

## Predatory Lending: What Will Stop It?

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## Predatory Lending: What Will Stop It?

PREDATORY LENDING HAS, IN RECENT YEARS, received increasingly negative publicity.<sup>1</sup> With predatory lending costing borrowers an average of nine billion dollars a year,<sup>2</sup> scholars and politicians alike are scrambling to find a solution.<sup>3</sup> Legislative and regulatory neglect only compound the problem.<sup>4</sup> Many existing federal laws have loopholes—the best of which only force predatory lenders to adapt their tactics—and states' action, for the most part proving equally ineffective, with the vast majority of state statutes simply mirroring unsuccessful federal regulation.<sup>5</sup>

To this point, a valid solution for the problem of predatory lending does not yet exist. The fact that scholars, economists, and politicians alike have struggled to even define the practice further complicates the issue. Unable to provide a coherent definition, scholars instead catalogue the practices associated with predatory lending.<sup>6</sup> By managing the definitional problem through cataloging, scholars propose a num-

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\* J.D., University of Maryland School of Law, May 2009; B.A. Government and Politics and Psychology, University of Maryland, College Park, *summa cum laude*, 2006. This comment would not have been possible without the beneficial feedback from University of Maryland School of Law faculty and the *Journal of Business & Technology Law* Executive Board. In particular, I thank Professor Jana Singer for her helpful comments and insightful editorial advice. Also, I wish to thank Brad Hecht for his comments on, and contribution to, the ideas presented in this comment. Lastly, I would be remiss if I did not thank my parents, Norman and Phyllis Ament, for their unwavering support.

1. Kurt Eggert, *Held up in Due Course: Predatory Lending, Securitization, and the Holder in Due Course Doctrine*, 35 CREIGHTON L. REV. 503, 507 (2002) (“Predatory lending is a scourge of the modern American financial system”).

2. *Id.*

3. See, e.g., Anna Beth Ferguson, *Predatory Lending: Practices, Remedies and Lack of Adequate Protection for Ohio Consumers*, 48 CLEV. ST. L. REV. 607, 635 (2000) (suggesting that legislatures expand the Mortgage Loan Act and the Consumer Sales and Practices Act); see also Kathleen C. Engel & Patricia A. McCoy, *A Tale of Three Markets: The Law and Economics of Predatory Lending*, 80 TEX. L. REV. 1255, 1259, 1317–66 (2002) [hereinafter Engel & McCoy, *Three Markets*] (proposing a duty of suitability in the subprime mortgage lending market).

4. See Engel & McCoy, *Three Markets*, *supra* note 3, at 1305–08, 1311–14 (demonstrating how federal legislation, such as the Home Owners and Equity Protection Act (HOEPA), has many loopholes which allow predatory lenders to continue to operate).

5. *Id.* at 1308–09; see David Reiss, *Subprime Standardization: How Rating Agencies Allow Predatory Lending to Flourish in the Secondary Mortgage Market*, 33 FLA. ST. U. L. REV. 985, 1023–51 (2006) (noting that, in addition to state predatory lending laws, state attorneys general have initiated lawsuits and regulators have taken administrative action; but noting that the holder in due course doctrine has stood in the way of remedies for predatory lending victims).

6. See *infra* Part I.

ber of solutions centering on statutory and regulatory adjustments.<sup>7</sup> In the process, most academics have brushed aside the idea of solving this problem through the common law, or more specifically, through contract law.<sup>8</sup> In response, this comment proposes a new solution arising out of the contract defense of unconscionability.<sup>9</sup>

This comment analyzes predatory lending in four separate parts. I begin with a general discussion of predatory lending.<sup>10</sup> From there, I turn to an explanation of the prime, subprime, and predatory markets.<sup>11</sup> To properly understand why predatory lending has been so successful, one must necessarily see how it differs from the prime and subprime markets.<sup>12</sup> The third part of this comment focuses on the legal remedies that lawmakers and the courts developed to regulate the mortgage market and consequently predatory lending.<sup>13</sup> This includes an explanation of why current state and federal law remains so ineffective in preventing predatory lending.<sup>14</sup> The final section of this comment advocates the use of the unconscionability doctrine as a means to stem foreclosures resulting from predatory lending.<sup>15</sup>

## I. DEFINING PREDATORY LENDING

Without a universal definition for predatory lending, substitute explanations come in various forms. Some state that “you know predatory lending when you see it,”<sup>16</sup> while others describe predatory lending “as a catalog of onerous lending practices.”<sup>17</sup> Most scholars use the catalogue approach because it “provides a useful starting point for detecting and describing the pathologies that underlie predatory lending.”<sup>18</sup>

The nature of predatory lending, generally, “benefit[s] mortgage brokers, lenders, and securitizers” and works to the detriment of the borrower.<sup>19</sup> Engle and McCoy, for example, list a number of abuses against borrowers:<sup>20</sup>

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7. See *supra* note 3 and accompanying text.

8. Engle & McCoy, *Three Markets*, *supra* note 3, at 1299–1301 (detailing the ineffectiveness of the equitable principle of unconscionability found in section 2-302 of the UCC).

9. See *infra* Part IV.C.

10. See *infra* Part I.

11. See *infra* Part II.A.–B.

12. See *infra* Part II.C.

13. See *infra* Part III.

14. See *infra* Part III.C.

15. See *infra* Part IV.C.

16. Engle & McCoy, *Three Markets*, *supra* note 3, at 1260.

17. *Id.*

18. *Id.*

19. Kathleen C. Engle & Patricia A. McCoy, *Turning A Blind Eye: Wall Street Finance of Predatory Lending*, 75 *FORDHAM L. REV.* 2039, 2043 (2007) [hereinafter Engle & McCoy, *Blind Eye*].

20. *Id.* at 2043–45.

- (1) “Loans structured to result in seriously disproportionate net harm to borrowers[;]”<sup>21</sup>
- (2) “Rent seeking[;]”<sup>22</sup>
- (3) “Loans involving illegal fraud or deception[;]”<sup>23</sup>
- (4) “Other forms of non-transparency that do not amount to fraud[;]”<sup>24</sup>
- (5) “Loans requiring borrowers to waive meaningful legal redress[;]”<sup>25</sup>
- (6) “Lending discrimination[; and]”<sup>26</sup>
- (7) “Servicing abuses[.]”<sup>27</sup>

Although this list does not exhaust predatory lending practices, most incidents involve two or more of the aforementioned practices.<sup>28</sup> Most of these abuses are not necessarily illegal.<sup>29</sup> To the contrary; most of these practices are legal or “regulated.”<sup>30</sup> The legality of most predatory lending practices is what in part presents a major barrier to the borrower’s recovery.<sup>31</sup>

Importantly, however, a catalogue approach is not the only accepted way to define predatory lending.<sup>32</sup> Both governmental agencies and the courts prefer the use of a more succinct definition. For example, a joint report between the U.S. Depart-

21. *Id.* at 2043. “A major example is asset-based lending, which consists of loans to borrowers whom the lender knows cannot afford the monthly payments. Pushing borrowers . . . to subprime loans, and refinancing low-interest loans into costlier loans with no justification can also inflict seriously disproportionate net harm on borrowers.” *Id.*

22. *Id.* at 2044. “Numerous subprime loans charge fees and interest rates that are exorbitant compared to the risk that the borrowers present. Rent seeking also encompasses steering and charging prepayment penalties and points without a corresponding cut in the interest rate, as is customary in the prime market.” *Id.*

23. *Id.* “Many predatory loans involve fraud or deception by brokers or lenders. For example, brokers or lenders may procure inflated appraisals or make false promises to refinance loans down the road on better terms.” *Id.*

24. *Id.*

These occur when lenders or brokers withhold information from borrowers in circumstances that fall short of fraud. For example, subprime lenders keep rate sheets containing their prices secret because they do not want borrowers to shop for better rates. Neither the Truth in Lending Act nor the Real Estate Settlement Procedure Act requires disclosure of rate sheets to borrowers. This secrecy impedes comparison shopping.

*Id.* (internal citations omitted).

