Governance in the Public Corporation of the Future: The Battle for Control of Corporate Governance

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Eight years after passage of the Sarbanes-Oxley Act, Congress has again passed sweeping legislation in response to a corporate crisis.[1] In addition to changes in the regulatory environment for Wall Street financial firms and banks, the Dodd-Frank Act (D-F Act) also proposes reforms to corporate governance.[2] Before passage of the D-F Act, the Securities and Exchange Commission (SEC) began rulemaking on several governance matters addressed by Congress in the D-F Act; however, the SEC will begin rulemaking on many of the new corporate governance mandates over the next six to twelve months.[3] As federal securities laws and rulemakings continue to define corporate governance requirements, the new rules raise anew a discussion of what is (or perhaps what should be) the balance between state corporate law and federal securities laws in regulating corporate governance for public corporations.[4]

As Congress, the SEC, and national exchanges continue to develop rulemaking on director independence, compliance processes, disclosures, and leadership structure, any concerns over further intrusion of federal securities laws into state

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1 Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (2002).

2 Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010).

3 *Testimony Before the Subcomm. on Sec., Ins., and Inv.*, 112th Cong. 6–8 (2011) (statement of Mary Schapiro, Chairman, U.S. Securities and Exchange Commission), *available at* http://banking.senate.gov/public/index.cfm?FuseAction=Files.View&FileStore_id=d1bd7e59-137a-4d00-93d0-8ede516f52a0.

4 Mark J. Roe, *Delaware's Competition*, 117 HARV. L. REV. 588, 592 (2003) (discussing the race to the bottom in corporate law, and how the "federal authorities set the broad boundaries—of an uncertain and changing demarcation—within which the states can move"); Richard A. Booth, *The Emerging Conflict Between Federal Securities Law and State Corporation Law*, 12 J. CORP. L. 73, 74 (1986) (discussing the "implication of the dependence of the federal law of disclosure upon the state law of fiduciary duty is that when state law changes, so will federal law"); Marcel Kahan & Edward Rock, *Symbiotic Federalism and the Structure of Corporate Law*, 58 VAND. L. REV. 1573, 1575 (2005) (discussing the relation between federal and state corporate lawmaking).

corporate governance are perhaps moot as the proverbial "camel's nose" has already penetrated the tent.[5] Even federalists have begun to accept that not only does Congress have the right to regulate public corporations, but also that it will do so when investors lobby for federal rules to address fraud or other governance failures.[6] However, notwithstanding federal efforts to impose additional governance mandates, most corporate governance covering the relationship between shareholders and management remains firmly within the purview of state corporate law.[7] Perhaps, the more narrow issue then becomes not whether we are headed toward a federal system of governance for public companies, but whether the intrusion by federal securities laws into state governance matters are beneficial to shareholders.

In this Article, I examine the latest governance mandates under the D-F Act. In particular, this Article focuses on the disclosure requirements on the CEO and chairman positions, and argues that disclosures of whether the CEO is also the chairman benefit shareholders' governance rights under state law. The new provisions under the D-F Act combined with recent SEC disclosure rulemaking on board leadership structure address a fundamental issue of board decision-making and the affects of structural bias and "group think" on director behavior. Bifurcation disclosures for public companies provide shareholders with beneficial information on board leadership structure, but more importantly, the disclosure requirements force directors to engage in discussion and analysis of how board decisions are made, and whether such decisions can be unduly influenced by a dominant CEO. State fiduciary duty requirements do not directly address social and structural decision-making biases. Shareholders benefit when federal disclosure rules address state governance shortcomings that are not otherwise conducive to private ordering.

Part I of this Article explains the complimentary relationship between federal and state law, and looks at how securities laws focus on disclosure and state laws focus on fiduciary duties to protect shareholders from management misconduct. This part looks at how Congress and the SEC use

5 Stephen M. Bainbridge, *The Short Life and Resurrection of SEC Rule 19C-4*, 69 WASH. U. L.Q. 565, 620 (1991); Z. Jill Barclift, *Codes of Ethics and State Fiduciary Duties: Where is the Line?*, 1 J. BUS. ENTREPRENEURSHIP & L. 237, 258 (2008).

6 Leo E. Strine, Jr., *Breaking the Corporate Governance Logjam in Washington: Some Constructive Thoughts on a Responsible Path Forward*, 63 BUS. LAW. 1079, 1084 (2008).

7 *Id.* at 1081.

federal disclosure mandates to affect behavioral changes in board and management conduct.

Part II examines recent efforts by the SEC to influence board and management governance prior to the passage of the D-F Act. This part looks at 2010 SEC rulemaking on risk, compensation, and governance; focusing specifically on the governance rulemaking on disclosure requirements for the CEO and chairman positions. This part discusses the rationale for the rulemaking to address leadership and structural biases in board decision-making, and why board structure influences board decision-making.

Part II also explores briefly the provisions of the D-F Act related to corporate governance and looks at which provisions use disclosure to effect corporate governance changes. While this part briefly identifies and explains other corporate governance provisions in the D-F Act, the focus is on the provisions of the D-F Act that provide Congressional support of the SEC's efforts to influence board leadership and structural bias by examining the legislative history of the bifurcation provisions in the Act.

Part III explores the meaning of structural bias and group-think. This part examines the social nature of boards, how such influences affect leadership structure, and why federal bifurcation rules may benefit shareholders.

Part IV explores Delaware's approach to structural bias and group-think in board decision-making. This part looks at the difficulty shareholders face in trying to demonstrate the governance harm when directors' decision-making is influenced by group-think and CEO dominance. This part argues that federal disclosures on bifurcation forces directors to assess its leadership structure for structural biases and that the D-F Act's and the SEC's disclosure mandates benefit shareholders.

I. THE COMPLIMENTARY RELATIONSHIP: FEDERAL AND STATE CORPORATE LAW

The relationship between federal securities laws and state corporate law is best described as synergistic and complimentary.[8] Federal securities laws and regulations, with their emphasis on public disclosures and financial reporting, are complimentary to state law's focus on the relationships between shareholders and corporate managers, and the fiduciary obligations of the board.[9] Recognizing the complimentary order

8 *Id.* at 1080–81.

9 *Id.*; Sean J. Griffith & Myron T. Steele, *On Corporate Law Federalism:*

of federal and state law, Congress has been careful not to intrude into areas reserved for state governance while carving out disclosure rules, which enables shareholders to make informed decisions.[10] The D-F Act provides an example of how Congress balances disclosure with state fiduciary obligations of directors. Language in the D-F Act on non-binding shareholders' vote on executive compensation specifically provides a rule of construction in which the non-binding shareholders' vote does not overrule a decision by the board, create or imply a change to fiduciary duties, or create additional fiduciary duties for directors.[11]

Notwithstanding the complimentary relationship of state and federal rules, the D-F Act and recent SEC rulemaking continue to demonstrate the effective use of disclosure rules to influence corporate governance.[12] Corporate governance requirements remain within states' regulatory purview and Delaware remains the dominant state for public company incorporation.[13] However, it is the truce between federal securities laws and Delaware corporate law, which continues to illustrate how governance, in particular fiduciary duties, develops in response to Congress' desire to act in the face of corporate crises.[14] History suggests that Congress acts in response to public pressures for reform.[15] Correspondingly, Delaware reacts by either amending its corporate laws or further defining fiduciary obligations of directors.[16] As Leo Strine writes, "why the American model of corporate governance has served investors so well is the synergies that arise from the combination of a strong regulatory structure governing public disclosures and

Threatening the Thaumatrope, 61 BUS. LAW. 1, 3–4 (2005) (discussing the origins of corporate governance federalism).

10 E. Norman Veasey, *State-Federal Tension in Corporate Governance and the Professional Responsibilities of Advisors*, 28 J. CORP. L. 441, 443–44 (2003) (discussing how federal law, such as the Sarbanes-Oxley Act, does not completely supplant state law); Griffith & Steele, *supra* note 9, at 4.

11 *Executive Compensation and Corporate Governance*, COVINGTON & BURLING LLP, 2 (July 21, 2010), http://www.cov.com/files/Publication/0fd9af21-04a7-4537-9d8e-bbc47050e295/Presentation/PublicationAttachment/e413a276-e87e-4af5-ac29-bfebc5f100ec/Dodd-Frank%20Act%20%20Executive%20Compensation%20and%20Corporate%20Governance.pdf.

12 Robert B. Thompson, *Corporate Federalism in the Administrative State: The SEC's Discretion to Move the Line Between the State and Federal Realms of Corporate Governance,* 82 NOTRE DAME L. REV. 1143, 1180–83 (2007).

13 Mark J. Roe, *Is Delaware's Corporate Law Too Big to Fail?*, 74 BROOK. L. REV. 75, 76–77 (2008) (discussing Delaware's dominance in corporate law, including explanations for its dominance).

14 *Id.* at 82 (discussing how Congress' response to corporate crises affects Delaware law rather than the law of other states due to its dominance in corporate law).

15 *Id.* at 83.

16 *Id.*

financial integrity, and a more nimble and enabling state law approach to the relations between corporate managers and stockholders."[17]

Yet, as Congress and the SEC continue to respond to investor concerns over management misconduct and board failures, new regulations and rules requiring disclosures on governance processes directly impact governance matters traditionally covered by state law.[18] Recent SEC rules and the governance provisions in the D-F Act continue to use disclosure as the way to compel boards to implement changes to their governance processes.[19] Before describing the D-F Act's governance provisions, it is necessary to examine rulemaking on governance by the SEC enacted prior to passage of the D-F Act and what effect the D-F Act may have on the SEC's rulemaking.

II. SEC RULES ON ENHANCED DISCLOSURE ABOUT RISK, COMPENSATION AND CORPORATE GOVERNANCE

Prior to passage of the D-F Act, effective in February 2010, the SEC implemented rulemaking covering board risk assessment, executive compensation, and corporate governance.[20] The new rules require disclosure of a company's compensation policies and risk management; disclosure on the experience, qualifications, attributes or skills of the director; disclosures about each director's experience at other public companies, including involvement in any legal proceedings; disclosure of how diversity is considered in the director nomination process; disclosure information about the role of the board's oversight of risk and leadership structure, including whether the company has combined or separated the chairman and CEO position, and why the company believes this structure is appropriate; quicker shareholder voting results; revisions to disclosure on director compensation; and disclosure about compensation consultants including fees paid to the consultant.[21]

The SEC's stated goal in adopting the new rules was to improve information in annual reports and proxy statements to give shareholders improved information to evaluate board leadership.[22] The D-F Act gave Congressional approval to many

17 Strine, *supra* note 6, at 1080.

18 Thompson, *supra* note 12, at 1180.

19 *See generally* Proxy Disclosure Enhancements, Exchange Act Release Nos. 33-9089; 34-62275 (Dec. 16, 2009), *available at* http://www.sec.gov/rules/final/2009/33-9089.pdf.

20 *Id.* at 39–45.

21 *Id.* at 29–45.

22 *Id.* at 4.

of the rulemaking provisions put forth in the SEC's rulemaking on proxy disclosure enhancements.[23] It is therefore unclear what adjustments the SEC must make to its prior rulemaking in order to satisfy the requirements under the D-F Act or whether there will be additional disclosure requirements. Although the D-F Act addressed systemic risk issues for the financial system, the SEC, as part of its 2010 rulemaking, issued rules to address the board's role in monitoring systemic risk.[24]

A. SEC's Disclosure on Risk Management and New Compensation Committee Rules

The SEC mandated that companies disclose the board's role in risk oversight, and whether such policies "are reasonably likely to have a material adverse effect on the company."[25] The new rules require companies to disclose and evaluate their compensation policies and practices for all employees (including non-executive officers) and assess whether there are any risks associated with those compensation policies and practices.[26] The purpose of the disclosure is to assist investors in determining whether a company has compensation incentives, which may lead to aggressive risk-taking by employees.[27]

The types of examples provided by the SEC for disclosure include: design of compensation policies and practices for employees whose behavior is most affected by compensation incentives and how such policies may relate to risk taking by the employees; how the company considers risk assessment in designing compensation incentives; explanation of how the company's compensation policies and practices may lead to risk taking by employees in both the short term and long term; any policies or changes to such policies regarding changes to compensation practices to adjust to risk profiles; and procedures to monitor risk policies and practices to determine whether its risk objectives are being met.[28]

These disclosures will require boards to inform shareholders how they monitor the level of risk taken by not just corporate executives, but all employees.[29] Boards will be better able to identify and address risky decisions by the chief executive, which

23 *Alert SEC Disclosure and Corporate Governance*, WEIL, GOTSHAL & MANGES LLP, 4 (Apr. 4, 2011), http://www.weil.com/files/upload/Weil_Alert_SEC_CG_April_4_2011.pdf.

24 Proxy Disclosure Enhancements, *supra* note 19, at 1.

25 *Id.* at 5.

26 *Id.* at 8.

27 *Id.* at 9.

28 *Id.* at 15–16.

29 *Id.* at 8–9.

may be driven by the CEO's compensation goals rather than the best interest of the corporation.[30] Improved risk management disclosures complement state fiduciary law by reinforcing good faith deliberations by the board.[31] Knowing that shareholders will be looking at its disclosures to see if the board's risk policies reward executives who take excessive risk with excessive compensation, directors will be careful to consider management decisions and engage in more open discord concerning management strategies.[32]

The combined new disclosures on compensation committee independence, executive compensation and risk management disclosures, and disclosures on the separation of CEO and chairman positions directly address issues of structural biases in board decision-making. The D-F Act provided Congressional approval of the SEC's rulemaking on board leadership structure.[33] The SEC's rationale for implementing bifurcation rules are explained below.

B. SEC Rulemaking on Board Leadership Structure

Under the SEC's rulemaking, companies are required to disclose why it has chosen to combine the positions of chairman and CEO and the reasons why the company believes this board leadership structure is appropriate for the company.[34] If the company combines the roles, but selects an independent lead director to chair meetings of independent directors, then the company must disclose why it has a lead director and the role the lead independent director plays in leadership of the company.[35] The disclosures are not intended to influence a company's leadership structure decisions; however, the purpose is to inform investors of the management's explanation for its board leadership structure, and to provide insight into the board's communication and the degree to which the board is able to exercise independent judgment about management.[36]

The SEC's rulemaking on governance remains within the traditional boundary of disclosure and financial integrity for federal rules. The disclosure function of the new bifurcation rule is consistent with recent federal efforts to influence director

30 *Id.* at 9.
31 *Id.*
32 *Id.* at 14.
33 *Id.* at 39.
34 *Id.*
35 *Id.*
36 *Id.* at 81 (discussing the benefits of the new disclosure about board leadership structure and the board's role in risk oversight).

behavior by mandating disclosures, notwithstanding the SEC's insistence that it did not intend to influence leadership structure decisions by the board.[37]

In response to investor concerns to perceived governance failures, the D-F Act includes several provisions to address governance lapses and enhance disclosure obligations of boards.[38] Congress' stated goals in passing legislation to further governance enhancements are to address the perceived failures of corporate governance in monitoring risk management and the governance failures.[39] The D-F Act provisions covering overall corporate governance is addressed below.

C. Dodd-Frank Act: Governance Provisions

The pertinent section of the D-F Act concerning corporate governance is Title IX, Subtitles E and G.[40] The provisions give shareholders proxy access by requiring a shareholder's vote to approve executive compensation, disclosure on executive compensation and financial performance of the company and recovery of erroneously awarded compensation; disclosure on director and employee hedging; call for rules on independence of compensation committee members and their consultants; and disclosure on bifurcation of chairman and chief executive officer positions.[41] Below are synopses of each governance provision and its stated goal in improving governance for shareholders.

