http://banking.senate.gov/files/dinham.pdf>.

230. For example, borrowers may be unaware that they are entitled to sue under state deceptive fraud statutes. See generally Glenn Kaplan & Chris Barry Smith, *Patching the Holes in the Consumer Product Safety Net: Using State Unfair Practices Laws to Make Handguns and Other Consumer Goods Safer*, 17 *YALE J. ON REG.* 253 (2000).

231. G. Richard Shell, *Opportunism and Trust in the Negotiation of Commercial Contracts: Toward a New Cause of Action*, 44 *VAND. L. REV.* 221, 230 (1991) ("Transaction cost economics uses the concepts of asset specificity and the resulting danger of opportunism to predict the form business enterprises will take.").

bargain context and the foresight that negotiation of the best terms requires.<sup>232</sup> More importantly, fiduciary duties can cover unforeseen circumstances.<sup>233</sup>

By reducing the inherently high economic costs of direct monitoring and detailed bargaining, or economizing the transaction costs associated with the relationship, the fiduciary obligation serves a particularly useful function. Fiduciary duties serve to make the transaction economically efficient because they serve as a check on the fiduciary's abuse of power. It is the actual exercise of the fiduciary's relationship that gives her a controlling influence. While the actual scope of the fiduciary duties may seem limited, it is the potential to use the granted duties more broadly that makes the relationship work as a constraint on decision making. This fiduciary's function is too critical to be relegated to whether it is bargained for or not. Whether the bargaining power is equal or unequal, or the principal is sophisticated or unsophisticated, the fiduciary has the capacity to create and expose the principal to risks.<sup>234</sup>

Furthermore, the imposition of fiduciary duties is appropriate in the mortgage broker context when the nature of financing the obligation is one involving structured financing.<sup>235</sup> Mortgage brokers routinely recommend mortgages that are innovative, alternative forms of financing and in that regard may be both unconventional and sophisticated.<sup>236</sup> Although innovative mortgage products are commonly

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232. See also Robert D. Cooter & Thomas S. Ulen, *An Economic Case for Comparative Negligence*, 61 N.Y.U. L. REV. 1067 (1986).

233. See Andrew S. Gold, *On the Elimination of Fiduciary Duties: A Theory of Good Faith for Unincorporated Firms*, 41 WAKE FOREST L. REV. 123, 164 (2006) (discussing waiver of fiduciary duties as providing no protection from unforeseen circumstances). See also Therese H. Maynard, *Spinning in a Hot IPO—breach of Fiduciary Duty or Business as Usual?* 43 WM. & MARY L. REV. 2023, 2062 (2002) (discussing how fiduciary duties compel an agent to act in a fair and ethical manner whenever unforeseen circumstances arise).

234. Frankel, *Fiduciary Law*, *supra* note 227, at 808–09 (1983) (“A central feature of fiduciary relations is that the fiduciary serves as a substitute for the entrustor . . . . The power that the fiduciary obtains is originally vested in someone else, and is delegated to the fiduciary not for his own use, but solely for the purpose of facilitating the performance of his functions.”).

235. Loans, including subprime loans with alternative financing features, include adjustable-rate mortgages, wrap-around mortgages, balloon payments, Alt-A mortgages, option ARMS, negative amortization, no-doc loans, no down-payment loans, piggy-back loans and loans with high prepayment fees. Structured financing can make it difficult to re-construct obligations because mortgage tranches are divided according to the investor's interest.

236. Taiesha L. Cantwell, *Yield-Spread Premiums: Who's Working for the Borrower? HUD's Erroneous Regulation and its Bar on Plaintiffs*, 21 LAW & INEQ. 367 (2003); see also David Listokin, Elvin K. Wyly, Brian Schmitt & Ioan Voicu, *The Potential and Limitations of Mortgage Innovation in Fostering Homeownership in the United States*, 12 HOUSING POL'Y DEBATE 465 (2001) (analyzing and discussing several of these alternative forms of financing).

found in the marketplace now, what makes them problematic is their structured nature. Structured financing mortgages are more difficult to understand and therefore require constructive advice from the mortgage broker who recommends these transactions and who has expertise in the various financing schemes.<sup>237</sup> Imposition of a fiduciary relationship between the broker and borrower would make encourage the broker to give constructive advice.