25. *Id.* “Subprime loans often contain mandatory arbitration clauses that require borrowers to take disputes to arbitration and preclude them from joining class actions. Such provisions deny borrowers access to the courts.” *Id.*

26. *Id.* “Many predatory loans impose more onerous terms on members of protected groups, resulting in discrimination even after controlling for risk.” *Id.*

27. *Id.* at 2044–45. “Once loans are securitized, a servicer typically becomes responsible for collecting the loan payments and distributing the proceeds. Some servicers have employed abusive servicing practices, including charging unjustified fees, actively pushing borrowers into default, and employing exploitative collection methods.” *Id.*

28. Engel & McCoy, *Three Markets*, *supra* note 3, at 1261.

29. Ferguson, *supra* note 3, at 611.

30. *Id.*

31. *Id.*

32. See *infra* notes 33–34.

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ment of Housing and Urban Development and the U.S. Department of the Treasury provided the following definition:

*Predatory lending—whether undertaken by creditors, brokers, or even home improvement contractors—involves engaging in deception or fraud, manipulating the borrower through aggressive sales tactics, or taking unfair advantage of a borrower’s lack of understanding about loan terms . . . that, alone or in combination, are abusive or make the borrower more vulnerable to abusive practices.*<sup>33</sup>

Similarly, at least one court adopted Daniel S. Ehrenberg’s definition of predatory lending, calling it:

*[A] mismatch between the needs and capacity of the borrower . . . . In essence, the loan does not fit the borrower, either because the borrower’s underlying needs for the loan are not being met or the terms of the loan are so disadvantageous to that particular borrower that there is little likelihood that the borrower has the capability to repay the loan.*<sup>34</sup>

Nevertheless, the array of definitions and different attempts to characterize predatory lending underscore the fact that predatory lending is easier to discuss than to define.

## II. EVOLVING MARKETS

Without a doubt, the proliferation of predatory lending results from a whole host of factors.<sup>35</sup> However, most commentators agree that the problems of predatory lending trace back to the changes in the mortgage market over the past twenty to thirty years.<sup>36</sup>

In the 1970s, the American mortgage market involved a simple and intimate process.<sup>37</sup> Most Americans who wanted to buy a home went to savings banks, sav-

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33. HUD-TREASURY TASK FORCE ON PREDATORY LENDING, CURBING PREDATORY HOME MORTGAGE LENDING 1 (2000), available at <http://www.hud.gov/library/bookshelf12/pressrel/treasrpt.pdf>.

34. Daniel S. Ehrenberg, *If the Loan Doesn’t Fit, Don’t Take It: Applying the Suitability Doctrine to the Mortgage Industry to Eliminate Predatory Lending*, 10 J. AFFORDABLE HOUSING & COMMUNITY DEV. L. 117, 119–20 (2001); see also *Assocs. Home Equity Servs. v. Troup*, 778 A.2d 529, 536–37 (N.J. Super. 2001).

35. See, e.g., Julia Patterson Forrester, *Still Mortgaging the American Dream: Predatory Lending, Preemption and Federally Supported Lenders*, 74 U. CIN. L. REV. 1303, 1323–40 (2006) (discussing the causes of predatory lending as including separating investors from the problems, the “holder-in-due-course doctrine,” providing additional insulation through securitization, the increase in the availability of subprime credit, failures of the market, and the “federal preemption of state consumer protection measures”).

36. See *id.* at 1323 (noting the changes in the mortgage market).

37. *Id.* (detailing how most mortgages involved primarily the borrower and the local depositor, called a thrift).

ings and loan associations, or mutual savings banks, otherwise known as thrifts.<sup>38</sup> Upon arrival, the thrift evaluated an individual's application, taking into account income, wealth, and ties to the community, and the loan officer would then either approve or reject the application.<sup>39</sup> Typically, only those individuals with good credentials—steady work history, good credit, and a large down payment—would receive approval.<sup>40</sup>

Thrifts not only acted as the central provider of mortgages, “but they also vertically dominated the residential mortgage market,”<sup>41</sup> meaning that in addition to financing mortgages, thrifts would typically hold onto the mortgage until the borrower paid it off or the property was foreclosed.<sup>42</sup> Thus, the thrift or finance company that created the loan also performed the “origination, servicing, and ownership functions associated with the loan.”<sup>43</sup>

In the 1980s, an increase in available capital led to the emergence of new types of lenders and, in the process, dramatically altered the mortgage landscape.<sup>44</sup> The increase in capital resulted from several changes in the financial markets,<sup>45</sup> most notably the securitization of home mortgages.<sup>46</sup>

#### A. *Securitization*

“Securitization is the financial technology that integrates the market for residential mortgages with the capital markets.”<sup>47</sup> Specifically, the loan originator, after completing the loan, bundles and transfers the loan to an entity, often known as a “special-purpose vehicle” (“SPV”), which “is owned by, but legally distinct from, the lender. The SPV then resells the loan pool to a second SPV,”<sup>48</sup> again independent of the lender.<sup>49</sup> Then, an “investment bank for the issuer carries the principal and interest payments into tranches”<sup>50</sup> of bonds.<sup>51</sup> Rating agencies then go through a detailed process,<sup>52</sup> giving each tranche an investment-grade

38. Reiss, *supra* note 5, at 992.

39. *Id.*

40. *Id.* at 992–93.

41. *Id.* at 993.

42. Forrester, *supra* note 35, at 1323.

43. *Id.* at 1323–24.

44. Engel & McCoy, *Three Markets*, *supra* note 3, at 1273.

45. *Id.* This includes the availability of new mortgage products and incentives for lenders to increase their lending activity in low and middle income neighborhoods. *Id.*

46. *Id.*

47. Engel & McCoy, *Blind Eye*, *supra* note 19, at 2045.

48. This is typically in the form of the trust. *Id.*

49. *Id.*

50. A tranche represents levels of debt. John T. Lynch, Comment, *Credit Derivatives: Industry Initiative Supplants Need for Direct Regulatory Intervention—A Model for the Future of U.S. Regulation?*, 55 *BUFF. L. REV.* 1371, 1386 (2008).

51. Engel & McCoy, *Blind Eye*, *supra* note 19, at 2046.

52. *Id.* “[R]ating agencies gauge the credit risk of each tranche by comparing the loan pool’s characteristics with historical data and forecasting the tranche’s performance. In calculating credit risk, however, rating agen-

rating.<sup>53</sup> Investment banks then “price the mortgage-backed securities and sell them to investors, either through a public offering or a private placement.”<sup>54</sup> In turn, the original lenders receive two separate forms of revenue from the (1) sale of securities and (2) “the right to any interest on the loans that exceeds the interest paid to the investors after deducting expenses on the asset-backed bonds,” known as the “excess spread.”<sup>55</sup> Accordingly, securitization allows “investors in asset-backed securities [to] come to own ‘the rights to the present and future economic value of the assets,’” and simultaneously provides increased capital to the residential mortgage market.<sup>56</sup>

In addition to providing an increase in available funds,<sup>57</sup> securitization reduces risks for investors.<sup>58</sup> The “two-tiered [loan] structure protects investors by preventing lenders’ creditors from reaching the assets backing the securities in case the lender goes bankrupt.”<sup>59</sup> Investors further protect themselves by bundling, a process by which an investor’s loss or gain no longer hinges on one mortgage but rather on a group of loans.<sup>60</sup>

### B. A Market for Subprime Loans

The increased supply of available funding provided by the vertical mortgage market<sup>61</sup> (i.e. securitization) made loans available for more people than ever before.<sup>62</sup> Out of this came the birth of the subprime mortgage market.<sup>63</sup> With the influx of capital, lenders found themselves free to loan to individuals who presented elevated credit risk (subprime borrowers) and as a result, lenders charged these borrowers

cies do not assess the suitability of the underlying loans for individual borrowers.” *Id.* at 2046–47 (citation omitted).

53. *Id.* at 2047.

The tranches are arrayed from the most senior to the most junior, with “as many as five mezzanine or subordinate tranches going down the ratings ladder” from AAA to B. The senior class is the AAA tranche, the mezzanine class consists of the AA and A tranches, and the BBB, BB, B and unrated classes take the junior position. . . . [In this system,] the senior tranche is paid off . . . [and then] the next tranche moves to the head of the line for principal payments until all of the tranches are retired.

*Id.* (internal citations omitted).

54. *Id.* at 2048.

55. *Id.*

56. Reiss, *supra* note 5, at 1002.

57. Engel & McCoy, *Blind Eye*, *supra* note 19, at 2048.

58. See Engel & McCoy, *Three Markets*, *supra* note 3, at 1274 (“[C]redit enhancements [also] have the effect of reducing the risks associated with defaults.”).

59. Engel & McCoy, *Blind Eye*, *supra* note 19, at 2046.

60. Christopher L. Peterson, *Predatory Structured Finance*, 28 CARDOZO L. REV. 2185, 2213 (2007) (noting that pooling (or bundling) mortgages together allows investors to “have a relatively reliable prediction of expected returns”).