D. Proxy Access: "Say on Pay"

Among the more talked about governance provisions are the so-called "say on pay" requirements.[42] The D-F Act authorizes the SEC to issue non-binding rules for shareholders' voting on executive compensation by giving shareholders greater

37 Josh Wright, *Stephen Bainbridge on Mandatory Disclosure: A Behavioral Analysis*, TRUTH ON THE MARKET (Dec. 7, 2010), http://truthonthemarket.com/2010/12/07/stephen-bainbridge-on-mandatory-disclosure-a-behavioral-analysis/ (discussing how "mandatory disclosure is a—maybe *the*—defining characteristic of U.S. securities regulation"); Thompson, *supra* note 12, at 1181–82 (discussing that if shareholder access rules were implemented, the federalism issue would likely disappear); Z. Jill Barclift, *supra* note 5, at 250 (discussing how federal securities law regulates disclosure).

38 Proxy Disclosure Enhancements, *supra* note 19, at 42.

39 CCH ATTORNEY-EDITOR STAFF, DODD-FRANK WALL STREET REFORM AND CONSUMER PROTECTION ACT: LAW, EXPLANATION AND ANALYSIS 420–21 (Aspen Pub. 2010).

40 Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. 111-203, §§ 951-57, 971-79, 124 Stat. 1376, 1899-1907, 1915-26 (2010) (to be codified in scattered sections of 15 U.S.C.).

41 *Id.*

42 Lucian A. Bebchuk, & Scott Hirst, *Private Ordering and the Proxy Access Debate*, 65 BUS. LAW. 329 (Harv. L. & Econ. Discussion Paper No. 653, 2010), *available at* http://ssrn.com/abstract=1513408 (discussing proxy access).

participation in executive compensation decisions.[43] Shareholders are given an advisory vote on executive compensation; however, shareholders are not permitted to micromanage executive compensation by setting limits and are limited to the right to express an opinion.[44] The purpose of the vote is to give shareholders information on compensation practices so that shareholders can evaluate whether such practices are in the shareholders' best interests.[45] Among the concerns expressed by Congress in passing these provisions was the desire to increase transparency and accountability, and to reinforce executive performance by rewarding short-term gain without penalizing for long-term consequences of decisions.[46]

The disclosures on pay versus performance require the SEC to develop proxy rules that provide an explanation of compensation and include information showing the connection between executive compensation paid and company performance.[47] Additionally, information on total median compensation of all employees, annual total compensation of the CEO, and a ratio comparing the CEOs total compensation to the median compensation of all employees must be disclosed.[48] The purpose of these disclosures is to improve the information provided to shareholders so that investors are informed about the relationship between executive pay and performance and can make comparisons with overall medians and assess what executives are being paid when the company's performance is failing.[49] The SEC addressed some of these enhanced compensation disclosure requirements in rulemaking effective February 2010 and will likely issue additional rulemaking to comply with the D-F Act requirements.[50]

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43 Dodd-Frank Wall Street Reform and Consumer Protection Act § 951-57; CCH ATTORNEY-EDITOR STAFF, *supra* note 39, at 420–23.

44 Dodd-Frank Wall Street Reform and Consumer Protection Act § 951; CCH ATTORNEY-EDITOR STAFF, *supra* note 39, at 421–23.

45 CCH ATTORNEY-EDITOR STAFF, *supra* note 39, at 421–22 ("Shareholders have raised concerns about large bonus plans in situation which they, as the company's owners have experienced loss.").

46 S. REP. NO. 111-176, at 133–34 (2010).

47 Dodd-Frank Wall Street Reform and Consumer Protection Act § 971; CCH ATTORNEY-EDITOR STAFF, *supra* note 39, at 430–31.

48 Dodd-Frank Wall Street Reform and Consumer Protection Act § 953; S. REP. NO. 111-176, at 135.

49 Dodd-Frank Wall Street Reform and Consumer Protection Act § 953; S. REP. NO. 111-176, at 135.

50 Proxy Disclosure Enhancements, *supra* note 19, at 1 (discussing that the amendments to these rules enhance the "information provided in connection with proxy solicitations and in other reports filed with the Commission"). The SEC issued a press release in January, 2011 adopting rules for Say-on-Pay and Golden Parachute Compensation in compliance with Dodd-Frank Act. Press Release, U.S. Sec. & Exch. Comm'n, SEC Adopts Rule on Say on Pay and Golden Parachute Compensation as

E. Executive Compensation: "Claw Backs"

The D-F Act imposes a requirement that public companies develop and disclose policies that, in the event the company is required to prepare an accounting restatement resulting from material noncompliance with financial reporting requirements, the company will recover from the executive officer any incentive compensation received.[51] Congress' intent was to require companies to recover executive compensation received due to lack of compliance with applicable reporting requirements so that shareholders would not have to resort to costly litigation to recover erroneously paid compensation.[52]

F. Disclosures on Hedging

The disclosures on hedging by employees and directors require shareholders to receive information in any annual proxy solicitation on whether employees or directors are permitted to purchase hedging financial instruments.[53] The purpose of this disclosure is so that investors know whether employees or directors have hedged any compensation granted to them in the event the company fails to meet its financial targets.[54]

G. Independent Compensation Committee

Another noteworthy provision in the Act is the independence requirements for compensation committee members and consultants.[55] The legislative history of the D-F Act suggests that Congress was not only concerned with disclosure, but also equally concerned with corporate governance processes.[56] Mandating the independence of key committees is not a new approach by Congress to deal with board decision-making; Congress, the SEC, and Exchange Act rules require independent audit committees and set forth parameters defining the meaning

Required under Dodd-Frank Act (Jan. 25, 2011), *available at* http://www.sec.gov/news/press/2011/2011-25.htm.

51 Dodd-Frank Wall Street Reform and Consumer Protection Act § 954; S. REP. NO. 111-176, at 135–36.

52 S. REP. NO. 111-176, at 135–36. "It has become apparent that a significant concern of shareholders is the relationship between executive pay and the company's financial performance for the benefit of shareholders." *Id.* at 135.

53 Dodd-Frank Wall Street Reform and Consumer Protection Act § 955; CCH ATTORNEY-EDITOR STAFF, *supra* note 39, at 427.

54 CCH ATTORNEY-EDITOR STAFF, *supra* note 39, at 427.

55 Dodd-Frank Wall Street Reform and Consumer Protection Act § 952; CCH ATTORNEY-EDITOR STAFF, *supra* note 39, at 423–25. "Independence" is not defined in the legislation, but rather that determination is left to the exchanges and associations. *Id.* at 423.

56 S. REP. NO. 111-176, at 137.

of "independent."[57] Similarly, the new requirements for independent directors on the compensation committee are consistent with prior federal governance rules on board committee structures.[58]

The D-F Act mandates that members of the compensation committee be independent board members.[59] The D-F Act leaves to the SEC the requirement of issuing rules for the national exchanges to prohibit listing companies that do not meet the compensation committee independence requirements.[60] The exchanges must consider certain factors when defining independence, including the source of the director's compensation and the director's affiliation with the company.[61] Additionally, compensation consultants to directors must also meet independence requirements.[62] The SEC must issue rules on the meaning of independence of compensation consultants, which must be considered by compensation committees before engaging the advisory services of consultants.[63] Factors in determining the independence of compensation committee consultants include whether the consultant provides other services to the company, the amount of fees paid to the consultant and the percentage of the consultant's total revenue from these fees, any business or personal relationships of the consultant to the company, policies and procedures for hiring consultants, and stock of the company owned by the consultant.[64]

The D-F Act also directs that a company give its compensation committee sole discretion to retain or to obtain advice from the consultant.[65] The company must also disclose whether it retained a consultant and whether there are "any conflict[s] of interest[,] and, if so, the nature of the conflict of

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57 15 U.S.C. § 78f (2010); Proxy Disclosure Enhancements, *supra* note 19, at 34–35 (discussing standards relating to Listed Company Audit Committee).

58 Dodd-Frank Wall Street Reform and Consumer Protection Act § 952; CCH ATTORNEY-EDITOR STAFF, *supra* note 39, at 423–25.

59 Dodd-Frank Wall Street Reform and Consumer Protection Act § 952; CCH ATTORNEY-EDITOR STAFF, *supra* note 39, at 423.

60 Dodd-Frank Wall Street Reform and Consumer Protection Act § 952; CCH ATTORNEY-EDITOR STAFF, *supra* note 39, at 425.

61 Dodd-Frank Wall Street Reform and Consumer Protection, Act § 952; CCH ATTORNEY-EDITOR STAFF, *supra* note 39, at 423.

62 Dodd-Frank Wall Street Reform and Consumer Protection Act § 952; CCH ATTORNEY-EDITOR STAFF, *supra* note 39, at 424.

63 Dodd-Frank Wall Street Reform and Consumer Protection Act § 952; CCH ATTORNEY-EDITOR STAFF, *supra* note 39, at 424.

64 Dodd-Frank Wall Street Reform and Consumer Protection Act § 952; CCH ATTORNEY-EDITOR STAFF, *supra* note 39, at 424.

65 Dodd-Frank Wall Street Reform and Consumer Protection Act § 952; CCH ATTORNEY-EDITOR STAFF, *supra* note 39, at 424.

interest."[66] The mandates for independent compensation committee members and rules on hiring and disclosure of compensation consultants are to provide investors with adequate information to assess the reliability of compensation committee reports.[67] Some of the legislative concerns over consultants have been addressed in earlier SEC rulemaking on compensation committee members' independence, and the SEC may modify or tweak its previously issued rules on compensation committee director independence to meet the requirements under the D-F Act.[68]

H. Disclosures on Bifurcation of CEO and Chairman Positions

The D-F Act requires the SEC to develop rules that require disclosure in annual proxy statements, which state the reasons why a company has chosen the same person to serve as chairman of the board of directors and CEO or why it has chosen different individuals in these positions.[69] The legislative history suggests that Congress understood there were valid reasons for having the same person serve as Chairman and CEO, yet recognized the importance of independent board leadership.[70] The SEC issued rulemaking on board leadership structure calling for disclosures on CEO and chairman roles, therefore additional SEC rulemaking may not be required to comply with D-F Act.[71]

All of the D-F Act's governance requirements cover governance areas traditionally left to federal securities laws—proxy rules, independent board members, and disclosure requirements.[72] What makes the federal rules on disclosing bifurcations in board leadership new is that, unlike rules for independent audit or compensation committee members, board leadership structure rules address the social and psychological reasons behind board decision-making.[73] It seems almost impossible not to disclose information on board leadership structure without the board first engaging in a discussion about

66 Dodd-Frank Wall Street Reform and Consumer Protection Act § 952; CCH ATTORNEY-EDITOR STAFF, *supra* note 39, at 424.

67 CCH ATTORNEY-EDITOR STAFF, *supra* note 39, at 424.

68 Proxy Disclosure Enhancements, *supra* note 19, at 47.

69 Dodd-Frank Wall Street Reform and Consumer Protection Act § 972; S. REP. NO. 111-176, at 147.

70 S. REP. NO. 111-176, at 147.

71 Proxy Disclosure Enhancements, *supra* note 19, at 39–45 (discussing proposed amendments and final rules on new disclosure about board leadership and the board's role in risk and oversight).

72 Holly J. Gregory, *Corporate Governance—United States*, WEIL.COM (last visited Mar. 23, 2011), http://www.weil.com/news/pubdetail.aspx?pub=4049.

73 Proxy Disclosure Enhancements, *supra* note 19, at 39 (requiring companies to disclose the reasons behind their choice of structure).

what is the most appropriate structure to encourage frank and open dialogue among directors. The SEC has designed rules, which give investors information on the inherent or the structural design of board membership, so that shareholders will know whether a dominant CEO or leader has exerted undue influence on board decision-making.[74] The influences Congress and the SEC seek to address are known as structural biases in decision-making by directors and the inability of boards to minimize the negative consequences of group-think. Part III examines the meaning of structural bias and group think.

III. STRUCTURAL BIAS AND THE SOCIAL NATURE OF BOARDS

Social science research documents that cohesive groups, such as boards, tend to engage in "group think" behavior and strongly identify with the group leader.[75] A dominant leader can often manipulate the group to comply with his wishes.[76] Directors thus often conform to the social norms of "group think" and limit frank discussion or dissent.[77] Governance processes to counter the effects of "group think" include not only independent directors, but removing the CEO as chairman or selecting an independent director to lead discussions with other independent directors without the influence of the CEO.[78] Boards engage in group think when there is limited discussion of ideas and few directors are willing to engage in critical analysis of ideas put forth by management.[79]

Rakesh Khurana, a noted leadership development scholar, and Katharina Pick, a Ph.D. candidate, in their article, *The Social Nature of Boards*, outline the challenges faced by boards as groups subject to influence by charismatic leaders.[80] Professor Khurana and Pick note the difficulty individual members of a group face in trying to stand up to leaders and why social norms of conformity often lead the board to acquiesce to the wishes of

74 *Id.* at 42–44.

75 *See generally* Marleen A. O'Connor, *The Enron Board: The Perils of Groupthink*, 71 U. CIN. L. REV. 1233 (2003).

76 Donald C. Langevoort, *Resetting the Corporate Thermostat: Lessons from the Recent Financial Scandals About Self-Deception, Deceiving Others and the Design of Internal Controls*, 93 GEO. L.J. 285, 297–300 (2004) (discussing the duration of CEO power and how it is obtained).

77 *Id.* at 295.

78 *Id.* at 313–14.

79 Troy A. Paredes, *Too Much Pay, Too Much Deference: Behavioral Corporate Finance, CEOs, and Corporate Governance*, 32 FLA. ST. U. L. REV. 673, 724–25 (2005); O'Connor, *supra* note 75, at 1238.

80 Rakesh Khurana & Katharina Pick, *The Social Nature of Boards*, 70 BROOK. L. REV. 1259, 1260 (2005).

the CEO, even when the CEO makes flawed decisions.[81] CEOs are often blinded in their decision-making by being unable to see the shortcomings of plans and by being surrounded by individuals unwilling or unable to challenge the prevailing views of the CEO.[82] Shareholders benefit from separating the CEO and chairman positions or designating a lead independent director because bifurcation affects structural biases and group think of board decision-making. State fiduciary duty laws limit the ability of shareholders to address issues of structural organizational bias, thus, the D-F Act governance provisions, combined with recent SEC rulemaking disclosure, enhance shareholders' rights under state corporate law, and arguably move federal securities laws even closer to regulating state corporate governance matters.[83] It is noteworthy to look at how Delaware, the state of choice for most public corporations, addresses the issue of structural bias in board decision-making in order to gain a better understanding of the limitations and benefits of federal bifurcation disclosures.

IV. THE DELAWARE APPROACH

Two Delaware cases, *Beam v. Stewart* and *In re Oracle Corp Derivative Litigation*, illustrate the issues faced by shareholders when trying to argue that a board or individual directors lack independence based on arguments of social or structural bias.[84]

In *Beam,* the shareholder brought derivative claims against Martha Stewart and other officers and directors for a variety of actions taken by the board after allegations of insider trading were brought against Martha Stewart, who was chairman and CEO, and the largest shareholder of Martha Stewart Living Omnimedia, Inc. (MSO).[85] It was agreed that Stewart and another officer were not independent or disinterested for

81 *Id.* at 1271. *See also* James D. Cox & Harry L. Munsinger, *Bias in the Boardroom: Psychological Foundations and Legal Implications of Corporate Cohesion*, 48 LAW & CONTEMP. PROBS. 83, 85–108 (1985).

82 Cox & Munsinger, *supra* note 81, at 85; Khurana & Pick, *supra* note 80, at 1273–74.

83 Kenneth B. Davis, Jr., *Structural Bias, Special Litigation Committee, and the Vagaries of Director Independence*, 90 IOWA L. REV. 1305, 1308 (discussing the meaning of structural bias for special litigation committees).