Mortgage brokers facilitate these transactions by implicitly, if not directly, representing to customers that the transactions are affordable. Affordability requires that under normal circumstances the long-term obligation will net a benefit for the homeowner resulting in ownership of the property and receipt of the property equity. Reliance is reasonable because the typical borrower will not have sufficient knowledge to evaluate the risk and benefits of the transaction.<sup>238</sup> The expectation is that the mortgage broker will make a complete review of all of the pertinent information and thoroughly explain the transaction to the borrower.

The nature of the disclosure and the full scope of the duty is contextual because both depend on the transaction. Nonetheless, the unconventional aspects of the transaction must be thoroughly explained and should be independently evaluated for affordability. Disclosing knowledge and material facts about the transaction requires that the mortgage broker make an independent evaluation of the risks and benefits of the proposed loan. Codifying this type of requirement is consistent, therefore, with a common law action establishing a duty because it is the expectation of the borrower that the mortgage broker will perform more than a clerical function in processing the borrower's loan. That expectation is a reasonable one and therefore must be considered when evaluating the parties's agreed upon contractual duties.

Significant to a breach of duty in agency law is whether the agent has placed the interests of the principal before those of the agent. Any rule regulating mortgage brokers must provide a bright line test that

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237. *Subprime Mortgage Market Turmoil: Examining the Role of Securitization: Before the S. Subcomm. on Securities, Insurance, and Invest Securities of the S. Banking, Housing, and Urban Affairs Comm.*, 110th Cong. 33 (2007) (statement of Christopher Petersen, Assistant Professor of Law, Levin College of Law, University of Florida), available at [http://banking.senate.gov/\\_files/ACFE4F.pdf](http://banking.senate.gov/_files/ACFE4F.pdf).

238. Support for this position is found in the *Restatement (Second) of Agency*, which implies reliance by the principal on the agent and therefore requires a duty whenever such reliance is reasonable. Section 378 provides:

One who, by a gratuitous promise or other conduct which he should realize will cause another reasonably to rely upon the performance of definite acts of service by him as the other's agent, causes the other to refrain from having such acts done by other available means is subject to a duty to use care to perform such service or, while other means are available, to give notice that he will not perform.

RESTATEMENT (SECOND) OF AGENCY § 378 (1958).

makes clear that self-dealing and dual agency are not permitted. In a structured financing transaction, not only is the lending arrangement unconventional but the mortgage broker's involvement with a credit-impaired borrower is by its very nature rehabilitative. The expected outcome is that the mortgage broker will re-construct the typical mortgage arrangement so that the borrower will be able to afford the loan. The mortgage broker reforms the transaction to make that which was unaffordable as a conventional mortgage become affordable as a subprime mortgage. While undoubtedly providing a service in qualifying a borrower that might otherwise not be eligible for any type of mortgage loan, the subprime borrower also takes on additional risks by becoming eligible for a loan. It is the act of qualifying the borrower that creates the conflict of interest. When the mortgage broker, as an agent of the borrower, earns a commission by qualifying the borrower, there is a duty to inform the principal, the borrower, of all material facts relating to the mortgage transaction.

The failure of a mortgage broker as an agent to draw the borrower's attention to significant risks is problematic in another aspect as well. When scrutinizing the transactions *post hac*, it is often difficult, if not impossible, to reconstruct the transaction to determine whether the pricing of the loan has considered all relevant factors from the borrower's perspective.<sup>239</sup> For a borrower who is presumably financially unsophisticated and unable to fully evaluate the risks and benefits of the proposed transaction, the unconventional, structured finance loan, is complex. Because of the unusual attributes and complexity of such a transaction, the borrower needs and deserves a great deal of assistance. Typically the borrower will not have sufficient information to independently evaluate the risks and benefits of the proposed transaction. A fiduciary duty requires full and complete disclosure of all material aspects of the transaction with disregard to how such disclosure might compromise the mortgage broker or agent's financial benefit.<sup>240</sup> The mortgage broker's duty to exercise reasonable skill and care is one of knowledge that depends on the context. Resolution of whether the duty was met may depend on whether there were other professionals involved or the borrower relied solely on the mortgage broker for advice.<sup>241</sup> Highlighting the "reliance on an expert" part of the standard demonstrates that the borrower's perspec-

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239. Jackson & Burlingame, *supra* note 58, at 348–51.