61. That is, the market created through securitization. See *supra* Part II.A.

62. Peterson, *supra* note 60, at 2213 (noting that securitization has “increased consumer access to purchase money mortgages, home equity lines of credit, and cash-out refinancing”).

63. *Id.* at 2214 (indicating that by the early 1990s securitization became entrenched and “[i]t was also in this period that the country saw an explosion in [the] relatively new and aggressive form of ‘subprime’ mortgage lending”).

interest and fees that exceeded that of those in the traditional “prime” mortgage market.<sup>64</sup> Despite facing increased risk, lower loan amounts, higher costs to originate and service loans, and faster payments, borrowers continued to apply for subprime loans.<sup>65</sup> In fact, from 1994 to 1999, the subprime market went from being non-existent to a 500-billion-dollar-a-year-industry.<sup>66</sup>

### C. Subprime Markets Open the Door for Predatory Markets

Along with an increase in capital, the changing mortgage market generated informational asymmetries in two separate contexts. First, “lenders and secondary-market purchasers have different levels of knowledge about the borrowers’ risks[,] . . . enabl[ing] lenders to gain an advantage by withholding information . . . .”<sup>67</sup> At the same time, informational asymmetries exist between lenders and inexperienced borrowers, who traditionally found themselves disconnected from the credit market.<sup>68</sup> Exploiting this second set of informational asymmetries provided lenders with a golden opportunity to engage in predatory tactics.<sup>69</sup>

In a predatory market,<sup>70</sup> lenders and brokers have extensive knowledge about credit and mortgage markets, while at the opposite end are borrowers with relatively little sophistication when it comes to mortgage markets.<sup>71</sup> Previously, these naïve borrowers were “excluded from the home-mortgage market because of credit rationing and discrimination.”<sup>72</sup> With new capital, predatory lenders have become all too willing to approach and proposition unsophisticated, first-time borrowers.<sup>73</sup> The introduction of complex documents detailing payments and percentages only compounds the problem.<sup>74</sup>

Once borrowers sign and commit to a predatory loan, it is only a matter of time before those same borrowers cannot afford their mortgage payments.<sup>75</sup> At this point, predatory lenders are ready to “work with” the borrower to help avoid foreclosure.<sup>76</sup> Taking full advantage of the borrowers’ vulnerability, predatory lenders engage in the well-known practice of “flipping,” which enables a “borrower to re-

64. *Id.*

65. Ferguson, *supra* note 3, at 611.

66. *Id.*

67. Engel & McCoy, *Three Markets*, *supra* note 3, at 1280.

68. Eggert, *supra* note 1, at 520.

69. *Id.*

70. “The predatory market generally exists as a subset of the subprime market.” Deanne Loonin & Elizabeth Renuart, *The Life and Debt Cycle: The Growing Debt Burdens of Older Consumers and Related Policy Recommendations*, 44 HARV. J. LEGIS. 167, 178 (2007).

71. Engel & McCoy, *Three Markets*, *supra* note 3, at 1280.

72. *Id.*

73. *Id.* at 1281.

74. *Id.* at 1280–81 (“[W]hen lenders and brokers give these borrowers estimates and loan documents, the borrowers may not be able to comprehend the information”).

75. *See id.* at 1281.

76. *Id.*



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peatedly refinance the original mortgage.<sup>77</sup> While flipping sounds enticing to a borrower because it staves off foreclosure, in actuality each time the lender flips the loan, it adds fees and increases profits.<sup>78</sup> Put another way, each time a lender flips an old loan, it becomes a brand new loan, which removes the equity from the loan without providing a benefit to the borrower.<sup>79</sup>

In addition to flipping, two other common predatory lending practices include “stripping” and “packing.”<sup>80</sup> Stripping occurs where a lender makes a loan knowing that the borrower cannot repay it, resulting in foreclosure and the additional loss of the equity previously built up by the borrower.<sup>81</sup> Packing occurs when lenders add other services to the loans.<sup>82</sup> These services usually take the form of different insurances, which borrowers neither need nor can afford.<sup>83</sup> Lenders find packing very lucrative because when the borrower refinances to stave off foreclosure, the lender “does not have to refund any of the premiums paid by the borrower.”<sup>84</sup>

### III. PREDATORY REGULATION

Regulations exist to combat predatory lending, but *effective* regulations do not.<sup>85</sup> If nothing else, the prevalence of predatory lending demonstrates the ineffectiveness of existing regulation.<sup>86</sup> There are a number of problems that have persisted throughout the predatory lending market, despite the current regulations.<sup>87</sup>

#### A. *Fraud: A Problem That Regulation Can Resolve*

One of the more egregious forms of predatory lending involves fraud.<sup>88</sup> As opposed to many other types of predatory lending, fraud can be deterred through traditional legal remedies. Put simply, fraud violates existing law.<sup>89</sup> In addition to state fraud and consumer protection laws, lending fraud also violates federal disclosure

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77. Ferguson, *supra* note 3, at 609.

78. *Id.*

79. *Id.* at 609–10.

80. *Id.* at 609.

81. *Id.*

82. Eggert, *supra* note 1, at 517.

83. *Id.*

84. Ferguson, *supra* note 3, at 610.

85. See, e.g., Peterson, *supra* note 60, at 2255 (commenting that most consumer protection statutes “precluded widespread securitization of subprime mortgages by over a decade[, and while this time frame is not meaningful in itself, it hints at a fundamental structural problem in the law]”).

86. See, e.g., Ferguson, *supra* note 3, at 612 (noting that with the advent of subprime loans and more directly predatory lending there has been a 200% increase in foreclosure rates since 1980, with over half a million in 1997).

87. See *infra* Part III.B.

88. Engel & McCoy, *Three Markets*, *supra* note 3, at 1267 (“The most blatant forms of predatory lending involve the age-old problem of fraud.”).

89. *Id.* These laws include: “state fraud statutes, state consumer-protection laws, state fiduciary duties, and federal disclosure statutes such as the Truth in Lending Act (TILA) or the Real Estate Settlement Procedures Act (RESPA).” *Id.*

statutes—namely the Truth in Lending Act (TILA)<sup>90</sup> and the Real Estate Settlement Procedures Act (RESPA).<sup>91</sup>

Two basic forms of fraud exist in the predatory lending market.<sup>92</sup> In both situations, the lender is the culprit.<sup>93</sup> The first form targets borrowers and involves lenders' "failures to disclose information as required by law," using bait-and-switch tactics,<sup>94</sup> and creating loans in conjunction with home repair scams.<sup>95</sup> The second type of fraud aims to deceive those individuals who provide capital resources; usually this means purchasers of loans in the secondary market.<sup>96</sup> Here, lenders typically falsify loan applications or inflate real estate appraisals.<sup>97</sup>

### B. *Predatory Market: A Regulatory Failure*

Although regulations effectively combat fraud, less overt methods of predatory lending continue undeterred.<sup>98</sup> The difference between fraud and deceptive practices, which fall into this category, is that fraud violates existing law whereas these deceptive practices merely skirt current regulations.<sup>99</sup> Some of the most widely publicized and criticized regulations have come in the form of disclosure laws and price regulations.<sup>100</sup> Specifically, three federal regulations mandate disclosure and price regulation in one form or another: TILA, RESPA, and the most promising of the three, HOEPA.<sup>101</sup>

"TILA requires lenders to disclose finance charges and annual percentage rates to applicants for home mortgages."<sup>102</sup> RESPA has a similar effect by entitling home-

90. 15 U.S.C. §§ 1601–1693(c) (2006).

91. 12 U.S.C. §§ 2601–2617 (2006).

92. Engel & McCoy, *Three Markets*, *supra* note 3, at 1267. While there are two main types of fraud that infect the predatory market, in reality there are endless forms. *Id.*

93. *Id.* at 1267–68.

94. See Michael O'Donnell & Katherine Planer, *If It Sounds Too Good to Be True: Identifying and Avoiding Common Mortgage Fraud Scams*, N.J. LAW., Oct. 2008, at 54, 55.

Here "the homeowner does not realize that he or she is surrendering ownership of the house in exchange for a 'rescue.'" The owner deeds ownership to the rescue service using a quit-claim deed, in an effort to prevent foreclosure. The owner believes he or she is signing documents for a new loan to bring the mortgage up to date. The homeowner is promised that he or she can buy back the home at a later time, but before the homeowner has an opportunity to repurchase, the rescue service has sold the home to another buyer.

*Id.* (internal citations omitted).

95. Engel & McCoy, *Three Markets*, *supra* note 3, at 1267.

96. *Id.* at 1268.

