# Litigating Consumer Debt Collection: A Study

**By Mary Spector**

Recent press reports have focused attention on some of the weaknesses in the collection of credit card debt.[1] However, relatively little empirical data exists regarding these deficiencies. The project described in this Article was designed to increase our understanding of how debt buyers and their attorneys conduct litigation to collect consumer debts and the effect of such litigation on consumers and the courts.

Much of modern collection litigation begins with portfolios of consumer debt that are packaged and sold as assets for entities whose primary business is collecting those debts.[2] The debt buyer purchases—for pennies on the dollar—debts that have been deemed uncollectable by the original creditor, and then attempts to collect the full face value of those debts through lawsuits against consumers that often result in default judgments.[3]

At the time of the sale, the debt buyer rarely receives more than a computer record summarizing the original creditor's records. Although the summaries generally contain the consumers' names, addresses and account numbers, as well as the total amount each owes at the time of sale,[4] some sellers do not vouch for the accuracy of the information they provide leaving the debt buyer without the means to verify it.[5] Nevertheless, in some cases, information may be sufficient to support an agreement between the debt buyer and an individual consumer to settle or repay the debt. Consumer advocates claim that attorneys representing debt buyers in court rarely produce more than summary information and yet still obtain judgments that are enforceable by garnishing wages, bank accounts, and other non-exempt property.[6] In some cases, debt buyers initiate suits to collect debts previously discharged in bankruptcy or debts that were repaid years before. In other cases, the person sued is not the real debtor but is the victim of mistaken identity or identity theft.[7]

Reportedly, debt buyers regularly obtain judgments on the basis of form pleadings that, on their face, fail to comply with applicable procedural, substantive, or evidentiary rules.[8] For example, suits may fail to sufficiently identify the parties to the suit,[9] fail to allege facts giving fair notice of the claims asserted,[10] or fail to allege facts giving fair notice of whether the claims might be subject to limitations or other defenses.[11] Conclusory allegations regarding the amount of debt with little, if any, information about its calculation and "robo-signed" affidavits also make it difficult for the consumer to effectively prepare a defense, especially without representation by an attorney.[12]

In most states, laws and rules of procedure that govern all litigation also govern consumer debt litigation. Such rules place the burden of raising deficiencies in pleading and the burden of proof on the opposing party, who waives such an objection if not raised in timely manner.[13] Many defendants, if they appear at all, often appear without counsel. Unfortunately, this frequently results in the entry of default judgments solely on the basis of unchallenged defective pleadings without any evidence of debt presented to the court.[14]

In early 2008, virtually no empirical data existed to substantiate the growing concerns of consumer advocates.[15] This project was a first step to collect and analyze data regarding collection litigation. Litigation files containing petitions, answers, evidence of service, motions, and dispositive orders were reviewed. Information was collected and analyzed and, in the end, the data confirmed some of the more troubling reports regarding the failure of collectors to provide information regarding the debt to consumers in litigation.[16]

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However, before discussing the methodology and findings of the project, the Article will discuss the context in which consumer debt litigation arises.

## Consumer Debt and Its Collection: A Broken System[17]

### Scope of Debt

The Fair Debt Collection Practices Act (FDCPA)[18] was enacted in 1977 to "eliminate abusive debt collection practices by debt collectors, to insure that those debt collectors who refrain from using abusive debt collection practices are not competitively disadvantaged, and to promote consistent State action to protect consumers against debt collection abuses."[19] Since then, total revolving consumer debt has grown exponentially. The modern debt industry is a by-product of the massive expansion of consumer lending by banks and other major financial institutions. In 2003, Americans had 1.46 billion credit cards, an average of five credit cards per person.[20] In 2009, outstanding consumer loans exceeded $2.5 trillion—double the amount one decade earlier—of which debt from credit cards and other revolving credit debt was nearly $1 trillion.[21] Although the amount of outstanding debt has decreased since 2008, as of March 2012, American consumers still held nearly $801 billion of revolving, unsecured debt.[22] Additionally, the delinquency rates for all consumer loans and consumer credit cards remained steady through 2011.[23] Similarly the charge-off rates for all consumer loans and credit cards remained steady through 2011.[24]

The debt collection industry has grown and changed to keep up with the increasing amount of delinquent consumer debt. By 2007 the debt-collection industry employed 217,000 people and reported annual revenue of $58 billion from consumer collections.[25] This growth also parallels increases in the number of new collection cases filed each year. For example, in one jurisdiction, a judge was forced to limit one law firm's filings to no more than 500 new debt-collection cases every two weeks.[26] It also created an environment in which the debt buying could emerge and subsequently thrive.

### The Debt Buying Industry

The debt buying industry, a subset of the larger collection industry, experienced tremendous growth over the last 15 years, with analysts estimating that approximately 450 entities acquired more than $100 billion in distressed debt in 2009.[27] Debt buyers do not originate delinquent accounts, they purchase portfolios of delinquent debt after the original lender or intermediate debt buyer ceases collection efforts or otherwise charges-off an account.[28] Debts may be bundled into portfolios with other debts having similar characteristics, such as age, type of debt, and location of the debtor, and then put out for competitive bids, often amounting to only a fraction of the face value of the debt.[29]

Industry trade associations encourage debt buyers to employ due diligence to avoid the purchasing of debts that were previously discharged in bankruptcy or barred by limitations, and debt buyers may take steps to avoid debt that was incurred fraudulently through identity theft or otherwise.[30] Admittedly, however, these efforts do not prevent attempted collection of stale or discharged accounts, known as "zombie debt," which, instead of disappearing, rises from the dead and is re-sold at bargain prices.[31] Likewise, industry efforts have not prevented purchase of debts the seller cannot verify which may be the subject of future litigation and the source of concern for consumers and their advocates.[32]

### Collecting Debt: The Legal Framework

The FDCPA, designed to prevent consumer deception and abuse during the collection process, is the primary federal statute governing the behavior of collectors. It regulates the time and place at which collectors may communicate with consumers and the appropriate method and content of such communications.[33] Enforced by The Federal Trade Commission (FTC), the Act also provides consumers with a private right of action for violations. In addition to the FDCPA, other federal laws regulate creditor's conduct. They include the Equal Credit Opportunity Act, which prohibits discrimination in connection with a credit transaction, and the Fair Credit Reporting Act, which limits collectors' ability to report accounts in collections that pre-date the report by more than seven years.[34]

In addition, forty-two states supplement the FDCPA with legislation governing debt collection.[35] Of those, a majority permit a private right of action for consumers harmed by debt collectors' unlawful conduct and some provide private remedies for unfair or deceptive acts and practices. A majority of states also require debt collection entities to obtain a license, post a bond, or register with the state. For example, in Texas, although a license is not required, an entity that fails to post the required bond may be enjoined from collecting debts, liable for civil penalties to consumers harmed by its conduct, and subject to criminal penalties.[36]

Within this framework, collection agencies usually begin with informal collection efforts such as contacting the consumer by phone or mail to encourage payment.[37] Under the FDCPA, the limited information acquired by the debt buyer when it purchases a consumer's debt portfolio may be sufficient to satisfy the collector's obligations to validate the consumer's debt.[38] It may also be the starting point for the debtor and debt buyer to negotiate a payment schedule or a reduced lump sum payment.

When informal collection methods do not result in settlement of the account, debt buyers increasingly turn to litigation or arbitration, which generally results in a judgment against the consumer.[39] Once collectors obtain a judgment, they have additional, powerful tools at their disposal, such as wage garnishment and property garnishment, to collect on the judgment.

Because most of the litigation occurs in state courts, FDCPA imposes no obligations on collectors' conduct in litigation other than requiring that suits be filed in the venue in which the consumer signed the contract or in which the consumer resides at the commencement of litigation.[40] Instead, state procedures and law almost exclusively govern the litigation of debts.

Due process requires that the defendant be given an opportunity to be heard before the plaintiff can establish his or her right to judgment in any type of litigation.[41] While modern pleading rules do not require that plaintiffs provide detailed allegations of fact, the defendant generally must receive notice sufficient to prepare a defense, generally who is bringing the claim and the subject matter of the suit are sufficient.[42] In all jurisdictions, rules of procedure, evidence, and professional responsibility govern the commencement and conduct of litigation. Such rules place the burden or raising deficiencies in pleading and proof on the opposing party, and that party's objections may be waived if not raised within a timely manner. While the rules vary by state, and even within the states, one thing is clear: the rate of default judgments in consumer debt collection cases is reported to have reached 95 percent in some jurisdictions and may be double the default judgment rate in debt cases generally.[43]

The high default judgment rate is especially troubling because debt buyers usually take the debt subject to all the consumer's potential defenses to payment, such as deceptive practices surrounding the extension of credit, limitations, unconscionability, or claims about insufficient quality of the goods or services.[44] Some, if not all, of those defenses may be available to at least some defaulting consumers. However, by failing to appear, the consumer waives valid counterclaims or offsets arising from the underlying transaction as well as affirmative claims arising out of attempts to collect the debt. Indeed, one study dating back more than 20 years found that more than half of the consumers against whom default judgments were entered had good faith defenses to collection and more than 70 percent "may have had defenses" to the litigation.[45]

## Federal Trade Commission Recommendations

In July 2010, based on the information collected at a series of roundtables and from the FTC's extensive experience in debt collection matters, it issued a report of findings and conclusions regarding debt collection litigation and arbitration and their effect on consumers.[46] In general, the FTC reported a broad consensus among roundtable participants regarding low rates of consumer participation in collection litigation, while it noted a wide divergence regarding the reasons for default. Representatives of the collection industry generally asserted that consumers choose not to defend collection litigation because they know they owe the debts and do not have any viable defenses. Some also conceded that consumers' trepidation about the legal process and inability to retain counsel may also be factors. Consumer advocates, on the other hand, generally attributed the low participation rate to inadequate notice of the action or procedural and economic hurdles that make it difficult for debtors to defend themselves.[47] Judges who participated in the roundtables expressed concern that consumer defendants were often puzzled by allegations that they owe debt to an entity that they do not recognize as well as the timing and amount of the alleged debt.

Acknowledging thtat no empirical data were presented, the FTC nevertheless urged the states to take steps to increase protections available to consumers in debt collection litigation by adopting measures insuring that collectors' complaints contain, at a minimum, the following information: 1) the identity of the original creditor; 2) the date of default or charge-off and amount due at that time; 3) the name of the current owner of the debt; 4) the amount currently due on the debt; and 5) a breakdown of the amount due, showing principal, interest, and fees.[48] The study described in this Article is a first step in collecting such data.

## Methodology: Collecting the Data

This project examined litigation files of the Dallas County Courts at Law. The Texas Office of Court Administration reported that in 2007 suits on debt accounted for more than 78 percent of the civil cases filed in county-level courts in Dallas County, but only 43.8 percent of civil cases filed in county courts statewide.[49] Suits on debt are one of the seven categories of civil cases and are defined as "[s]uits based on *enforcing* the terms of a certain and express agreement, usually for the purpose of recovering a specific sum of money."[50] In addition to consumer debt cases, this category also includes suits to recover wages or sums of money allegedly due under a variety of contracts. These figures for Dallas courts were also consistent with reports from other jurisdictions finding that civil litigation is concentrated in cities and counties with significant minority populations, lower median income, and lower home ownership rates.[51]

Although debt buyers seeking between $500 and $10,000 may file their cases in justice courts, county courts-at-law, or district courts in Dallas County,[52] only the case files from the county courts-at-law were examined. Statutory county courts were selected for three primary reasons. First, the five county courts-at-law are contained in a single building and use a centralized filing system that enabled researchers to work in a single location, thus providing efficiencies for the research. In contrast, the justice courts serve five geographically diverse precincts and are contained in ten different buildings spread throughout the county. Moreover, each justice court maintains its own files—meaning records for one precinct may be located almost twenty-five miles from the records for another. Secondly, because the justice courts serve a smaller geographic area within the county, it could be expected that data from courts with countywide jurisdiction would reflect a broader picture than data collected from a single geographic precinct within a county because each individual justice court precinct is significantly less diverse than the county as a whole. For example, within Justice Court Precinct 1, individual voting tracts may be as much as 95 percent non-Hispanic Whites, while non-Hispanic Whites may comprise less than two percent of the population in an individual voting precinct for Justice Court Precinct 3.[53] The third—and in some ways most important—reason for selecting the county courts at law is that corporate parties must retain counsel to enter an appearance in the county courts; only individuals can appear *pro se*.[54] Because one goal of the project was to examine the conduct of debt buyers and their attorneys in litigation, it was necessary to select a court in which debt buyers who were not individuals could appear in court only through an attorney.[55]

After the court was selected, it was necessary to create a random sample of cases to analyze. In 2007, a total of 16,819 civil cases were filed in the jurisdiction. Each file generally contains a petition, summons, record of service, and dispositive order. While docket information may be reviewed remotely over the Internet, the cases are not electronically searchable by type of case. Because individually reviewing all 16,819 cases was not feasible, a random sample was generated using cluster sampling. Researchers using cluster sampling divide an entire population into clusters or blocks. After the blocks are randomly selected, researchers gather data from all of the elements within the selected block.[56]

After reviewing an experimental sample of approximately 150 cases, a final sample of 21 clusters containing 2,019 cases was generated providing a margin of error of approximately four percent.[57] Researchers then examined the files contained in each cluster and eliminated all cases not involving debt buyer plaintiffs seeking to collect individual consumer credit card debt. This process produced a set of 507 cases. For each case, researchers recorded and coded information in thirty different categories. Inconsistent data triggered reexamination of the relevant original case file.

Coded information was divided into four general categories. The first category included identifying information, such as the case number, date of filing, date of closing, name of plaintiff/assignee and its attorney, name of original creditor, and name and, if possible, gender of defendant. The second category contained defensive information—for example, whether there was service on the defendant, whether there was an answer or evidence of appearance, and whether an attorney appeared on behalf of the defendant and, if so, his or her identity. Where there was evidence that an attorney appeared, researchers also reviewed the answer to determine the nature of any defenses and counterclaims. The third category included information about the claims alleged in the petition: the amount sought, including the amount of principal and interest if separately alleged; amounts of attorneys fees sought and the method of calculating them; and details of any other charges or fees, such as late payments or over-the-limit fees. Researchers also noted whether the file contained an affidavit or other documentary evidence supporting the petition. When files contained affidavits, researchers recorded the identity and business affiliation of the affiant and noted whether the plaintiff filed any supporting documents, such as a credit agreement or records of payment history identifying the date of last payment or other date of default; they also noted whether plaintiff served discovery on the defendant. Finally, researchers collected data about the outcome of the case; whether it resulted in a default judgment, dismissal without prejudice, agreed judgment, dismissal with prejudice, or affirmative recovery for the defendant.[58]

## Findings

The data indicated that approximately 25.11 percent of the total cases filed in Dallas County Courts-at-Law during 2007 were debt-buyer suits to collect consumer debt. When measured against the total number of suits on debt, simple calculations suggest that one-third of all debt cases filed in Dallas County in 2007 were suits seeking recovery of a delinquent credit card account by someone other than the original creditor.[59]

These figures are consistent with reports from other jurisdictions. For example, 72.8 percent of all civil cases filed in Kansas in 2007 were "seller plaintiff (debt collection)" cases, a number that is very close to the 75.3 percent reported in Dallas County.[60] Nevertheless, perfect comparison with other jurisdictions is difficult. Aside from differences in substantive law that may influence the decision to file a suit to collect debt, there are a number of practical considerations that contribute to the levels of concentration of such cases in certain jurisdictions. Perhaps the most obvious is the range of courts available to a plaintiff seeking to file a lawsuit to collect debt. Because the Dallas debt buyer can choose between three jurisdictions for filing, one might expect cases in any one of the jurisdictions to occupy a smaller portion of the docket than in a jurisdiction where a plaintiff's choice of forum is far more limited. In New York City, for example, a debt buyer seeking to recover less than $25,000 *must* file in the New York City Civil Court, where debt buyers filed more than 200,000 cases in 2009.[61]

Economic and other non-legal factors may also explain differences among jurisdictions. For example, experts reported that during 2007, economic conditions were slightly better in the geographic region of the country that includes Dallas than in other parts of the country. Thus, even if these percentages are lower than figures reported in other jurisdictions, the debt buyer cases still make up a sizeable portion of the Dallas County docket.

## The Parties: Plaintiffs, Original Creditors, and Plaintiff's Attorneys

### Plaintiff Debt-buyers

Although hundreds of debt buyers operate nationwide, just thirty-five different debt buyers appeared in the 507 cases; an even smaller number were responsible for the majority of cases filed. The two most frequently named plaintiffs initiated 182 cases, or slightly more than 35.9 percent of the total filed, and the top five plaintiffs accounted for 326 cases, or nearly 64.3 percent of the total filed. The identities and frequency of filings of the five most active plaintiffs are set out below.

### Identity and Frequency of Plaintiff

Of the thirty-five different debt buyers represented in the sample, nine, or about 25 percent, failed to comply with the Texas law requiring debt collectors to file a

| **Plaintiff** | **Number of Cases** | **Percentage** |
|---|---|---|
| Dodeka LLC | 107 | 21.10% |
| LVNV Funding LLC | 75 | 14.79% |
| CACV of Colorado LLC | 52 | 10.26% |
| CACH LLC | 52 | 10.26% |
| Resurgence Financial LLC | 40 | 7.89% |
| **Total** | 326 | 64.30% |

bond, and did not have active bonds on file with the Secretary of State for the calendar year of 2007. Their failure to do so amounts to a *per se* violation of the Texas law.[62] These unbonded plaintiffs accounted for thirty-eight cases, or 7.49 percent of cases examined in the study. While those numbers may seems insignificant at first glance, when that percentage is applied to the total number of cases filed in the county, it can be estimated that unbonded debt buyers filed approximately 1,200 cases during 2007. Had any of the defendant consumers in those cases been aware of the unbonded status of the plaintiff, they might have been able to avoid the lawsuits altogether and even obtain injunctive relief and statutory damages for the debt collectors' illegal conduct. Yet, none of the thirty-five defendants sued by unbonded debt buyers raised those claims or defenses. Indeed only two defendants sued by unbonded plaintiffs even appeared and their cases were concluded with agreed judgments requiring a monthly payout. The remaining cases resulted in a default judgment.