84 Beam v. Stewart, 845 A.2d 1040, 1040 (Del. Super. Ct. 2004) ("Shareholder brought derivative action against corporation's founder, officers and directors, and against corporation as a nominal defendant, seeking relief in relation to accusations of insider trading by founder, private sales of sizable shares of stock by some of the directors following insider trading scandal, and board of director's decision to provide founder with 'split-dollar' life insurance."); *In re* Oracle Corp Derivative Litigation, 824 A.2d 917, 917 (Del. Ch. 2003) ("Shareholders brought derivative action alleging insider trading by chief executive officer (CEO), chief financial officer (CFO), and two directors.").

85 Beam v. Stewart, 845 A.2d at 1044.

purposes of demand.[86] The shareholders argued that other members of the board were not independent because of either their longstanding personal relationships with Martha Stewart, or their indebtedness to Stewart in some personal or professional manner.[87] In affirming the Chancery Court's conclusion that the shareholder had failed to show facts raising a reasonable doubt as to the independence of the named directors, the Delaware Supreme Court stated that the court must make a fact-specific determination "by answering the inquiries: independent from whom and independent for what purpose? To excuse pre-suit demand in this case, the plaintiff has the burden to plead particularized facts that create a reasonable doubt sufficient to rebut the presumption that [the directors were] independent of defendant Stewart."[88] The court went on to state that the jurisprudence balance was to deter baseless shareholder lawsuits while permitting shareholders to demonstrate with particularized facts a lack of independence by directors.[89]

The court was unwilling to find that personal friendships or business relationships alone result in bias enough to render a director incapable of exercising independent judgment.[90] The court characterized the shareholders' arguments as "structural bias" and directly stated that while it was aware of the biases common to boards as part of the socialization process, it was unwilling to take notice of such arguments unless established in appropriately plead complaints.[91] The court acknowledged that the assessment of director independence varies depending on the state of litigation and that at the demand stage, a shareholder's limited discovery on independence may be "outcome-determinative" on the issue of independence.[92]

In *Oracle*, a case distinguished in *Beam*, the court concluded that close personal relationships were a factor in deciding that a special litigation committee was not independent.[93] The Oracle board established a Special Litigation Committee (SLC) in response to the derivative action filed by shareholders against the officers and directors.[94] The SLC recommended termination of the litigation.[95] The SLC had the burden of proof to establish

86 *Id.* at 1045.
87 *Id.* at 1046.
88 *Id.* at 1049–50.
89 *Id.* at 1050.
90 *Id.*
91 *Id.* at 1050–51.
92 *Id.* at 1055.
93 *In re* Oracle Corp Derivative Litig. 824 A.2d 917, 938 (Del. Ch. 2003).
94 *Id.* at 923.
95 *Id.* at 928.

that it satisfied the independence requirements set forth in *Zapata* v. *Maldonado*.[96] Focusing on whether the SLC was capable of being impartial and objective in reaching its decision, the court analyzed the ties of two SLC directors, professors at Stanford University, who were asked to investigate the conduct of a fellow director, who also had connections to Stanford.[97] The chairman and CEO was Lawrence Ellison, who was also a large contributor to Stanford.[98]

The court examined the close personal relationships among the directors with the Stanford connections and concluded that there was reasonable doubt as to the independence of the SLC.[99] While acknowledging that the SLC had engaged in extensive work and investigation, the court concluded that the Stanford ties and the relationship with Ellison made the SLC directors beholden to Ellison even though there were no financial ties.[100] Focusing less on whether the directors were in fact dominated or controlled by Ellison, but rather on knowledge of human motivations, the court stated:

> Delaware law should not be based on a reductionist view of human nature that simplifies human motivations on the lines of the least sophisticated notions of the law and economics movement. . . . We may be thankful that an array of other motivations exist that influence human behavior; not all are any better than greed or avarice, think of envy, to name just one. But also think of motives like love, friendship, and collegiality, think of those among us who direct their behavior as best they can on a guiding creed or set of moral values.[101]

The court took further notice of the social behavior and structural biases of boards by stating,

> corporate directors are generally the sort of people deeply enmeshed in social institutions. Such institutions have norms, expectations that, explicitly and implicitly, influence and channel the behavior of those who participate in their operation. Some things are "just not done," or only at a cost, which might not be so severe as a loss of position, but may involve a loss of standing in the institution. In being appropriately sensitive to this factor, our law also cannot assume—absent some proof of the point—that corporate directors are, as a general matter, persons of unusual social bravery, who operate

96 *Id.*
97 *Id.* at 929–36.
98 *Id.* at 932.
99 *Id.* at 942.
100 *Id.* at 925.
101 *Id.* at 938.

> heedless to the inhibitions that social norms generate for ordinary folk.[102]

Beam and *Oracle* demonstrate the different approaches taken by the Delaware courts in dealing with structural biases. In explaining the different approaches, noting the uniqueness of the SLC, the court in *Beam* writes "[u]nlike the demand-excusal context, where the board is presumed to be independent, the SLC has the burden of establishing its own independence by a yardstick that must be 'like Caesar's wife'—'above reproach.'"[103] The court went on to state "unlike the pre-suit demand context, the SLC analysis contemplates not only a shift in the burden of persuasion but also the availability of discovery into various issues, including independence."[104]

When shareholders have the burden of demonstrating independence, they must demonstrate with particularized facts more than structural biases.[105] When directors have the burden of demonstrating independence, they must demonstrate impartiality and courts are willing to consider structural biases in assessing independence.[106] Delaware's approach leaves shareholders at a disadvantage when structural biases limit the ability of shareholders to move a derivative case forward prior to the formation of a special litigation committee established to evaluate the merits of a derivative claim.[107]

A. Federal Bifurcation Rules and Common Law Fiduciary Duty

The D-F Act requirements and SEC disclosure mandates will require boards to evaluate and disclose its rationale for a board structure in which the CEO also serves as chairman of the board.[108] In circumstances where the CEO is also the chairman, under SEC rules, a company is permitted to appoint a lead independent director.[109] In such instances, company disclosures must define the responsibilities of the lead director.[110] Requiring companies to disclose and explain its governance policies as it relates to the CEO and chairman provides shareholders with

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102 *Id.*

103 Beam v. Stewart, 845 A.2d 1040, 1055 (Del. Super. Ct. 2004).

104 *Id.*

105 *Id.* at 1048–49.

106 *Id.* at 1049–51.

107 *Id.* at 1054.

108 For an example of recent company disclosures on board leadership see MCDONALD'S CORP., NOTICE OF 2010 ANNUAL SHAREHOLDERS' MEETING AND PROXY STATEMENT 2 (2010), *available at* http://www.aboutmcdonalds.com/etc/medialib/aboutMcDonalds/investor_relations0.Par.34096.File.dat/2010%20mcd%20proxy.pdf.

109 Proxy Disclosure Enhancements, *supra* note 19, at 43.

110 *Id.*

important information on the potential for the CEO to exercise dominance over board decision-making.

Delaware currently has no legislative requirements on the make-up of the board. Delaware common law examines director independence under a duty of loyalty and a demand futility analysis.[111] The analysis focuses on whether a director is interested or independent.[112] In a demand futility analysis, the court assesses whether a director is personally interested in the outcome of the litigation, or whether the director benefits or suffers directly from the outcome of the shareholder litigation.[113] Director independence in a duty of loyalty analysis also includes an assessment by the court of whether the director is dominated by an interested director.[114] In determining whether a director might be beholden to an interested director, Delaware courts have focused on whether there were financial ties between the directors.[115] Although the burden of proof depends on whether the allegations of lack of director independence are at the demand futility or the fiduciary analysis stage of the litigation, Delaware relies on its business judgment rule presumption and enhanced judicial scrutiny of board decisions in circumstances when there is a conflict of interest or breach of the duty of loyalty.[116] Provided an independent board or a committee has performed its duties in good faith, Delaware courts are reluctant to substitute its judgment for that of the board.[117]

While Delaware law permits shareholders to raise issues of domination in the context of assessing director independence, Delaware's fiduciary duty does not permit shareholders to shift the burden to directors to demonstrate that a board leadership structure in which the CEO is also chairman is not a conflict of interest or otherwise a breach of the duty of loyalty.[118] Provided the directors otherwise demonstrate independence and good faith, the board will be entitled to the business judgment rule presumption.[119] Delaware fiduciary law has done little to address directly CEO biases and domination when the CEO holds

111 *See In re* Tyson Foods, Inc. Consol. S'holder Litig., 919 A.2d 563, 582–83 (Del. Ch. 2007) (discussing the *Aronson* test for demand futility and the test for determining whether a duty of loyalty claim survives a motion to dismiss); *In re* Oracle Derivative Litig., 824 A.2d 917, 939 (Del. Ch. 2003) (discussing the standards set forth in *Aronson v. Lewis* and *Rales v. Blasband*).

112 *In re* Tyson Foods, Inc. Consol. S'holder Litig., 919 A.2d at 582.

113 *Id.*

114 *Id.*

115 *In re* Oracle Derivative Litig., 824 A.2d at 936.

116 *In re* Tyson Foods, Inc. Consol. S'holder Litig., 919 A.2d at 582.

117 *Id.*

118 *Id.*

119 *Id.* at 584.

both positions.[120] With improved federal disclosures on why a CEO holds dual positions or appointment of independent lead director, investors can evaluate structural biases in board decision-making.[121] More importantly, it is the opportunity for directors to more fully account for the effects of group think on board decision-making by understanding what social science data reveals about how decisions are made in groups.[122]

B. Bifurcation: The Benefit to Shareholders

Prior to passage of the D-F Act and SEC rules on bifurcation, shareholders had limited information on board leadership and structural bias.[123] Federal rules requiring disclosures of board leadership structure benefit shareholders by not only providing better information on board structure, but also by requiring directors to assess its board structure for structural biases and independence.[124] Engaging in a review of its board leadership structure improves directors' fiduciary obligations by ensuring independent directors are able to engage in frank discord without undue management influences.[125] Although companies are not required to separate the CEO and chairman's job, by forcing disclosures, the board must at least engage in an analysis of how its board structure works.[126] Separating the role of the CEO and chairman improves corporate governance by recognizing the social dynamic of board interaction in ways state fiduciary analysis does not.[127] Having the board justify its leadership structure also benefits shareholders in situations where shareholder derivative claims for breach of fiduciary limit the ability of shareholders to use discovery to uncover structural biases.[128] Shareholders may be better able to demonstrate demand futility when the board has disclosed its rationale for a leadership structure that does not separate the roles of chairman and CEO.

120 Langevoort, *supra* note 76, at 289–91 (discussing capture and the balance of power between the board and CEO); Paredes, *supra* note 79, at 724–25 (discussing how Delaware corporate law provides that the "[t]he business and affairs of every corporation . . . shall be managed by or under the direction of [the] board of directors," and thus the CEO has control because the board delegates it to him).

121 Joseph McCafferty, *Splitting the CEO and the Chair*, BLOOMBERG BUSINESSWEEK (June 12, 2009, 2:08 PM), http://www.businessweek.com/managing/content/jun2009/ca20090612_359612.htm.

122 *See supra* note 85, and accompanying text.

123 Proxy Disclosure Enhancements, *supra* note 19, at 4.

124 *Id.* at 4–5.

125 *Id.* at 43–44.

126 *Id.* at 44.

127 McCafferty, *supra* note 121.

128 Proxy Disclosure Enhancements, *supra* note 19, at 44.

Bifurcation disclosure requirements are a positive benefit for state corporate governance. Until state corporate law, in particular Delaware, begins to reexamine its rules on board structure, federal securities laws are likely to continue to legislate disclosure requirements to address issues of board group think in decision-making. Bifurcation of the CEO and Chairman moves a bit closer to blurring the complementary balance between federal and state law on governance.

CONCLUSION

In 2003, Professor Roe[129] wrote an article in which he argued that the real competition in corporate governance was not between Delaware and other states, but between Delaware and federal securities laws.[130] I agree with Professor Roe's observation. Federal rules continue to use disclosure mandates to affect behavior of corporate managers in their relationship with shareholders. The politics of responding to corporate crises is unlikely to see Congress or the SEC limit its role in effecting corporate governance changes for the public corporation. Congress sought to address specific corporate failures in the D-F Act—governance failures such as highly paid executive compensation in the wake of corporate failures, compensation committees rewarding executives for taking excessive risk, and directors seemingly unwilling to engage in critical analysis of the CEO or management's decisions.[131]

Do the new federal disclosure requirements on corporate governance benefit shareholders under state law? I believe the short answer to this question is yes; however, I am not convinced that the disclosure requirements can achieve improvements in board leadership without a corresponding shift in state corporate governance. The new rules will force the boards of public companies to engage in greater oversight of risk and disclose such risk. More importantly, the disclosures on board leadership structure will likely increase the overall independence of the board, allowing for improvements in frank discussion among board members. Where state fiduciary duty does not address or, as in Delaware, varies depending on the stage of shareholder litigation, shareholders are likely to face litigation disadvantages in a demand futility analysis for independence. State fiduciary

129 Professor Mark Roe is a noted scholar, who writes in the areas of corporate law and governance. He is the author of *Strong Managers Weak Owners: The Political Roots of American Corporate Finance*. Professor Roe is currently a professor at Harvard Law School.

130 Roe, *supra* note 4, at 592.

131 McCafferty, *supra* note 121.

duty analysis will continue to be supplemented by federal rules of disclosures. As Congress responds to specific corporate failures, state corporate law can respond to investor concerns with a more methodological, nuanced analysis of corporate conduct. Courts will respect good faith efforts by independent boards, and shareholders can be informed of how compensation committees and their consultants make their decisions. Boards who have an independent source of information with new rules on compensation consultants will continue to have the protection of business judgment rule. So in the end, notwithstanding federal laws' increasing push on state corporate law, the complimentary balance of federal and state law remains.

The Federal Government in the Fringe Economy

Jim Hawkins[*]

When most Americans need to borrow money, they turn to their local bank or credit union. For a substantial minority, around thirty million people, however, banks and credit unions never enter the picture.[1] Instead, people who are unbanked or underbanked turn to payday lenders, pawnshops, rent-to-own stores, or auto-title lenders for loans.[2] These businesses, commonly referred to as fringe banking companies, offer short-term loans to people who have been excluded from mainstream financial services because of poor or nonexistent credit histories or sporadic incomes.[3]

The term "fringe banking" almost conveys the erroneous notion that these lenders are a trivial part of the economy. In fact, quite the opposite is true; payday lenders and check cashers outnumber McDonald's restaurants and Wal-Mart stores in the United States.[4] Some estimates indicate that one in every ten Americans borrows money from a pawnshop every year.[5] For many Americans, alternative financial services providers represent their only access to financial services.[6]

Despite the important role fringe creditors play in the lives of millions of Americans, the federal agencies that regulate consumer credit have paid little attention to these lenders.

[*] Assistant Professor of Law, University of Houston Law Center. I am grateful to the *Chapman Law Review* for hosting such a superb, timely symposium, to Ronald Mann for comments, and to Eamon Briggs, Jason Gay, and Blaine Larson for excellent research assistance.

1 FEDERAL DEPOSIT INSURANCE CORPORATION, FDIC NATIONAL SURVEY OF UNBANKED AND UNDERBANKED HOUSEHOLDS 10 (2009) [hereinafter FDIC SURVEY] (reporting that 7.7 percent of American households, or nine million people, are unbanked, and 17.9 percent of households, or twenty-one million people, are underbanked).

2 *See* Ronald H. Silverman, *Toward Curing Predatory Lending*, 122 BANKING L.J. 483, 486 (2005).