97. *Id.*

98. See Reiss, *supra* note 5, at 1026 (noting the limited protection provided by federal law).

99. Engel & McCoy, *Three Markets*, *supra* note 3, at 1268.

100. See generally Ferguson, *supra* note 3, at 616–22 (discussing the limited relief provided by TILA, RESPA, and HOEPA).

101. 15 U.S.C. § 1601 (2006).

102. Engel & McCoy, *Three Markets*, *supra* note 3, at 1305.

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owners “to good-faith estimates of settlement costs . . . and statements of their actual closing costs in HUD-1 settlement statements.”<sup>103</sup>

In response to a rising number of incidents related to predatory lending, Congress in 1994 enacted HOEPA.<sup>104</sup> Importantly, “HOEPA defines certain home mortgage loans as ‘high cost’ loans and, with respect to [such] loans, requires particular disclosures and prohibits designated unfair terms.”<sup>105</sup> Specifically, “HOEPA prohibits lenders from engaging ‘in a pattern or practice’ of making high-cost loans without regard to the borrower’s ability to repay.”<sup>106</sup> Moreover, “[u]nder HOEPA[’s] advance-disclosure provisions, the lender must inform the borrower of the APR, the dollar amount of the periodic payments, the size of any balloon payments, the amount borrowed, and any charges for optional credit insurance or debt-cancellation coverage.”<sup>107</sup> Additionally, HOEPA mandates that lenders “advise borrowers in writing that they could lose their homes . . . .”<sup>108</sup> Still more promising, “HOEPA eliminates holder in due course status for purchasers of HOEPA-covered loans,” and as a result, “assignees of HOEPA loans are subject to all claims and defenses that the homeowner could have asserted against the original lender.”<sup>109</sup> Finally, HOEPA requires disclosure of interest rates and monthly payment increases.<sup>110</sup>

Moreover, all three of these statutes authorize private right of action.<sup>111</sup> HOEPA offers the widest range of remedies, allowing private individuals expanded rights of recession to stave off foreclosure for up to three years and the right to collect special enhanced damages consisting of all finance charges and fees.<sup>112</sup> TILA offers similar remedies, save the expanded right of rescission and special enhanced damages.<sup>113</sup> RESPA limits private remedies compared to those of TILA and HOEPA.<sup>114</sup> For borrowers to collect remedies under RESPA, they must prove that lenders: (1) failed to inform them that their loans could be transferred, (2) received kickbacks, or (3) steered them to title companies—no easy task.<sup>115</sup> In addition to private rights

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103. *Id.*

104. Home Owners and Equity Protection Act of 1994, Pub. L. No. 103-325, § 151, 108 Stat. 2160, 2190 (1994).

105. Forrester, *supra* note 35, at 1316.

HOEPA initially defined high-cost home mortgage loans as those with an annual percentage rate more than ten points above Treasury bill rates or with points and fees exceeding the greater of eight percent of the loan amount or \$400, but the Act provides for adjustment by the Federal Reserve Board after two years.

*Id.*

106. *Id.* at 1316–17.

107. Engel & McCoy, *Three Markets*, *supra* note 3, at 1305.

108. *Id.*; see also 15 U.S.C. § 1639(a)(2)(B) (2006).

109. Forrester, *supra* note 35, at 1317.

110. Engel & McCoy, *Three Markets*, *supra* note 3, at 1305.

111. *Id.* at 1306.

112. *Id.*

113. *Id.*

114. *Id.*

115. *Id.*

of action, all three statutes include agency enforcement.<sup>116</sup> Furthermore, violators of TILA and HOEPA may face criminal prosecution.<sup>117</sup>

It would seem that HOEPA, TILA, and RESPA serve as the perfect solutions to predatory lending, but their practical ineffectiveness diminishes their promise.<sup>118</sup> Numerous loopholes in the aforementioned statutes allow lenders to avoid disclosing many of their deceptive practices.<sup>119</sup> TILA failed in large part due to the “long list of closing costs,” which the regulations do not include when computing finance charges and annual percentage rates.<sup>120</sup> RESPA remains equally ineffective—the result of long and unclear good faith settlement costs and HUD-1 statements that are too late and unreliable to help borrowers.<sup>121</sup>

HOEPA had great promise, but like TILA and RESPA, it has not realized its potential. The narrow scope of HOEPA serves as its fatal flaw.<sup>122</sup> More specifically, HOEPA is inapplicable to purchase-money mortgages or open-ended credit lines of any kind.<sup>123</sup> Additionally, even if a mortgage is within its scope, HOEPA does not apply unless lenders charge interest or total points exceeding a given percentage.<sup>124</sup> Therefore, a lender can circumvent HOEPA by categorizing a loan as an open-ended extension or by keeping interest and fees below HOEPA percentage requirements.<sup>125</sup> Simply stated, predatory lenders with all too much frequency are able to avoid HOEPA regulations.

Even HOEPA’s attempt to eliminate or limit holder in due course status falls short. For one, HOEPA limits the liability of assignees of the mortgage loan, to the total amount of the debt paid and remaining unpaid.<sup>126</sup> Moreover, “HOEPA provides a safe harbor for assignees who can demonstrate that ‘a reasonable person exercising ordinary due diligence, could not determine . . . that the mortgage was [a HOEPA-covered loan].’”<sup>127</sup>

### C. Attempted State Regulation

In response to the failure of federal regulations, states created their own disclosure regulations.<sup>128</sup> Many of these disclosure regulations mimic federal regulations and

116. *Id.* at 1305.

117. *Id.*; see also 15 U.S.C. §§ 1611, 1644 (2006).

118. See *supra* note 100 and accompanying text.

119. Engel & McCoy, *Three Markets*, *supra* note 3, at 1306–07.

120. *Id.*

121. *Id.* at 1307.

122. Eggert, *supra* note 1, at 587 (noting that HOEPA seems “too easy to evade”).

123. See 15 U.S.C. § 1602(i), (w), (bb) (2006); 12 C.F.R. § 226.32(a)(2) (2006).

124. Eggert, *supra* note 1, at 587.

125. *Id.*

126. 15 U.S.C. § 1641(d)(1).

127. Forrester, *supra* note 35, at 1317.

128. Engel & McCoy, *Three Markets*, *supra* note 3, at 1308. See generally Reiss, *supra* note 5, at 1028–51 (referencing New Jersey, North Carolina, and Georgia—three of the more recognized state attempts to regulate predatory lending).

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employ necessary modifications as deemed by the states.<sup>129</sup> For example, North Carolina in 1999 enacted the first predatory lending statute, which it patterned after HOEPA.<sup>130</sup> Learning from the mistakes of HOEPA, the North Carolina statute covers a broader range of loans.<sup>131</sup> The statute accomplishes this by lowering the trigger for total points and fees.<sup>132</sup> While many consumer advocate groups tout North Carolina's statute as a success,<sup>133</sup> the statistics bear a different story. Since the enactment of the statute, North Carolina has seen an increase in the growth of subprime lending that parallels the rise in states that have not adopted similar regulations.<sup>134</sup> Not only has the number of subprime loans increased since the North Carolina legislature enacted the statute in 1999, but every significant subprime lender in North Carolina has continued to do business since.<sup>135</sup>

In addition, state regulation which goes too far runs the risk of angering "privileged raters." Privileged raters are the three major bond and securities rating agencies: Standard & Poor's, Moody's Investors Service, and Fitch Ratings.<sup>136</sup> Privileged raters will not rate securities backed by pools of residential mortgages if any of those mortgages violate their rating guidelines.<sup>137</sup> Thus, if a state allows assignee liability and unqualified damages—in effect eliminating holder in due course status—some privileged raters refuse to rate that state's mortgage loans, effectively shutting down the mortgage market in states with strong anti-predatory lending legislation.<sup>138</sup>

### IV. A NEW APPROACH: UNCONSCIONABILITY

Academics and scholars alike recognize the problems associated with current regulations.<sup>139</sup> In response to regulatory failures, legislators and scholars have proposed a myriad of new theories and ideas.<sup>140</sup> Many of these ideas focus on altering the regulatory field as well as the mortgage market.<sup>141</sup> Scholars, however, too quickly

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129. Engel & McCoy, *Three Markets*, *supra* note 3, at 1308 (noting that a handful of states have responded to the problem of evading HOEPA, by adopting measures patterned after HOEPA to a large degree).

130. Reiss, *supra* note 5, at 1028.

131. Forrester, *supra* note 35, at 1320 (indicating that the North Carolina Statute goes "beyond" the protections provided by HOEPA).