### Original Creditors

Researchers could not always determine the identity of the original creditor from the plaintiff debt buyer's allegations. In many of the cases in which plaintiffs did not formally allege the original creditor's identity, the identity was often indicated in the caption or style of the case. When it was not, and the petition did not contain any allegations or hints of any kind regarding the original creditor's identity, careful review of affidavits or exhibits to affidavits submitted in support of the petition provided the only clues to the original creditor's identity. In eight cases, however, researchers were not able to locate any information in the case file regarding the identity of the original creditor.

Including the identity of the original creditor in an allegation can be critical to ensure due process, to establish that the plaintiff actually owns the account, and to give notice to a defendant of the availability of defenses and counterclaims. Proper identification of the original creditor may also be necessary to comply with FDCPA's obligation to validate the debt.[63] Additionally, slight differences in corporate names of creditors can carry legal significance. For example, Texas law contains numerous regulations regarding the reservation, registration, and use of corporate names. Among them is the requirement that out-of-state financial institutions must file an application with the Secretary of State before operating a branch within the state.[64] State law also requires that an entity doing business under a name other than its legal name file an assumed name certificate with the Secretary of State and in each county in which it maintains business premises.[65] An entity that fails to do so may be liable to an opposing party for the "expenses incurred, including attorney's fees, in locating and effecting service of process on the defendant."[66] Subtle differences in entity names can also signify independent corporate entities with independent legal rights and responsibilities. Significantly, however, these differences often go unnoticed by individual consumers who, without attorney representation, may not fully appreciate the legal significance of proper identification.

Even when the plaintiff debt buyer provided some information with which to identify the original creditor, the data contained substantial variations. For example, 133 cases identified original creditors whose names contained some variation of the word "Citi."

Many variations were also found with "Chase" as part of the original creditor's name.

### Number of Original Creditors with "Chase" in the name

None of the nine "Citi" entities that plaintiffs identified as original creditors were actually registered—as required by law—with Texas' Office of the Secretary of State during the period in which the cases were filed or pending. A search of the online business service, which is provided by the Office of the Secretary of State, for the term "Citibank" revealed nine filings; however, only one of them—an entity identified as "Citibank Texas N.A."—was in existence for any length of time prior to and during the year in which the collection cases were filed. Yet, that entity was never identified as an original creditor in the cases examined. The charter for a second entity, "Citibank, N.A.," was cancelled in October of 2007, and charters for another five were either "cancelled," "dissolved," or "forfeited" prior to 2007; the remaining entities did not appear to be related.[67]

Likewise, a search for the term "Chase Manhattan Bank," identified as an original creditor in thirty-nine cases, revealed a total of twenty-four filings with the Secretary of State. Only one of those filings was an exact

| Name of Original Creditor | Number of Cases |
|---|---|
| Citibank | 77 |
| Citibank (South Dakota) | 39 |
| Citi-Sears | 9 |
| Citibank (South Dakota) N.A. | 3 |
| Citibank South Dakota | 1 |
| Citibank/Home Depot | 1 |
| Sears-Citi-Sears | 1 |
| Sears or Citibank | 1 |
| Citibank Credit Services, Inc. (USA) | 1 |
| **Total** | 133 |

*Number of Original Creditors with "Citi" in the Name*

| Name of Original Creditor | Number of Cases |
|---|---|
| Chase Manhattan Bank | 39 |
| Chase | 24 |
| Chase Manhattan | 5 |
| Chase Visa/ Master Card | 5 |
| Chase/ Bank One | 3 |
| Bank One (subs. merged w/ Chase Bank) | 2 |
| Chase Bank | 1 |
| Chase Bank NA | 1 |
| Chase Bank USA | 1 |
| Chase Bank USA NA | 1 |
| Chase Manhattan Bank USA | 1 |
| Chase Manhattan Bank USA, NA | 1 |
| JP Morgan/ Chase | 1 |
| **Total** | 85 |

match, but that entity was identified as a "foreign corporate fiduciary" whose charter was cancelled in 2002. The same search revealed a close match with another entity identified as "*The* Chase Manhattan Bank" (emphasis added) that had a valid charter pre-dating and post-dating 2007. However, that entity was also not identified as an original creditor in any of the eighty-five "Chase" cases. Further research revealed no other matches to the remaining "Chase" entities identified.[68]

Improper identification of an original creditor has at least two consequences. First, it can easily frustrate a consumer's third-party claim by making it difficult—if not impossible—to locate and serve the creditor, much less enforce any judgment obtained against it. Secondly, it can serve as the basis for a valid counterclaim against the debt buyer in its collection case. Had the defendants in any of the "Citi" or "Chase" cases established that the plaintiff debt buyer improperly identified the original creditor, they may have been entitled to statutory damages for a violation of the FDCPA's requirement to accurately validate the debt.[69]

## Plaintiffs' Attorneys & Law Firms

Similar results to those found among plaintiffs and creditors also existed among the law firms they represented. In fact, six law firms were responsible for filing 356—or 69.5 percent—of the 509 cases in the sample. Although the economics of the debt collection practice was beyond the scope of the project , the volume of cases handled by individual lawyers and their firms must be considered as a factor in the conduct of the collection litigation and should be the subject of further research.

### *Service and Appearance*

Somewhat surprisingly, plaintiffs did not accomplish service in more than 12 percent of the cases filed; all of those cases were dismissed without prejudice. Large numbers of filings that are not fully litigated suggest, at a minimum, an unnecessary burden on the courts. In certain circumstances they may also represent the use of false or unfair collection practices.[70]

Far more insidious than a dismissal after non-service, however, is the entry of a default judgment after the filing of a false affidavit of service, a phenomenon known colloquially as "sewer service." In California, it is unlawful for a collector to engage in judicial proceedings to collect a debt when it knows that service of process has "not been legally effected."[71] Recent efforts to curb this practice in New York City resulted in the arrest of at least one process servicer for filing fraudulent affidavits in connection with non-service of defendants and led to stricter requirements for process servers doing business in the city.[72] However, the rate of dismissals following non-service—12 percent—in Dallas County cases suggests that sewer service may not be as prevalent as it is in California, New York City, and elsewhere.

When evidence in the file indicated that the defendant had been served, researchers recorded any indication that the defendant attempted to respond to the suit as an "appearance" even if the communications did not technically comply with the procedural requirements for an "answer."[73] Under these criteria, defendants appeared in 102 cases or 20.12 percent of the time. However, because a defendant cannot "appear" if the plaintiff did not accomplish service, a more accurate measure of the appearance rate considers only the cases in which the defendant was served. Under this measurement, the defendants appeared in 22.87 percent of the cases in which they were served. Under each measure, the appearance rate is nearly twice what the Urban Justice Center reported in New York City courts and may be partially attributable to the higher rate of sewer service there.[74] The broad definition of "appearance" used in the Dallas study may explain some of the difference between the two rates of appearance; the number may also suggest that Dallas plaintiffs did a better job of actually accomplishing service than their counterparts elsewhere.

The data does not provide sufficient information to determine why defendants did or did not appear, it nevertheless suggests at least one factor that may influence defendants' decisions regarding appearance: the amount in controversy. Of the 102 defendants who appeared, fifty-three, or slightly more than half, did so in cases in which the plaintiff sought $5,000 to $10,000, twenty-nine appeared in cases seeking over $10,000, and twenty appeared in cases seeking less than $5,000. The data shows higher appearance rates in cases seeking between $5,000 and $10,000 and lower rates above and below those values.

## Substance of the Pleadings

As previously discussed, the FTC advised that collectors' petitions should allege five categories of information: "(1) the identity of the original creditor; (2) the date of default or charge-off and amount due at that time; (3) the name of the current owner of the debt; (4) the amount currently due on the debt; and (5) a breakdown of the amount due, showing principal, interest, and fees."[75] Of those five categories, only two were routinely included in the cases examined. Indeed, all of the cases contained some allegation regarding the identity of the plaintiff or current owner of the debt and most contained allegations regarding the original creditor. Plaintiffs' petitions otherwise failed to allege any of the remaining kinds of information the FTC recommended.

Likewise, in all of the cases reviewed, plaintiffs also specifically alleged the dollar amount sought. Somewhat surprisingly, more than half of the cases sought less than $10,000, an amount over which the justice court has concurrent jurisdiction.[76] Additionally, more than 30 percent of the cases contained allegations regarding the calculation and amount of attorneys' fees sought. Less than five percent of the cases, however, contained any allegations breaking down the total amount sought into component parts of principal, interest, and fees. Likewise, less than five percent of cases contained allegations regarding payment history, such as date of default or date of the last payment. In other words, in more than 95 percent of the cases, plaintiffs failed to provide defendants with *any* information in at least two of the categories the FTC identified as being critical to providing due process. The following table illustrates the type and frequency of allegations found in the 507 case files.

## Types and Frequency of Allegations

While the absence of certain allegations is troublesome, the data also revealed significant problems with many of the allegations that *were* present, particularly with regard to supporting affidavits. Problems with supporting affidavits fall into two general categories. The first involves misuse of the sworn account procedure designed to facilitate proof of a debt in circumstances where a merchant or tradesman sells goods or services "on account" and keeps only a record of the items sold. The second involves sufficiency of the evidence submitted to prove the existence and amount of the debts.

Regarding the first category, Texas law permits proof of an account through the use of a report or summary of the account accompanied by an affidavit.[77] There must be testimony that the report or summary was "made at or near the time by, or from information transmitted

| | **Number of Cases** | **Percent** |
|---|---|---|
| Calculation of Attorney's Fees | 191 | 30.20% |
| Date of Last payment or Date of Default | 30 | 4.70% |
| Identification of Fees (e.g., late payment, over-the-limit, etc.) | 29 | 4.60% |
| Calculation of Interest | 3 | .50% |
| Signed Credit Agreement Attached to Petition or Affidavit | 1 | .20% |

by, a person with knowledge, if kept in the course of a regularly conducted business activity, and if it was the regular practice of that business activity to make the report, record, or data compilation.[78] Evidence of compliance can be offered through the testimony of the custodian of records "or other qualified witness," either through live testimony or in the form of an affidavit. Compliance with these pleading requirements creates a presumption, only challengeable by a sworn statement of the defendant that the account stated is correct. This procedure was designed to permit the merchant who sold goods or services on "account," keeping a record of items and services sold, to submit the account records in court as proof of the debt.

Although courts have held this procedure inapplicable to suits seeking to recover a credit card debt,[79] plaintiffs' submission of affidavits in almost 400 cases suggests intent to trigger the presumption. Any misuse of the sworn account procedures by plaintiffs and their attorneys may result from harmless mistake or unfamiliarity with a rule that may not be consistently applied; however, it may also indicate their desire to gain an unfair advantage in litigation and may even amount to an unfair or deceptive collection practice to the extent that it falsely represents "the character" of a consumer debt.[80]

Regardless of how the affidavits may be used procedurally, they still must comply with evidentiary rules requiring that a summary be compiled by "a person with knowledge" regarding either the underlying data or "the method or circumstances of preparation" of the summary.[81] However, because debt buyers purchase their accounts after default, it would be highly unlikely that any of their employees would possess sufficient "personal knowledge" to testify under oath about the creation of the underlying account or any other details regarding the account. Yet, in 397 of the 400 cases in which affidavits were filed, the affidavits made by employees of the *plaintiff* who purported to have actual knowledge that the plaintiff owned the debt and that an amount contained in the summary or data compilation represented an overdue account of the defendant. Only fourteen files contained affidavits made by an agent or employee of the original creditor. Yet, in 97.22 percent of the cases in which an affidavit was filed, the affidavit constituted the *only* evidence of the validity of the account.

As described above, people signing and swearing to affidavits with little or no personal knowledge of the facts recited in them are the heart of civil and criminal investigations into banks' foreclosure practices across the country. The data in this study suggest that robo-signing may not be limited to a particular jurisdiction or to an individual entity engaged in credit card collection. Indeed, a Tennessee appeals court recently held that affidavits of the type described above were insufficient to support a judgment in the plaintiff's favor.[82] Further research is necessary to understand the extent of the practice. Likewise, additional research may also shed some light on attorneys' roles in obtaining, submitting, and relying upon such "evidence" as well as the extent to which their conduct is consistent with their professional responsibilities to the courts and the public.

## Outcomes

### Dispositions without Prejudice to Refiling

Researches recorded outcomes by placing the title of the order disposing of the case into one of eight categories: default judgments, dismissals without prejudice, nonsuits, agreed judgments, dismissals with prejudice, closed or bankruptcy, affirmative recovery for defendant and other. By far the most common outcome was not—as some suggest—a default judgment, but rather was a dismissal without prejudice to refiling. Dismissals without prejudice occurred in 51.25 percent of cases in which the defendant was served and 61.77 percent in which the defendant appeared. That number increased even more—to 75 percent—when an attorney entered and appeared on behalf of the defendant.

There are a number of possible reasons for this surprisingly high rate of dismissals without prejudice. One is simple error. Another is the possibility that cases settled. It is common practice in the jurisdiction for the parties to file a dismissal *with* prejudice following the settlement or resolution of the parties' dispute; the files of six of the cases in which the disposition occurred without prejudice revealed that the parties reached an agreement. Hence despite the apparent existence of an agreement to settle the case, the plaintiff maintained the right to sue on the same underlying claims. Another five cases contained dispositive orders with titles indicating dismissals without prejudice even though the orders stated that the disposition occurred with prejudice.

Just as surprising as the number of dismissals was the number of defaults. In contrast to reports from other jurisdictions, defaults occurred in just 39.46 percent of cases. The following tables illustrate the outcomes of all cases in which the defendant was served.

### Outcomes and Appearance in Served Cases

The data suggest that by merely appearing, the defendant will likely avoid a default judgment and liability. In some cases, the defendant's appearance resulted in the permanent avoidance of liability. In two of the three cases in which an affirmative judgment for the defendant occurred, the defendant's appearance, without more, resulted in a final judgment in his favor. In one case, the defendant appeared for trial but the plaintiff did not, and the court entered judgment for the defendant. In the second, both parties proceeded to trial after the court denied the plaintiff's request for a continuance. Despite the plaintiff's presentation of two witnesses, the court ruled that the plaintiff failed to carry its burden and entered judgment for the defendant. The defendant's level of participation in that case clearly made a difference in the outcome. What is surprising, however, is how minimal a defendant's participation need be to alter the outcome of the case dramatically. Simply showing up can be the key to success.

| Outcomes | All Cases Served | Percentage |
|---|---|---|
| Dismissal without Prejudice by Court or Plaintiff | 229 | 51.35% |
| Default Judgment | 176 | 39.46% |
| Agreed Judgment | 22 | 4.93% |
| Dismissed with Prejudice | 9 | 2.02% |
| Closed for Bankruptcy | 4 | .90% |
| Affirmative Recovery for Defendant | 3 | .67% |
| Other | 3 | .67% |

Outcomes in Served Cases

| Type of Appearance | None | Pro Se | Attorney | All Cases |
|---|---|---|---|---|
| Dismissal without Prejudice by Court or Plaintiff/ Nonsuit | 170 | 27 | 32 | 229 |
| Default Judgment | 166 | 9 | 1 | 179 |
| Agreed Judgment | 7 | 13 | 2 | 22 |
| Dismissal with Prejudice | 1 | 4 | 4 | 9 |
| Closed for Bankruptcy | 0 | 2 | 2 | 4 |
| Affirmative Recovery for Defendant | 0 | 1 | 2 | 3 |
| Other | 0 | 2 | 0 | 3 |
| **Total** | 344 | 58 | 44 | 446 |

## Conclusion

This study is a first step in the collection of empirical data regarding litigation initiated by debt buyers to collect consumer debts. The results are largely consistent with many anecdotal reports regarding collection litigation and provide empirical support for some of the more serious concerns expressed by the Federal Trade Commission in its July 2010 report. Specifically, the study confirmed that many consumers do not participate in the litigation and that debt buyers provide consumers with very little information concerning the debt. For example, of the 507 cases examined:

- More than 95 percent of the complaints failed to provide any information regarding date of default or calculation of the amount allegedly owed, allegations the FTC suggests are necessary to insuring due process.
- More than 78 percent of cases contained affidavits having characteristics of robo-signing.
- Nearly 40 percent of all cases resulted in default judgment.
- More than 25 percent of the collectors failed to file state-mandated bonds and, therefore, were operating outside the law at the time they filed their suits.
- Fewer than 10 percent of defendants retained counsel.

The data provided little evidence, however, that faulty service played a role in the entry of judgments. Indeed, slightly more than 12 percent of the cases were dismissed before the defendants were served. Of those that remained, more than half resulted in a dismissal without prejudice. While the high rate of dismissal may indicate that "sewer service" was not a problem in the jurisdiction, it may raise other questions regarding debt collectors' use of the courts as a tool in the collection process.

Despite the many aspects of the litigation that remain to be explored, this study nevertheless provides an important starting point for understanding the impact consumer collection litigation has on consumers and the courts. It also provides rule makers, legislators, and the courts with important tools to insure that the justice system functions to protect the interests of all the parties it serves.