3 *Id.*

4 HOWARD KARGER, SHORTCHANGED: LIFE AND DEBT IN THE FRINGE ECONOMY 6 (2005).

5 Jarret C. Oeltjen, *Florida Pawnbroking: An Industry in Transition*, 23 FLA. ST. U. L. REV. 995, 998 (1996).

6 FDIC SURVEY, *supra* note 1, at 10.

Indeed, almost no federal laws are aimed directly at fringe banking.[7] Although many states have implemented measures to protect consumers, the federal government has largely sat on the sidelines—until now.

The Dodd-Frank Wall Street Reform and Consumer Protection Act represents a massive overhaul of the federal government approach to financial markets generally, and a momentous sea change in the relationship between the federal government and fringe banking. One part of this legislation created the Bureau of Consumer Financial Protection (Bureau). Unlike the federal agencies before it, the Bureau presents a remarkable opportunity for the federal government to intervene in the fringe economy. For the first time ever, the federal government has empowered an agency to monitor and supervise fringe creditors, to study fringe credit markets, and to promulgate rules relating to fringe banking transactions.

This Article aims to describe and assess the effects the Bureau will have on fringe credit markets. I make two central claims. First, I argue that the Consumer Financial Protection Act (Act) gives broad, novel powers to the Bureau to regulate fringe credit. Part I describes the scope of the Bureau's power under the Act, demonstrating how the Act covers the vast majority of fringe credit transactions. Part II surveys the substance of the Act to reveal the surprising emphasis the Act places on the Bureau governing fringe banking transactions. The scope of the Bureau's authority coupled with its substantive mandate to confront problems in fringe credit markets signal the new power and interest the federal government has taken in the fringe economy.

Second, I argue that most of the justifications that have been offered for the Bureau regulating fringe credit are flawed. To understand why people have contended the Bureau should govern the fringe economy, I surveyed the two most important academic articles arguing in favor of the Bureau, and I conducted an empirical study to measure the frequency of the rationales for the Bureau regulating fringe credit in media, government press releases, and testimony to Congress. Part III presents the results of the study, and it assesses the different rationales for the Bureau intervening in fringe credit markets. Some

7 The one exception is the Talent-Nelson Amendment aimed at stopping payday lenders from lending money to military personnel. 10 U.S.C. § 987 (2006). *See generally* Patrick M. Aul, Note, *Federal Usury Law for Service Members: The Talent-Nelson Amendment*, 12 N.C. BANKING INST. 163 (2008) (discussing the intent and effects of the Talent-Nelson Amendment).

important rationales, such as the idea that the Bureau is needed to make fringe credit contracts less opaque or to prevent fringe credit from causing borrowers to experience financial distress, fail to comprehend fringe banking transactions and their effects. Other rationales for the Bureau, however, represent solid opportunities for the Bureau to improve the functioning of fringe credit markets and protect consumers. For instance, the Bureau can fill the need for a nimble regulator that can stop innovative ways fringe creditors avoid existing regulation. I conclude by urging the Bureau to seize the opportunity to act and to solve real problems in the fringe economy, not problems that are merely assumed to exist without evidence.

I. THE FRINGE ECONOMY AND THE SCOPE OF THE CONSUMER FINANCIAL PROTECTION ACT

For some time, legislators and commentators debated whether the Act should include pawnbrokers and payday lenders.[8] With the possible exception of rent-to-own contracts, however, it is clear that fringe banking services to consumers are within the scope of the Act. This part outlines which parts of the statute authorize the Bureau to regulate fringe credit.

A. Coverage Generally

The Act empowers the Bureau to "regulate the offering and provision of consumer financial products or services under the federal consumer financial laws."[9] In determining what consumer financial products or services means, it is important to note that the Bureau only has authority over *consumer* financial products and services. The Act defines "consumer" as an individual or someone acting on behalf of an individual,[10] although it does not define an individual, and limits consumer financial products or services to those "offered or provided for use by consumers primarily for personal, family, or household purposes."[11] In light of these definitions, a portion of fringe banking activity will not fall under the Bureau's authority because these products are used for business purposes, not personal ones.[12] This definition should assuage the fears of those

8 Binyamin Appelbaum, *Compromise Would Shield Some Lenders*, WASH. POST, Mar. 11, 2010, at A14.

9 Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 1011(a), 124 Stat. 1376, 1964 (2010) [hereinafter Dodd-Frank].

10 Dodd-Frank § 1002(4).

11 Dodd-Frank § 1002(5).

12 *See, e.g.*, Todd J. Zywicki, *Consumer Use and Government Regulation of Title Pledge Lending*, 22 LOY. CONS. L. REV. 425, 449 (2010) (asserting that around twenty-five to thirty percent of auto-title loans are taken out by small businesses).

who think that the Bureau's regulations will prevent small businesses from accessing credit.[13]

The definition for financial products and services reveals the lion's share of what the Act covers. The Act offers a list of transactions that it defines as financial products or services. Most significantly, the term includes "extending credit and servicing loans, including acquiring, purchasing, selling, brokering, or other extensions of credit."[14] Credit is given the same expansive definition as debt is in the Fair Debt Collection Practices Act[15] and is given a more expansive definition than in the Truth in Lending Act.[16] Credit means "the right granted by a person to a consumer to defer payment of a debt, incur debt and defer its payment, or purchase property or services and defer payment for such purchase."[17]

Based on this provision alone, the bulk of fringe banking transactions fall within the scope of the Act. In payday loans, auto-title loans, secured credit cards, and pawn loans, the lender generally directly extends credit to consumers. This definition encompasses the activity of payday and auto-title lenders who act as credit service organizations and merely charge a fee for connecting customers with lenders[18] because it includes firms that broker extensions of credit.[19]

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13 *See id.* at 425–26 (expressing concern that the creation of the Consumer Financial Protection Bureau could eliminate auto title lending which would "create hardship for many Americans who rely on auto title lending [such as unbanked consumers and independent small businesses] to meet urgent short-term expenses for utilities, housing and home repairs, and business expenses").

14 Dodd-Frank § 1002(15)(A)(i).

15 15 U.S.C. § 1692a(5) (2006) ("The term 'debt' means any obligation or alleged obligation of a consumer to pay money arising out of a transaction in which the money, property, insurance, or services which are the subject of the transaction are primarily for personal, family, or household purposes, whether or not such obligation has been reduced to judgment.").

16 15 U.S.C. § 1602(e) (2006); 12 C.F.R. § 226.2(14) (2010) ("Credit means the right to defer payment of debt or to incur debt and defer its payment.").

17 Dodd-Frank § 1002(7).

18 For a discussion of how payday lenders operate as credit service organizations, see Mary Spector, *Taming the Beast: Payday Loans, Regulatory Efforts, and Unintended Consequences*, 57 DEPAUL L. REV. 961, 983–95 (2008).

19 Dodd-Frank § 1002(15)(A)(i). Not only is the definition of credit more expansive in the Consumer Financial Protection Act than the Truth in Lending Act, the Truth in Lending Act's restrictions on who is a creditor are not found in the Consumer Financial Protection Act. *See* 15 U.S.C. § 1602(f) (2006) ("The term 'creditor' refers only to a person who both (1) regularly extends, whether in connection with loans, sales of property or services, or otherwise, consumer credit which is payable by agreement in more than four installments or for which the payment of a finance charge is or may be required, and (2) is the person to whom the debt arising from the consumer credit transaction is initially payable on the face of the evidence of indebtedness or, if there is no such evidence of indebtedness, by agreement.").

In some cases, the statute even specifies that fringe banking transactions are governed by the Bureau. For instance, check cashing is defined as a financial service.[20] Also, one section empowering the Bureau to obtain reports and conduct examinations of a limited number of non-depository entities specifically gives the Bureau such powers over anyone who "offers or provides to a consumer a payday loan."[21] Thus, it is clear that the Act is intended to cover payday loans.

There are several groups exempted from the Act's coverage, but in discussing these exemptions, the Act carefully specifies that fringe transactions are included under the Bureau's power. The Act exempts tax preparers from the Bureau's authority,[22] but the Act excludes firms offering refund anticipation loans from this exemption.[23] In a controversial provision,[24] the Act exempts car dealerships,[25] but it still includes companies commonly considered to offer car loans in the fringe economy—car dealerships that directly offer loans to customers and do not assign the loans to third parties.[26]

It is possible that some fringe banking firms will be exempt from the Bureau's power if the Bureau itself exempts them. The Act gives the Bureau the power to exempt any business from any provision of the Act or rule promulgated by the Bureau.[27] The factors the Bureau must consider in exempting a category of firms include the assets of the category of firms, the volume of transactions in which the firm engages, and "existing provisions of law which are applicable to the consumer financial product or service and the extent to which such provisions provide consumers with adequate protections."[28] Pawnshops are the

20 Dodd-Frank § 1002(15)(A)(vi).

21 Dodd-Frank § 1024(a)(1)(E).

22 Dodd-Frank § 1027(d).

23 Dodd-Frank § 1027(d)(2)(B) ("For purposes of this subsection, extending or brokering credit is not a customary and usual accounting activity, or incidental thereto.").

24 For an account of the controversy, see Appelbaum, *supra* note 8.

25 Dodd-Frank § 1029(a) ("Except as permitted in subsection (b), the Bureau may not exercise any rulemaking, supervisory, enforcement or any other authority, including any authority to order assessments, over a motor vehicle dealer that is predominantly engaged in the sale and servicing of motor vehicles, the leasing and servicing of motor vehicles, or both.").

26 Dodd-Frank § 1029(b)(2)(B) ("Subsection (a) shall not apply to any person, to the extent that such person . . . operates a line of business . . . in which . . . the extension of retail credit or retail leases are provided directly to consumers; and . . . the contract governing such extension of retail credit or retail leases is not routinely assigned to an unaffiliated third party finance or leasing source . . . .").

27 Dodd-Frank § 1022(b)(3).

28 Dodd-Frank § 1022(b)(3)(B).

most likely possibility because they are declining in number[29] and they are extensively regulated by every state.[30]

Finally, the Act has built into it a mechanism to prevent lenders from circumventing regulation by disguising credit sales as sales of other products or services. Reports indicate some fringe bankers have created such schemes in attempt to avoid state interest rate limits.[31] To prevent this strategic behavior, the Act clarifies that although the Bureau does not have authority to regulate a "merchant, retailer, or seller of any nonfinancial good or service,"[32] this exemption

> does not apply to any credit transaction or collection of debt . . . in which the credit extended significantly exceeds the market value of the nonfinancial good or service provided, or the Bureau otherwise finds that the sale of the nonfinancial good or service is done as a subterfuge, so as to evade or circumvent the provisions of this title.[33]

B. Pawnshops as Exchange Facilitators?

One commentator has argued that the Act singles out pawnshops for a study, which would reinforce the belief that pawnshops are covered by the Act.[34] The Act calls for a report on exchange facilitators,[35] and the commentator argues that the report thus refers to pawnshops:

> Among other kinds of fringe financial services, pawn shops as a source of temporary credit is suspected to be asset-stripping and predatory. The Bureau must conduct a study on consumers who use exchange facilitators for transactions primarily for personal, family, or household purpose to analyze the effect of these firms on consumer credit.[36]

This is almost certainly not right. The Act's definition of an "exchange facilitator" is a person who

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29 See John Caskey, Fringe Banking and the Rise of Payday Lending, in Credit Markets for the Poor 26 (Patrick Bolton & Howard Rosenthal eds., 2005) (noting that the growth in pawnbroking stopped around 1997 and in "many states, the number of pawnshops actually declined between 2000 and 2002").

30 *See generally* Oeltjen, *supra* note 5 (discussing the effect of state regulations on the pawnshop industry).

31 *See* Creola Johnson, *Payday Loans: Shrewd Business or Predatory Lending?*, 87 MINN. L. REV. 1, 20–21 (2002) (reporting that some payday lenders avoided rate caps by selling advertising space to consumers).

32 Dodd-Frank § 1027(a)(1).

33 Dodd-Frank § 1027(a)(2)(B).

34 TIM FERNHOLZ, NEW AMERICA FOUNDATION, THE CONSUMER FINANCIAL PROTECTION BUREAU: TOOLS, TRANSITIONS, AND CHOICES 9 (2010), *available at* http://pubcit.typepad.com/files/fernholz_cfpb_10-2010_final.pdf.

35 Dodd-Frank § 1079.

36 FERNHOLZ, *supra* note 34, at 9.

> facilitates, for a fee, an exchange of like kind property by entering into an agreement with a taxpayer by which the exchange facilitator acquires from the taxpayer the contractual rights to sell the taxpayer's relinquished property and transfers a replacement property to the taxpayer as a qualified intermediary (within the meaning of Treasury Regulations section 1.1031(k)-1(g)(4)) or enters into an agreement with the taxpayer to take title to a property as an exchange accommodation titleholder (within the meaning of Revenue Procedure 2000-37) or enters into an agreement with a taxpayer to act as a qualified trustee or qualified escrow holder (within the meaning of Treasury Regulations section 1.1031(k)-1(g)(3)).[37]

The term exchange facilitator, in both the Act's definition and common usage within the tax community, references tax transactions where an intermediary facilitates a tax-deferred exchange under section 1031 of the Internal Revenue Code.[38] Thus, while pawnshops are covered in the Act because they extend credit, the Act does not call for a special report on the industry.

C. Rent-to-Own

The only fringe banking product not clearly covered by the statute is rent-to-own. Commentary has covered a wide spectrum in discussing whether rent-to-own is covered by the Act. Some reports about[39] and analyses of[40] the Act conclude that

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37 Dodd-Frank § 1079(d)(1).

38 *See FEA Calls New Financial Reform Bill a Good Start Toward Federal Regulation*, NEWSWIRE TODAY, July 21, 2010, http://www.newswiretoday.com/news/74271/ (reporting that the Federation of Exchange Accommodators support this provision of the Dodd-Frank Act because they want federal regulation of their tax-related conduct).

39 *See* Ezra Klein, *Digging Into Finance's Pay Dirt*, WASH. POST, July 25, 2010, at G1 ("Sometime this spring, Democrats stopped calling Sen. Chris Dodd's bill 'financial reform' and started calling it 'Wall Street reform.' Most of the headlines and news releases on the sweeping legislation focused on the well-heeled, white-collar, upper crust of finance—investment banks, private-equity firms and hedge funds. But the bill President Obama signed into law Thursday will have a lot to say about payday lenders and check cashers and rent-to-own furniture stores—the blue-collar, far-off-Main Street joints."); Jonathan D. Epstein, *Financial Reforms Mean Big Changes*, BUFFALO NEWS, July 4, 2010, at C1 ("The new consumer financial protection bureau would have extensive power to make and enforce regulations, even over industries previously subject to little federal regulation. It will have authority over traditional products such as mortgage, credit card, student and other consumer loans, as well as non-banks like check-cashers, pawn shops, payday lenders and rent-to-own stores."); Jessica Machetta, *New Federal Oversight Bureau to Crack Down on Payday Lenders*, MISSOURINET, Nov. 23, 2010, http://www.missourinet.com/2010/11/23/new-federal-oversight-bureau-to-crack-down-on-payday-lenders/ ("[Brenda Procter of the University of Missouri] believes this new step of hiring a director to oversee non-depository institutions such as payday lenders and rent-to-own stores will give some focused attention to the issues that consumer advocates have requested for years.").