132. Engel & McCoy, *Three Markets*, *supra* note 3, at 1308.

133. Forrester, *supra* note 35, at 1320.

134. *Id.*

135. *Id.*

136. Reiss, *supra* note 5, at 987.

137. *Id.*

138. *Id.* at 1032 (noting that this very situation occurred in Georgia).

139. *See supra* Parts III.B.—C.

140. *See, e.g.,* Peterson, *supra* note 60, at 2273 (proposing the reformation of consumer protection laws); *see also* Engel & McCoy, *Three Markets*, *supra* note 3, at 1363–64 (arguing for increased regulation of mortgage brokers and appraisers).

141. *See supra* note 140.

dismiss common law remedies,<sup>142</sup> particularly the contract defense of unconscionability.<sup>143</sup>

There are three problems with using the theory of unconscionability to resolve the predatory lending problem.<sup>144</sup> First, since investors in the secondary market are often responsible for suing borrowers who fail to pay their loans, borrowers are prohibited from raising the defense of unconscionability due to the holder in due course doctrine.<sup>145</sup> Under that doctrine, a secondary market purchaser receives the mortgage from the lender free and clear of defenses.<sup>146</sup> The “waiver of defense clauses” serves as another obstacle.<sup>147</sup> Finally, scholars have, somewhat incorrectly, pointed to the reluctance of courts to condemn excessive price as unconscionable “without more”—it is this problem which this comment confronts head on.<sup>148</sup>

At first glance, all of these legitimate problems appear to justify the reluctance to use the defense of unconscionability. However, examining the doctrine of unconscionability from a different angle diminishes or eliminates the third problem, the price term argument.<sup>149</sup> Although unconscionability does not diminish the holder in due course doctrine or the waiver of defense clause, these doctrines are not as determinative as one may think.<sup>150</sup> Recently, because of public policy concerns, courts have begun to chip away at the foundation of the holder in due course doctrine and the waiver of defense clause.<sup>151</sup>

#### A. *Unconscionability*

The equitable concept of unconscionability, found in section 2-302 of the Uniform Commercial Code, states:

*If the court as a matter of law finds the contract or any clause of the contract to have been unconscionable at the time it was made the court may refuse to enforce the contract, or it may enforce the remainder of the contract without*

142. Engel & McCoy, *Three Markets*, *supra* note 3, at 1299–1301 (describing the limitations of the contract defense of unconscionability).

143. *Id.*

144. *Id.* at 1301.

145. *Id.*

146. *Id.* “[A] secondary-market purchaser can defeat ‘personal’ defenses [only] if it meets the following requirements for a holder in due course: (1) the purchaser is the holder, (2) of a negotiable note, (3) who took the note for value (4) in good faith, and (5) without notice of the defenses.” *Id.*

147. ALLEN E. FARNSWORTH, *CONTRACTS* § 11.8 (4th ed. 2004) (“Instead of using a separate promissory note, financial institutions sometimes had retailers include in the contract of sale itself a clause known as a ‘waiver-of-defense’ clause . . . . Under such a clause the consumer agreed that, should the right to payment be assigned, the consumer would not set up any defenses against the assignee.”).

148. Engel & McCoy, *Three Markets*, *supra* note 3, at 1300.

149. See *infra* Part IV.C.

150. See Peterson, *supra* note 60, at 2234–37 (describing how “courts have developed a variety of mechanisms for allowing consumers to prevent enforcement of a waiver of defense clause, or deprive a loan assignee of holder in due course status”).

151. *Id.*

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*the unconscionable clause, or it may so limit the application of any unconscionable clause as to avoid any unconscionable result.*<sup>152</sup>

Although section 2-302 only governs “transactions in goods,” numerous courts have applied it, “either by analogy or by expression of general doctrine, to many other kinds of contracts.”<sup>153</sup>

Even though there exists no precise definition of unconscionability, the court in *Williams v. Walker-Thomas Furniture Co.*<sup>154</sup> provided one of the more lasting definitions, defining unconscionability as “an absence of meaningful choice on the part of one of the parties together with contract terms which are unreasonably favorable to the other party.”<sup>155</sup> Phrased another way, unconscionability has both a procedural and substantive element.<sup>156</sup> As courts refined the definition articulated by the *Williams* court, “an absence of meaningful choice” became synonymous with procedural unconscionability and “unreasonably favorable” likened to substantive unconscionability.<sup>157</sup> An absence of meaningful choice “encompass[es] not only the employment of sharp bargaining practices and the use of fine print and convoluted language, but [also] a lack of understanding and an inequality of bargaining power . . . .”<sup>158</sup> Substantive unconscionability arises where contractual terms are overly harsh or one-sided.<sup>159</sup> Thus, while procedural unconscionability is concerned with the element of unfair surprise, substantive unconscionability deals with contracts or contractual provisions which are so unfair that they shock the conscience.

It is now common practice for courts to require a complaining party to demonstrate that the contract is both procedurally and substantively unconscionable.<sup>160</sup> Each element, however, does not necessarily have to be to the same degree.<sup>161</sup> As Judge Mosk stated in *Armendariz v. Foundation Health Psychcare Services, Inc.*,<sup>162</sup> “[e]ssentially a sliding scale test is invoked [by the courts] . . . . [T]he more substantively oppressive the contract term, the less evidence of procedural unconscionabil-

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152. U.C.C. § 2-302(1) (1998).

153. FARNSWORTH, *supra* note 147, § 4.28.

154. 350 F.2d 445 (D.C. Cir. 1965).

155. *Id.* at 449.

156. FARNSWORTH, *supra* note 147, § 4.28.

157. *Id.* See, e.g., *Ingle v. Circuit City Stores, Inc.*, 328 F.3d 1165, 1170 (9th Cir. 2003) (quoting *A&M Produce Co. v. FMC Corp.*, 186 Cal. Rptr. 114, 122 (Cal. Ct. App. 1982)) (stating that unconscionability refers to “an absence of meaningful choice on the part of one of the parties together with contract terms which are unreasonably favorable to the other party”); *Stapp v. NCR Corp.*, 494 F. Supp. 2d 826, 836 (S.D. Ohio 2007) (citing *Raasch v. NCR Corp.*, 254 F. Supp. 2d 847, 860 (S.D. Ohio 2003)) (noting that a party must demonstrate both substantive unconscionability by showing respectively that the contract terms are so unfair, and by showing that there was an absence of meaningful choice).

158. FARNSWORTH, *supra* note 147, § 4.28.

159. *Id.*

160. *Id.*

161. Margaret M. Smith, Comment, *Adhesion Contracts Don't Stick in Michigan: Why Rory Got it Right*, 5 *AVE MARIA L. REV.* 237, 247 (2007).

162. 6 P.3d 669 (Cal. 2000).

ity is required to come to the conclusion that the term is unenforceable, and vice versa.<sup>163</sup> Significantly, however, some courts have found a contract unconscionable based on its substantive terms alone.<sup>164</sup> To that end, courts have ruled that the combination of gross excessiveness of price combined with the purchaser's unawareness of that fact is enough to find a contract unconscionable.<sup>165</sup> Additionally, courts have found a contract unconscionable based solely on procedural grounds when the process "rises to the level of misrepresentation, duress, or undue influence . . . ."<sup>166</sup>

### B. Waiver of Defense Clause and the Holder in Due Course

In general, "[an] assignee stands in the shoes of the assignor."<sup>167</sup> The default rule in the mortgage market remains unchanged.<sup>168</sup> In other words, the purchaser in the secondary market, the assignee, "takes subject to the claims and defenses that the borrower might assert against the original lender."<sup>169</sup> However, the waiver of defense clause and the holder in due course doctrine marginalize an assignee's legal liability.<sup>170</sup> Both rules—the waiver of defense clause and the holder in due course doctrine—have the same basic purpose of denying the borrower the use of contract defenses.<sup>171</sup>

Financial institutions in the secondary market (assignees) often have lenders include in the contract of sale a waiver of defense clause.<sup>172</sup> "Under such a clause the [borrower] agree[s] that, should the [mortgage] be assigned," the borrower will not assert any defense against the assignee.<sup>173</sup> For the most part, courts have upheld the doctrine under the basic premise "that after the financial institution has given value

163. *Id.* at 690.

164. See, e.g., *Maxwell v. Fidelity Fin. Servs., Inc.*, 907 P.2d 51, 59 (Ariz. 1995) (holding dual requirement "more coincidental than doctrinal"); *Sosa v. Paulos*, 924 P.2d 357, 360–61 (Utah 1996) ("Gross disparity in terms, absent evidence of procedural unconscionability, can support a finding of unconscionability." (quoting *Res. Mgmt. Co. v. Weston Ranch*, 706 P.2d 1028 (Utah 1985))); see also FARNSWORTH, *supra* note 147, § 4.28.