## Notes

1. *E.g.,* Joe Nocera, *Why People Hate the Banks*, N.Y. Times, (Apr. 2, 2012), http://www.nytimes.com/2012/04/03/opinion/nocera-why-people-hate-the-banks.html

   Jeff Horwitz, *OCC Probing JPMorgan Chase Credit Card Collections,* American Banker (Mar. 12, 2012), http://www.americanbanker.com/issues/177_49/chase-credit-cards-collections-occ-probe-linda-almonte-1047437-1.html?zkPrintable=1&nopagination=1; Jeff Horwitz, *'Robo' Credit Card Suits Menace Banks*, American Banker (Jan. 31, 2012).
2. Federal Trade Commission, Collecting Consumer Debts: The Challenges of Change, A Workshop Report 13 (Feb. 2009) [hereinafter Workshop Report].
3. Jeff Horwitz, *Bank of America Sold Card Debts to Collectors Despite Faulty Records*, American Banker (Mar. 29, 2012), http://www.americanbanker.com/issues/177_62/bofa-credit-cards-collections-debts-faulty-records-1047992-1.html?zkPrintable=1&nopagination=1.
4. Workshop Report, *supra* note 2, at 22.
5. *See* Horwitz, *supra* note 3.
6. *See* Jon Leibowitz et al., Federal Trade Comm'n, Repairing a Broken System: Protecting Consumers in Debt Collection Litigation and Arbitration 6, 15-16 (July 2010) [hereinafter Broken System].
7. The National Consumer Law Center has estimated that one out of ten lawsuits filed by debt buyers are premised on bad or incorrect information.
8. Broken System, *supra* note 6, at 14, 17.
9. *See, e.g.*, William V. Dorsaneo III, Texas Litigation Guide §§ 11.51(d) (noting that the "defendant is entitled to know character of legal entity that brings him or her into court"), 11.51(f), 12.100 (2006).
10. *See* Tex. R. Civ. P. Ann. 45(b) (West 2003) (stating that conclusory allegations are objectionable unless fair notice is given).
11. *See* United States Government Accountability Office, Credit Cards: Fair Debt Collection Practices Could Better Reflect Evolving Debt Collection Marketplace and Use of Technology 43 (Sept. 2009) [hereinafter GAO Report].
12. Robo-signing is the practice of filing mass-produced, computer-generated legal documents—so-called "sworn" statements—without reading or verifying the accuracy of the contents in order to speed up the collection process. *See* Press Release, Office of the Minnesota Attorney General (Mar. 28, 2011), *available at* http://www.ag.state.mn.us/consumer/pressrelease/110328debtbuyers.asp.
13. Texas law, for example, states that a party challenging the sufficiency of a pleading must "point out intelligibly and with particularity the defect, omission, obscurity, duplicity, generality, or other insufficiency in the allegations." Tex. R. Civ. P. 91. Unless such deficiencies are "pointed out . . . in a writing . . . [they] shall be deemed to have been waived." Tex. R. Civ. P. 90.
14. National Consumer Law Center, Comments to the Federal Trade Commission Regarding the Fair Debt Collection Practices Act, Protecting Consumers in Debt Collection Litigation and Arbitration: A Roundtable Discussion 4 (Aug. 2009), *available at* http://www.nclc.org/images/pdf/debt_collection/comments_ftc_09.pdf; *see* Horwitz, *supra* note 2.
15. A significant exception is the Urban Justice Center's 2007 report on regarding 600 cases filed in New York City during a one-month period of 2006. Community Development Project, Urban Justice Ctr., Debt Weight: The Consumer Credit Crisis in New York City and its Impact on the Working Poor, 1, 18 (Oct. 2007), http://www.urbanjustice.org/pdf/publications/CDP_Debt_Weight.pdf.
16. See Broken System, supra note 6, at ii; Peter A. Holland, The One Hundred Billion Dollar Problem in Small Claims Court: Robo-Signing and Lack of Proof in Debt Buyer Cases, 6 J. Bus. & Tech. L. 259, 264-73 (2011).
17. *See* Broken System, *supra* note 6.
18. Fair Debt Collection Practices Act, 15 U.S.C. §§ 1692-1692p (2009).
19. 15 U.S.C. §§ 1692, 802(e).
20. Holland, *supra* note 15, at 264-73.
21. Rick Jurgens & Robert J. Hobbs, Nat'l Consumer Law Ctr., The Debt Machine, How the Collection Industry Hounds Consumers and Overwhelms Courts, (July 2010), *available at www.nclc.org/images/pdf/pr-reports/debt-machine.pdf* [hereinafter The Debt Machine].
22. Federal Reserve, Federal Reserve Statistical Release: Consumer Credit, http://www.federalreserve.gov/releases/g19/Current/ (last updated Mar. 7, 2012) [hereinafter Federal Reserve Statistical Release].
23. Federal Reserve, Charge-Off and Delinquency Rates on Loans and Leases at Commercial Banks: Delinquency Rates for All Banks, http://www.federalreserve.gov/releases/chargeoff/delallsa.htm (last updated Aug. 22, 2011) [hereinafter Delinquency Rates]
24. Federal Reserve, Charge-Off and Delinquency Rates on Loans and Leases at Commercial Banks: Delinquency Rates for All Banks, http://www.federalreserve.gov/releases/chargeoff/delallsa.htm (last updated Aug. 22, 2011).
25. *See* The Debt Machine, *supra* note 21, at 1.
26. Jessica Silver-Greenberg, *Boom in Debt Buying Fuels another Boom—in Lawsuits*, Wall St. J. (Nov. 28, 2010), *available at*

http://online.wsj.com/article/SB10001424052702304510704575562212919179410.html.

27. Workshop Report, *supra* note 2, at 13-14; Barbara Sinsley, Fed. Trade Comm'n, DBA International's Comments Related to Debt Collection for the FTC Debt Collection Workshop, 2-3 (June 2, 2007), *available at www.ftc.gov/.../comments/debtcollectionworkshop/529233-00010.pdf [hereinafter DBA* COMMENTS*]*

28. DBA COMMENTS, *supra* note 27, at 1-2.

29. Silver-Greenberg, *supra* note 26 (describing one company's practice of buying "distressed debt" for a "few pennies on the dollar.").

30. Andrew M. Beato & Rozanne M. Anderson, Fed. Trade Comm'n, Comments of ACA International to FTC Regarding the Debt Collection Workshop 1, 6-11, 42, 53 (June 6, 2007), http://www.ftc.gov/os/comments/debtcollectionworkshop/529233- 00016.pdf [hereinafter ACA Comments].

31. *See* Richard Dalton, *'Zombie Debt': When collectors haunt you*, NEWSDAY (Feb. 10, 2008), *available at* http://www.kaulkin.com/files/2008-02-08_Newsday.com.pdf

32. *See* Horwitz, *supra* note 3.

33. FDCPA is codified at 15 U.S.C. §§ 1692-1692p. It prevents communication at "any unusual time or place," before 8:00 AM, or after 9:00 PM. 15 U.S.C. § 1692c. Debt collectors are prevented from using postcards when communicating with persons other than the consumer to acquire location information. 15 U.S.C. § 1692b(4). In collector contact with consumers, they are required to give notice of the amount of the debt, the name of the creditor to whom it is owed, and a statement that the debtor can request verification of the debt. 15 U.S.C. § 1692g.

34. The Equal Credit Opportunity Act is codified at 15. U.S.C. § 1691 and the Fair Credit Reporting act at 15 U.S.C. § 1681c(a)(4).

35. Carolyn L. Carter et al., Nat'l Consumer Law Ctr., The Consumer Credit and Sales Legal Practice Series: Fair Debt Collection, Appendix E, 731-41 (2008).

36. TEX. FIN. CODE § 392.101 (2006) (requiring $10,000 bond to be filed with Secretary of State; *see also* Marauder v. Beall, 301 S.W.3d 817, 821 (Tex. App.—Dallas 2009, no pet.).

37. *See* Debt Buyers' Ass'n v. Snow, 481 F. Supp. 2d 1, 4 (D.D.C. 2006). At times, such efforts may be extremely creative, as in the use of mailing sent to consumer debtors offering a "pre-approved" credit card with a limit set just above the amount owed on the previous card. *See* Notice sent by Resurgent Capital Services, L.P. to Past-Due Debtor (on file with the author) ("Take Advantage of $178.58 of DEBT REDUCTION and get Immediate Available Credit of $50.00 . . . Pay your $3378.58 debt in full by balance transferring $3200 of your debt to a new Visa credit card, and when your credit card is issued, the remaining $178.58 will be forgiven. You will have $50.00 available credit when you receive your credit card. . . . Collection activity on your old debt will stop if you accept this offer[.]").

38. Failure to completely and accurately identify the original creditor in the informal stage of collection may subject collectors to liability for consumer statutory damages. *See* Schneider v. TSYS Total Debt Mgmt., Inc., No. 06-C-345, 2006 WL 1982499, at *3 (E.D. Wis. 2006) (refusing to dismiss § 1692g claim where it was "impossible . . . to decide whether the collector's identification of Target" as original creditor satisfied its obligations under the statute.).

39. *See* Horwitz, *supra* note 3.

40. The FDCPA solely governs debt collectors' conduct through the various phases of the collection process. *See* 15 U.S.C. § 1691i(a).

41. *See* Ashcroft v. Iqbal, 129 S. Ct. 1937, 1949 (2009) (stating that plaintiff's complaint should contain "more than an unadorned, the-defendant-unlawfully-harmed-me accusation"); Bell Atlantic Corp. v. Twombly, 550 U.S. 544, 555 n.3 (2007) (stating that a plaintiff must include some factual allegation in a complaint to "provid[e] not only 'fair notice' of the nature of the claim, but also 'grounds' on which the claim rests").

42. *See e.g.*, FED. R. CIV. P. 7.1(a) (requiring corporate parties to disclose certain corporate affiliations); FED. R. CIV. P. 8(a)(2) (requiring a "short and plain statement of the claim showing that the pleader is entitled to relief"); *see also* 2 JAMES WM. MOORE ET AL., MOORE'S FEDERAL PRACTICE ¶ 8.04[2] (3d ed. 2008).

43. BROKEN SYSTEM, *supra* note 6, at 7.

44. DBA COMMENTS, *supra* note 27, at 1-2.

45. Hilliard M. Sterling & Philip G. Schrag, *Default Judgments Against Consumers: Has the System Failed?* 67 DENV. U. L. REV. 357, 357-59 (1990).

46. *See* BROKEN SYSTEM, *supra* note 5.

47. BROKEN SYSTEM, *supra* note 6, at 12.

48. BROKEN SYSTEM, *supra* note 6, at iii.

49. Texas Office of Court Administration, Trial Court Judicial Data Management System, *County-Level Courts: Reported Activity by County from January 1, 2007 to December 31, 2007*, *available at* http://dm.courts.state.tx.us/oca/oca_ReportViewer.aspx?ReportName=CC_Reported_ Activity_New.rpt&ddlFromMonth=1&ddlFromYear=2007&txtFromMonthField= @FromMonth&txtFromYearField=@FromYear&ddlToMonth=12&ddlToYear=2007&txtToMonthField=@ToMonth&txtToYearField=@ToYear&ddlCountyPostBack=57&txtCountyPostBackField=@CountyID&export=1706 [hereinafter *County-Level Reports: Reported Activity 2007*].

50. Office of Court Administration, Texas Judicial Counsel, *Official County Court Monthly Report Instructions* 10 (July 2009), http://www.courts.state.tx.us/oca/pdf/Cnty_Inst.pdf (emphasis added).

51. See Richard M. Hynes, Broke but not Bankrupt: Consumer Debt Collection in State Courts, 60 FLA. L. REV. 1, 5-6 (2008).

52. The justice courts have jurisdiction over civil cases involving not more than $10,000. TEX. GOV'T CODE § 27.031(a)(1).

County courts at law and district courts in Dallas County have concurrent jurisdiction over all matters. Tex. Gov't. Code § 25.0592. Debt buyers may not bring their claims in a small claims court, because it is not available to collection agencies or other assignees of claims seeking to recover on the assigned claims. Tex. Gov't. Code § 28.003(b).

53. Compare 2000 Census of Population and Housing Summary File 1 Characteristics for Dallas County Voting Precinct 1148, North Central Texas Council of Governments, http:// www.nctcog.org/ris/census/sf1.asp?geo=DALCO&area=1148, *with* 2000 Census of Population and Housing Summary File 1 Characteristics for Dallas County Voting Precinct 3517, North Central Texas Council of Governments, http:// www.nctcog.org/ris/census/sf1.asp?geo=DALCO&area=3517.

54. Although Tex. R. Civ. P. 7 provides that parties may appear "either in person or by an attorney," Texas courts interpret the provision to mean that only individuals can appear pro se. *See* Kunstoplast of Am., Inc. v. Formosa Plastics Corp., 937 S.W.2d 455, 456 (Tex. 1996) (finding only limited exception to the general Texas rule that corporate parties may be represented only by licensed attorney); *see also* Paul Stanley Leasing Corp. v. Hoffman, 651 S.W.2d 440 (Tex. App.—Dallas 1983, no writ) (holding that although plaintiff corporation was unable to proceed to trial without an attorney, trial court abused discretion in failing to give plaintiff opportunity to obtain licensed counsel).

55. Tex. Gov't Code § 27.031(d) ("A corporation need not be represented by an attorney in justice court.").

56. Richard D. De Veaux, Paul F. Velleman & David E. Bock, Intro Stats 311-12 (3d ed. 2009).

57. E-mail from Lynne Stokes, Professor, SMU Dept. of Statistical Science to Mary Spector, Associate Professor ofLaw, SMU Dedman School of Law (July 16, 2008, 1:15 PM CST) (on file with the author).

58. Default Judgment occurs when one party fails to appear or plead at the time appointed. A Dismissal *without* prejudice is a final judgment disposing of a case without a trial on the merits that does not bar the complainant from suing again on the same cause of action. An agreed judgment is a dismissal entered by agreement of the parties, amounting to an adjudication of the matters in dispute or to a renunciation by the complainant of the claims asserted in his pleadings. Dismissal *with* prejudice is a final judgment disposing of a case without a trial on the merits that bars relitigation of the underlying cause of action. An affirmative recovery for the defendant occurs when the defendant asserts counterclaims against the complainant and wins. *See* Black's Law Dictionary (9th ed. 2009), *available at* http://blackslawdictionary.org (emphasis added).

59. In this calculation, the dividend is the percentage of "suits on debt" added in Dallas County as reported by the Texas Office of Court Administration—75.3%. *See County-Level Reports: Reported Activity 2007*, *supra* note 46. The divisor is the percentage of cases that the study shows were initiated by debt buyers to collect credit card debt. Stated in numerical form, the equation becomes: 25.11% ÷ 75.3% = 33.35%.

60. R. LA Fountain et al., The Work of State Courts: An Analysis of 2007 State Court Caseloads 10 (2009) (reporting the results of a joint project of the Conference of State Court Administrators, the Bureau of Justice Statistics, and the National Center for State Courts).

61. NY City Civ. Ct. Act §§ 201-02, Task Force to Expand Access to Civil Legal Services in New York, Report to the Chief Judge of the State of New York 16 (Nov. 2010); New York City Bar, Report by the Civil Court and Consumer Affairs Committee in Support of Intro. 0660-2007, (Jan. 21, 2009), *available at* http://www.nycbar.org/pdf/report/Consumer_Debt.pdf.

62. Tex. Fine. Code Ann. § 392.101 (West 1997); *see Marauder*, 301 S.W.3d at 821.

63. *See* 15 U.S.C. § 1692g. Although the collector's initial pleading is not treated as a communication which must contain the required validation, improper identification in the pleading might nevertheless amount to deceptive or misleading conduct in violation of 15 U.S.C. § 1692e(10).

64. Tex. Fin. Code § 201.102.

65. *See* Tex. Bus. & Com. Code § 71.101 (2009).

66. Tex. Bus. & Com. Code § 71.201(b); *cf.* Tex. Bus. & Com. Code § 17.46(b) (establishing that in some circumstances, a corporate entity's failure to identify itself properly can amount to a deceptive trade practice).

67. This information is available with a password at http://direct.sos.state.tx.us/home/home- corp.asp (follow "Find Entity" hyperlink and search "Citibank." Similar results were achieved searching more broadly with the term "Citi").

68. This information is available with a password at http://direct.sos.state.tx.us/home/home- corp.asp (follow "Find Entity" hyperlink and search "Chase Manhattan Bank."). A similar search using the term "Chase Bank" reported twelve filings. One of them, an entity identified as JPMorgan Chase Bank, National Association, appears to be a close match to "JPMorgan/Chase," which was identified as an original creditor in one case.

69. *See* 15 USC 1692g(a) (requiring collector to identify original creditor upon consumer's request).

70. *See* 15 USC 1692e, 1692f. *See also* Delawder v. Platinum Financial Services Corp. 443 F.Supp. 2d 942 (S.D. Ohio 2005) (holding that debtor stated claim for violation of section 1692e against debt buyer who voluntarily dismissed prior collection case after debtor answered and sought discovery).

71. Cal. Civ. Code § 1788.15(a).

72. Ray Rivera, *Counsel Seeks to Crack Down on Process Servers Who Lie*, N.Y. Times, Feb. 26, 2010, at A18. In early 2011, a Dallas County auditor found evidence that deputy constables had lied about obtaining service of process in a range of civil matters. Reports focused on the widespread nature of such conduct—allegedly involving over half of the deputies who serve civil papers—and the role it may have played in evictions, which are filed exclusively in the justice courts. Editorial, *Time to Unplug the Entire Constable Operation?*, Dallas Morning News, May 19, 2011, http:// www.dallasnews.com/opinion/editorials/20110519-editorial-time-to-

unplug-the-entire-constable-operation.ece. Little is known, however, about the extent to which alleged wrongdoing by the constables played a role in collection cases filed outside of the justice courts.

73. *See* Tex. R. Civ. P. 83 (Answer; Original and Supplemental; Endorsement), 84 (Answer May Include Several Matters), 85 (Original Answer, Contents), 92 (General Denial), and 93 (Certain Please to be Verified).

74. The Legal Aid Society, Neighborhood Economic Development Advocacy Project, MFY Legal Services, and Community Development Project, Urban Justice Ctr., Debt Deception: How Debt Buyers Abuse the Legal System to Prey on Lower-Income New Yorkers, Urban Justice Ctr. 1, 9 (May 2010), http:// www.urbanjustice.org/pdf/publications/cdp_24may10.pdf [hereinafter Debt Deception].

75. Broken System, *supra* note 6, at 17.

76. Judith Fox, Do We Have a Debt Collection Crisis? Some Cautionary Tales of Debt Collection in Indiana, 24Loy. Consumer L. Rev. 355 (2012).

77. *See* Tex. R. Civ. P. 185.

78. Tex. R. Evid. 803(6).

79. *See* Williams v. Unifund CCR Partners Assignee of Citibank, 264 S.W.3d 231 (Tex. App.—Houston [1st Dist.] 2008, no pet.); Bird v. First Dep. Nat'l Bank, 994 S.W.2d 280 (Tex. App. — El Paso 1999, pet. denied).

80. *See e.g.*, 15 U.S.C. § 1692e(2)(A).