40 *See* JAY KIM ET AL., DORSEY, DODD-FRANK WALL STREET REFORM AND CONSUMER PROTECTION ACT 17 (2010), http://www.dorsey.com/files/upload/DoddFrankOverview.pdf ("The BCFP [Bureau of Consumer Financial Protection] is authorized to regulate the activities of any person or entity (a 'covered person') engaged in the business of providing

rent-to-own is covered by the Act. Some consumer advocates have noted it is unclear whether rent-to-own falls within the Act's control,[41] and some industry sources have similarly expressed concern over whether the Bureau will regulate rent-to-own.[42]

But beyond comments made mostly in passing, there has not been a clear exposition of the Act's coverage of rent-to-own based on the legislative history, the position taken by supporters of the Act, and the text of the statute. The following surveys the evidence from each of these categories and concludes that although the legislative history and positions taken by supporters do not give a clear indication about whether the law is intended to cover rent-to-own, the text of the statute suggests rent-to-own is not covered by the Act.

First, the legislative history is inconclusive regarding whether rent-to-own falls within the Bureau's purview. The rent-to-own industry tried to obtain language in the Act which

consumer financial products or services, including taking deposits; extending credit; servicing loans; leasing or brokering leases of real or personal property on a rent-to-own basis . . . ."); SUTHERLAND, NEW WHISTLEBLOWER PROTECTIONS FOR FINANCIAL SERVICE EMPLOYEES 1 (2010), http://www.sutherland.com (follow "Alerts+Publications" hyperlink, search "new whistleblower protections") ("The whistleblower must be in the employ of a 'covered person' (or a service provider assisting such covered person). A covered person is defined by Title X as any individual or incorporated entity that provides 'consumer financial products or services,' defined broadly to include lending (including payday lending), loan servicing, 'rent-to-own' leasing . . . ."); RICHARD P. HACKETT & FRANK H. BISHOP JR., PIERCE ATWOOD LLP, WORKING SUMMARY OF THE CONSUMER FINANCIAL PROTECTION ACT OF 2010 9 n.26 (2010), http://pierceatwood.com/files/811_WorkingSummaryoftheConsumerFinancialProtectionActof2010.pdf ("This exclusion *does not* apply if: (i) the person assigns, sells, or otherwise conveys non-delinquent debt (i.e., sells the consumer obligation); (ii) the credit extended significantly exceeds the market value of the non-financial good or service provided (e.g., rent-to-own); or (iii) the person regularly extends such credit and the credit is subject to a finance charge.") (emphasis added).

41 *Special Double Issue on the Dodd-Frank Financial Reform Bill*, NAT'L CONSUMER L. CENTER, July–Aug. 2010, at 7, http://www.nclc.org/dodd-frank/nclc-rpts-ccu-jul-aug-2010-web.pdf.

42 *Consumer Protection Agency Passes Key Committee*, TARGETED NEWS SERVICE, Oct. 22, 2009, *available at* http://www.rtohq.org/02826apro-consumer-protection-agency-passes-key-committee.html ("The U.S. House Financial Services Committee today approved creation of a controversial Consumer Financial Protection Agency (CFPA), charged with writing rules for mortgage and credit card lenders and other financial service providers which could include rent-to-own."); *Rent-A-Center Inc. Outlook Revised To Stable; 'BB' Corporate Credit, All Other Ratings Affirmed*, MARKET NEWS PUBLISHING, Nov. 10, 2009 ("The outlook revision to stable from positive reflects our reassessment of the probability of a ratings upgrade over the near term, and not any recent substantial unfavorable developments with respect to potential future RTO industry regulation under the proposed Consumer Financial Protection Agency Act of 2009 (CFPA). The reassessment reflects uncertainty surrounding whether the CFPA will be passed, what industries (including RTO) may be regulated by the act, and the impact of any such regulation. If we had greater assurance that Rent-A-Center would not be substantially negatively impacted by CFPA regulation, we would give consideration to a ratings upgrade.").

would have explicitly excluded rent-to-own, and this effort failed, potentially signaling that the Act includes rent-to-own.[43] Some Senators balked at the idea of exempting rent-to-own from the Act's coverage.[44] On the other hand, Charles Schumer attempted to insert language into the Act to ensure the Act covered rent-to-own and failed to get this language passed into law, suggesting the opposite conclusion, that rent-to-own is not covered.[45]

Several pieces of evidence from discussions and testimony about the Act suggest that some Senators thought rent-to-own was covered. For instance, consider this exchange between Senators Dodd and Schumer when discussing the differences between the bill the House and Senate passed:

> DODD: Could we try, I'm not going to—as I said I'm not going to offer the amendment now but could we try to deal with the non-bank payday lenders and the non-bank rent to own type people who escape regulation here?
>
> DODD: Well, we've raised that with the other side . . .
>
> SCHUMER: The House put it in. No, the House is OK with it. The House has it in their bill.[46]

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43 Letter from Americans for Financial Reform, to Christopher Dodd, Chairman, Senate Banking Committee (Dec. 7, 2009), *available at* http://ourfinancialsecurity.org/2009/12/consumer-financial-protection-agency-should-cover-rent-to-own-transactions/ ("In particular, we write to urge you to reject any amendments that would exempt the Rent-to-Own industry from coverage by the CFPA. Such an amendment was offered in House, phrased as an exclusion from the definition of credit of 'a bailment or lease which is terminable without penalty at any time by the consumer.'"); Victoria McGrane, *Industries Covet CFPA Exemptions*, POLITICO.COM, Oct. 21, 2009, http://www.politico.com/news/stories/1009/28538.html ("'Every industry is working hard to weaken the bill,' said Ed Mierzwinski, director of U.S. PIRG's consumer program, observing that even the rent-to-own industry is getting help seeking its own exemption from Democratic Rep. Joe Baca of California. 'Rent-to-own is just another predatory lender,' he said.").

44 *See* 156 CONG. REC. S3303-03 (daily ed. May 6, 2010) (statement of Senator Charles Schumer) ("And many of these businesses-payday lenders, rent-to-own companies-currently operate below the radar screen to prey on vulnerable communities. How can we exempt some of these payday lenders and rent-to-own companies? I have seen them prey on poor people in my State. How can we exempt them from regulation when they often are worse than many of the financial institutions?").

45 *See* 156 CONG. REC. S3065-02 (daily ed. May 4, 2010) (statement of Senator Charles Schumer) ("I am sponsoring an amendment to expand the enforcement authority of the Consumer Protection Bureau over all nonbanks, such as payday lenders and rent-to-own companies, to make sure consumers are protected no matter who they rely on for financial services."). *See also* Brian Tumulty, *New York Senators Buck Wall Street*, GANNETT NEWS SERVICE, Apr. 29, 2010 ("[Schumer's] working with Democratic Sen. Jack Reed of Rhode Island on an amendment that would create an independent Consumer Financial Protection Agency. The current bill would make the agency part of the Federal Reserve. Schumer also hopes to cosponsor an amendment with Sen. Kay Hagan, D-N.C., that would put payday lenders and rent-to-own centers under federal regulatory control.").

46 *House/Senate Conference Committee Holds a Meeting on the Wall Street Reform and Consumer Protection Act*, FD (FAIR DISCLOSURE) WIRE, June 22, 2010.

Testimony from people supporting the Act also assumes rent-to-own is covered. For instance, in support of an amendment to the Act regarding military families, Senator Jack Reed stated:

> Rent-to-own loans. This is where you go to a shop and you say I would like to rent a TV for 30 days because you am [sic] deploying in 45 days. Then you don't deploy so you keep it, and in some cases you end up paying two to three times the retail price of the appliance. At least individual soldiers have to be informed of those practices and know about it. We have to be sure they are getting that information . . . . That is what we want to do—coordinate these activities through a military liaison at a consumer financial protection agency. We want to do that because it is the right thing to do and because if we cannot protect the men and women who are protecting us, then we have to ask seriously whether we are doing our job. I know they are doing their job.[47]

Of course this testimony merely represents a single Senator's view about the law, and it is not even clear from the statement that Senator Reed believes rent-to-own is covered by the Act, as opposed to Reed believing the Act should cover rent-to-own. In the end, this testimony is like the other evidence of legislative intent—inconclusive.

With the evidence from legislative history being inconclusive, the text of the statute—the starting point for statutory interpretation[48]—is the best guide for determining rent-to-own's status under the Act. As is the case with many consumer protection laws, how rent-to-own is categorized will determine whether it is covered by the Act.

If rent-to-own is treated as a lease, it will almost certainly fall outside the Bureau's authority. The Act only governs leases of personal property within the definition of a financial product or service if "the lease is on a non-operating basis . . . [and] the initial term of the lease is at least 90 days . . . ."[49] Rent-to-own

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47 Senator Jack Reed, *Floor Statement Introducing Joint Amendment to Strengthen Consumer Protection for Military Families*, STATES NEWS SERVICE, May 7, 2010. *See also Media Conference Call with Senator Richard Durbin (D-IL); Senator Jack Reed (D-RI); And Holly Petraeus, Director, Better Business Bureau Military Line; Subject: Protection for Military Families Against Abusive Lending Practices*, FEDERAL NEWS SERVICE, May 12, 2010 ("They're numerous. They're legion. And, you know, we've got Marine squad leaders who need to do a lot more than, you know, take care of consumer activities of their Marines. This is something that should be done systematically by a consumer protection agency. Our families, our military families are vulnerable not just to auto dealers. They've [sic] vulnerable to pay-day loans who offer up to—interest rates up to 800 percent. You know, back where I come from, you know, that's—that would be frowned on by people who, you know, aren't legitimate businessmen and women. Rent-to-own loans, two to three times the price of the goods. We could go on and on and on.").

48 United States v. Ron Pair Entrs., Inc., 489 U.S. 235, 241 (1988).

49 Dodd-Frank § 1002(15)(A)(ii).

contracts are almost universally for less than 90 days, causing them to fall outside the Act.[50] On the other hand, if rent-to-own is considered an extension of credit, it will fall within the basic definition of a financial product or service.[51]

There is a significant debate both in courts and in academic commentary about whether rent-to-own transactions are sales on credit or leases.[52] People who argue it is a lease focus on the fact that the consumer does not have any obligation to complete the contract but can terminate it at any time.[53] Those who claim it is a credit sale emphasize the fact that the transaction is the functional equivalent of credit even if the form is different because the end result is people acquire ownership of a good over time and pay a premium for the good.[54]

The Bureau could govern rent-to-own transactions either if they fall within the Act's definition of credit or if the Bureau determines rent-to-own is a subterfuge to avoid federal consumer credit laws, like the Truth in Lending Act. The latter power is found in a provision of the definition of financial product or service which states that the Bureau can define rent-to-own as a financial product or service by rule "if the Bureau finds that such financial product or service is entered into or conducted as a subterfuge or with a purpose to evade any Federal consumer financial law."[55] The fact that some people consider rent-to-own a disguised credit sale might empower the Bureau to regulate it.

One way we could imagine determining whether rent-to-own is credit is by looking to state law. Different states define the transaction differently—most treating it as a lease by statute,[56] and some considering it a credit-sale by judicial decision.[57] Based on differences in state statutes, it is possible the Bureau would only have authority over rent-to-own transactions in states that treat the transaction as a form of credit. This, however, is

50 *See generally* Jim Hawkins, *Renting the Good Life*, 49 WM. & MARY L. REV. 2041 (2008) (discussing the rent-to-own industry and examining arguments for regulating it).

51 *Id.*

52 *Id.* at 2048 (collecting arguments for both sides).

53 *Id.* at 2051.

54 *Id.* at 2050.

55 Dodd-Frank § 1002(15)(A)(xi).

56 *See, e.g.*, CAL CIV. CODE § 1812.622(d) (West 2010) ("'Rental-purchase agreement' . . . means an agreement between a lessor and a consumer pursuant to which the lessor rents or leases, for valuable consideration, personal property for use by a consumer for personal, family, or household purposes for an initial term not exceeding four months that may be renewed or otherwise extended, if under the terms of the agreement the consumer acquires an option or other legally enforceable right to become owner of the property.").

57 Perez v. Rent-A-Center, Inc., 892 A.2d 1255, 1268 (N.J. 2006); Miller v. Colortyme, Inc., 518 N.W.2d 544, 549 (Minn. 1994).

unlikely because the Bureau or any court interpreting the Act will have to look to the Act's definition of credit, not any individual state's definition of credit. The Act sets out a definition of credit.[58] It does not defer to states' definitions of credit, so courts will have to analyze transactions in light of the Act's definition regardless of state law. In similar contexts, courts look only to the federal statute's definition of a term to determine its meaning. For example, in determining whether rent-to-own transactions are credit within the meaning of the Truth in Lending Act, courts do not consider state law but instead just evaluate the definition of credit in the Truth in Lending Act statute.[59]

Looking instead to the Act itself, it seems unlikely rent-to-own is credit. Credit means (1) "the right granted by a person to a consumer to defer payment of a debt, incur debt and defer its payment" or (2) "the right granted by a person to . . . purchase property or services and defer payment for such purchase."[60] Rent-to-own agreements fall outside both of these parts of the definition. The statute does not define debt, but debt is commonly defined as an obligation to pay money arising out of a transaction.[61] Rent-to-own-agreements do not involve taking on debt because the rental agreements obligate consumers to pay for rental periods at the start of the rental period, not the end, so the consumer generally does not owe money because of the agreement.[62]

Additionally, rent-to-own agreements do not involve deferring payment for a purchase. Like debt, the statute does not define purchase, but in most cases purchase involves a transfer of an interest in property for money.[63] Because

58 Dodd-Frank § 1002(7).

59 *See* Ortiz v. Rental Mgmt., Inc., 65 F.3d 335, 341 (3d Cir. 1995) (determining rent-to-own is not "credit" based on the definition in the statute and the Regulations promulgated to implement it and the federal commentary on the statute); Starks v. Rent-A-Center, No. 3-89-0786, 1990 U.S. Dist. LEXIS 20099 (D. Minn. May 16, 1990) (concluding that rent-to-own contracts are not extensions of credit under TILA even though the court found that rent-to-own contracts were credit sales under Minnesota law); *In re* Crawford, No. 90-50066, 1992 Bankr. LEXIS 2515 (E.D. Bankr. Ky. 1992) (assessing whether rent-to-own was a credit sale under TILA completely separately from assessing rent-to-own's status under Kentucky law).

60 Dodd-Frank § 1002(7).

61 *See, e.g.*, 15 U.S.C. § 1692a(5) (2006) (reporting the Fair Debt Collection Practices Act's definition of debt).

62 Even cases finding that rent-to-own agreements are credit sales state that rent-to-own does not entail accumulating debt. *See Miller*, 518 N.W.2d at 549.

63 *See, e.g.*, 16 U.S.C. § 3372(c)(2) (2006) ("It is deemed to be a purchase of fish or wildlife in violation of this Act for a person to obtain for money or other consideration . . . (A) guiding, outfitting, or other services; or (B) a hunting or fishing license or permit . . . ."); U.C.C. § 1-201(29) (2007) ("'Purchase' means taking by sale, lease, discount, negotiation, mortgage, pledge, lien, security interest, issue or reissue, gift,

payments for renting are due before the rental period begins, rent-to-own does not entail deferring payment for purchasing even the right to possess the goods during the rental period. Also, the consumer must pay in advance to actually acquire ownership of the goods, so purchasing the title of the goods is not deferred. The only way rent-to-own involves a purchase under common definitions of that term is if it is a disguised deferred purchase—i.e., the consumer really purchases title of the goods at the start of the first rental period but defers payment for the title until the end of the rental agreement.

More compelling than the definition of credit, however, is the section of definitions dealing with leases. That section sets out a specific type of lease that is a financial product or service under the Act.[64] Under the principle of *expressio unius*, the fact it states one type of lease and does not state other types of leases suggests that all leases not covered by the stated definition are not financial products.[65]

More to the point, the section covering leases is plainly aimed at lease contracts that are disguises for credit sales. The only leases covered by the Act are leases that are "*the functional equivalent of purchase finance arrangements*."[66] Thus, the statute implies that a deferred purchase that is disguised as a lease should not be considered credit but should instead be covered only if it meets the requirements of the section of leases. The Bureau merely finding that a lease is a disguise for a credit sale should not be enough for the Bureau to govern such a lease or to consider the transaction to be a subterfuge. Instead, deciding that a transaction is the functional equivalent of a credit sale merely meets one of the parts of the definition of what leases are financial products or services.