240. Robert Litan et al., *The Community Reinvestment Act After Financial Modernization: A Final Report* (2001) (prepared for the Department of the Treasury), available at <http://www.treas.gov/press/releases/reports.finalrpt.pdf>.

241. As proposed below, borrowers need a private right of action. The Real Estate Settlement Practices Act does not provide a private right of action. The Truth in Lending Act provides one, but it is inadequate because of its one-year state of limitations. Fogel, *supra* note 57, at 440.

tive of the breadth of the brokers' advice and knowledge is crucial.<sup>242</sup> A critical inquiry focuses on identifying the exact nature and extent of the broker's services.

#### IV. A PARTIAL RESPONSE TO A MARKET THAT FAILS BORROWERS

The goals of equality and justice in the subprime market are not inimical to a free market. The consumer mortgage market has undergone a dramatic transformation and needs to become more uniform and efficient in order to function well and equitably. The subprime mortgage market is basically unregulated and is dominated by a non-bank financial system. This transformation follows changes that have occurred in the financial services industry but without the necessary adjustments to the current regulatory structure.<sup>243</sup>

##### A. Why a Federal Approach is Needed<sup>244</sup>

The lack of uniformity in mortgage broker regulation allows mortgage brokers to focus narrowly on selling a product rather than providing a level of expert service for complex transactions to the borrower. The absence of a uniform statute means the terms of the written contract vary with each transaction. In many instances, bor-

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242. Teri J. Dobbins, *Losing Faith: Extracting the Implied Covenant of Good Faith from (Some) Contracts* 84 OR. L. REV. 22 (2005) (arguing that such a duty elevates the implied duty of good faith to a duty of full disclosure).

243. Heidi Mandanis Schooner, *Consuming Debt: Structuring the Federal Response to Abuses in Consumer Credit*, 18 LOY. CONSUMER L. REV. 43, (2005) (recommending changes to consumer debt regulatory structure).

244. On March 31, 2008, the U.S. Treasury Department released its *Blueprint for a Modernized Financial Regulatory Structure (The Financial Modernization Blueprint)*. The improvements are designed to both stabilize the market and enhance financial innovation, while also providing greater consumer protections. The *Financial Modernization Blueprint* recommendations on mortgage origination call for consistent national standards for all types of mortgages and consistent enforcement at the federal and state levels. The *Blueprint* has three components, specifically, the report recommends:

- 1) the creation of a new federal commission led by a Presidential appointee, to evaluate, rate, and report on the adequacy of each state's system for licensing and regulating participants in the mortgage origination process. Federal legislation should establish uniform minimum qualifications for state mortgage market participant licensing systems;

- 2) national mortgage lending laws promulgated and implemented by the Federal Reserve; and

- 3) clarification and enhancement of the federal enforcement authority over these laws.

See, Department of Treasury, *The Department of the Treasury Blueprint for a Modernized Financial Regulatory Structure*, 2008, 78-82, available at <http://www.treas.gov/press/releases/reports/Blueprint.pdf>.

rowers waive any duty that the brokers have to them, or worse yet, depend on brokers for solid advice but are not really aware when the advice is incomplete, misleading, or simply not there. Consequentially, many borrowers are uncertain about the scope of the services provided by the mortgage broker as well as the proportion of the compensation owed to the mortgage broker. Because home ownership is such a deeply-ingrained American value, indisputably a part of the country's economic and social fiber, mortgage brokers who now originate at least half of all home loans should be governed by a comprehensive and effective federal standard that the states implement.

The current regulatory scheme is incongruent. Even with the great many local and state statutes, regulations, and policies regulating mortgage brokers, there has not been the dramatic market effect that underscores a resounding policy. The possibility of success for individual litigants is not predictable and is costly. The probability of dormant claims due to an inadequate and ineffective system of resolution underscores the need for a federal approach.