81. Tex. R. Evid. 803(6), 902(10).

82. *See* LVNV Funding, LLC v. Mastaw, No. M 2011-00990-COA-R3-CV (Tenn. Ct. App. Apr. 30, 2012).

# The Subprime Mortgage Crisis and Economic Checks and Balances

**By Chunlin Leonhard**

The subprime mortgage crisis has challenged deeply held beliefs such as the presumed efficiency of free markets, a theoretical underpinning of US contract law.[1] Even some staunch defenders of the free market economy acknowledged that the market does not always regulate itself for the best.[2] The subprime mortgage crisis offers a good opportunity for reflection by US contract law scholars as well.

This article points out that contract law played an enabling, albeit hidden, role in the subprime mortgage crisis.[3] Contract law helped bring about the subprime mortgage crisis in two ways. First, contract law's *laissez faire* paradigm has incentivized contractual parties to pursue their self-interests while failing to provide any constraint on excessive pursuit of self-interests. Second, contract law's private ordering paradigm has nurtured a business culture of "survival of the fittest." Contract law gives parties in economic transactions the moral permission to watch out only for themselves.[4] Contract law's general tolerance of parties' single-minded pursuit of self-interest has led to a "moral deficit."[5]

Because of the importance of economic exchanges in our society, contract law is uniquely positioned to encourage socially desirable conduct.[6] What rules contract law chooses to recognize will likely set the tone for all economic exchanges and define our society itself.[7] As Professor Shiller notes, economic policies can either reinforce or fray the "social fabric—the trust and optimism people feel for each other and for their shared institutions and ways of life."[8] By choosing the *laissez faire* approach, US contract law is abdicating its responsibility to encourage socially desirable conduct and to discourage undesirable conduct.[9] Maintaining the status quo will lead to a loss of trust and belief in the economic system, with serious consequences for the economy and society as a whole.[10] This article proposes that contract law adopt a more proactive approach by recognizing a broader duty of good faith in economic relationships prior to the formation of a contract.

To provide a context for discussion, this article first discusses briefly the role contract law played in the subprime mortgage crisis. As a result of the lessons learned from the subprime mortgage crisis, this article advocates adoption of a pre formation duty of good faith. The "reasonable person" standard developed within the negligence tort law framework can be used to determine when the duty of good faith has been breached. The negligence framework would limit this broader duty of good faith so that the broader duty would not unduly disrupt contractual certainty in regular business transactions. This article concludes by setting forth some arguments in support of a pre formation duty of good faith.

## Contract Law's Role in the Subprime Mortgage Crisis

To understand contract law's role in the subprime mortgage crisis, we need to unpack the basic structure of the subprime mortgage world.[11] A subprime mortgage transaction began with loan transactions between lenders or brokers and borrowers.[12] The transactions typically involved borrowers with bad credit scores who would not qualify for a standard mortgage.[13] These borrowers are commonly known as subprime borrowers. Subprime mortgages refer mortgages provided by lenders to subprime borrowers. The banks, mortgage companies, and brokers involved in the initial loan origination are referred to as originators.[14]

Subprime mortgage contracts at the loan origination stage have some basic characteristics. Professor Bar-Gill found that the subprime mortgage contracts

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were deliberately designed to appear affordable.[15] The appearance of affordability arose from certain cost-deferral features.[16] Subprime mortgage loan contracts deferred costs by offering small down payments, high loan-to-value ratios (LTVs), and teaser rates (or "escalating payments").[17] Because of the appearance of affordability, borrowers generally underestimated the true costs associated with the loans.[18]

Another feature of the subprime mortgage transactions was their complexity.[19] The complexity made it difficult for borrowers to appreciate the risks or even understand the transactions.[20] These mortgages were full of "booby traps and deceptions."[21] As a result, borrowers entered into costly loan contracts that they could not actually afford for very long, resulting in defaults and foreclosures that set off the financial crisis worldwide.

Once the loans were originated, the lenders would sometimes transfer the loans as a pool to a special purpose vehicle (SPV), a legal entity set up by the lenders solely for the purpose of receiving those loans.[22] In some cases, Wall Street investment banks directly bought mortgages from originators.[23] Then, investment banks working as employees or agents for the SPVs, also referred to as the issuers, would package the loan pool into different tranches of bonds known as mortgage-backed securities (MBSs). The big rating agencies, such as Standard & Poor's and Moody's Investor Service, would then rate the MBS based on the risks of each tranche.[24] The bottom tranche was considered the riskiest and had the lowest rating while the top tranche was considered the safest and had the highest rating.[25] This process is known as securitization.[26]

Once mortgages were packaged into different securities, investment banks offered the MBSs to other investors. At this point, multiple contracts were entered into to sell the MBSs to various investors.[27] Presumably capable of assessing the risks associated with such securities,[28] the foreign and domestic investors bought billions of dollars of subprime mortgage backed securities. Lenders thus shifted the risks inherent in subprime mortgages to third party investors.[29] However, these securities were structured in such a complex manner that a proper risk evaluation was "difficult, if not impossible."[30] Because these securities—backed by ostensibly secure mortgages—were further blessed by rating agencies as highly safe investments,[31] there was an insatiable demand for them.[32] Investment banks were eager to find additional loans to package and sell.[33]

Investment banks did not stop with packaging subprime mortgages into securities. When there weren't enough MBSs to sell, Wall Street began creating additional financial products derived from MBSs. These derivative financial products were called collateralized debt obligations ("CDO") and other variations of CDOs.[34] CDOs at their peak were primarily made up of MBSs instead of the mortgage loans themselves.[35] Wall Street also created mezzanine CDOs consisting of the bottom (riskiest) tranches that no investor wanted to buy.[36] Once the mezzanine CDOs were magically blessed with the highest ratings by the rating agencies, they were "unloaded on unsuspecting investors the world over."[37] Wall Street also created additional CDO-derivative products to generate more demand for CDOs and MBSs.[38] Wall Street thus kept its money machine running.[39]

Wall Street firms received handsome fees for their efforts.[40] The hedge fund managers also found it convenient to rely on the rating agencies.[41] They were paid generous salaries, bonuses, and fees for investing someone else's money.[42] For the brokers and lenders, the more loans they could sell, the better off they were, at least in the short term.[43] The brokers and lenders were paid based on the quantity, not the quality of the loans.[44] The vicious cycle continued until the house of cards fell in 2007.[45]

## Adopting A Pre Formation Duty of Good Faith

The subprime mortgage crisis happened in part because contract law gave Wall Street the legal and moral permission to sell esoteric financial products to buyers as long as buyers were willing to buy. This reliance on private ordering broke down in the subprime mortgage context because of severe information asymmetry. It shows the need for contract law to adopt some form of checks and balances.

Adopting a duty of good faith prior to the formation of a contract could be one of the options. This position raises some immediate questions. One question is how to formulate a rule that would discourage opportunistic commercial behavior without dampening parties' creativity and innovation. How can contract law calibrate the incentives so that the parties are motivated to look for mutually beneficial opportunities that may also benefit the society as a whole?[46] What factors should the courts use to assess when a breach has occurred? In pre-contract formation cases, where should the courts draw the line between acceptable commercial behavior pre-contract formation and a breach of the duty of good faith? What limitations should be in place to prevent undue interference in parties' freedom to contract?

This section first discusses briefly the current status of the duty of good faith in contract law. Courts and legislatures have recognized a narrow duty of good faith in contractual relationships. Absent any special relationship between parties, courts and legislatures have generally imposed the duty only in contract performance or enforcement after a contract has been formed.[47] This section then discusses a potential standard to apply when assessing whether a party breaches a duty of good faith prior to contract formation. Lastly, this section advocates applying the "reasonable person" standard borrowed from tort law.

## Current Status of the Duty of Good Faith in US Contract Law

The good faith concept is well recognized in contract law.[48] However, courts currently impose a duty of good faith on parties performing the terms of a contract generally only after a contract has been formed.[49] The doctrine requires a party vested with discretion under the terms of the contract to exercise the discretion in good faith.[50] Courts have struggled with a precise definition of the doctrine of good faith.[51] The doctrine has been primarily defined by what it does—for example, to exclude different forms of bad faith, to limit contractual parties' discretion, to prevent a party from reneging on performing under the contract, or to protect parties' reasonable expectations.[52] The Uniform Commercial Code (UCC) defines "good faith" as "honesty in fact" and "fair dealing."[53]

The doctrine's history in the United States demonstrates its controversial nature even in its current narrow scope. Courts had generally resisted recognizing the doctrine prior to the adoption of the UCC in the 1950s.[54] When the UCC incorporated the doctrine of good faith, the drafters pointed out that the UCC does not recognize an independent cause of action for failure to perform or enforce it in good faith, except in relation to a specific duty or obligation under the contract.[55] The refusal to recognize a separate cause of action reflects the scholars' concern about the doctrine's capacity to interfere with the parties' private bargains.[56] Despite the controversies surrounding the doctrine, it is worthwhile to examine whether the doctrine of good faith can or should be the vehicle to provide some checks and balances in economic relationships.

## Breaching a Pre Formation Duty of Good Faith

If a duty of good faith is imposed prior to contract formation, what standard should the court use to assess when the duty has been breached? In post-contract formation cases, there is a well-developed body of case law regarding when a breach of the duty of good faith occurs.[57] In cases involving claims prior to contract formation, we can borrow a page from tort law. Courts have had extensive experience in weighing multiple public interest and policy concerns in assessing whether a duty of care has been breached in tort law. Negligence law requires a party to conform its conduct to that of "a reasonable man under like circumstances."[58] "The words 'reasonable man' denote a person exercising those qualities of attention, knowledge, intelligence, and judgment which society requires of its members for the protection of their own interests and the interests of others."[59] The reasonable person standard is objective and external and reflects a "standard of conduct demanded by the community for the protection of others against unreasonable risk."[60] The standard is flexible because it allows the fact finder to consider the particular circumstances of the case while providing a formula whereby a uniform standard may be fashioned and maintained.[61]

Applying community standards through the "reasonable person" test would impose some reasonable limits on a pre formation duty of good faith. In economic transactions, the reasonable person standard would sanction commercial behavior that a reasonable person would consider acceptable. For example, in cases where parties have equal bargaining power and access to information, a reasonable person standard would not result in liability for one party if the other party suffers an economic loss and claims breach. On the other hand, if one party has little or no bargaining power and no access to information, the stronger party would be required to behave like a reasonable person in the community in a similar situation to avoid a breach of the duty. In the case of subprime mortgage transactions, lenders and/or originators would have breached the duty if it were shown that the mortgage products had been designed to deliberately mislead and confuse the borrowers.

In addition to the limits placed by the reasonable person standard, defenses to a negligence action, such as consent and contributory negligence, will also shield a party from being exposed to liability despite commercially reasonable behavior. For example, the defense of consent can be asserted against a breach of duty of good faith where the defendant can sustain its burden of proving that the plaintiff effectively consented to the economic exchange.[62] Allowing consent as an affirmative defense removes the presumption of voluntary consent by plaintiff in a breach of contract action currently indulged by contract law.

Once a breach is found, what damages should plaintiffs be entitled to? This article suggests that a party that breached its duty of good faith should be liable for all damages permissible under tort law. For instance, some courts have allowed tort damages for breach of the duty of good faith in insurance transactions.[63] Scholars have pointed out that contract law's compensatory damages approach does not do enough to deter wrongful conduct.[64] Allowing tort recovery would have more of a deterrent effect and would provide the necessary checks and balances against excessive opportunistic behavior.

## In Support of a Pre Formation Duty of Good Faith

Why should contract law adopt a pre formation duty of good faith? Potential objections include that the doctrine interjects a third party into the private contracting process. It has the potential to interfere with individual autonomy and freedom of contract, two related and fundamental principles of contract law.[65] The approach raises the familiar specter of paternalism. The good faith doctrine's vagueness also causes concern that it may allow the courts to inject an amorphous moral standard in contractual relationships.[66] The vagueness and ambiguity might disrupt contractual certainty and interfere with the parties' own risk allocation.[67]

All of the concerns are good reasons to be cautious, but what are the alternatives? Maintaining the status quo may not be a viable option in light of the subprime mortgage crisis and increasing disparity in wealth and resources.[68] There are betters reasons why contract law should play a more active role. Contract law governs economic relationships in our society.[69] Leaving the economic relationships to the whims of the parties fails to take into consideration the societal interests in economic relationships.[70] A broader pre formation duty of good faith, with appropriate limiting principles, will help provide some external checks and balances against excessive opportunistic behavior. This section will set forth a few arguments in support of recognizing a broader duty of good faith in economic relationships.

## Behavioral Studies Show that Underlying Assumptions of Contract Law are Generally Wrong.

Recognizing a broader duty of good faith in economic relationships is necessary because the underlying assumptions relied upon to justify the current passive approach are generally wrong, as demonstrated by behavioral findings by a group of scholars over the recent decades.[71] The current contract law paradigm, heavily influenced by the rational choice model[72] of free market economy, assumes that people have equal access to information and equal bargaining power. These assumptions are appealing because they are consistent with cherished values of individual autonomy and freedom of contract.[73]

The simplicity and elegance of those assumptions vanishes, however, when one realizes that the real world is very different from the world assumed by contract law.[74] That the contract law paradigm is based on unwarranted assumptions is well established and critiqued.[75] For the last several decades, behavioral economists[76] have demonstrated that people are more complicated and far less rational than the standard economic theory assumes.[77] Behavioral economists have observed deviations from the rationality assumption regardless of its definition.[78]

Interestingly, the challenge to contract law in the twenty-first century is the mere fact that human beings are all too human. Behavioral economists have demonstrated that the human decision-making process can be illogical. People are notoriously incapable of estimating future costs.[79] They tend to be overly optimistic, myopic, and place too little weight on the future costs and benefits and too much weight on the short-term costs and benefits.[80] Individuals also tend to misjudge the likelihood or probability of a future event. They rely on the short cut of a small sample of present events as indicative of future events while ignoring other evidence, such as prior occurrences and the quality of the sample.[81] These biases lead to systematic underestimation of future risks.[82]

The human tendency to rely on shortcuts to make decisions often leads to predictable mistakes.[83] For example, when making a decision, human beings tend to overemphasize information that is salient or available to them (referred to as the saliency effect).[84] These known biases make it possible to predict people's irrationality.[85] Studies have shown that people's choices are often affected by how the choices were presented to them (referred to as the framing effect).[86]

The finding that people are "predictably irrational" has significant implications.[87] It means that people's decision-making can be manipulated. Manipulation of those biases was exactly what happened during the subprime mortgage transactions.[88]

During the subprime mortgage transactions, the lenders manipulated those with less information through deliberate contract design.[89] Subprime loan products with cost-deferral features exploited people's inherent biases of optimism and myopia. The borrowers focused on short-term benefits and underestimated future risks. Borrowers' decision-making biases were further exacerbated by lenders' eager assurances not to worry about the future high rates because borrowers could refinance in a short time.[90] Lenders and brokers led the borrowers further astray with deceptively appealing solicitations.[91] The manipulation rendered contract law's assumption of voluntary choice and equal access to information largely illusory.[92]

To sum up, behavioral research shows that the underlying assumptions justifying the passive contract law model are generally wrong because of human decision-making flaws. That those flaws are being actively exploited creates an urgent need to reevaluate contract law's passive approach.[93] The current widespread information asymmetry and unequal bargaining power prove that contract law has no built-in checks and balances to prevent excessive opportunistic behavior in economic relationships. A more proactive contract law paradigm is needed to provide some necessary constraints.[94]

## Social Changes in the Twenty-first Century Support Recognizing a Broader Duty of Good Faith

Social changes also support imposing a broader duty of good faith in economic relationships—a more proactive contract law paradigm.[95] Because modern technologies increase access to the global marketplace, the last few decades have seen unprecedented growth and consolidation of financial power.[96] Such concentration of economic power, combined with a better understanding of human beings and human decision-making processes, has created powerful commercial forces singularly focused on profit making. These commercial entities have devoted considerable resources to manipulate consumer behavior more than ever before.[97] The resulting information asymmetry leads to even greater inequality in bargaining power between the parties.

Because of the consolidation of financial resources and information advantages in the hands of relatively few powerful companies, the *laissez faire* approach of the current contract law is no longer appropriate.[98] As Professor Stiglitz pointed out, powerful entities will try to take advantage of their positions to benefit themselves.[99] The Wall Street firms behind the subprime mortgage crisis created the demand for mortgages by developing exotic mortgage-backed financial products for sale to investors.[100] They manipulated the rating agencies to bless those products with the top ratings.[101] The top ratings ensured a continuous flow of buyers for those financial products because of access to global money.[102] Wall Street's financial power not only gave it an information advantage, but also the wherewithal to corrupt the system itself.[103]

If contract law maintains the status quo, parties with more resources and information advantages can count on the court system to maintain their advantages.[104] Contract law is, in effect, aiding and abetting the exploitation of those who are disempowered and contributing to the perception that the system is rigged in favor of the rich.[105] If contract law continues to turn a blind eye to the inequality, it will only exacerbate the gap between the rich and the poor.[106]

An interesting inconsistency pervades American society: Americans are generally suspicious of big government and concentrated political power,[107] yet they tolerate elites who maximize and consolidate their wealth.[108] The Founding Fathers drafted the Constitution with the explicit purpose of restricting governmental power.[109] The Constitution sets forth a system of checks and balances by creating three separate but equal branches of the government so as to prevent the concentration of political power in any one branch.[110] However, American society appears to tolerate the concentration of economic wealth, and indeed, encourages it by adopting a *laissez faire* approach in economic policies.[111] Yet, concentrated economic power can also lead to corruption and result in serious consequences for the society.[112] As Professor Ramirez recently proposed, "the power of growth-retarding elites must be constrained through law in order to secure maximum macroeconomic growth."[113]

The incentive to pursue self-interest may have been what people needed in the late nineteenth century when classic contract law began to take its shape. Strong incentives were necessary to kick start this country's economy. However, the twenty-first century provides a very different social context.[114] The subprime mortgage crisis has shown us the dark side of the unbridled pursuit of self-interests.