165. See, e.g., *Ahern v. Knecht*, 563 N.E.2d 787, 788, 792 (Ill. App. Ct. 1990) ("Gross excessiveness of price alone can make an agreement unconscionable"); *Sho-Pro of Ind., Inc. v. Brown*, 585 N.E.2d 1357, 1358, 1361 (Ind. Ct. App. 1992) (asserting that a home improvement contract is unconscionable when there is an unreasonable difference between the price charged and the fair market value of the services rendered); *Kugler v. Romain*, 279 A.2d 640, 652 (N.J. 1971) ("[A]n exorbitant price ostensibly agreed to by a purchaser of the type involved in this case . . . constitutes an [unreasonable] bargain from which such a purchaser should be relieved under Section 2 [of the Uniform Commercial Code]"). Commentators debate whether this scenario encompasses both substantive and procedural terms alone or an example of courts finding a contract unconscionable based solely on substantive elements. CALAMARI AND PERILLO ON CONTRACTS § 9.40 (5th ed. 2003).

166. FARNSWORTH, *supra* note 147, § 4.28.

167. *Id.* § 11.8 (noting that for the most part the aforementioned metaphor—"the assignee stands in the shoes of the assignor"—is an accurate generalization); see also *James Talcott, Inc. v. H. Corenzwit & Co.*, 387 A.2d 350 (N.J. 1978).

168. *Peterson*, *supra* note 60, at 2233.

169. *Id.*

170. *Id.*

171. *Id.*

172. FARNSWORTH, *supra* note 147, § 11.8.

173. *Id.*



in reliance on such a clause," the court should prohibit the consumer (borrower) from asserting contract defenses against financial institutions in the secondary market.<sup>174</sup>

A second qualification from the traditional common law rule—that "the assignee stands in the shoes of the assignor"—is the holder in due course doctrine.<sup>175</sup> This "rule states that if the assignee, in good faith, paid value for a negotiable promissory note, and lacked notice that the loan is in default . . . , then the assignee is considered a holder in due course."<sup>176</sup> Although the assignee will still be subject to "real defenses," including infancy and duress, the financial institution—assignee—will take the mortgage free and clear of many of the defenses which can be used by a borrower to avoid the effects of predatory lending, including that of unconscionability.<sup>177</sup> If the assignee is considered a holder in due course, courts are disinclined to allow borrowers to defeat predatory contracts by pursuing claims against the owner of their loans—namely those in the secondary mortgage market.<sup>178</sup> Courts, instead, instruct the borrower to pay the mortgage or go into foreclosure and at that point seek redress against the original lenders, an unacceptable option for many borrowers.<sup>179</sup>

In recent years, for public policy reasons, the courts began to chip away at the absolute effect of both the holder in due course doctrine and the waiver of defense clause.<sup>180</sup> As the Supreme Court of Florida stated when it addressed the waiver of defense doctrine, "[w]e believe the finance company is better able to bear the risk of the dealer's insolvency than the buyer and in a far better position to protect his interests against unscrupulous and insolvent dealers."<sup>181</sup> Numerous courts have echoed this very point refusing to enforce the waiver of defense clause solely on public policy grounds.<sup>182</sup> Fearing the case in which the waiver of defense clause survives an assault by the courts, most states enacted statutes applicable to consumer transactions prohibiting the waiver of defense clause, limiting their effectiveness, or depriving them of effect altogether.<sup>183</sup>

174. *Id.* (noting that the argument in favor of the "waiver of defense" clause is premised on free assignability).

175. Peterson, *supra* note 60, at 2233.

176. *Id.*

177. *Id.*

178. *Id.*

179. *Id.*

180. *Id.* at 2234.

181. Mutual Fin. Co. v. Martin, 63 So. 2d 649, 653 (Fla. 1953).

182. Fairfield Credit Corp. v. Donnelly, 264 A.2d 547 (Conn. 1969) (noting the use of a waiver of defense clause is "[a]n attempt to evade the clear prerequisites of negotiability"); Quality Fin. Co. v. Hurley 148 N.E.2d 385, 389 (Mass. 1958) ("[A] blanket provision like the waiver clause . . . should be disregarded as contrary to [policy]"); see also Peterson, *supra* note 60, at 2234.

183. FARNSWORTH, *supra* note 147, § 11.8. See, e.g., CAL. CIV. CODE § 1804.2 (West 1998).

As is the case with the waiver of defense doctrine, the courts, as of late, have scrutinized the holder in due course rule with renewed vigor.<sup>184</sup> The courts and UCC effectively limited the holder in due course doctrine by ensuring that an assignee meets a litany of technical requirements.<sup>185</sup> For example, the transfer of the negotiable instrument must be “negotiated” to the assignee requiring the transferor to endorse the instrument “either by writing on the paper itself or firmly affixing an ‘allonge’ . . . .”<sup>186</sup> In a perfectly regulated industry, many of the technicalities would have little effect but “[i]n the subprime mortgage market, some businesses have been less than perfect in correctly endorsing their notes,” giving borrowers the ability to assert the defense of unconscionability against the assignee.<sup>187</sup> Moreover, the courts refuse to allow financial institutions to benefit from holder in due course status when the institution remains closely connected to the original lender.<sup>188</sup> Finally, a developing body of case law denies holder in due course status to the assignee if, “in one way or another, the assignee had notice of the [borrower’s] defenses or was otherwise culpable in the [loan] originator’s [predatory] behavior.”<sup>189</sup> Although the courts have not completely eliminated the holder in due course doctrine, that same doctrine’s ability to protect assignees has been substantially diminished.<sup>190</sup>

### C. *Looking in Unexpected Places: Unconscionability*

A contract is unconscionable if it is predatory; this simple statement best illustrates the approach advocated for by this comment. Although simple, this theory still leaves some basic questions unanswered. First and foremost, is there any legal foundation or support for such a theory? Secondly, how do we determine when a contract is predatory and thus unconscionable as a matter of law? Moreover, what remedies does the unconscionability doctrine provide a borrower? Put another way, how is a borrower who has been affected by predatory lending benefited by the defense of unconscionability? Finally, have courts ever applied such a theory in other areas of the law?

Under a subsection of the unconscionability doctrine known as price unconscionability, gross excessiveness of price is itself unconscionable.<sup>191</sup> Various claims, some successful, under such a doctrine have emerged in an array of different transactions, including “rent-to-own contracts, loans and interest charges, royalties and rents, commodities prices, water bills, and contracts” in numerous other services.<sup>192</sup>

184. Peterson, *supra* note 60, at 2234.

185. *Id.* at 2235. See, e.g., U.C.C. § 3-302 (2003).

186. Peterson, *supra* note 60, at 2236.

187. *Id.*

188. *Id.* at 2236–37.

189. *Id.* at 2236.

190. See *supra* notes 184–89.

191. Frank P. Darr, *Unconscionability and Price Fairness*, 30 HOUSING L. REV. 1819, 1820 (1994).

192. *Id.* at 1821.

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Nevertheless, both courts and scholars have been increasingly skeptical of price unconscionability.<sup>193</sup> For example, in describing such cases, scholar Frank Darr commented that “[s]uccessful claims often resemble nothing more than judicial attempts to protect gullible consumers from extortionate prices.”<sup>194</sup> Judge Bracher, in *Carpenter v. Suffolk Franking Savings Bank*,<sup>195</sup> put it this way:

*[n]o doubt the contracts between the [mortgagors] and the bank were “adhesion” contracts, but we are not prepared to hold that they were unconscionable in the aspects here in issue . . . . Customers who adhere to standardized contractual terms ordinarily “understand that they are assenting to the terms not read or not understood, subject to such limitations as the law may impose.”*<sup>196</sup>

Underlying this criticism is the belief that the doctrine of unconscionability, as outlined in *Williams*,<sup>197</sup> requires both procedural and substantive elements as opposed to only procedural unconscionability—which is the case with the price unconscionability doctrine.<sup>198</sup>

More frequently, possibly in an attempt to subvert the criticisms of the price unconscionability doctrine, courts have limited the doctrine, finding a contract unconscionable only when gross excessiveness of price combines with a purchaser’s—borrower’s—unawareness of the excessive price terms.<sup>199</sup> Also note that such an approach responds to the problems with using the theory of unconscionability to resolve the predatory lending problem.<sup>200</sup> One may view these cases as having both procedural and substantive unconscionability, or, put another way, such contracts combine unfair terms, specifically excessive price terms, with a lender “unfairly surprising” the borrower.<sup>201</sup>

In *Ahern v. Knecht*,<sup>202</sup> for example, a homeowner brought an action against a repairman to recover for excessive repair charges.<sup>203</sup> After condemning the excessive price of the repair<sup>204</sup> and noting the plaintiffs’ ignorance of the procedures neces-

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193. See *infra* notes 194–96.