In the end, it appears that almost all fringe banking products except rent-to-own are within the Bureau's purview. In surveying the definitions in the Act, this part has taken the first step in establishing the claim that the Act empowers the Bureau to intervene into fringe credit markets because it demonstrates the Bureau has power over fringe banking. The next part looks at the substantive rules of the Act to illustrate the impressive opportunity Congress has given the Bureau to regulate fringe credit.

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or any other voluntary transaction creating an interest in property.").

64 Dodd-Frank § 1002(15)(A)(ii).

65 *Expressio unius* is the principle of statutory interpretation which states that the expression of one thing means the exclusion of another. Chevron U.S.A. v. Echazabel, 536 U.S. 73, 80 (2002).

66 Dodd-Frank § 1002(15)(A)(ii) (emphasis added).

II. THE CONSUMER FINANCIAL PROTECTION ACT'S SUBSTANTIAL POWER TO REGULATE FRINGE CREDIT

This part discusses the major components of the Consumer Financial Protection Act that will affect fringe banking and reveals how the federal government will now be directly involved in the fringe economy in a substantial way. Fringe banking permeates the bill. Even beyond the components this section analyzes in depth, which all involve fringe banking, consider the following provisions which demonstrate the sustained attention the Act pays to fringe banking:

- The Act instructs the Bureau's Director to establish an entire unit dedicated solely to consumers who are unbanked or underbanked.[67]
- The Office of Financial Education created by the Act is charged with moving people from fringe banking firms to mainstream financial institutions.[68]
- In creating the Consumer Advisory Board, the Director must seek "representatives of depository institutions that primarily serve underserved communities."[69]
- To encourage less reliance on fringe banking services, the Act requires "[e]ach of the Federal banking agencies and the National Credit Union Administration [to] provide guidelines to financial institutions under the jurisdiction of the agency regarding the offering of low-cost remittance transfers and no-cost or low-cost basic consumer accounts, as well as agency services to remittance transfer providers."[70]

The following goes beyond these few examples to explain the power the substance of the Act gives to the Bureau to affect fringe banking.

A. Research

A major focus of the Bureau will be research,[71] and the Act instructs the Bureau's Director to create a research unit.[72]

67 Dodd-Frank § 1013(b)(2) ("The Director shall establish a unit whose functions shall include providing information, guidance, and technical assistance regarding the offering and provision of consumer financial products or services to traditionally underserved consumers and communities.").

68 Dodd-Frank § 1013(d)(2)(C) (setting as a priority of the Office of Financial Education the provision of "opportunities for consumers to access . . . savings, borrowing, and other services found at mainstream financial institutions").

69 Dodd-Frank § 1014(b).

70 Dodd-Frank § 1073(c).

71 Dodd-Frank § 1021(c)(3) (stating a primary function of the Bureau will be "collecting, researching, monitoring, and publishing information relevant to the

Remarkably, three of the six foci of the research unit directly relate to fringe banking, and the other three are indirectly related to it.

The first area the Act directs the research unit to study is developments in credit markets, "including market areas of alternative consumer financial products or services with high growth rates and areas of risk to consumers."[73] The phrase "alternative consumer financial products or services" mirrors almost exactly a common name for fringe banking: alternative financial services. While not directly stating that the unit should research fringe banking, this language and the fact fringe banking is a high growth industry that many consider a risk to consumers suggest that this agenda item for the research unit is directed at fringe banking. The other two areas the unit must research involve fringe banking customers in a much clearer way, as one directs the unit to research "access to fair and affordable credit for traditionally underserved communities,"[74] and the other demands research about "experiences of traditionally underserved consumers, including un-banked and under-banked consumers."[75]

The other three areas of research do not explicitly involve only fringe banking, but they all relate to concerns people have expressed about fringe credit: disclosure and suboptimal consumer decision-making. The research unit must analyze consumers' understanding of disclosures, awareness of risks and costs of credit, and behavior regarding financial products and services.[76] Each of these three items has been the focus of significant academic debate about fringe banking,[77] and so a study of any one of them is likely to involve fringe credit.

Given the preeminence of fringe banking in the Bureau's research agenda, it is likely the Bureau will produce a significant number of reports about fringe credit and will fill in some holes in the academic literature about fringe banking. The next section outlines one source of data from which the Bureau will

functioning of markets for consumer financial products and services to identify risks to consumers and the proper functioning of such markets").

72 Dodd-Frank § 1013(b)(1).

73 Dodd-Frank § 1013(b)(1)(A).

74 Dodd-Frank § 1013(b)(1)(B).

75 Dodd-Frank § 1013(b)(1)(F).

76 Dodd-Frank § 1013(b)(1)(C)–(E).

77 *See generally* Susan Block-Lieb & Edward J. Janger, *The Myth of the Rational Borrower: Rationality, Behavioralism, and the Misguided "Reform" of Bankruptcy Law*, 84 TEX. L. REV. 1481 (2006) (providing an in-depth analysis of these three items in the context of fringe banking).

draw: information obtained directly from fringe banking firms through the Bureau's supervision powers.

B. Monitoring and Supervision

Fringe banking will also be affected in a second innovation found in the Act: the Act empowers the Bureau to monitor and supervise nondepositories.[78] These powers have the potential to dramatically increase the amount of data available about fringe banking firms, but also to impose costs on firms operating in these markets.

First, the Act mandates that the Bureau "monitor for risks to consumers in the offering or provision of consumer financial products or services."[79] As in other contexts, the fringe economy should play an important role in this monitoring because the Act instructs the Bureau to allocate its resources for monitoring in light of "the extent, if any, to which the risks of a consumer financial product or service may disproportionately affect traditionally underserved consumers . . . ."[80]

This monitoring power has the potential to supply the Bureau with substantial information about the fringe economy because the Bureau can require covered entities to file special or annual reports or to submit answers to questions from the Bureau.[81] This power to obtain information even extends to entities that are not determined to be covered by the Act; the Bureau can require firms to file annual reports so that the Bureau can assess whether they are covered by the Act.[82]

In addition to requiring reports, the Bureau can also require fringe banking firms to register with the federal government.[83] Registration requirements in some cases will be duplicative of the extensive state registration rules,[84] so the Act requires the Bureau to consult with state agencies when promulgating its rules.[85]

78 Dodd-Frank § 1024(b).

79 Dodd-Frank § 1022(c)(1).

80 Dodd-Frank § 1022(c)(2)(E).

81 Dodd-Frank § 1022(c)(4)(B)(ii).

82 Dodd-Frank § 1022(c)(5) ("In order to assess whether a nondepository is a covered person, as defined in section 1002, the Bureau may require such nondepository to file with the Bureau, under oath or otherwise, in such form and within such reasonable period of time as the Bureau may prescribe by rule or order, annual or special reports, or answers in writing to specific questions.").

83 Dodd-Frank § 1022(c)(7)(A).

84 *See, e.g.*, DEL. CODE ANN. tit. 5, § 2202 (2010) (requiring title lenders to obtain licenses from the state); FLA. STAT. § 537.007 (2010) (same); IDAHO CODE ANN. § 28-46-503 (2010) (same).

85 Dodd-Frank § 1022(c)(7)(C).

Second, in addition to monitoring, the Act empowers the Bureau to supervise some fringe lenders. The Act specifically empowers the Bureau to supervise just three types of lenders: (1) mortgage originators, brokers, and servicers; (2) those offering education loans; and (3) payday lenders.[86] The specific language of the section granting supervisory power over payday lenders is broad enough to include payday lenders operating in a variety of business models because it is not limited to companies that provide payday loans—it includes anyone who even offers them.[87] Thus, the Bureau will supervise payday lenders who operate as Credit Service Organizations that merely connect borrowers with third-party lenders.[88]

In addition to these specific firms to be supervised, the Act sets out two general nets to catch other firms for supervision, both of which have a strong potential to bring in fringe creditors other than just payday lenders. First, the Bureau can supervise anyone who is "a larger participant of a market for other consumer financial products or services . . . ."[89] Several large pawnbrokers,[90] auto-title lenders,[91] and refund anticipation lenders[92] are large publicly held companies and could easily fall into this category. Second, the Bureau can supervise any person who "is engaging, or has engaged, in conduct that poses risks to consumers."[93] As Part III.C points out, many people believe fringe credit is risky for consumers, so the potential to draw in fringe lenders is substantial. The upshot of these provisions is that payday lenders will certainly be supervised by the Bureau and many other fringe lenders have a strong potential to be supervised.

Being supervised by the Bureau may require firms to produce "reports and conduct examinations on a periodic basis[;]"[94] maintain a certain level of capital or bonds;[95] submit to "background checks for principals, officers, directors, or key personnel[;]"[96] and generate and maintain records so that the

86 Dodd-Frank § 1024(a)(1)(A), (D), (E).

87 Dodd-Frank § 1024(a)(1)(E) (granting power to supervise a person who "offers or provides to a consumer a payday loan").

88 Spector, *supra* note 18, at 983–95.

89 Dodd-Frank § 1024(a)(1)(B).

90 Cash America International, Inc. is a pawnshop traded on the New York Stock Exchange listed under the symbol "CSH."

91 EZ Corp. offers title loans and is traded on NASDAQ under the symbol "EZPW."

92 Advance America is one of the largest payday lenders and is traded on the New York Stock Exchange under the symbol "AEA."

93 Dodd-Frank § 1024(a)(1)(C).

94 Dodd-Frank § 1024(b)(1).

95 Dodd-Frank § 1024(b)(7)(C).

96 *Id.*

Bureau can perform its supervisory function.[97] These requirements could have a variety of effects in fringe markets. For instance, if only payday lenders are supervised, it could put other fringe lenders in a better competitive position because they will be able to avoid the costs payday lenders are paying for compliance. More generally, capital requirements and substantial reporting requirements could favor larger firms and drive mom and pop shops out of business.

It would be easy to underestimate the importance of this information-gathering function. As David Skeel points out:

> The power to investigate and require data may be the most important power of all. As a scholar seeking data, Warren was not a welcome presence at the office of the credit card banks. But now banks are required to open their doors and answer questions about their business practices.[98]

This observation is especially true for fringe banking operations that have not been subject to examinations like banks but, for the first time, will have to produce significant amounts of information for the Bureau.

C. Rulemaking

The Bureau's ability to promulgate rules is the least delimited of its powers, has the least understood power, and has the greatest potential to affect businesses in the fringe economy. The Act empowers the Bureau to make rules supporting two goals: sections 1021(c)(5) and 1022(a) authorize rulemaking to enforce federal consumer protection laws,[99] and section 1031(b) gives the Bureau the right to create rules to identify "unlawful, unfair, deceptive, or abusive acts or practices . . . ."[100] The Bureau's power to write new rules to enforce existing federal consumer laws might affect fringe lenders, but there is little room for surprise here as the federal consumer laws are already on the books and have been implemented by other agencies writing rules for years. The main effect of this rulemaking power will be that existing laws will be more stringently enforced.

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97 Dodd-Frank § 1024(b)(7)(B).

98 DAVID SKEEL, THE NEW FINANCIAL DEAL: UNDERSTANDING THE DODD-FRANK ACT AND ITS (UNINTENDED) CONSEQUENCES 112 (2011).

99 Dodd-Frank § 1021(c)(5) ("The primary functions of the Bureau are . . . issuing rules, orders, and guidance implementing Federal consumer financial law."); § 1022(a) ("The Bureau is authorized to exercise its authorities under Federal consumer financial law to administer, enforce, and otherwise implement the provisions of Federal consumer financial law.").

100 Dodd-Frank § 1031(b).

On the other hand, the Act's instruction to create rules to regulate "unfair, deceptive, or abusive acts"[101] has much more potential to affect fringe lenders. None of these terms are explicitly defined by the Act. The Act does give some indication of when the Bureau can define a practice as unfair and abusive, but it gives no guidance concerning defining acts as deceptive.

The Bureau cannot define a practice as unfair "unless the Bureau has a reasonable basis to conclude that . . . the act or practice causes or is likely to cause substantial injury to consumers which is not reasonably avoidable by consumers; and such substantial injury is not outweighed by countervailing benefits to consumers or to competition."[102] The Bureau can only define an act as abusive if it:

> (1) materially interferes with the ability of a consumer to understand a term or condition of a consumer financial product or service; or
>
> (2) takes unreasonable advantage of—
>
> (A) a lack of understanding on the part of the consumer of the material risks, costs, or conditions of the product or service;
>
> (B) the inability of the consumer to protect the interests of the consumer in selecting or using a consumer financial product or service; or
>
> (C) the reasonable reliance by the consumer on a covered person to act in the interests of the consumer.[103]

In addition to this language in the Act, we have some idea of what sort of rules the Bureau will write for unfair and deceptive acts because the Federal Trade Commission (FTC) has had a similar mandate for a considerable time.[104] The FTC Act empowers the FTC to prevent businesses from engaging in unfair or deceptive acts,[105] and the Magnuson-Moss Warranty-Federal Trade Commission Improvement Act gives the FTC rulemaking authority.[106] Thus, the FTC's enforcement activities against

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101 *Id.*

102 Dodd-Frank § 1031(c)(1).

103 Dodd-Frank § 1031(d)(1)&(2).

104 *See* 15 U.S.C. § 45(a) (2006) (using the same language as the Consumer Financial Protection Act when empowering the FTC to prevent unfair and deceptive acts or practices but omitting "abusive").

105 15 U.S.C. § 45(a)(2) ("The Commission is hereby empowered and directed to prevent persons, partnerships, or corporations . . . from using unfair methods of competition in or affecting commerce and unfair or deceptive acts or practices in or affecting commerce.").

106 *See* 15 U.S.C. § 57a(a)(1)(B) (2006) ("[T]he Commission may prescribe . . . rules which define with specificity acts or practices which are unfair or deceptive acts or practices in or affecting commerce (within the meaning of section 45(a)(1) of this title), except that the Commission shall not develop or promulgate any trade rule or regulation with regard to the regulation of the development and utilization of the standards and certification activities pursuant to this section. Rules under this subparagraph may

unfair and deceptive conduct may help predict what conduct the Bureau will define as unfair and deceptive.

Like the Consumer Financial Protection Act, the FTC Act does not define unfair or deceptive and only gives guidance about how to formulate rules relating to unfair acts.[107] In the early 1980s, the FTC issued policy statements on both unfairness and deception that are still routinely cited today.[108] The following sections attempt to identify what unfair, deceptive, and abusive mean. Because these terms do not have specific definitions, these sections demonstrate that they give substantial power to the Bureau to regulate fringe credit markets.

i. Unfair Acts or Practices

The FTC's policy statement on unfairness explains that an act or practice is "likely to cause substantial injury to consumers" only if the injury is a "monetary, economic, or other tangible harm"[109] that is more than "trivial or speculative" and not subjective injuries like "embarrassment, emotional distress, etc."[110] In determining if consumers can reasonably avoid the injuries, the FTC looks to whether something about the act or practice unjustifiably hinders free market decision-making.[111] Thus, in most cases where the FTC claims an act is unfair, the consumer has been tricked in some way or there will be some sort of market failure.[112] As Jean Braucher summarizes, "The FTC

include requirements prescribed for the purpose of preventing such acts or practices.").

107 15 U.S.C. § 45(n).

108 *See* Stephen Calkins, *FTC Unfairness: An Essay*, 46 WAYNE L. REV. 1935, 1936 (2000).