## The Current Contract Law Paradigm Undermines Its Goal of Efficiency

It is generally accepted that one goal of contract law is to promote economic efficiency.[115] The current contract law paradigm is said to promote wealth maximization because it assumes that if both parties to an agreement are willing to enter into the contract, they must both be made better off as a result.[116] Regardless of the definition of efficiency, contract law apparently assumes that the best way to promote efficiency is to allow private parties to arrange their own affairs.

Discussions of efficiency in the contract law context have not differentiated between efficiency for one party to the contract, efficiency for both parties to the contract, or efficiency to society as a whole. Perhaps, there are some implicit assumptions that efficiency for the individual parties coincides with efficiency for the society as a whole. This article will refer to these efficiencies as individual efficiency, microefficiency, and macroefficiency, respectively. Although one can envision a situation where all three efficiencies coincide, they do not necessarily all exist in every case.

The subprime mortgage crisis demonstrates that the current *laissez faire* contract law paradigm undermines its goal of efficiency, both at the microefficiency level (between individual parties) and at the macroefficiency level (for the society as a whole).[117] The contract law paradigm failed to promote microefficiency because subprime mortgage transactions solely benefitted the parties with more resources and more access to information. The transactions were thus only "individually efficient" for Wall Street firms.[118] Extensive evidence shows that many subprime borrowers entered into loan transactions not because the deals were good for them, but because borrowers' decisional biases were manipulated by lenders.[119] Without equal access to information, one can hardly argue that the parties can allocate the resources efficiently at the micro level.[120]

The near collapse of the financial system and the ramifications thereof demonstrated that subprime mortgage transactions failed to promote macroefficiency.[121] The subprime mortgage crisis brought down some venerable financial firms such as Bear Stearns and Lehman Brothers.[122] A massive government bailout was necessary to prop up the financial and insurance industries.[123] Thousands of people lost their jobs and their homes.[124] Incredible amounts of wealth were wiped out in a very short span. Trillions of dollars (between the losses on the stock market and real estate) were lost in about two years.[125] Andrews blamed the United States for sending the global economy into "its worst downturn in decades."[126] The subprime mortgage crisis generated hundreds of lawsuits amongst multiple parties.[127] The consequences of the massive government bailout are still unknown.[128] The social costs of job and home loss, the trauma to the nation's psyche, lost trust, and other collateral damage are immeasurable.

By inducing borrowers to enter subprime mortgage contracts whose risks and terms they largely failed to comprehend or misunderstood, lenders took advantage of their resource, informational, and legal positions. Despite providing banks with individual gains, the micro-*inefficient* contracts en masse created a very inefficient macroeconomic situation. The divergence of efficiencies supports a need for a more proactive paradigm.[129]

### Contract Law's Tolerance of Unbridled Pursuit of Self Interest Has Led to a Moral Erosion of Business Culture

Contract law has nurtured a business environment where one only needs to focus on maximizing one's own profits.[130] In her article *Divergence of Contract and Promise*, Professor Shiffrin pointed out that contract law's remedial doctrines encouraged breaches of promises, a departure from the moral rule that promises should be kept.[131] She argued that contract law should be fashioned to allow people to live consistently with their moral beliefs.[132] The subprime mortgage crisis shows that contract law's *laissez faire* approach failed to promote the "moral being" and made it harder for an otherwise decent human being to behave reasonably in the face of great incentives to profit.[133]

The subprime mortgage crisis offers an example of moral corrosion due to the inconsistency of contract law with moral norms applicable to the same behavior. Contract law facilitated unfettered greed by giving parties in contractual relationships legal and moral permission to maximize their own profits without regard for any other party's wellbeing; after all, the other party is presumed to know how to watch out for his or her own interests.[134] In Andrews' words, the subprime mortgage crisis is "a debacle that stemmed from deep-seated rot and corroded ethics in our financial systems."[135]

### A Broader Duty of Good Faith Can "Nudge" Parties Toward More Trust in Economic Relationships

Trust is an important ingredient for the success of a modern society.[136] Francis Fukuyama argued that a high degree of social trust is critical to the success of a modern society.[137] Positive economic relationships create public good such as fostering trust in the marketplace.[138] Trust lowers transaction costs in a society by facilitating transactions.[139] When people trust each other, it reduces the "number of contingencies that must be considered when 'doing a deal.' "[140] On the other hand, when trust does not exist, economic crises such as the subprime mortgage crisis occur: the crisis began when investors lost faith in their bankers and the banks refused to trust each other.[141]

Structural changes can influence the level of social trust. The subprime mortgage crisis came about partly because of misaligned incentives.[142] Over the past few decades, behavioral economists have demonstrated that incentives matter.[143] Contract law should help align incentives to encourage people to behave in a socially responsible manner.[144] Requiring that people exercise good faith in economic transactions helps improve trust by providing some external constraints on people's opportunistic behavior. A broader duty of good faith may "nudge" people in the right direction for the benefit of the society as a whole.[145]

Studies show that people will engage in opportunistic behavior if there are no external constraints.[146] However, if people are reminded of some moral standards, they will try to refrain from opportunistic behavior. In a series of experiments on cheating, there were significant differences between the groups that could recall the Ten Commandments[147] and students who signed an honor code,[148] for example, and those that did not. Both the Ten Commandments and the honor code in those experiments served as reminders of a certain moral standard. A contract law paradigm incorporating a duty of good faith can provide the same necessary reminder and "nudge" people in the right direction. Contract law's recognition of a duty of good faith serves as an authoritative pronouncement of what the law expects from people when they engage in economic transactions with others. People are likely to cooperate when an authority instructs them to do so.[149]

Requiring people to abide by a certain standard when engaging in economic transactions is also consistent with people's innate sense of fairness. Although human beings are motivated by self-interest, behavioral economists have demonstrated that humans have a strong sense of fairness.[150] People are socially oriented.[151] Evolution has taught human beings that cooperation and altruism are more conducive for survival.[152] Experiments have shown that people are willing to act against their financial interests for the sake of fairness.[153] Shermer refers to this as an "Evolutionary Stable Strategy": fairness evolved as a strategy for maintaining social harmony in small groups.[154]

Over the long run, imposing a duty of good faith will help foster more positive, trusting economic relationships for the benefit of the society as a whole. On one hand, it places some external constraints and serves as a reminder of the standard they have to abide by in economic relationships. On the other, its existence brings out the best in people—people's sense of fairness.

## Conclusion

The subprime mortgage crisis has brought to the forefront a systemic flaw of contract law. It has demonstrated that the system relied on unwarranted assumptions which effectively eliminated the only built-in checks and balances. The lack of equal access to information and resources leaves the weaker party to the contract at the mercy of the stronger party. Without any actual bargaining in the process, contract law's *laissez faire* approach fails to provide any checks and balances against excessive opportunistic behavior.

The severe informational asymmetry is exacerbated by manipulation of human decision-making biases identified by behavioral economists over the past few decades. Powerful commercial interests devote substantial resources to manipulating people's decision-making. What is more, modern society has seen an unprecedented concentration of financial power due to new technology and access to the global marketplace. The US financial industry exemplifies such concentration of financial power. Because of their resources, Wall Street firms were able to manipulate the system for their own benefit. All of these developments vitiate the passive approach of contract law.

Despite the concerns surrounding a broader duty of good faith in economic relationships, recognizing such a duty would provide a better balance between competing interests of individual autonomy and freedom of contract, efficiency, and fairness. It may offer some counterbalance against excessively opportunistic commercial behavior in economic relationships. It could further create an incentive for parties to work together for the benefit of both parties and society as a result. In addition, adopting a broader duty of good faith will elevate the baseline standard of acceptable economic behavior. This principle recognizes that because we live in an interconnected modern society where the entire society benefits when all of us, including the weakest members, are protected.[155]

Could an expanded duty of good faith have prevented the subprime mortgage crisis?[156] To begin, a broader duty of good faith would have fostered a vastly different business culture. A business culture honoring honesty in fact and commercial reasonableness, for example, might have prevented the vicious cycle from forming in the first place. Had there been a broader duty of good faith, the loan originators would not have sold mortgages to borrowers that the originators knew did not have the financial resources to repay the loan, since they would not be able to successfully sue the borrower to recoup the money lent. Wall Street firms would not have created all of those esoteric derivative financial products just so that they could sell them to other investors and earn handsome fees for themselves in the process, since they might have been forced to pay back the money they received from the purchasers. A duty of good faith in economic relationships could have been the proverbial flapping of butterfly wings which altered the course of history and helped avoid a financial hurricane of the magnitude that struck our world. Perhaps adopting a broader duty of good faith now will prevent another similar crisis in the future.

## Notes

1. In his recent book examining what he calls "the Great Recession," Professor Joseph Stiglitz, winner of the Nobel Prize in Economics, points out that "markets do not work well on their own" and that the American economy lost the "balance between the role of markets and the role of government." Joseph E. Stiglitz, Free Fall, America, Free Markets, and the Sinking of the World Economy, Preface at xii (2010).
2. Alan Greenspan who has been a big champion of free markets admitted that he had put too much faith in the self-correcting power of free markets and not enough in the self-destructive power of markets gone amok. Edmund L. Andrews, Busted, life Inside the Great Mortgage Meltdown 65 (2009). Judge Richard A. Posner, one of the most influential scholars in the law and economics movement, acknowledged the "need for a more active and intelligent government to keep our model of a capitalist economy from running off the rails," and that "[t]he movement to deregulate went too far by exaggerating the resilience – the self healing powers – of laissez-faire capitalism." Richard Posner, A Failure of Capitalism, xii (2009).
3. I am not suggesting here that U.S. contract law by itself causes the subprime mortgage crisis. Needless to say, the "perfect storm" resulted from a confluence of multiple factors. For a comprehensive examination on the multiple causes of the crisis, *see* Comm'n on the Causes of Finan. & Econ. Crisis in the U.S., The Financial Crisis Inquiry Report (2011) (hereinafter FCIC Report).
4. When questioned about Goldman Sachs' practice of selling mortgage securities to investors, then betting that those securities would drop in value, Goldman CEO Lloyd Blankfein was

quoted as saying, "These are the professional investors who want this exposure." Wall Street Journal January 14, 2010, available at http://online.wsj.com/article/SB10001424052748704362004575000752756113586.html, last visited on January 26, 2010. In a New York Times article about the same Goldman Sachs' practice, another Goldman Sachs spokesman was quoted as saying, "clients knew Goldman might be betting against mortgages linked to the securities, and that the buyers of synthetic mortgage C.D.O.'s were large, sophisticated investors" . . . "investors could have rejected the CDO if they did not like the assets." available at http://www/nytimes.com/2009/12/24/business/24trading.html?pagewanted=print last visited on January 19, 2010. Another Wall Street Journal article dated December 3, 2007, reported lenders as saying that "they aren't responsible for borrowers who may have been reckless in their real estate investments or their finances, or who have their own reasons for considering loans with subprime terms." Available at http://online.wsj.com/articles/SB119662974358911035.html, last visited on January 26, 2010.

5. Stiglitz, *supra* note 1 at 278.

6. It is beyond this paper's scope to discuss contract law's role in promoting morality.

7. Francis Fukuyama, Trust: The Social Virtues and the Creation of Prosperity 7 (1995).

8. Robert J. Shiller, The Subprime Solution: How Today's Global Financial Crisis Happened, and What To do About it 2 (2008). David Faber, And Then The Roof Caved In: How Wall Street's Greed And Stupidity Brought Capitalism to Its Knees 1 (2009) (pointing out that financial companies rely on trust in order to survive).

9. Roy Kreitner, *Fault at the Contract-Tort Interface*, 107 Mich. L. Rev. 1533, 1549 (arguing that contract law is "a mode of social regulation whose rules ought to serve social goals"); Richard H. Thaler and Cass r. Sunstein, Nudge: Improving Decisions About Health, Wealth and Happiness 14 (2009); Stiglitz, *supra* note 1 at 38 (stating that "the role of the government is to make the economy more efficient and to help the poor and those who cannot fend for themselves").

10. Shiller, *supra* note 8 at 101. One can see evidence of law's broad impact. For example, well-developed tort law in the United States encourages people to take reasonable precautions to prevent personal injury. The United States is one of the most safety conscious societies in the world. On the other hand, the United States lags behind most other developed countries in terms of reputation for honesty. Dan Ariely, Predictably Irrational, The Hidden Forces that Shape Our decisions 214 (2008) (difficult-to-measure qualities and tendencies such as levels of societal corruption, freedom, and honesty are often gauged by such perception indices). The 2009 Transparency International Corruption Perceptions Index shows that the United States has now slipped to number 19 in the table. http://www.transparency.org/policy_research/surveys_indices/cpi/2009/cpi_2009_table, last visited on August 6, 2010. One cannot help but wonder whether this has anything at all to do with the business mentality nurtured by the U.S. contract law. Stiglitz, *supra* note 1 at 289 (pointing out that "we have created an economic system that encourages shortsighted behavior–behavior that is so shortsighted that the costs of the breakdown in trust are never taken into account").

11. I only offer a brief and somewhat simplified summary of the complicated world of subprime mortgage and its derivative financial products to provide a context for discussion. For a more in-depth examination of the subprime mortgage world, please see Mark Zandi, Financial Shock, A 360 Degree Look at the Subprime Mortgage Implosion and How to Avoid the Next Financial Crisis (2nd Ed. 2008). For an interesting personal account of the subprime mortgage crisis, see Andrews, *supra* note 2.

12. Nomi Prins, It Takes a Pillage 42 (2009).

13. In some cases, however, some lenders apparently steered minority borrowers who could have qualified for normal mortgages to subprime mortgages because subprime mortgage rates were more profitable. Andrews, *supra* note 2 at 190–91.

14. Oren Bar-Gill, *The Law, Economics, and Psychology of Subprime Mortgage Contracts*, 94 Cornell Law. Rev. 1089-91, 1090 n. 41 (2009).

15. *See* Bar-Gill, *supra* note 14, at 1108 ("If a borrower cannot afford to make a substantial down payment, then she will take a mortgage with a high LTV."); Andrews, *supra* note 2, at 49–50.

16. *See* Bar-Gill, *supra* note 14, at 1096, 1120; Zandi, *supra* note 11, at 30.

17. Bar-Gill, *supra* note 14, at 1096.

18. Bar-Gill*, supra* note 14*,* at 1120. This optimism was often purposefully fostered by the broker. *See* Faber, *supra* note 8, at 54.

19. Bar-Gill, *supra* note 14, at 1102–03, 1121–23; Zandi, *supra* note 11, at 30.

20. Even the former Fed Chairman Alan Greenspan acknowledged that "some of the exotic new mortgages were so complicated that a person with a Ph.D. in mathematics wouldn't understand them." Andrews, *supra* note 2, at 77.

21. Andrews, *supra* note 2, at 50.

22. Audrey Strauss, *Turning a Blind Eye: Wall Street Finance of Predatory Lending*, 75 Fordham L. Rev. 2045 (March 2007).

23. Faber, *supra* note 8, at 66–74 (describing in detail how Wall Street both bought and created the demand for subprime mortgages that fueled the crisis).

24. Investors faced the following credit risks: that a borrower would default on their loans, that the borrowers would pay off their loans too early, and that borrowers would sue the SPV for wrongdoings in the loan origination. Strauss, *supra* note 22, at 2050–54.

25. Strauss, *supra* note 22, at 2046–48.

26. Strauss, *supra* note 22, at 2045–48 (describing the securitization process in detail).

27. *See* Jason Cox et al., *Why Did the Credit Crisis Spread to Global Markets? in* The E-Book on International Finance and Development (Enrique Carrasco ed., 2010), http://www.uiowa.edu/ifdebook/ebook2/contents/part5-II.shtml. Investors here face a different problem from that confronted by the borrowers.

All the major financial firms have become public companies, and many investment funds are managed by managers. The managers (not the investors themselves) made investment decisions. These managers' fees were based on the trades they did and on the short term performances. Some scholars have referred to this as an agency problem. Stiglitz, *supra* note 1, at 12–13; Faber, *supra* note 8, at 130–33 (pointing out that thirty years ago, most of the firms on Wall Street were partnerships while these days all the major financial firms are public companies

28. *See* Cox et al., *supra* note 27.

29. One may wonder why then the subprime mortgage crisis brought down so many lenders and investment banks such as Bear Stearns and Lehman Brothers. One explanation is that some investors had contractual protection from risk. Before 2006, most of the sales of MBSs did not offer any protections to third-party investors other than the standard warranties. Allan N. Krinsman, *Subprime Mortgage Meltdown: How Did It Happen and How Will It End*, 13 J. Structured Fin., Summer 2007, at 13, 15–16. After 2006, as investors began to worry about the default risks, some of the agreements contained features that would protect an investor in the event when default exceeds a certain level. When the defaults began in 2007, these agreements came back to haunt the sellers of those financial products. Another explanation is that toward the end of the subprime mortgage bubble, some of the banks might not have been able to sell all of the derivative products that they put together before the increase in defaults that set off the subprime mortgage crisis. *See, e.g.*, Kara Scannell, *SEC Split on Goldman Case*, Wall St. J., April 20, 2010, at A1. After it put together the Abacus CDO in 2007, Goldman Sachs apparently had to keep a part of it because it was not able to find a buyer, according to people familiar with the Abacus CDO, the subject of a Securities and Exchange Commission civil fraud lawsuit filed in April 2010 against Goldman Sachs). Some of the financial players bought into their own fiction and invested heavily in those securities products themselves. Stiglitz, *supra* note 1, at 14; Michael Lewis, The Big Short, Inside the Doomsday Machine 206–07 (2010).

30. Zandi, *supra* note 11, at 13, 79–87 (pointing out that in 2006, at the peak of the subprime boom, foreign investors owned nearly one-third of all U.S. mortgages); Faber, *supra* note 8, at 72, 111–19, 165 (detailing a small town called Narvik in Norway, 150 miles inside the Arctic Circle, that bought some American CDOs as an investment without understanding the CDO products).

31. Arguably, Wall Street would not have been able to create such a demand for esoteric financial products without the AAA ratings provided by rating agencies. The rating agencies, unfortunately, had incentives to issue the high ratings Wall Street wanted because Wall Street paid the agencies' fees. The rating agencies' role in this crisis is an example of how resourceful companies or industries can corrupt the system for its own benefit. Andrews, *supra* note 2 at 147–48 (citing a Wall Street analyst's research that Wall Street firms corrupted the rating agencies).