194. Darr, *supra* note 191, at 1820.

195. 346 N.E.2d 892 (Mass. 1976).

196. *Id.* at 900.

197. 350 F.2d 445, 449 (D.C. Cir. 1965) (defining unconscionability as “an absence of meaningful choice on the part of the parties together with contract terms which are unreasonably favorable to the other party”).

198. See Darr, *supra* note 191, at 1820 (“Generally, courts require the party asserting the unconscionability defense to show both substantive and procedural unconscionability.”).

199. See *supra* notes 164–66 and accompanying text.

200. See *supra* notes 144–48 and accompanying text.

201. CALAMARI AND PERILLO, *supra* note 165, § 9.40.

202. 563 N.E.2d 787 (Ill. App. Ct. 1990).

203. *Id.* at 788.

204. *Id.* The repairman charged the plaintiff a total of \$762 for the repairs. *Id.* The court stated that the repairman should have charged \$150 for the work that was done. *Id.*

sary to repair an air conditioner, the court proceeded to hold the contract unconscionable, specifically stating,

*[i]n view of the consumer's lack of experience in this type of transaction, the defendant's substantial charge . . . [and] his representations . . . persuades us that there was more than sufficient evidence for the trial court to set aside the unconscionable terms of the agreement and to allow defendant what it determined to be the actual value of his services.*<sup>205</sup>

Courts everywhere employ the same rationale, finding contracts unconscionable when they contain an excessive price provision combined with a consumer's ignorance of that fact.<sup>206</sup> Although, to this point, the courts have not applied this principle to predatory contracts or the mortgage market in general, one can easily imagine a repairman replaced by a lender, a borrower unaware of the complexities of the mortgage market in place of consumers unaware of the ins and outs of heating repairs, and an exorbitant interest rate or balloon payment substituted for an excessive repair cost.<sup>207</sup>

If anything, the disparities involved in predatory lending are even greater than those in basic consumer transactions. The substance of a predatory contract tends to contain an abundance of complicated terms, including interest rates, payment plans and penalties, balloon payments, and appraisals.<sup>208</sup> Compounding the problem is that most borrowers entering into these contracts are relatively unsophisticated and rarely enter into the most basic of contracts, let alone understand what it means to enter into a contract in the complex mortgage market.<sup>209</sup> In essence, the borrowers who are regularly the targets of predatory lending stand to lose significantly more than a consumer in a basic consumer contract and these same borrowers are just as incapable of recognizing the excessive fees hidden within a predatory loan.<sup>210</sup>

Applying the logic followed by the court in *Ahern*<sup>211</sup> to the problem of predatory lending provides future courts with a means with which to hold predatory contracts unconscionable. The obvious problem this presents is determining when a

205. *Id.* at 793.

206. CALAMARI AND PERILLO, *supra* note 165, § 9.40 & n.6; *see also supra* note 165 and accompanying text. 207. *See* Eggert, *supra* note 1, at 514–22 (discussing balloon payments and excessive prepayment penalties).

208. *Id.* at 513.

209. Susan E. Hauser, *Predatory Lending, Passive Judicial Activism, and the Duty to Decide*, 86 N.C. L. REV. 1501, 1509 (2008) (“Compounding the abuse, predatory lending practices have been heavily marketed to groups perceived by lenders as financially unsophisticated, including low-income, elderly, and minority borrowers.” (footnotes omitted)).

210. *Id.*; *see also* Laura Dietrich, Note, *Massachusetts' New Predatory Lending Law and the Expanding Rift Between Federal and State Lending Protection*, 26 B.C. THIRD WORLD L.J. 169, 179 (2006) (noting “[t]he harmful effect of predatory lending practices on American homeowners is massive” (emphasis added)); Eggert, *supra* note 1, at 507 (noting that predatory lending results in foreclosure).

211. 563 N.E.2d 787 (Ill. App. Ct. 1990).

mortgage contract becomes predatory and thus as a matter of law unconscionable.<sup>212</sup> As mentioned, under the unconscionability doctrine a lending practice is predatory if and only if a lending contract includes (1) unfair or excessive “price terms” along with (2) a borrower’s unawareness of such terms and conditions.<sup>213</sup> Fortunately, the existence of these two elements—unfair price terms in combination with a borrower’s surprise to find such terms—is universal to the practice of predatory lending.<sup>214</sup>

As discussed, predatory lending takes the form of many different practices.<sup>215</sup> No matter what practice or technique a predatory lender wishes to engage, at the heart of predatory lending are “fees and interest rates far greater than necessary to provide a reasonable, market-driven rate of return to the lender given the risk of lending to that particular borrower.”<sup>216</sup> Put simply, unreasonable fees and interest rates are a necessary element of predatory lending.<sup>217</sup> For example, a practice common to predatory lending is “high pressure and misleading sales and marketing techniques”—an approach that seems benign when it comes to fees and interest.<sup>218</sup> However, the point of such an approach is to force or pressure a borrower to sign a loan with unreasonable interest rates.<sup>219</sup> The practices of “stripping,” “flipping,” and “packing” all involve the use of interest rates and fees which are disproportionate and unreasonable compared to the borrower’s risk and needs.<sup>220</sup> The same holds true of balloon and penalty payments often hidden within the predatory contract.<sup>221</sup> In sum, almost universally, predatory lending encompasses exorbitantly high interest rates and fees, thus satisfying the first requirement of unconscionability, as laid out by the courts.<sup>222</sup>

If a borrower is aware of the use of oppressive price terms, then a lending practice does not qualify as predatory.<sup>223</sup> Providentially, almost without exception, every court and scholarly “definition” of predatory lending demands that a borrower is

212. See *supra* Part I (noting the difficulty in defining predatory lending).

213. CALAMARI AND PERILLO, *supra* note 165, § 9.40; see also *supra* notes 164–65 and accompanying text.

214. See *infra* notes 215–29 and accompanying text.

215. See *supra* notes 21–27 and accompanying text.

216. Eggert, *supra* note 1, at 514.

217. *Id.*

218. *Id.* at 516.

219. *Id.* (describing practices used by predatory lenders).

220. Ferguson, *supra* note 3, at 609–10. “Packing” is the practice of forcing or inducing borrowers to use some of their loans’ proceeds to pay for unnecessary or undesired products, such as single premium credit life insurance. *Id.* An especially damaging form of predatory lending is the origination of loans by a lender who has no reasonable expectation that the borrowers can repay them. *Id.* Lending to borrowers who cannot repay the loans is known as “equity stripping.” *Id.* Flipping is the early or frequent refinancing of a loan, normally with each new set of loan fees financed by the loan, so that the loan amount continually rises, even while the homeowner makes her payments. *Id.*

221. Eggert, *supra* note 1, at 519–20.

222. See *supra* notes 216–21 and accompanying text.

223. See *infra* notes 214–29 and accompanying text.

unaware of the oppressive terms within the contract.<sup>224</sup> In *American Financial Services Ass'n v. Toledo*<sup>225</sup> for example, the court understood predatory lending to “involve[ ] the use of fraud or deception, manipulation of the borrower through aggressive sales tactics, or taking unfair advantage of a borrower’s lack of understanding of loan terms.”<sup>226</sup> Similarly, in *In re First Alliance Mortgage Co.*,<sup>227</sup> the court characterized predatory lending as “the practice of making loans containing interest rates, fees or closing costs that are higher than they should be in light of the borrower’s credit and net income, or containing other exploitative terms that the borrower does not comprehend.”<sup>228</sup> These consistent characterizations lend support to the same result, namely that a borrower who is subject to predatory lending is de facto unsophisticated and consequently unaware of the excessive price, high interest rates or other “unfair” terms hidden within the contract.<sup>229</sup>

Looking back, it is no surprise that predatory lending universally encompasses both excessive price terms and a borrower’s unawareness of such terms.<sup>230</sup> After all, the goal of predatory lenders is to turn a significant and unreasonable profit by providing loans to, as one prominent individual put it, anyone that “could fog up a mirror, if you had red blood running through your veins, they would lend you money.”<sup>231</sup> To accomplish such a goal, predatory lenders need to “coerce or trick homeowners into obtaining loans with interest rates or fees higher than the borrowers’ credit profiles and the market would justify or loans larger than or different from what the borrowers need, want or can afford.”<sup>232</sup> Such an approach demands both excessive fees and a borrower’s ignorance.<sup>233</sup>

Although an argument that a contract is unconscionable if it is predatory may seem somewhat unique or foreign to contract law, courts implore a similar ap-

224. See, e.g., Engel & McCoy, *Three Markets*, *supra* note 3, at 1257 (defining predatory lending as the practice of making “exploitative high-cost loans to naïve borrowers” (emphasis added)); Rashmi Dyal-Chand, *Exporting the Ownership Society: A Case Study on the Economic Impact of Property Rights*, 39 RUTGERS L.J. 59, 83 n.120 (2007) (commenting that predatory lending “is the use by lenders of *deceptive*, manipulative, or coercive practices in order to induce borrowers to accept loans that (1) have interest rates or fees significantly above the current market rate given the risk profile of the borrowers or other terms significantly worse than the market norm offered by legitimate lenders, or (2) which leave the borrowers worse off than they would have been without any new loans, or (3) both.” (emphasis added)); see also *infra* notes 225–28.