A federal law that completely preempts state law is unnecessary for a number of reasons. First, it ignores federalism concerns and the traditional sharing of power and authority by the state and federal government in this particular area. Again, Justices Stevens' statement that consumer law is "quintessentially an area of state regulation" is rather foreboding. A uniform standard specifically affirms a broker's fiduciary duty to the borrower. It gives borrowers an established set of expectations and information-based points from which to be able to assess mortgage broker violations. Uniformity in this area also provides a borrower a private right of action in addition to the enforcement actions that may be brought by the state government.<sup>245</sup> Moreover, it is important to understand why this needed uniformity cannot be addressed solely through the Federal Reserve's regulatory authority. The structured finance operations that created and continue to support this credit market have extended beyond the traditional banking system into the non-bank financial system. To rely on the banking system's limited role as an intermediary in the subprime mortgage credit market diminishes the effect that regulatory intervention can have in stemming the current crisis. Thus, the regulatory arm must reach wider than the Federal Reserve's limited jurisdiction over the banking system.

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245. Cf. Robert M. Jaworski, *Just When You Thought it Was Safe to Go in the Water: Recent Court Decisions Regarding Yield Spread Premiums Class Certification*, 11 LOY. CONSUMER L. REV. 91 (1999) (advocating need for YSP class action moratorium legislation).



## B. Defining Fiduciary Duty Principles for Mortgage Brokers

Whether borrowers should have contractual rights or statutorily imposed rights raises issues of how broad the duties should be. If negotiated terms apply, a borrower is able to protect herself only if she has equal bargaining power. Mortgage brokers have greater power over the negotiation process because they are familiar with the specifics. More likely than not, the mortgage broker would rebuff a borrower's objection to a dual agency provision. Borrowers unknowingly contract to make mortgage brokers independent contractors. Similarly, borrowers may not be aware of the implied duty of good faith. Later, a borrower is left with little recourse.

On the other hand, if fiduciary duties are created by law, the duties do not have to be negotiated and may encompass specific obligations. Indeed, statutorily imposed fiduciary duties can require mortgage brokers to thoroughly review the borrower's financial information, compare the benefits of certain mortgage products and adequately disclose the risks of the recommended mortgage products. The exact nature and extent of the mortgage broker's services must be identified. Because assessing care and skill is not a simple matter, it is more efficient and predictable to establish a bright-line test.<sup>246</sup>

The federal legislation creating a fiduciary duty for mortgage brokers to protect consumers from undisclosed information and ineffective counseling should have three parts. First, the law should incorporate some standards of industry uniformity. It should prohibit mortgage brokers from making any loan recommendations unless they can document the borrower's ability to repay at the indexed rate and require written disclosures with clear and specific language explaining to the borrower when and how the terms of the loan change. The call for financial literacy, while inappropriate as a comprehensive solution, can be heeded as well. To the extent that notices can be drafted with clear and specific language explaining the product that the borrower is agreeing to, borrowers become more knowledgeable, better informed, and able to reject some offered products as inappropriate.<sup>247</sup>

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246. To assess care and skill, not only are the representations and warranties made by the broker important, but also the agent's level of knowledge and experience and even level of compensation will be significant. Dana M. Muir & Cindy A. Schipani, *Fiduciary Constraints: Correlating Obligation with Liability*, 42 WAKE FOREST L. REV. 697, 705 (2007) (discussing an agent's level of expertise in context of corporate officer and director fiduciary duty).

247. Borrower protections could possibly include: proof of income from borrowers; ability to re-pay; fiduciary duty in underwriting requirements; guarantee that property taxes and insurance bills are covered; no prepayment penalties; and no yield spread premiums.