32. Faber, *supra* note 8, at 66–74.

33. Andrews, *supra* note 2, at 112–18.

34. Faber, *supra* note 8, at 98–101.

35 .Faber, *supra* note 8, at 100.

36. Faber, *supra* note 8, at 102.

37. Faber, *supra* note 8, at 102 (quoting Ann Rutledge, a former analyst at Moody's who rated structured products).

38. For a detailed explanation of the various CDO products, please see Faber, *supra* note 8, at 103–09.

39. Faber, *supra* note 8, at 102.

40. Zandi, *supra* note 11, at 42.

41. Andrews, *supra* note 2, at 145; Faber, *supra* note 8, at 127–30.

42. Andrews, *supra* note 2, at 145; Faber, *supra* note 8, at 130–33 (pointing out that thirty years ago, most of the firms on Wall Street were partnerships while now all the major financial firms are public companies).

43. Zandi, *supra* note 11, at 95.

44. Faber, *supra* note 8, at 66–74, 163 (describing Wall Street's role in creating the subprime mortgage frenzy because of its willingness to buy the mortgages from originators which in turn incentivized the originators to push the loan products to borrowers).

45. Can one argue that securitization is the culprit? I would disagree. Securitization is a legitimate tool to connect the mortgage markets with the capital markets. Securitization by itself allows the shifting of the risks to investors who are compensated for their willingness to bear the risk; however, securitization alone would not have spawned such reckless disregard for the risks without the unfettered incentive to maximize profits.

46. Professors Schwartz and Scott seem to assume that businesses are automatically motivated to maximize joint gain in a contractual relationship. *See* Alan Schwartz and Robert E. Scott, *Contract Theory and Limits of Contract Law*, 542 Yale L. J. 541, 547–48 (December 2003). This position assumes that all the firms have equal access to information and equal bargaining power; however, not all firms do. An example in the business-to-business context is the disparity in bargaining power between Walmart and its suppliers. The same concerns exist in business-to-consumer contexts.

47. Robert S. Adler & Richard A. Mann, *Good Faith: A New Look at an Old Doctrine*, 28 Akron L. Rev. 31, 35, 42 n.24 (1994).

48. *See* Chunlin Leonhard, *A Legal Chameleon: An Examination of the Doctrine of Good Faith in Chinese and American Contract Law*, 25 Conn. J. Int'l L. 305, 311–15 (2010), and all articles cited therein, for an overview of the doctrine of good faith in contract law.

49. Leonhard, supra note 48, at 313–14.

50. Leonhard, supra note 48, at 313-14

51. Leonhard, supra note 48, at 312–13.

52. Leonhard, *supra* note 48, at 313 (and the articles cited therein).

53. "Good faith, except as otherwise provided in Article 5, means honesty in fact and the observance of reasonable commercial standards of fair dealing." U.C.C. § 1-201 (2008).

54. Leonhard, *supra* note 48, at 311–12.

55. Leonhard, supra note 48 at 314.

56. Luigi Russi, *Can Good Faith Performance Be Unfair? An Economic Framework for Understanding the Problem*, 29 Whittier L. Rev. 565, 572 (2008).

57. For a detailed discussion on the doctrine, please *see* Harold Dubroff, *The Implied Covenant of Good Faith in Contract Interpretation and Gap-Filling: Reviling a Revered Relic*, 80 St. John's L. Rev. 559 (2006).

58. Restatement (Second) of Torts § 283 (1965) (hereafter "Rest. (2d) Torts".

59. Rest. (2d) Torts § 283 cmt. B.

60. Rest. (2d) Torts § 283 cmt. c.

61. Rest. (2d) Torts § 283 cmt. c.

62. Restatement (Second) of Torts § 892B (1979).

63. Nicola W. Palmieri, *Good Faith Disclosure Required During Precontractual Negotiations*, 24 Seton Hall L. Rev. 70, 102–04 (1993).

64. Seana Valentine Shiffrin, *The Divergence of Contract and Promise*, 120 Harv. L. Rev. 708, 739 (2007).

65. Steve W. Feldman, *Autonomy and Accountability in the Law of Contracts: A Response to Professor Shiffrin*, 58 Drake L. Rev. 177, 220 (2009).

66. Clayton Gillette, *Limitations on the Obligations of Good Faith*, 1981 Duke L.J. 619, 620–21.

67. Michael Bridge, *Doubting Good Faith*, 11 New Zealand. Bus. L.Q. 426, 433 (2005).

68. Steven Rattner, *The Rich Get Even Richer*, The New York Times OP-ED Monday, p. A23, March 26, 2012.

69. *See generally* Fukuyama, *supra* note 7, at 6–7 (espousing the need for economic relationships that create rather than destroy wealth).

70. *See* Kreitner, *supra* note 9, at 1547 (stating that the focus on individual exchange will not capture all the social stakes).

71. Daniel Kahneman, THINKING FAST AND SLOW 8-10 (2011) (tracing the studies that he and his colleagues have done since the 1970s that eventually uncovered many human decision biases undermining the generally accepted basic notion that human beings were rational.) I do not mean to suggest that the rationality assumption fails in all cases. Part of the difficulty with contract law is that the word "contract" fails to capture the complexities of commercial relationships encompassed by the word. On one end of the spectrum of contractual relationships there are multiple-year complex relationships in areas dealing with natural resources such as oil exploration, and on the other end, there are single-item sales transactions. Between the two extremes lie many variations of economic relationships. In some situations, contractual parties may have equal bargaining power and equal access to information. However, the adoption of a broader duty of good faith applying the "reasonable person" standard would not disrupt those types of contractual relationships that are consistent with the current contract law paradigm.

72. The predominant conception of the rational choice microeconomic theory is that people act rationally to maximize their own expected utility. *See* Russell Korobkin & Thomas S. Ulen, *Law and Behavioral Science: Removing the Rationality Assumption from Law and Economics*, 88 Calif. L. Rev. 1051, 1062 (2000), for a detailed discussion of the various conceptions of the rational choice theory. This theory assumes that decision makers conduct a cost/benefit analysis of competing options and choose the option that would maximize their expected utility. Korobkin*, et. al.* at 1063.

73. *See, e.g.*, *Lochner v. New York*, 198 U.S. 45, 53 (1905).

74. It is true that every rule of general applicability has certain exceptions. That some assumptions can be wrong sometimes does not necessary undermine the validity of that particular general principle which relied on those assumptions. However, there comes a time when the underlying assumptions are so wrong and to such a large extent that the general principle can no longer be justified. That moment has arrived for contract law.

75. Korobkin & Ulen, *supra* note 72, at 1055–56.

76. *See* Robert A. Prentice, *Chicago Man, K-T Man, and the Future of Behavioral Law and Economics*, 56 Vand. L. Rev. 1663 (2003), for a detailed discussion of the shortcomings of the behavioral economics theory and its challenges.

77. Ariely, *supra* note 10, at xx.

78. *See* Christine Jolls, Cass R. Sunstein, and Richard Thaler, *A Behavioral Approach to Law and Economics*, 50 Stanford L. Rev. 1488 (May 1998). Professors Jolls et al. pointed out that there could be five different definitions of rationality. It could mean that the person's behavior: (1) conforms to the expected utility theory; (2) is responsive to cost and benefit incentives; (3) is internally consistent; (4) promotes his or her own welfare; or (5) is effective in achieving his or her own goal.

79. Bar-Gill, *supra* note 14, at 1118–21.

80. Kahneman, *supra* note 71, at 113-14, 120-21, 130, 138, 218, 252-53.

81. Kahneman, *supra* note 71, at 130-31.

82. Kahneman, *supra* note 71, at 138.

83. Kahneman, *supra* note 71, at 10.

84. Kahneman, *supra* note 71 at 130-31.

85. Ariely, *supra* note 10, at xx (offering an interesting in-depth examination of the human decision-making process and the biases that affect it).

86. Kahneman, *supra* note 71 at 88.

87. Ariely, *supra* note 10, at xx.

88. Bar-Gill, *supra* note 14, at 1119–23.

89. *See* Faber, *supra* note 8, at 51-52 (stating that a lack of regulation enabled unscrupulous practices, such as not verifying income); Alan White, *Behavior and Contract,* 27 Law & Ineq. 158-60 (Winter 2009) (pointing out that the marketing industry spends billions of dollars on behavioral research to devise marketing strategies which can increase sales).

90. Faber, *supra* note 8, at 54.

91. Faber, *supra* note 8, at 45. For a detailed discussion of how lenders exploited these decisional biases in consumer contract contexts, see White, *supra* note 89, and the articles cited therein.

92. Information asymmetry can be caused by multiple factors. It could be due to a lack of access to relevant information, the inability to understand relevant information because of its difficulty, and/or the deliberate manipulation of human decision-making biases. The information asymmetry during the subprime mortgage transactions is caused by all of the above factors. That is also the reason why merely improving disclosure, which goes to the issue of access to information only, is insufficient.

93. *See generally* Jolls et al., *supra* note 78, at 1522 (exploring ways law can best be structured to achieve specific ends, such as deterring socially undesirable behavior).

94. *See* Jolls et al., *supra* note 78, at 1522 (advocating a behavioral approach to legal analysis that reflects better understanding of human behavior).

95. Great contract law scholars view "rules of law not as mystical absolutes but as tentative approximations subject to change as the conditions which called them forth themselves changed." Ronald K.L. Collins, *Foreword, in* Grant Gilmore, The Death of Contract, at vii, xix (2d ed. 1995) (quoting Grant Gilmore, *Review: Justice Joseph Story and the Rise of the Supreme Court*, 39 U. Chi. L. Rev. 244, 244–45 (1971)).

96. Stiglitz, *supra* note 1, at 205.

97. *See, e.g.,* Steven D. Levitt & Stephen J. Dubner, Freakonomics 64-69 (2005) (discussing how real estate agents use their information advantage to manipulate home prices).

98. Stiglitz, *supra* note 1, at 207 ("The old rules, whether they worked well in the past, are not the right rules for the twenty first century.").

99. Stiglitz, *supra* note 1, at 175–76 (endorsing the need for a Financial Products Safety Commission).

100. Faber, *supra* note 8, at 66–74.

101. Lewis, *supra* note 29, at 72–77.

102. Zandi, *supra* note 11, at 13, 79–87.

103. Brody Mullins, *Senators Seek Cash as They Mull Rules*, Wall St. J., April 21, 2010, at A4 (reporting on various fundraising activities by both Republican and Democratic Parties while they were actively debating possible regulations of the financial markets in the wake of the subprime mortgage crisis). One cannot help but wonder how much the millions of dollars are going to affect the regulators' zest for creating and implementing any financial regulations.

104. *See* Danielle Kie Hart, *Contract Formation and the Entrenchment of Power*, 41 Loy. U. Chi. L.J. 175, 216 (2009) (stating that discrepancies in the relative power of parties are maintained by judicial enforcement of the contract).

105. *Bill Moyers Talks with David Cay Johnston*, PBS.com (Jan. 18, 2008), http://www.pbs.org/moyers/journal/01182008/transcript1.html?print. There is extensive evidence that the subprime mortgage crisis disproportionately affected minority groups. Lenders in fact employed various race-based tactics to entice minority groups to buy subprime mortgage products. *See also* Andrews, *supra* note 2, at 190–93.

106. There is an increasing disparity between the rich and the poor in the United States. Stiglitz, *supra* note 1, at xxii. *See also* Andrew Ross Sorkin, Too Big to Fail 3–4 (2009); David Cay Johnston, *The Gap Between Rich and Poor Grows in the United States*, N.Y. Times, Mar. 29, 2007, http://www.nytimes.com/2007/03/29/business/worldbusiness/29iht-income.4.5075504.html (reporting that "income inequality grew significantly in 2005, with the top 1 percent of Americans—those with incomes that year of more than $348,000--receiving their largest share of national income since 1928").

107. U.S. Const. arts. I–III.

108. Steve Ramirez, *Toward a More Perfect Capitalism: Legal Infrastructure and the Subprime Mortgage Crisis of 2007-2009* at 2 (draft manuscript) (on file with author).

109. *See* U.S. Const. arts. I–III.

110. *See* U.S. Const. arts. I–III.

111. *See* Hart, *supra* note 104, at 216-17 (discussing the ways that the presumption of contract validity immunizes coercive elements from being effectively challenged, thereby providing insight into one mechanism by which wealth is concentrated).

112. Ramirez, *supra* note 108, at 2.

113. Ramirez, *supra* note 108, at 11.

114. Stiglitz, *supra* note 1, at 207.

115. Some scholars have challenged contract law's focus on efficiency maximization only. *See, e.g.,* White, *supra* note 89. Professor Kar also challenged the principle of efficiency maximization because of its failure to "respect the separateness of persons, and . . . what is special about our distinctive relationships with one another" and its exclusion of "considerations of justice and fairness from the relevant legal calculus." Robin Bradley Kar, *Contract Law and the Second-Person Standpoint: Why Efficiency Maximization Principles Can Neither Explain Nor Justify the Expectation Damages Remedy*, 40 Loy. L.A. L. Rev. 977, 980 (2007). *See also* Schwartz & Scott, *supra* note 46, at 545 (advocating that contract law should only concern itself with the efficiency goal in business to business contracts).

116. Schwartz and Scott argue that the only normative goal of contract law in firm to firm contracts (referred to as Category I contracts) is to facilitate their efforts to maximize the gains for both parties. Schwartz & Scott, *supra* note 46, at 544, 549. They argue that the negative externalities that might potentially be generated by these contracts such as environmental pollution or price fixing can be regulated by environmental laws and anti-trust laws. They concluded that contract law for a modern economy should be "little more than honest courts and a set of enforcement rules," aided by a set of strict "textualist interpretation rules." Schwartz & Scott, *supra* note 46, at 546–47.

117. For purposes of this discussion, this article does not challenge contract law's adherence to the normative goal of efficiency. It is beyond the scope of this article to examine in depth the

various definitions of efficiency. Some scholars have questioned whether efficiency should be the only normative goal of contract law. There are advocates on both sides of the fence. *Compare* White, *supra* note 89, at 136 (arguing that the normative goal of contract law should be a balancing of competing interests of efficiency and fairness in the consumer contract context), *with* Schwartz & Scott, *supra* note 46, at 545 (arguing that contract law should only concern itself with efficiency).

118. Zandi, supra note 11, at 42; FCIC Report, *supra* note 3, at 8 (describing a term coined during the subprime mortgage boom—IBGYBG, or "I'll be gone, you'll be gone"—that referred to deals that brought in big fees to bankers while pushing larger losses to the future and to third parties).

119. *See* discussion *supra*.

120. The failure is especially acute if one understands "wealth" to mean not just economic wealth, but also human wellbeing. *See* Uwe E. Reinhardt, *Where All that Money Went*, N.Y. Times, Apr. 30, 2010, http://economix.blogs.nytimes.com/2010/04/30/where-all-that-money-went (writing that "economists think of wealth not just in monetary terms—as cash, stocks, bonds and real estate—but in terms of human well-being.").

121. FCIC Report, *supra* note 3, at xv, 8. To the extent one narrowly defines efficiency only in terms of wealth maximization at the individual efficiency level, one could argue that the contract law's *laissez faire* approach promoted efficiency at the individual level in some cases because some individuals and companies were able to arguably maximize wealth for themselves. Lewis, *supra* note 29, at 256. However, this view of the efficiency goal is very problematic because the individual wealth maximization was at the expense of the society as a whole.

122. FCIC Report, *supra* note 3, at xvi, xxi.

123. Prins, *supra* note 12, at 6–7.

124. FCIC Report, *supra* note 3, at xv (pointing out that as of the printing time of the report, "there are more than 26 million Americans who are out of work, cannot find full-time work, or have given up looking for work. About four million families have lost their homes to foreclosure and another four and a half million have slipped into the foreclosure process or are seriously behind on their mortgage payments.").

125. FCIC Report, *supra* note 3, at xv.

126. Andrews, *supra* note 2, at x–xi.

127. Jonathan C. Dickey, *Subprime Related Securities Litigation: Where Do We Go From Here?*, (PLI-Corp. Law & Practice Course Handbook Series No. 14433, 2008).

128. Preliminarily, the investments in the auto and financial industries appear to be yielding returns, though not enough to pay back the bailouts. *See, e.g.*, Rachelle Younglai & Andrew Hay, *AIG's Financial Condition Improving: U.S. Watchdog*, Reuters (Jan 20, 2011, 4:58 p.m.), http://www.reuters.com/article/idUSTRE70J79320110120; Josh Mitchell & Sharon Terlep, *U.S. Unlikely to Recoup GM Bailout, Panel Says*, Wall St. J., Jan. 13, 2011, at B4. FCIC Report, *supra* note 3, at xvi (pointing out that "the impacts of this crisis are likely to be felt for a generation. And the nation faces no easy path to renewed economic strength.").

129. Where the contractual parties actually have equal access to information and equal bargaining power, one can understand that the transaction may create efficiencies because the parties would not have entered into this transaction unless they believed that it was good for them.

130. This is consistent with the individualistic culture and the free market economy of this society. Contract law has elevated those values to new heights by cheering on the pursuit of individual self-interests and protecting those self-interests when necessary.

131. Shiffrin, *supra* note 64, at 722.

132. Shiffrin, *supra* note 64, at 717–18. Professor Shiffrin's article focused on contract law's apparent departure from the moral rule that "breach of promise is wrong," Shiffrin, *supra* note 64, at 724, with respect to its remedial doctrines. My quarrel with contract law is the theoretical underpinnings for the contract law paradigm itself. The contractual remedial doctrines' tolerance of breach (viewed by Professor Shiffrin as a departure from the moral rule) reflects certain unwarranted assumptions underlying contract law theory.

133. Shiffrin, *supra* note 64, at 740–41.

134. Professor Shiffrin expressed "a further worry about a legal regime that introduces divergent norms that apply to agents simultaneously alongside moral norms—namely, whether moral individuals can participate in both cultures without running the risk that their participation will corrode the habits and expectations associated with moral practice." Shiffrin, *supra* note 64, at 740.