109 49 Fed. Reg. 7740, 7743 (Mar. 1, 1984); Unfair or Deceptive Acts or Practices, 74 Fed. Reg. 5498, 5502 (Jan. 29, 2009).

110 49 Fed. Reg. 7740, 7743 (Mar. 1, 1984).

111 49 Fed. Reg. 7740, 7744 (Mar. 1, 1984). *See also* Unfair or Deceptive Acts or Practices, 74 Fed. Reg. 5498, 5503 (Jan. 29, 2009) ("An injury is not reasonably avoidable when consumers are prevented from effectively making their own decisions about whether to incur that injury . . . . The test is not whether the consumer could have made a wiser decision but whether an act or practice unreasonably creates or takes advantage of an obstacle to the consumer's ability to make that decision freely.").

112 H.R. REP. NO. 98-156 (1983); FTC Policy Statement on Unfairness, (Dec. 17, 1980), *available at* http://www.ftc.gov/bpc/policystmt/ad-unfair.htm ("Normally we expect the marketplace to be self-correcting, and we rely on consumer choice—the ability of individual consumers to make their own private purchasing decisions without regulatory intervention—to govern the market. We anticipate that consumers will survey the available alternatives, choose those that are most desirable and avoid those that are inadequate or unsatisfactory. However, it has long been recognized that certain types of sales techniques may prevent consumers from effectively making their own decisions, and that corrective action may then become necessary. Most of the Commission's unfairness matters are brought under these circumstances. They are brought, not to second-guess the wisdom of particular consumer decisions, but rather to halt some form of seller behavior that unreasonably creates or takes advantage of an obstacle to the free exercise of consumer decisionmaking. Sellers may adopt a number of practices that unjustifiably

has come to the initially surprising conclusion that unfairness in consumer contracts means gross inefficiency."[113] Under the statute and its policy statement, the FTC will only take action when the benefits of further regulation outweigh the costs to consumers and competition.[114]

A recent case exemplifies how the FTC approaches unfairness. In *F.T.C. v. IFC Credit Corp.*, a telecommunications company leased telecommunications equipment to consumers.[115] The Equipment Rental Agreements contained a "hell or high water" clause which obligated the consumer to continue making rental payments even if the telecommunication services were terminated, despite the fact the services were the only purpose of the equipment.[116] The FTC alleged that the business' attempt to collect on the rental agreements "when they are worthless is unfair."[117] In deciding the issue, the court found that the practice caused a substantial injury to consumers because the cost of renting the worthless equipment was significant and because the practice affected many consumers.[118] Furthermore, it found that the consumers could not reasonably avoid the injury, despite the fact they should have known about the hell or high water clause and had not been deceived under traditional contract law notions.[119] The court explained:

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hinder such free market decisions. Some may withhold or fail to generate critical price or performance data, for example, leaving buyers with insufficient information for informed comparisons. Some may engage in overt coercion, as by dismantling a home appliance for 'inspection' and refusing to reassemble it until a service contract is signed. And some may exercise undue influence over highly susceptible classes of purchasers as by promoting fraudulent 'cures' to seriously ill cancer patients. Each of these practices undermines an essential precondition to a free and informed consumer transaction, and, in turn, to a well functioning market. Each of them is therefore properly banned as an unfair practice under the FTC Act.").

113 Jean Braucher, *Defining Unfairness: Empathy and Economic Analysis at the Federal Trade Commission*, 68 B.U. L. REV. 349, 351 (1988).

114 49 Fed. Reg. 7740, 7745 (Mar. 1, 1984).

115 FTC v. IFC Credit Corp., 543 F. Supp. 2d 925, 928 (N.D. Ill. 2008).

116 *Id.* at 930 ("The ERA appeared to be a standard form equipment lease, covering both sides of a single page. It made no mention of telecommunications services and covered only the rental of the equipment necessary to provide the services. Its terms were straightforward and understandable. The front side provided that the 'renter' agreed that the equipment would 'not be used for personal, family or household purposes.' Also on the first side, in bold type a bit above the signature line, the ERA stated that the '**obligations to make all Rental Payments for the entire term are not subject to set off, withholding or deduction for any reason whatsoever.**' Directly over the signature lines, also in bold-faced type but capitalized as well, the ERA stated: '**THIS RENTAL MAY NOT BE CANCELLED OR TERMINATED EARLY.**'").

117 *Id.* at 945.

118 *Id.* ("Here the injuries were substantial, both in monetary terms and in numbers of consumers affected. The total payments under an ERA over its five-year term ranged from $4,439 to $160,672, depending on the lease—even though the cost of a box never exceeded $1,300 and in a number of cases was less than $300.").

119 *Id.* at 945–48.

> While the consumers knew that their monthly payment was being allocated in prescribed percentages, that fact would have been meaningless to a reasonable consumer and would not have alerted the consumer of what was to come. While the ERA said that the obligation to make monthly payments was unconditional, the consumers could not have reasonably anticipated that, to use Justice Cardozo's phrase, "the doom of mere sterility was on the [transaction] from the beginning," and that it was a virtual certainty, not merely a possibility inherent in any comparable transaction, that its contracted for telecommunications services would cease and they would be on the hook to an assignee. Having no reason to anticipate the harm that was certain to befall them, there was no occasion for the consumers even to consider taking steps to avoid it.[120]

Because the practice caused substantial injury that could not be avoided, it was considered unfair.

How might unfairness factor into the rules the Bureau makes concerning fringe banking products? It opens a significant number of practices up to scrutiny. It will not be difficult for the Bureau to establish that some aspects of fringe transactions cause substantial harm because even if the actual dollar amount of each harm is low, fringe banking is a common source of credit,[121] so many consumers will be affected. Also, critics of fringe banking consider several different aspects of fringe transactions to be a result of market failures, meeting the test that consumers cannot reasonably avoid the harm.[122]

The most likely target of rules based on unfairness is payday loan rollovers. Payday lending appears to be a high priority to the Bureau,[123] although it is possible the Bureau will first

120 *Id.* at 948.

121 *See* KARGER, *supra* note 4, at 6 (reporting the United States has more payday lending and check cashing stores than McDonald's, Burger King, Target, Sears, JC Penney, and Wal-Mart locations combined).

122 *See, e.g.*, Alan M. White, *Behavior and Contract*, 27 LAW & INEQ. 135, 159 (2009) ("Payday loans, for example, are described (falsely) as a short-term credit product, exploiting the consumer's optimism bias that predicts an ability to pay the loan in full at the next payday, and discounts the inevitable recurrence of the cash shortage that prompted the loan. 'Framing,' which consists of altering a consumer's preferences by defining the menu from which choices are made, is also used by payday lenders. Payday lenders compare the extremely high Annual Percentage Rate (APR) of a payday loan to the cost of bank overdraft fees if the payday loan is not used (avoiding a loss) rather than, say, the much cheaper alternative of a cash advance on a credit card.").

123 Ann Sanner, *White House Consumer Adviser Gathers Input in Ohio*, DAILY CALLER (Oct. 14, 2010), http://dailycaller.com/2010/10/14/obama-consumer-adviser-gathers-input-in-ohio/ ("Warren told reporters before the round-table that payday lending would be a 'high priority' for the agency. People should have access to small-dollar loans for emergencies, she said, but 'a model that is designed to keep those families in a revolving door of debt is not good for families—and ultimately not good for the economy.' Warren said federal regulators would look at the business models used in payday lending, the costs to consumers and the actions states have taken to regulate it.").

address credit cards and mortgages.[124] Some payday lenders think the Bureau will address payday lending first because it is low hanging fruit and an easy early win for the Bureau.[125] In any case, given the emphasis on payday lending in the Act itself and news stories about the Act, it is highly likely the Bureau will make rules about it.

Rollovers are a probable place for the Bureau to start. "Rollover" refers to the practice of payday borrowers paying just the interest due on their loans and rolling over the principal for another loan period and thereby incurring another interest fee.[126] Although an amendment to limit rollovers in the Act itself failed,[127] Warren has criticized rollovers both in her academic writing[128] and in her activities as a special advisor to President Obama;[129] some experts have claimed that the Bureau has the

124 *See* Janet Bodnar, *Elizabeth Warren Explains What We Can Expect from the New Consumer Agency*, KIPLINGER (Nov. 24, 2010), http://community.nasdaq.com/News/2010-11/elizabeth-warren-explains-what-we-can-expect-from-the-new-consumer-agency.aspx?storyid=46462#ixzz16fLrAGh3 (reporting Warren's response to an interview question about the first steps the Bureau will take: "The first two initiatives are centered around credit cards and home mortgages. I've already met with CEOs of the major credit-card issuers and other financial-services companies and with consumer groups on the readability of credit disclosures."); Rebecca Christie & Carter Dougherty, *Treasury Aide Says Consumer Bureau Job Likely Filled by July*, BLOOMBERG (Nov. 18, 2010), http://www.bloomberg.com/news/2010-11-18/treasury-aide-says-consumer-bureau-job-likely-filled-by-july.html ("[Treasury Department's general counsel George Madison] said the consumer bureau probably would start by focusing on consumer banking products before adding in oversight of payday lenders and other financial firms not traditionally monitored by bank regulators.").

125 Hilary B. Miller, *The Future of the Payday Loan Industry Revisited Again—An Expert Opinion*, PAYDAY LOAN INDUSTRY BLOG (July 28, 2010), http://paydayloanindustryblog.com/the-future-of-the-payday-loan-industry-revisited-again-an-expert-opinion/ ("The industry's antagonists have pronounced that the [Bureau of Consumer Financial Protection's (BCFP)] . . . first act will be to regulate payday lenders out of business (even though payday lending was entirely unrelated to the causes of the recent financial crisis, they assume that the BCFP will have no bigger fish to fry than payday lending). Some of my colleagues believe that payday lending is 'low-hanging fruit' that the BCFP can use to put up a quick and easy 'W' on the scorecard and, in the process, placate consumer groups.").

126 *Researcher Tackles Payday Loan Industry*, GUELPHMERCURY (Jan. 19, 2010), http://www.guelphmercury.com/news/article/467344--researcher-tackles-payday-loan-industry.

127 Ylan Q. Mui, *Storefront Operations Argue for Exclusion from Financial Bill; Lawmakers Hear from Payday-Lending and Check-Cashing Firms*, WASH. POST, May 10, 2010, at A4 ("The industry also faces a renewed fight on payday lending. Consumer groups have long criticized the practice for charging triple-digit interest rates and accused lenders of preying on low-income customers. The nonprofit Center for Responsible Lending worked with North Carolina Sen. Kay Hagan (D) to introduce an amendment to the financial reform bill last week that would limit the number of payday loans consumers can take out to six per year and require lenders to give customers more time to repay the loan if needed. In addition, the amendment would give the Federal Reserve the authority to license payday lenders.").

128 Oren Bar-Gill & Elizabeth Warren, *Making Credit Safer*, 157 U. PA. L. REV. 1, 55–56 (2008).

129 *See* Sanner, *supra* note 123 (quoting Warren as saying: "[A] model that is designed

power to eliminate rollovers.[130] The Bureau could argue that rollovers are expensive for individual payday lending customers[131] and could use evidence that rollovers are common to establish that many consumers are affected by the practice.[132] Many people claim that consumers do not anticipate rolling over their loans when they take them out, suggesting a market failure,[133] which implies consumers could not reasonably avoid the injury.

What effect would banning rollovers or limiting the number of rollovers have on the industry? It might significantly decrease the number of companies willing to make short term loans. The cost of originated two week loans is high, and rollovers are an important component to payday lenders' profit models.[134] It is possible that a complete ban on rollovers could cripple the industry.

One industry attorney, Hilary Miller, is tentatively skeptical that the Bureau could take action against payday loans under either the unfairness or deceptive prongs of the Act.[135] Because the FTC already has had the authority to prevent unfair and deceptive acts but has never found payday lending to fall within these categories, Miller argues that the Bureau cannot use these prongs against the industry: "To my mind, this argument entirely disposes of two of the three 'bad conduct' badges in the Act . . . . The FTC Act and Title X of Dodd-Frank are manifestly *in pari materia*, and chaos would result if they were interpreted differently."[136]

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to keep those families in a revolving door of debt is not good for families—and ultimately not good for the economy.").

130 Machetta, *supra* note 39 ("Whiel [sic] the bureau does not have the authority to cap interest rates, as some states have done, she says they do have the power to regulate other aspects of payday lending, such as limiting the number of loans. [Brenda Procter of the University of Missouri, a payday loan expert,] believes this is the first step in leveling the playing field between consumers and lenders.").

131 *See Payday Loans Tempting, But Not Good Deals*, WIS. STATE J., Jan. 17, 2010, at C1 (giving the example of a "$200 two-week payday loan charging $38.36 in interest. Within 10 weeks, the interest totals $191.78.").

132 See *infra* notes 239–240 and accompanying text.

133 See *infra* notes 241–246 and accompanying text.

134 Mark Flannery & Katherine Samolyk, *Payday Lending: Do the Costs Justify the Price?*, (FDIC Ctr. for Fin. Research, Working Paper No. 2005-09, 2005).

135 Miller, *supra* note 125.

136 *Id. See also* Carey Alexander, Note, *Abusive: Dodd-Frank Section 1301 and the Continuing Struggle to Protect Consumers*, ST. JOHN'S L. REV. (forthcoming 2011) (manuscript at 13), *available at* http://ssrn.com/abstract=1719600 (citing Capital Traction Co. v. Hof, 174 U.S. 1, 36 (1899) and Carolene Prods. Co. v. United States, 323 U.S. 18, 26 (1944) for the proposition that "[w]henever Congress adopts language with a 'known and settled construction,' it is presumed to adopt the previous judicial interpretations surrounding the language.").

The problem with the argument, however, is that the FTC has never affirmatively found payday lending to be fair or not deceptive. It just has not taken action either way. It is possible to read this as an affirmation of the industry, but it is more likely that the FTC has never acted because it does not have infinite resources. As Jeff Sovern has argued, the FTC lacks the resources to bring even cases it considers worthwhile.[137] Thus, the Bureau could rule that rollovers or some other aspect of a fringe credit transaction are unfair despite the fact the FTC has never pursued a suit against this conduct on the theory that the FTC's past actions just reflect scarce resources, not a judgment about all consumer credit practices that currently exist in the market. Moreover, because the Bureau was created out of a sense that other agencies were not actually protecting consumers,[138] it is likely the Bureau will take a more aggressive stance than the FTC on many issues. Also, the Bureau will have a much easier time promulgating rules than the FTC. The FTC has a burdensome rulemaking procedure[139] compared to the Bureau's procedure, which is relatively straightforward. For instance, from 1980 to 2000, the FTC did not create a single rule related to unfair acts or practices.[140] This difference may result in the Bureau having an easier time creating rules for fringe creditors. Finally, the language defining unfairness in the FTC Act is not exactly the same as the language in the Dodd-Frank Act, suggesting the Bureau has a new chance to define unfairness.[141]

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137 *See* Jeff Sovern, *Private Actions Under the Deceptive Trade Practices Act: Reconsidering the FTC Act as Rule Model*, 52 OHIO ST. L.J. 437, 441–42 (1991) ("One practical limit restraining FTC abuses is, of course, politics. FTC commissioners are appointed by the President and confirmed by the Senate for terms of seven years. While commissioners may be removed only for 'inefficiency, neglect of duty, or malfeasance in office,' thus insulating commissioners to some extent from political considerations, it is inevitable that at least some commissioners will remain sensitive to the winds of political life . . . A second practical limit to FTC excess is scarce resources. The FTC budget is less than 55 million dollars, which is obviously a small sum for regulating the many transactions and businesses within the FTC's purview. Because the FTC lacks the staff to pursue many significant improprieties, it is unlikely to expend its scarce resources on trivial deceptions.").