225. 830 N.E.2d 1233 (Ohio Ct. App. 2005), *rev’d*, 859 N.E.2d 923 (Ohio 2006).

226. *Id.* at 1238.

227. 471 F.3d 977 (9th Cir. 2006).

228. *Id.* at 984.

229. See Eggert, *supra* note 1, at 507.

230. See *infra* notes 231–33 and accompanying text.

231. Eggert, *supra* note 1, at 506 (“Ronald J. Michnik, president of the Western New York Association of Mortgage Brokers, referring to the mortgage originating arm of United Companies Financial Corp., reported in *High Risk Loan Disaster a Bankrupt Mortgage Lender from Baton Rouge, La., Which Gave High-Risk Loans to People with Damaged Credit Ratings, Owns 126 Neglected Houses in Buffalo*, BUFF. NEWS, Dec. 17, 2000, at C5, 2000 WL 5703112.”).

232. *Id.* at 507.

233. *Id.* at 507, 633.

proach and logic to contracts of adhesion.<sup>234</sup> Courts and legal scholars alike define an adhesion contract as “a standardized contract, imposed and drafted by a party with superior bargaining power, which relegates to the subscribing party only the opportunity to adhere to the contract or reject it.”<sup>235</sup> As the court in *Neal v. State Farm Insurance Co.*<sup>236</sup> stated, such contracts do not “issue from that freedom in bargaining and equality of bargaining which are the theoretical parents of the American law of contracts.”<sup>237</sup> Adhesion contracts, however, are not necessarily unconscionable but only procedurally unconscionable, meaning they are not void or voidable without some degree of substantive unconscionability.<sup>238</sup> Nonetheless, as the court in *Ting v. AT&T*<sup>239</sup> stated “[a] contract is procedurally unconscionable if it is a contract of adhesion, *i.e.*, a standardized contract, drafted by the party of superior bargaining strength, that relegates to the subscribing party only the opportunity to adhere to the contract or reject it.”<sup>240</sup> Such language indicates that a theory holding predatory contracts unconscionable will find firm footing in the jurisprudence of the United States courts.<sup>241</sup>

The successful use of the unconscionability doctrine provides a buyer with a litany of promising remedies. Particularly promising is the UCC<sup>242</sup> permitting the courts to refuse to enforce the contract, to excise an unconscionable clause, or to limit the application of such a clause.<sup>243</sup> Moreover, recently the courts expanded upon the basic terms in the UCC by “remaking bargains by reducing price terms, increasing a duration term, and reducing interest rates.”<sup>244</sup> Such remedies enable the courts to renegotiate a predatory contract in order to ensure that its terms are fair and equitable to all the parties involved, thus providing the buyer with an opportunity to stave off imminent foreclosure.<sup>245</sup>

One can imagine, for example, a contract containing excessive interest rates. This same contract could potentially include payment penalties or balloon payments almost ensuring foreclosure.<sup>246</sup> Couple such a contract with the borrower’s unawareness of the oppressive interest rates and penalty payments and the result is an

234. Sierra David Sterkin, Comment, *Challenging Adhesion Contracts in California: A Consumer’s Guide*, 34 GOLDEN GATE U. L. REV. 285, 298 (2004) (“The process of determining whether a contract is unconscionable is directly linked to a determination that the contract is adhesive”).

235. *Id.* at 289.

236. 10 Cal. Rptr. 781 (Cal. Dist. Ct. App. 1961).

237. *Id.* at 784.

238. See Sterkin, *supra* note 234, at 298 (noting in California, when a contract is found to be adhesive, that contract is considered procedurally unconscionable).

239. 319 F.3d 1126 (9th Cir. 2003).

240. *Id.* at 1148.

241. See *supra* notes 236–40 and accompanying text.

242. U.C.C. § 2-302 (2003).

243. *Id.*

244. CALAMARI AND PERILLO, *supra* note 165, § 9.39.

245. *Id.* § 9.38 (noting that unconscionability was developed primarily in equity).

246. Eggert, *supra* note 1, at 507, 518–20.

unconscionable contract.<sup>247</sup> A court confronting such a contract, under the doctrine of unconscionability, could rewrite the oppressive terms in order to ensure that the terms are fair and equitable to all parties, including the formerly oppressed borrower.<sup>248</sup> With a fair and equitable contract in hand a borrower can now afford to make his regular mortgage payments and thus not only stave off foreclosure but begin the process of owning a home, at least that is the hope.<sup>249</sup>

#### D. Qualifications

The unconscionability doctrine is not a perfect solution nor is it a substitute for regulation.<sup>250</sup> Of course, costs associated with litigation may prevent a buyer from ever entering the courtroom and thus deny him the opportunity to rebut enforcement through the defense of unconscionability.<sup>251</sup> Additionally, it is unlikely that this theory will end the practice of predatory lending, but instead help borrowers on a more individualized basis.<sup>252</sup> To this point, however, regulation has been no more effective in curtailing predatory lending.<sup>253</sup> Moreover, like any regulation or contract provision, one cannot be sure that an unsophisticated borrower will become aware of this theory.<sup>254</sup> In the end, no one, including me, can force a borrower to know that he has recourse, or that the doctrine of unconscionability is available to him.<sup>255</sup> The implementation of this approach along with many others can start to deter, if not altogether prohibit, lenders and individuals in the secondary market from engaging in predatory tactics and in the process restore order to the mortgage market.<sup>256</sup>

### V. CONCLUSION

Predatory lending has devastated the mortgage market and as foreclosures rise, politicians and scholars are in the unenviable position of finding a solution.<sup>257</sup> The ineffectiveness of regulations, specifically HOEPA, TILA and RESPA, only compounds matters.<sup>258</sup> A solution may be found in the courts through the use of con-

247. *Id.* at 507 (noting that predatory lending includes the borrower's ignorance of such terms).

248. CALAMARI AND PERILLO, *supra* note 165, § 9.39.

249. *See id.* (noting that a court can rewrite a contracts to make the terms more fair and equitable).

250. *See supra* Part IV.C. (discussing how unconscionability works with respect to predatory lending).

251. *See* Theodore J. St. Antoine, *Mandatory Arbitration: Why It's Better Than It Looks*, 41 U. MICH. J.L. REFORM 783, 791 (2008) ("One of the key potential advantages of employment arbitration over litigation is that the relatively high costs of litigation inhibit access to the courts by lower to mid-income ranges [sic] employees.").

252. *See supra* Parts IV.A.–C.

253. *See supra* Part III.

254. *See supra* Parts IV.A.–C.

255. *See, e.g.*, Merle H. Weiner, *International Child Abduction and the Escape from Domestic Violence*, 69 FORDHAM L. REV. 593, 625 n.141 (2000) (noting poor women are generally unaware of legal remedies).

256. *See supra* Parts IV.A.–C.

257. *See supra* note 3 and accompanying text.

258. *See supra* Part III.



## PREDATORY LENDING: WHAT WILL STOP IT?

tract law and the doctrine of unconscionability.<sup>259</sup> By no means will such an approach eradicate the problems of predatory lending; more likely the defense of unconscionability can serve as a useful supplement to regulation.<sup>260</sup> Nonetheless, scholars and politicians have for too long ignored the doctrine of unconscionability as a way to resolve predatory lending; such a doctrine warrants at least a look.<sup>261</sup>

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259. *See supra* Part IV.

260. *See supra* Part IV.D.

261. *See supra* Parts III.–IV.