135. Andrews, *supra* note 2, at xiii.

136. Raymond H. Brescia, *Trust in the Shadows: Law, Behavior, and Financial Re-Regulation*, 57 Buff. L. Rev. 1361, 1366–68 (2009).

137. Fukuyama, *supra* note 7. I do not intend to suggest that the duty of good faith is a panacea for all the ills that plague the free market economy. I believe that it would nurture a different mindset more conducive for the growth of the society as a whole.

138. Kreitner, *supra* note 9, at 1548.

139. Michael Shermer, The Mind of the Market 178 (Henry Holt & Co. 2008).

140. Shermer, *supra* note 139, at 178.

141. *See* Faber, *supra* note 8, at 1, 10.

142. Stiglitz, *supra* note 1, at 200.

143. See*, e.g.*, Levitt & Dubner, *supra* note 97, at 16–17.

144. See Levitt & Dubner, *supra* note 97, at 16–17

145. *See generally* Thaler & Sunstein, *supra* note 9. I borrowed the "nudge" concept from Professors Thaler and Sunstein.

146. Ariely, *supra* note 10, at 222.

147. Ariely, *supra* note 10,at 208–09.

148. Ariely, *supra* note 10,at 212.

149. David Sally, *Conversation and Cooperation in Social Dilemmas: A Meta-Analysis of Experiments from 1958 to 1992*, 7 Rationality & Soc'y 58, 78 (1995) (summarizing results of prior studies).

150. Shermer, *supra* note 139, at 176.

151. Shermer, *supra* note 139, at 125.

152. Shermer, *supra* note 139, at 125.

153. Jolls et al., *supra* note 78, at 1492, 1545.

154. Shermer, *supra* note 139, at 126.

155. Professor Mitchell F. Crusto advocates applying constitutional principles to protect predatory lending victims—who are often socially and economically disadvantaged citizens—in what he terms, " 'moral capitalism,' guaranteeing freedom from economic oppression and ensuring financial fair dealing." Mitchell F. Crusto, *Obama's Moral Capitalism, Resuscitating the American Dream*, 63 U. Miami L. Rev. 1011 (2009).

156. The FCIC report concluded that the financial crisis was avoidable. *See* FCIC Report, *supra* note 3, at xviii.

The sentries were not at their posts, in no small part due to the widely accepted faith in the self-correcting nature of the markets and the ability of financial institutions to effectively police themselves. More than 30 years of deregulation and reliance on self-regulation by financial institutions, championed by former Federal Reserve chairman Alan Greenspan and others, supported by successive administrations and Congresses, and actively pushed by the powerful financial industry at every turn, had stripped away key safeguards, which could have helped avoid catastrophe.

# THE MONITOR

The Monitor is an agenda of matters of interest to the financial services industry. The Monitor includes: (1) regulatory and related matters on which comment periods are open; (2) important regulatory initiatives that are still pending and under active consideration; (3) recent regulatory matters of continued urgency to the financial services community; and (4) cases pending before the US Supreme Court and other federal and state courts. All cases are listed by subject. Unless otherwise noted, this issue of The Monitor covers developments during the period April 20, 2012 through May 20, 2012.

## BANK REGULATION

### Examinations Prompt Lending Concerns, ABA Study Shows

Bankers are concerned that the post-financial crisis examination regime could permanently chill lending, either by making it more expensive or by leading banks to deny loans that could face regulatory criticism, a new survey from the American Bankers Association reveals. "We find that in dangerous ways distance has developed between the bank supervisory program and its value-added mission," the study, *Value-Added Bank Supervision: A Framework for Safely Fostering Economic Growth*, says.

According to the survey, 73 percent of respondents felt bank examinations added value before the financial crisis, whereas only 45 percent felt this was the case post-crisis. Meanwhile, 34 percent of bankers felt examinations post-crisis actually were counterproductive, compared to three percent with the same view prior to the crisis. The study notes that the change in attitude reflects the various concerns that emerged during in-depth interviews with bank executives.

Other findings in the survey show:

- 49 percent of respondents indicated that changes in examination practices would toughen underwriting standards permanently;
- 48 percent agreed that changes would require borrowers to have more equity in their deals; and
- 48 percent said that changes would reduce their willingness to lend to borrowers that previously they would have considered creditworthy.

*Study Recommendations*

The study offers a number of recommendations to reinforce the concept of value-added examinations and supervision. Those recommendations include greater customization of examinations and more concentration on the "big picture," rather than focusing on technicalities and minor issues that have little bearing on the safety and soundness of an institution.

Other recommendations include increased clarity about effective minimum capital standards, as regulators weigh the costs of capital standards that are higher still. Also, the study advocates giving more banks the option of going through a stress test rather than relying on loan classifications and supports the use of experienced examiners, cooperation with state bank examiners and self-review by regulators.

### Debit Card Interchange Fees Falling, Fed Study Shows

Average debit card interchange fees charged by issuers subject to the Federal Reserve Board's interchange fee cap fell in the fourth quarter of 2011 to 24 cents, compared with an average of 43 cents prior to enactment of the rule on Oct. 1, 2011, a Fed study has determined. The average interchange fee for exempt issuers remained at 43 cents. The study was mandated by the "Durbin Amendment," to the Dodd-Frank Act, which required the Fed to set fee caps.

The Fed study showed that there were approximately 46.7 billion debit card transactions in 2011, with a value of more than $1.8 trillion, representing a 24-percent increase over the number of 2009 transactions and a 27-percent increase over the value of 2009 transactions. According to the Fed, signature debit transactions represented about 63 percent of transaction volume and 61 percent of transaction value in 2011, with the remainder represented by PIN debit transactions.

The Fed noted that the average interchange fee for signature debit transactions fell 57 percent for non-exempt issuers in 2011 compared with 2009, and 8 percent for exempt issuers. Meanwhile, the average interchange fee per PIN transaction fell less than one percent over the same period for non-exempt issuers and rose 32 percent for exempt issuers. Furthermore, the Fed reported that the large disparity that existed in 2009 between the average signature debit and PIN debit interchange fees had narrowed substantially by 2011.

### *ABA Complaints*

The American Bankers Association remarked that due to the phased implementation of the Durbin Amendment, "it's impossible for this initial report to fully reflect or predict the consequences of upending the market with government price controls. It's just too soon to tell." The group also stressed that many small businesses now face higher interchange fees for small-dollar transactions, "a classic example of strange things that occur when government creates unnatural pressures to make up for lost revenue.

## Mutual Insurance Holding Company Treatment Clarified

The Federal Deposit Insurance Corp. has finalized a rule that treats a mutual insurance holding company as an insurance company for purposes of Section 203(e) of the Dodd-Frank Act. The final rule clarifies that the liquidation and rehabilitation of a covered financial company that is a mutual insurance holding company will be conducted in the same manner as an insurance company. The rule also harmonizes the treatment of mutual insurance holding companies under Section 203(e) of the Dodd-Frank Act with the treatment of such companies under state insurance company insolvency laws.

In providing for the orderly liquidation of a covered financial company under the Dodd-Frank Act, Congress recognized that insurance companies historically had been liquidated and rehabilitated pursuant to a state insolvency framework. As a result, Congress provided that "if an insurance company is a covered financial company or a subsidiary or affiliate of a covered financial company, the liquidation or rehabilitation of such insurance company, and any subsidiary or affiliate of such company that is [an insurance company], shall be conducted as provided under applicable State law."

According to the FDIC, from a regulatory policy perspective, the extensive regulation of the mutual insurance holding company by the insurance commissioner of its domiciliary state and the inclusion of the mutual insurance holding company and its assets in the liquidation of the converted mutual insurance company support the treatment of a mutual insurance holding company, under certain circumstances, as an insurance company. This treatment is appropriate given the legal structure that forms a mutual insurance holding company from a converted mutual insurance company and the continuing interest of the policyholders of the converted mutual insurance company in both the converted mutual insurance company, as its customers, and the mutual insurance holding company, as holders of its membership interests, the agency asserted.

The rule is effective May 30, 2012. The FDIC's notice appeared at 77 *Federal Register* 25349 on April 30, 2012.

## CFPB Seeks Comment on Information Collections

The Consumer Financial Protection Bureau has requested comments on the following information collections that have been submitted to the Office of Management and Budget for review and approval.

- **Mortgage Assistance Relief Services.**—The information collected helps prospective purchasers of mortgage assistance relief services make well informed decisions and avoid deceptive and unfair acts and practices. The information also is used by the CFPB and other relevant agencies for enforcement purposes and to ensure compliance by mortgage assistance relief service providers. (77 *Federal Register* 24181, April 23, 2012)
- **Consumer Leasing Act.**—Federal and state enforcement and private litigants use the information collected to determine whether accurate and complete disclosures of the cost of leases have been provided to consumers prior to consummation of a lease. This information provides the primary evidence in Consumer Leasing Act enforcement actions brought by federal agencies. (77 *Federal Register* 24182, April 23, 2012)
- **Mortgage Acts and Practices.**—The information collected helps ensure efficient and effective law enforcement to address deceptive practices that occur in the mortgage advertising area. (77 *Federal Register* 24181, April 23, 2012)
- **Real Estate Settlement Procedures Act.**—This collection helps to protect consumers from unnecessarily high settlement costs by providing information about the nature and cost of real estate

settlement services. It also enables consumers to compare estimated settlement costs with actual settlement costs and helps to protect borrowers from unnecessarily high settlement service charges due to the settlement service provider's use of an affiliated provider. Disclosures related to the servicing of the mortgage loan help to protect consumers if the servicing of the loan could be or is transferred. Disclosures related to consumers' escrow accounts help to protect them from unnecessarily high escrow charges. (77 *Federal Register*24182, April 23, 2012)

Written comments must be received by May 23, 2012.

### Regulators Clarify Volcker Rule Deadline

Entities covered by the Volcker Rule have until July 21, 2014, to conform their activities to the rule's restrictions on proprietary trading and on relationships with hedge and private equity funds, the federal banking, securities and commodities futures trading regulatory agencies have announced. A further extension of the deadline would be permitted by law, the agencies also noted.

Under the Dodd-Frank Act, the agencies were required to adopt regulations specifying the deadline for both banks and nonbanks to comply with the restrictions on their activities, and these regulations were adopted in February 2011 (*see* Reg. Y—Bank Holding Companies and Change in Bank Control (12 CFR 225) beginning at ¶13-851). The current guidance is intended to make clear that affected entities have the full period provided by Dodd-Frank to bring their activities into compliance. The agencies noted that, in the interim, they expect companies to engage in "good faith planning efforts" that will allow them to be in compliance by the deadline.

The guidance was issued formally by the Federal Reserve Board; however, the other regulatory agencies have said they intend to conform their supervisory activities to the clarification.

### FDIC Says DIF Restoration on Track

The Federal Deposit Insurance Corp. expects that the Deposit Insurance Fund balance is on track to meet the requirements of the DIF Restoration Plan and the Dodd-Frank Act, noting that the insurance fund has continued to recover as the banking industry's performance has improved. Under Dodd-Frank, the DIF has until Sept. 30, 2020, to reach the minimum designated reserve ratio of 1.35 percent. The FDIC is projecting that the reserve ratio should reach 1.15 percent in the second half of 2018. The designated reserve ratio is the ratio of the DIF to the estimated insured deposits.

The DIF balance has increased for eight quarters in a row, following seven quarters of decline, according to the FDIC, and now stands at $11.8 billion. For the period from 2012 to 2016 the FDIC is anticipating that bank failures will cost the DIF $12 billion, compared to estimated losses of $88 billion in the period 2008 to 2011. The FDIC is forecasting a continued slowdown in the number of bank failures, while the pace of upgrades will increase.

The American Bankers Association noted that banks will provide over $65 billion in revenue over the next five years, more than five times what the FDIC expects in bank failure costs. "As a result, the fund will capitalize much faster than the FDIC anticipates," the association predicted.

#### *Economic Uncertainty*

The FDIC added a cautionary note concerning economic uncertainty and the impact on the DIF. A slowdown in the economic recovery could result in bank failures rising above projections and failed bank assets declining in value. Such a decline in value could make past and future failures more costly, the FDIC said. Meanwhile, future assessment revenue and estimated insured deposits could diverge from staff projections depending on how banks adapt to the assessment rules adopted in 2011, as well as changes in bank risk profiles.

### CFPB Begins Planning for Arbitration Agreement Study

The Consumer Financial Protection Bureau has taken the first step into investigating arbitration agreements in consumer financial contracts by asking for comments on the scope, methods and data sources that should be used for a study required by the Dodd-Frank Act. Dodd-Frank gives the CFPB the authority to adopt regulations governing the use of pre-dispute arbitration agreements, even to the extent of banning them, but it requires the bureau first to carry out a study and report the study results to Congress. The current request does not ask for comments on what regulation, if any, the bureau should adopt. Rather, it is limited to the structure of the required study.

The CFPB is asking for suggestions on whether, and how, it should study:

- the prevalence of arbitration agreements in consumer financial contracts;
- what types of claims consumers bring in arbitration;
- whether financial services companies use arbitration to bring claims against consumers;
- whether consumers and companies are affected by the presence of an arbitration agreement in a contract; and
- how consumers and companies are affected by the use of arbitration proceedings.

## CFPB Seeks Comment on Information Collections

The Consumer Financial Protection Bureau is seeking comments on the following information collections that have been submitted to the Office of Management and Budget for review and approval.

**Financial Education Program**.—The collection will focus on financial education program elements related to increasing household nonretirement savings and/or reducing financial distress. The CFPB expects to collect quantitative and qualitative data through in-person, telephone or Internet based surveys.

**Secure and Fair Enforcement for Mortgage Licensing Act (Regulation G) 12 CFR Part 1007**.—The information collection is intended to improve the flow of information to and between regulators, provide accountability and tracking of mortgage loan originators, enhance consumer protections, reduce fraud in the residential mortgage loan origination process and provide consumers with easily accessible information at no charge regarding the employment history of, and publicly adjudicated disciplinary and enforcement actions against, mortgage loan originators.

**Truth in Savings (Regulation DD) 12 CFR 1030**.—Information collected will be used to ascertain whether accurate and complete disclosures of depository accounts have been provided to consumers. It also will provide the primary evidence of law violations in Truth in Savings enforcement actions brought by the CFPB and other agencies.

**Fair Credit Reporting Act (Regulation V) 12 CFR 1022**.—Information collected is intended to provide consumers with the information necessary to consider how and when to check and use their credit reports.

Written comments must be received by May 17, 2012. The CFPB's notices appeared at 77 Federal Register 22763 and 22764 on April 17, 2012.

### *Lending Discrimination Enforcement Principles Reaffirmed*

The Consumer Financial Protection Bureau has made clear that, in enforcing the Equal Credit Opportunity Act and its implementing regulation, the bureau will rely on all established legal principles including the disparate impact doctrine. The CFPB affirmed its adoption of the 1994 Policy Statement on Discrimination in Lending as part of all of its lending examination procedures. Thus the bureau will consider not just mortgage lending but also lending for purposes such as education, vehicle purchases and credit cards.

The ECOA makes it illegal for a lender to discriminate against applicants based on race, color, religion, national origin, sex, marital status or age (as long as the applicant is old enough to enter into a contract). Discrimination because an applicant has previously exercised a right under the Consumer Credit Protection Act or receives income from public assistance also is prohibited.

As described by the bureau, there are three methods of proving lending discrimination:

- overt evidence of discrimination;
- evidence of disparate treatment; and
- evidence of disparate impact.

The bureau cited the staff commentary to Reg. B to explain the disparate impact test. The commentary says that "The act and regulation may prohibit a creditor practice that is discriminatory in effect because it has a disproportionately negative impact on a prohibited basis, even though the creditor has no intent to discriminate and the practice appears neutral on its face, unless the creditor practice meets a legitimate business need that cannot reasonably be achieved as well by means that are less disparate in their impact."

*Consumer "Red Flags"*

In addition to issuing a bulletin for lenders, the CFPB published guidance for consumers that includes a set of "red flags" that could indicate illegal discrimination. Consumers were told to be alert for indications such as:

- being treated differently in person than on the telephone;
- being discouraged from making a credit application;
- hearing negative comments about members of any protected group;
- being denied credit for which they qualify, or being offered credit at a higher rate when they qualified for a lower rate;
- being denied credit without any explanation;
- receiving an offer that seems too good to be true;
- being pushed or pressured into accepting an offer.

### CFPB Proposes Altered Limit on Credit Card Fees

The Consumer Financial Protection Bureau has proposed to amend the section of Reg. Z—Truth in Lending (12 CFR 1026) that limits the total amount of fees a credit card issuer may require a consumer to pay with respect to an account. Reg. Z currently states that the limitation to 25 percent of the credit limit in effect when the account is opened applies prior to account opening and during the first year after account opening. The CFPB has proposed to revise the limit so that it applies only to the first year after the account is opened, in response to a federal court ruling that granted a preliminary injunction to block a 2011 Federal Reserve Board credit card fee rule from taking effect.

At issue in the lawsuit is the total amount of fees that a credit card issuer may require a consumer to pay with respect to a credit card account prior to the opening of the account. The 2009 Credit CARD Act limited certain fees charged during the first year after the account is opened to 25 percent of the account's initial credit limit. The CFPB notes that, for example, if the credit limit is $400, fees charged during the first year the account is opened generally cannot exceed $100. In April 2011, the Fed amended its rules implementing the CARD Act to extend this limitation to fees that the consumer must pay prior to opening an account, such as an application fee.

*Challenge*

The amendment was challenged in September 2011, in the US District Court for South Dakota. Chief Judge Karen Schreier granted a motion for preliminary injunction preventing the amendment from taking effect, citing the plain language of the statute that applied restrictions on fees only after a credit card account has been opened by a customer (see *First Premier Bank, et al. v. Consumer Financial Protection Bureau*).

In order to resolve the litigation, the CFPB is seeking comment on whether it should conform the rule to the court ruling so that it no longer applies to fees charged prior to account opening. The overall 25-percent cap on certain credit card fees charged during the first year, along with the other specific provisions of the CARD Act, would remain in place.

Comments must be received by June 11, 2012. The CFPB's notice appeared at 77 *Federal Register* 21875 on April 12, 2012.