Second, the statute should require a non-waiveable legal standard. This standard is important because borrowers are unknowingly giving up their rights when they initially retain a broker. By calling a borrower's signed statement agreement to dual agency disclosure, there is a legitimacy attached to it. The "disclosure" is an unceremonious waiver although it is presented as a simple contract term. Borrowers are led to equate a retainer condition to the relinquishment of a legal right. This is patently unfair.<sup>248</sup>

Third, the test of breach should be a bright line standard that evaluates the broker's affirmative actions and conduct towards the borrower. A test of active persuasion is less onerous for mortgage brokers, but requires borrowers to meet a more difficult standard of proof. Thus, balancing leniency in favor of the borrower when there is an "exotic" mortgage product in the transaction requires only a showing that the borrower accepted a product that was inconsistent with the borrower's true risk. The mortgage broker would therefore be found liable for breach of fiduciary breach if the borrower was advised to accept abusive loan terms based on specific statements or actions that can be both attributed to the lender and verified.<sup>249</sup>

Finally, the statute must specify when the Federal Reserve, OCC, OTS, or FDIC, as federal banking regulators should take civil enforcement action against states. The policy should be limited to those times when a state (1) fails to take any action to implement the mortgage broker laws; (2) fails to take timely and appropriate action when there is a charge of mortgage broker abuse; and (3) has a situation that involves precedent-setting issues or issues in which federal involvement is needed to ensure national consistency.

## V. CONCLUSION

*The sub-prime mortgage saga is the same old story.  
The little guys get tough love.  
The big guys get forgiveness . . .*<sup>250</sup>

Undoubtedly, the market has failed many hard-working Americans and dashed their dreams of home ownership. Many subprime borrowers find themselves subject to even more inequality as they lose

248. The statute can also address industry uniformity by requiring Fannie Mae and Freddie Mac to have uniform underwriting standards.

249. Plaintiffs will have to allege that there was a there was an equally effective, less financially burdensome loan product that they would qualify for. To avoid the same problems that have arisen in litigation involving housing discrimination regarding the defendant's burden of proof, legislation should specify the burdens of proof to avoid confusion. See Peter E. Mahoney, *The End(s) of Disparate Impact: Doctrinal Reconstruction, Fair Housing and Lending Law, and the Antidiscrimination Principle*, 47 EMORY L.J. 409, 491(1998).

250. Robert B. Reich, *Who Gets Bailed Out? You Guessed It*, Sept. 19, 2007, <http://www.robertreich.org/reich/20070919.asp>.

their primary economic base. This failure is due, in part, to the transformation of the residential mortgage market. Mortgage brokers, whose participation in loan originations constitutes at least half of the mortgage originations in this country, are a largely unregulated force in the market. While mortgage brokers are not the sole source contributing to the market's failure, they have powerful incentives to engage in lending abuses. More efficaciousness in the regulation of mortgage brokers and more defined duties regarding their relationship with borrowers will provide borrowers with more protection and reduce the occurrence of lending abuses.

The mortgage lending market is deeply flawed in another way as well. The economic performance of subprime mortgage products has perpetuated common myths about subprime borrowers. These myths are effective in perpetuating greater social marginalization. The subprime market has far too many reckless lenders. It operates devoid of the needed critical assessment that allows this crisis to be manifest not as one of credit-impaired borrowers but as a social one. Only when the use of abusive subprime lending products is recognized as a permutation of the persistent problem of unfair lending practices can the myths be corrected and the economic performance of the subprime market addressed equitably. This calls for the same precautions to be applied to lenders, distributors and investors. Both failures—a market that has failed subprime borrowers and a market failure of inefficient loans—dictate a change in legislation and policy to ensure fair and equal access to credit. The notion of voluntary policing is necessary but insufficient given the scope of the problem. While mortgage brokers are not the only source of the subprime lending problem, their participation in this market segment is significant. Unregulated mortgage brokers have incentives to engage in lending abuses. A modest intervention in the regulatory environment will protect borrowers from being compromised. Borrowers can be given sufficient protection if existing laws are expanded to require the mortgage broker to act as a fiduciary to the borrower. Moreover, the proposed changes to the borrower-broker relationship will have a greater public benefit because these changes will protect all borrowers.

Public policy can strike a proper balance between the access that mortgage brokers provide to credit-impaired borrowers, mortgage sustainability, and a profitable mortgage industry. The equitable concept of fiduciary duty addresses this gap in borrower protection by placing the obligations of disclosure on mortgage brokers, bankers and lenders. By enacting this law, Congress will be taking an important step to address legitimate concerns in a way that ensures a competitive market while protecting consumer's economic interests.