## SECURITIES/SECTION 20/BROKER-DEALER

### SEC Chair Highlights Recent Reform Initiatives at Oversight Hearing

SEC Chair Mary Schapiro testified before the House Subcommittee on Capital Markets about the enormous changes and challenges for the SEC in the past three years. Subcommittee Chair Scott Garrett (R-NJ) said there was no shortage of issues to address with the chair—from money market funds, to conflict minerals, to the implementation of the JOBS Act, to oversight of broker-dealers and investment advisers, to Dodd-Frank Title VII rulemaking, to credit rating agencies, to market structure, to accounting and auditing oversight, to municipal advisers and much more.

In opening remarks, Rep. Garrett thanked Ms. Schapiro for her recent focus on reviewing the costs and benefits of SEC rules, including the new guidance that was issued last month to agency divisions and offices. He said he hopes Ms. Schapiro will be more supportive of his SEC cost-benefit legislation which would ensure that future chairs are subject to the same standard.

Financial Services Committee Chair Spencer Bachus (R-AL) referred to a letter that he and Rep. Jeb Hensarling (R-TX) sent to Ms. Schapiro about the SEC's intention to propose additional amendments to the money market fund rules given that the SEC has already missed numerous deadlines for implementing rules under the Dodd-Frank Act. Without any empirical data to support the need for additional reform measures, Rep. Bachus questioned Ms. Schapiro's priorities.

Rep. Bachus also noted that one regulatory gap that remains is the lack of sufficient oversight of investment advisers. He said that bipartisan legislation was introduced this week to establish one or more self-regulatory organizations in order to increase the examination rate for investment advisers that serve retail investors.

Rep. Hensarling commended Rep. Garrett for his legislation on cost-benefit analysis at the SEC and agreed with his view about the SEC's priorities and misallocation of resources in pursuing money market fund reform. Given that the SEC has missed a large number of Dodd-Frank mandatory deadlines for rulemaking, he said it raises questions about undertaking discretionary rulemaking initiatives.

Rep. Maxine Waters (D-CA) expressed concerns about the JOBS Act provision relating to research and said that Congress may have to revisit the matter. She also asked about the SEC's priorities and its plans to pursue proxy access. Ms. Schapiro said the staff is hard at work on the Dodd-Frank and JOBS Act provisions and has no capacity to take on proxy access at this time.

Rep. Carolyn Maloney (D-NY) asked for an update on the SEC's market structure initiatives. Ms. Schapiro addressed the measures that were adopted after the so-called flash crash. Rep. Maloney noted that it took the SEC five months to figure out what caused the flash crash and asked if the SEC has walked away from its initiative to require real-time reporting.

Ms. Schapiro said the SEC will go forward with a consolidated audit trail proposal which should be ready for a vote in the near future. The proposal likely will not include a requirement for real-time reporting, she said, because the costs are enormous.

Rep. David Schweikert (R-AZ) also questioned the need for additional money market fund reforms. Ms. Schapiro said the proposals under consideration would finish the job begun in 2010. The idea is to never again have taxpayers on the hook for a default, she said. She assured the congressman that the SEC will carefully examine the impact of any of the proposals that are under consideration.

In response to further questioning by subcommittee members about the money market fund issue, Ms. Schapiro acknowledged that there is no question that the available options require trade-offs. She has been subjected to a lot of vitriol for just raising the subject and the SEC has not even put out a proposal yet.

Rep. Brad Sherman (D-CA) reminded Ms. Schapiro that she told him in 2010 that the SEC would educate investors about the Iran sanctions and the risks of investing in companies that do business with Iran. The SEC once had a listing on its Web site relating to companies doing business in Iran. Rep. Sherman noted that it was disconnected four years ago and has not been reinstated. Ms. Schapiro said the information had been removed by her predecessor and she would have to look into the matter and get back to him.

### SEC Issues Definitions for Swaps-Related Terms

The SEC has issued new rules and interpretive guidance under the Exchange Act and the Commodity Exchange Act to define a series of terms related to the over-the-counter swaps market. The rules, written and adopted jointly with the CFTC, implement provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act that established a comprehensive framework for regulating derivatives. The Commission, in accordance with Title VII of the Dodd-Frank Act, has added to the Exchange Act definitions of key terms for security-based swaps. The Commission also has issued a Fact Sheet describing key provisions. These rules were adopted unanimously at the Commission's open meeting on April 18, 2012 following consultation with the Board of Governors of the Federal Reserve System. The rules are effective 60 days following publication in the *Federal Register*, although some CFTC final and interim rules have separate compliance dates and comment periods.

The new rules define the terms "swap dealer," "security-based swap dealer," "major swap participant," "major security-based swap participant," and "eligible contract participant." The term "swap dealer" will encompass firms conducting swaps of derivatives with a value of $8 billion a year. The original proposal suggested a $100 million de minimis threshold. Under the Dodd-Frank Act, the SEC has oversight over "security-based swaps", of which most are single-name credit default swaps. The threshold for other security-based swaps will be $150 million.

## FUTURES/DERIVATIVES/SWAPS/ COMMODITIES

### CFTC Eases Access to SDR Data for Foreign Regulators

The Commodity Futures Trading Commission voted to issue a Proposed Interpretative Statement regarding the confidentiality and indemnification provisions in the Dodd-Frank Wall Street Reform and Consumer Protection Act. The proposal generally exempts foreign regulators from the indemnification and confidentiality provision in the Dodd-Frank Act, and ensures that foreign regulators have access to data in Swap Data Repositories (SDR). This exemption applies only to data that is required to be reported and only if the SDR is recognized by the country's law and regulation.

The proposal passed the Commission by a vote of 5-0. The proposal's comment period will be open for 30 days from the date of publication in the Federal Register.

#### *Background*

The Dodd-Frank Act, passed by Congress in 2010, established a comprehensive framework for regulating the over-the-counter swap markets. To enhance transparency and promote standardization, the Dodd-Frank Act created a new class of registered entity—SDRs—to perform functions related to the collection and maintenance of swap transaction data and information.

CEA section 21(c)(7) requires that SDRs make swap data available to certain domestic and foreign regulators under specified circumstances. Separately, section 21(d) mandates that before an SDR may share the requested data or information, such regulators must agree in writing to abide by confidentiality requirements established in the CEA and to indemnify the SDR and the Commission for any expenses arising from litigation relating to the information provided by the SDR.

Section 752 of the Dodd-Frank Act seeks to "promote effective and consistent global regulation of swaps" and provides that the CFTC and foreign regulatory authorities "may agree to such information-sharing arrangements as may be deemed to be necessary or appropriate in the public interest…" In light of this statutory directive, and mindful of concerns raised by foreign regulatory authorities with respect to the indemnification provisions of CEA section 21(d), the Commission has strived to provide sufficient access to SDR data to appropriate domestic and foreign regulatory authorities.

In June 2011, the Chairman of the CFTC and the Chairman of the SEC, in a letter to the European Commissioner for Internal Markets and Services, expressed their belief that indemnification and notice requirements need not apply when a registered SDR is also registered in a foreign jurisdiction and the foreign regulator, acting within the scope of its jurisdiction, seeks information directly from the SDR.

#### *The Commission's Proposed Interpretative Statement*

Because some registered SDRs may also be registered, recognized or otherwise authorized in a foreign jurisdiction and may accept swap data reported pursuant to a foreign regulatory regime, the Commission concludes that the confidentiality and indemnification provisions of CEA section 21(d) generally apply only to such data reported pursuant to the CEA and Commission regulations.

The Commission further concludes that the confidentiality and indemnification provisions of section 21(d) should not operate to inhibit or prevent foreign regulatory authorities from accessing data in which they have an independent and sufficient regulatory interest—even if that data also has been reported pursuant to the CEA and Commission regulations. The Commission concludes that application of the requirements of CEA section 21(d) in these circumstances is unreasonable in light of, among other things:

- The importance of such data to the foreign jurisdiction's regulatory regime;
- Foreign regulators' interest in unfettered access to such data; and
- Traditions of mutual trust and cooperation among international regulators.

Accordingly, consistent with the Commission's Final SDR Rules, the Commission proposes to interpret CEA section 21(d) such that a registered SDR would not be subject to the confidentiality and indemnification provisions of that section if:

- Such registered SDR is also registered, recognized or otherwise authorized in a foreign jurisdiction's regulatory regime; and
- The data sought to be accessed by a foreign regulatory authority has been reported to such registered SDR pursuant to the foreign jurisdiction's regulatory regime.

*International Considerations*

The Commission remains committed to a cooperative international approach to the registration and regulation of SDRs, has consulted extensively with various foreign regulatory authorities in promulgating both its proposed and SDR Final Rules, and continues to work with these authorities to ensure appropriate access to swap data in SDRs. During its consultations, many foreign regulatory authorities expressed concern about the difficulty in complying with the indemnification provisions of CEA section 21(d).

As a consequence of these consultations with foreign regulatory authorities, and pursuant to the mandate for international cooperation in section 752 of the Dodd-Frank Act, the Commission has concluded that further guidance is necessary to ensure that appropriate access by foreign regulatory authorities is not inhibited.

While the SDR Final Rules address access to data by foreign regulators which have supervisory authority and regulatory responsibility over SDRs, the Commission is proposing an interpretative statement to ensure that other foreign regulators also receive sufficient access to data held in SDRs, which is reported pursuant to a foreign regulatory regime and where such foreign regulators have a sufficient and independent regulatory interest.

*Public Comment Requested*

The Commission requests comment on all aspects of its proposed interpretative statement. In particular, the Commission requests comment addressing whether and how the timing and implementation of foreign jurisdictions' regulatory regimes affect the Commission's proposed statement.

Comments may be submitted for 30 days from the date of publication in the Federal Register.

## COURT DEVELOPMENTS

### State Laws on Repossession Process Not Preempted

Maryland laws on the notices a national bank was required to send if it wished to repossess and sell the vehicle that secured an automobile loan were not preempted by the National Bank Act (NBA) or implementing Office of the Comptroller of the Currency (OCC) regulations, according to the US Court of Appeals for the Fourth Circuit. The court reversed the dismissal of a class action and sent the suit back to the trial court.

According to the court, the consumer bought a used car from a dealer and initially obtained financing from the dealer. However, the dealer then sold the contract to a national bank. The contract included a term specifying that it was subject to the state closed-end credit law; however, that term was optional, in that the dealer could have chosen to rely on the state retail installment sales law. Under the closed-end credit law, the dealer—and subsequently, the bank—was permitted to impose much higher late fees but was required to comply with certain notice requirements if it repossessed and sold the vehicle.

The consumer eventually fell behind in her payments. The bank repossessed the vehicle, sold it and informed the consumer that it intended to seek a judgment for the remaining unpaid balance, but it did not comply with the notice requirements. The consumer then sued the bank, raising a number of state statutory and common law claims. After the bank removed the suit to federal court, the judge decided that the NBA and OCC regulations preempted the state law claims and dismissed the case. The appellate court, however, completely rejected the trial court ruling.

*Preemption*

Since the NBA did not itself preempt the state law, the question was whether preemption resulted from the regulation the OCC adopted to implement the act, found at 12 CFR 7.4008. As a starting point, the court considered whether the ordinary presumption against the preemption of a state law applied. The general presumption against preemption did not apply when the state attempted to act in an area that had a history of significant federal activity, the court said, a federal law granting powers to national banks ordinarily would preempt contrary state law. Thus, there was no presumption against preemption.

The court then analyzed the interaction between the state law and the OCC regulation under various claimed bases for preemption. To begin with, the state law was not included in the express preemption clause of the OCC regulation, the court said. The authority to repossess and sell collateral was a power granted by state law, not by federal law. That meant the state notice requirements did not obstruct the national bank's exercise of any power granted by federal law.

Neither the NBA nor the OCC regulations completely occupied the field of non-real estate lending, the court continued. Unlike the Home Owners Loan Act, which governed savings associations' activities, the NBA did not grant this full field preemption authority. Moreover, the OCC's regulations did not attempt to occupy the field fully, the court determined.

The NBA did grant national banks the power to make non-real estate loans, and that included the authority to collect those loans, the court agreed. However, that grant of authority did not address the methods of collecting those loans. The OCC regulations treated lending and debt collection differently, the court noted; in fact, debt collection was included in a part of the regulation addressing state laws that were not preempted.

The court also rejected the bank's claim that the state law was preempted by the part of the OCC regulation that preempted state disclosure requirements, concluding that the required notices did not constitute disclosures. A disclosure is an informational statement of terms given before a transaction, the court said, while the state law required a specific communication of a claim or demand to be given during or after a transaction. Since the notices related to the collection of a debt were not disclosures, the state law requiring them was not preempted. For the same reason, the notice requirement did not trigger preemption by the part of the regulation addressing "other credit related documents."

Finally, the court decided that the state law had only an incidental effect on national banks' lending activities. The regulation specifically mentioned "debt collection" as an area of state law that was not preempted, and the OCC statement at the time the regulation was adopted made clear that the regulation did not preempt state debt collection laws as long as the laws did not discriminate against national banks. There was no discrimination, according to the curt, because the law applied to all lenders.

*Breach of Contract*

The court also decided that the consumer should be permitted to proceed with her claim that the lender's failure to comply with the notice law breached a contractual agreement that required compliance, rejecting the bank's assertion that it should not be required to comply with a term it had no choice but to accept. The original lender had the choice of whether or not to include the contract term based on the remedies it wished to have in the case of default, the court noted. The bank that later bought the loan could not evade the consequences of the original lender's voluntary choice. [*Epps v. JP Morgan Chase Bank* (4thCir)]

## Extension of FIRREA Claim Period Denied

A trustee wishing to contest the payment of insurance policy proceeds to the Federal Deposit Insurance Corp., which was acting as receiver for a failed bank, has been denied an opportunity to sue after having failed to file a claim by the receivership deadline. The US Court of Appeals for the Seventh Circuit decided as part of its ruling that 12 days notice of the need to file an administrative claim was sufficient.

The facts described by the court were that the trust shared a split-dollar life insurance policy on the trust creator with a bank of which the creator was an executive and chairman. When the bank failed, the policy had a cash value of more than $662,000, of which the trust's interest was approximately $240,000. The remainder was owned by the bank.

The bank was placed into receivership on July 9, 2009, and the FDIC sent notices of the receivership that set the deadline for filing claims at October 7—90 days after the date of the notices, as provided by the Financial Institutions Reform, Recovery, and Enforcement Act. On August 25, the FDIC asked the insurance company for the policy cash value, and the company paid the full amount to the receivership on September 1. The trustee learned of the payment on September 24 when he called the insurance company to discuss the next payment.

On October 6, the trustee sent the insurance company a letter demanding payment, and the demand was repeated on November 5 and November 11. However, the insurer refused to make any further payment, pointing out that under the policy it had no liability for having surrendered the policy to the FDIC.

The trustee contacted the receiver for the first time on December 16, more than two months after the deadline for claims. The FDIC refused to consider the trustee's claim, noting that both the trustee (who also was an officer of the bank) and the trust creator had been sent notices of the receivership and proof of claim forms, but that no claims had been filed before the deadline.

### *FIRREA Claims Process*

FIRREA requires anyone wishing to make a claim against a receivership to file a claim with the receiver before filing suit. Assuming the receiver has provided the required notices, a claim not filed within 90 days of the first notice will be barred unless the claimant did not receive the notice in time to file the claim.

The trustee did not meet the 90-day deadline. However, he asserted that the deadline should be extended, basing his several arguments on when he learned of the potential claim and when he said the claim arose.

### *Denial of Extension*

The trustee's first argument was that he did not know of the claim against the receivership until the insurance company refused to make a payment, by which time the claims deadline already had passed. If this were true, an extension would be appropriate, the court conceded. However, the trustee learned the policy proceeds had been paid to the FDIC before the claims deadline, and that would have been enough for him to realize the trust's interests had been harmed and that a claim could exist against the receivership. No extension was appropriate on that basis, the court decided.

The fact that the claim arose during the 90-day period between the bank's failure and the claims deadline, rather than before the failure, also would not permit an extension, the court said. There simply was no justification under FIRREA for extending the deadline for claims that arose during the 90-day period as long as the trustee had enough time to file.

Twelve days was an adequate, although not ideal, time period, the court continued. While it would be appropriate to grant an extension to a claimant who did not have enough time to file, the trustee had not described such a "near-midnight discovery." The trustee did have enough time to make a formal demand on the insurance company, the court noted. The trustee's complaint that he never received formal notice of the receivership in his capacity as trustee was disregarded because he was a bank officer who would have had actual knowledge of the receivership.

### *Equal Protection Claim*

The court also rejected the trustee's last-ditch argument—that treating claims arising after the deadline differently from those arising before the deadline violated the constitutional requirement of equal protection under the law. The trustee was not a member of a protected class, the court pointed out. As a result, he was required to show that there was no rational basis for treating the two types of claims differently. "There is clearly a rational basis" for the different treatment, the court said. [*Campbell v. FDIC* (7thCir)]

## Consumer Loses Dispute Over Card Numbers

A credit card company's incorrect choice of which number constituted the card number would not have resulted in a willful violation of the prohibition on printing more than the last five digits on a receipt, according to the US Court of Appeals for the Seventh Circuit. The court reversed a trial court's decision to allow a consumer's Fair and Accurate Credit Transactions Act suit to proceed and instructed the trial judge to dismiss the case.

The company's cards displayed 14 digits, which were divided into two sets of numbers—a nine-digit account number followed by a five-digit card number. The company printed on its electronically created receipts the last four digits of the account number. The consumer asserted that this violated the FACT Act prohibition on printing anything other than the last five digits of the card number, and the trial court agreed. The appellate court disagreed.

*Meaning of "Card Number"*

The FACT Act did not define "card number," the court first said. Beyond that, the relevant section of the act used "card number" in one place and "account number" in another. As far as the court was concerned, however, precision was not necessary as long as the receipt did not include enough information to make the consumer vulnerable to identity theft.

Moreover, the standard was whether the company had willfully violated the act, the court continued. Given the lack of clarity in the act as to what number mattered and the lack of any increased risk to consumers, the company's violation—if there was a violation—could not have been willful, the court concluded. [*van Straaten v. Shell Oil Products Co.* (7thCir)]