138 Adam J. Levitin, *The Consumer Financial Protection Agency* (The Pew Financial Reform Project, Briefing Paper No. 3, 2009), *available at* http://www.aei.org/docLib/Levitin%20-%20Consumer%20Financial%20Protection%20Agency.pdf.

139 15 U.S.C. § 57a(b). *See* Mark E. Budnitz, *The FTC's Consumer Protection Program During the Miller Years: Lessons for Administrative Agency Structure and Operation*, 46 CATH. U. L. REV. 371, 417 (1997) ("[T]he Improvements Act of 1980 imposed stringent procedural requirements relating to the FTC's rulemaking procedures.").

140 Calkins, *supra* note 108, at 1960.

141 Alexander, *supra* note 136, at 13 ("Had Congress codified the House language expressly adopting the FTC's policy statements, the CFPB's powers to prohibit unfair and deceptive acts would be known and settled; they would be the same as the FTC's under the FTC Act. Instead, because Congress effectively rejected the FTC's definitions, the

ii. Deceptive Acts or Practices

The second prong of rulemaking power for the Bureau—deception—is also in the FTC Act. In general, the FTC produces rules to make it easy to find particular actions deceptive.[142] "A representation or omission is deceptive if the overall net impression created is likely to mislead consumers."[143] The business' intent is unimportant,[144] and the act does not actually have to deceive anyone—it is enough that the act is likely to deceive someone,[145] and that the representation is material.[146] Usually, deception cases relate to advertising claims,[147] and the FTC has provided a non-exhaustive list of misleading or deceptive practices:

> [F]alse oral or written representations, misleading price claims, sales of hazardous or systematically defective products or services without adequate disclosures, failure to disclose information regarding pyramid sales, use of bait and switch techniques, failure to perform promised services, and failure to meet warranty obligations.[148]

Federal Trade Comm'n v. Pharmtech Research, Inc. provides an example of the FTC's understanding of the term deceptive.[149] In *Pharmtech*, the court granted a preliminary injunction preventing a business from continuing to advertise its dietary supplement.[150] The business sold pills made of dehydrated and compressed vegetables and claimed that taking the pills reduced the risk of certain cancers because a study found that "frequent consumption of certain fruits and vegetables is associated with a reduction in the incidence of cancer in human beings, and found that carotene-rich vegetables, such as carrots, and cruciferous vegetables, such as broccoli, cabbage and Brussels sprouts, provide this benefit."[151] The business' advertisements were

CFPB may have a freer hand to define its ability to reach unfair and deceptive practices under Dodd-Frank.").

142 Sovern, *supra* note 137, at 444.

143 Unfair or Deceptive Acts or Practices, 74 Fed. Reg. 5498, 5504 (Jan. 29, 2009).

144 FTC v. Bay Area Bus. Council, Inc., 423 F.3d 627, 635 (7th Cir. 2005).

145 *In re* Cliffdale Assocs., Inc., 103 F.T.C. 110, 174 app. at 4 (1984) [hereinafter FTC Policy Statement on Deception] (Appendix titled "FTC Policy Statement on Deception").

146 *Id.* at 15–16.

147 FTC v. IFC Credit Corp., 543 F. Supp. 2d 925, 941 (N.D. Ill. 2008) (observing that deception cases "usually involve advertisements made by the defendant to induce consumers into purchasing the defendant's products or services" and giving as examples FTC v. Bay Area Bus. Council, Inc., 423 F.3d 627, 635 (7th Cir. 2005), which found that "defendants misled consumers with bad credit into believing they were buying credit cards when in fact they were buying worthless 'ChexCards,'" and F.T.C. v. World Travel Vacation Brokers, Inc., 861 F.2d 1020, 1029 (7th Cir. 1988), which found that "defendants misrepresented the cost of vacation packages to Hawaii").

148 FTC Policy Statement on Deception, *supra* note 145, at 2–3.

149 FTC v. Pharmtech Research, Inc., 576 F. Supp. 294 (D.D.C. 1983).

150 *Id.* at 296.

151 *Id.* at 297.

deceptive within the meaning of the FTC Act because "they convey a misleading impression."[152] They implied that the study found that vegetable pills could reduce the risk of cancer when the study did not explicitly find that; in fact, the study specifically expressed doubts about whether processed vegetables could have the same salutary effects as fresh ones.[153]

The Bureau might use this prong of its rulemaking power to require new disclosures on fringe banking products. For instance, the Bureau might require payday lenders to post information about how often borrowers rollover loans or how much an average loan costs a borrower in total, much like the requirement that credit card companies put information on credit card statements which discloses how long it would take to pay off the debt and how much money borrowers will spend in interest payments if they only make minimum monthly payments.[154]

For the most part, such disclosure requirements will likely have little effect on fringe creditors. As discussed in Part III.A.ii, fringe credit contracts are relatively straightforward. Disclosure regimes are usually supported by mainstream fringe creditors, so such rules would probably not encounter significant opposition. However, some disclosure requirements may have unintended consequences. For instance, some states require rent-to-own stores to disclose APRs on rented goods. This requirement has resulted in rent-to-own firms exiting these states almost completely.[155] Thus, even in promulgating disclosure requirements, the Bureau may exercise its new power in a way to significantly limit the availability of alternative financial services to consumers.

iii. Abusive Acts or Practices

Few federal agencies have powers related to abusive acts or practices, so we have the least guidance when predicting what sorts of rules the Bureau may promulgate pursuant to this power.[156] The examples in current statutes empowering agencies to regulate abusive contracts have either been basically unused or do not parallel the Bureau's power. For instance, the Federal Reserve has the power to find lending practices related to

152 *Id.* at 301.

153 *Id.* at 302.

154 15 U.S.C. § 1637(b)(11) (2006).

155 *See* Hawkins, *supra* note 50, at 2045.

156 Michael A. Benoit, *The Birth of a New Financial Services Regulator*, BUS. L. TODAY (Nov. 22, 2010), http://www.abanet.org/buslaw/blt/content/2010/11/article-benoit.shtml (last visited Nov. 30, 2010) ("While we have years of jurisprudence from which providers may glean what acts or practices may be unfair or deceptive, the standard for 'abusive' practices is new and untested.").

mortgage financing abusive.[157] The Federal Reserve, however, rarely exercises that power, leaving us with little understanding of the term.[158] Also, the FTC has the power to regulate abusive telemarketing acts or practices,[159] and it has promulgated regulations under this statute, but the regulations do not provide a meaningful parallel to the Bureau's power. The term "abusive" is not defined in the Telemarketing and Consumer Fraud and Abuse Prevention statute,[160] but the statute and regulations give examples of abusive acts,[161] and courts have deemed some conduct abusive under the statute.[162] Unfortunately, however, very little of the FTC's power in this area relates to credit,[163] so it is difficult to extrapolate what abusive means from the regulations in this statute.

This lack of current precedent has caused some observers to worry that the Bureau will have vast power to curtail consumer lending products. One recent article in the *American Banker*, for instance, quotes, among other concerned parties, the president of the Consumer Bankers Association, a partner with Morrison & Foerster LLP, a partner at Covington & Burling LLP, and a partner at Goodwin Procter saying that the power to create rules under the abusive standard is "egregious," allows the Bureau to

157 15 U.S.C. § 1639(l)(2)(B) (2006).

158 Alexander, *supra* note 136, at 19–20 ("The Fed hesitantly declared only two practices as abusive: loan flipping and equity stripping . . . . The Fed's findings suggest that two threads run through both practices: consumer action is induced by a potential benefit that is suppose to run to him, and the action taken causes either no benefit or a detriment of the consumer. Such a definition was far too restrictive to carry out the Fed's mandate to address abusive practices. If anything, it serves as an example of a narrow definition that the CFPB should avoid.").

159 15 U.S.C. § 6102(a)(1) (2006) ("The Commission shall prescribe rules prohibiting deceptive telemarketing acts or practices and other abusive telemarketing acts or practices.").

160 15 U.S.C. § 6106 (2006).

161 16 C.F.R. § 310.4(a)(1) (2010) (outlawing "[t]hreats, intimidation, or the use of profane or obscene language"); 16 C.F.R. § 310.4(c) (2010) ("Calling time restrictions. Without the prior consent of a person, it is an abusive telemarketing act or practice and a violation of this Rule for a telemarketer to engage in outbound telephone calls to a person's residence at any time other than between 8:00 a.m. and 9:00 p.m. local time at the called person's location.").

162 FTC v. MacGregor, 360 F. App'x 891, 894–95 (9th Cir. 2009) (holding that high volume of consumer complaints, high refund and return rates, and the number of investigations by state Attorney General was enough for the court to hold that there was a practice of engaging in abusive conduct); The Broadcast Team, Inc. v. FTC., 429 F. Supp. 2d 1292 (M.D. Fla. 2006) (finding for-profit "telefunders" utilizing prerecorded calls to solicit funds on behalf of non-profit charities is abusive).

163 The only regulation related to initiating credit relationships (and not debt settlement) is in section 310.4(a)(4) which states that it is abusive to "[r]equest[] or receive[] payment of any fee or consideration in advance of obtaining a loan or other extension of credit when the seller or telemarketer has guaranteed or represented a high likelihood of success in obtaining or arranging a loan or other extension of credit for a person." 16 C.F.R. § 310.4(a)(4).

pass any rule because the standard is "whatever the bureau director says it is," and is likely impossible for businesses to comply with because "the term is so broad and the definition is so broad" and the standard is "very subjective."[164]

The language of the statute, however, suggests that the standard for abusive acts is, for the most part, very similar to the standard for deceptive acts and unfair acts.[165] Several of the bases the Bureau can use to determine an act is abusive relate to a consumer being deceived and misunderstanding a transaction: An act is abusive if it "materially interferes with the ability of a consumer to understand" or unreasonably takes advantage of a consumer's lack of understanding of the material risks, costs, or conditions of the product or service.[166] Indeed, the requirements that the act "materially" interfere with the consumer's ability to understand the transaction and that the consumer misunderstand the "material" risks of the product incorporate the court-created requirement that the deceptive act must be material to the transaction.[167]

Similarly, the ability to declare an act abusive if the consumer cannot protect herself from harm contains almost the same language as the definition of an unfair act.[168] The major difference is that this part of the standard for abusive conduct does not require a "substantial injury" to the consumer, potentially opening up new rulemaking for acts that cause insubstantial injury. The standard does, however, require that the transaction unreasonably take advantage of the consumer who cannot protect herself, so the Bureau cannot declare all such acts abusive. Considering the fact the Bureau will not likely concern itself with acts that cause little harm, it is not clear that

164 Cheyenne Hopkins, *New 'Abusive' Standard in Dodd-Frank Has Bankers Nervous*, AM. BANKER, Nov. 23, 2010, *available at* http://www.americanbanker.com/issues/175_225/dodd-frank-abusive-1028984-1.html.

165 In contrast to my view here, Carey Alexander suggests the fact that "abusive" was added to "unfair and deceptive" means that they necessarily mean different things. *See* Alexander, *supra* note 136, at 4 ("Unfairness and deception have well-established meanings, and their inclusion alongside 'abusive' suggests that the new doctrine represents something unique and apart from the old doctrines.").

166 Dodd-Frank § 1031(d).

167 FTC Policy Statement on Deception, *supra* note 145, at 4.

168 *Compare* Dodd-Frank § 1031(c)(1) (stating the Bureau can only declare an act unfair if "the Bureau has a reasonable basis to conclude that . . . the act or practice causes or is likely to cause substantial injury to consumers which is not reasonably avoidable by consumers . . . and such substantial injury is not outweighed by countervailing benefits to consumers or to competition"), *with* Dodd-Frank § 1031(d)(2)(B) (stating that the Bureau can define an act as abusive if it "takes unreasonable advantage of . . . the inability of the consumer to protect the interests of the consumer in selecting or using a consumer financial product or service").

the ability to declare acts abusive without substantial injury really gives the Bureau any new authority.

The only truly new part of the standard is the Bureau's ability to declare an act abusive if it "takes unreasonable advantage of . . . the reasonable reliance by the consumer on a covered person to act in the interests of the consumer."[169] One commentator has suggested that businesses will be able to protect themselves from problems under this part of the standard by disclosing to consumers that they should not rely on the business to protect their interests in the transaction.[170] Such statements have been effective to negate reliance under state consumer protection laws. In Texas, if a consumer signs a contract that states the consumer is purchasing a good or property "as is" and without reliance on the seller's representations, the consumer cannot claim that she relied on the seller's representations.[171] The Texas Supreme Court explained in a seminal case that:

> [The plaintiff's] 'as is' agreement negates his claim that any action by Prudential caused his injury. His contractual disavowal of reliance upon any representation by Prudential was an important element of their arm's-length transaction and is binding on Goldman unless set aside. The 'as is' agreement negates causation essential to recovery on all theories Goldman asserts . . . .[172]

Thus, it is possible through effective disclosure that businesses will be able to avoid liability under this part of the abusive standard.

The fact that this prong requires the consumer's reliance be reasonable seems to again incorporate deception into this prong. In most commercial relationships, all parties assume that the other negotiates in such a way as to obtain the maximum benefit for itself under the transaction.[173] Thus, to create a situation in which a consumer reasonably relies on the business to act in the consumer's interest would seem to require that the business

169 Dodd-Frank § 1031(d)(2)(C). *See* Benoit, *supra* note 156 ("There is, however, a new twist to this standard that has not been seen before. That is, this 'abusive' standard includes a fiduciary element unprecedented in the consumer lending industry, i.e., taking unreasonable advantage of the 'reasonable reliance by the consumer on a covered person to act in the consumer's interests.'").

170 Benoit, *supra* note 156.

171 TEX. BUS. & COM. CODE ANN. § 17.42 (West 2009).

172 Prudential Ins. Co. of Am. v. Jefferson Assocs. Ltd., 896 S.W.2d 156, 161 (Tex. 1995). *See also* Larsen v. Carlene Langford & Assocs., 41 S.W.3d 245, 255 (Tex. App. 2001) (holding that an "as is" clause in a contract illustrated that the consumer did not rely on the seller's representations).

173 *See e.g.*, U.C.C. § 1-304 (2007) (requiring parties to use good faith in performing and enforcing contracts but not in negotiating them).

falsely communicate to the consumer that it will act in the consumer's interest.

Despite my analysis that the abusive power seems largely repetitive of the unfair and deceptive powers, the Bureau may construe the word very differently, as others have urged it to do.[174] As with the unfairness prong, the abusive prong of the Bureau's rule-making power enables it to potentially intervene into fringe credit markets in substantial, innovative ways.

D. Enforcement

Fringe banking firms will also likely be affected by enhanced enforcement of existing federal consumer protection laws. As Part III.D explains, current federal consumer law constrains fringe banking transactions. The Act increases the likelihood fringe lenders will pay penalties for violating these laws as well as any rules the Bureau creates because it gives the Bureau significant enforcement powers.

Under the Act, the Bureau can demand material and testimony if it suspects a violation of federal consumer protection law,[175] it can issue cease and desist orders,[176] and it can commence litigation against violators.[177] Although it cannot seek exemplary or punitive damages,[178] it can seek a variety of remedies, including rescission or reformation of contracts, restitution, payment of damages or other monetary relief, civil penalties, and the costs of pursuing the violator.[179] The civil penalties are severe. For violations without recklessness, "a civil penalty may not exceed $5,000 for each day during which such violation or failure to pay continues," but "for any person that recklessly engages in a violation of a Federal consumer financial law, a civil penalty may not exceed $25,000 for each day during which such violation continues."[180] If the person knowingly violates the law, "a civil penalty may not exceed $1,000,000 for each day during which such violation continues."[181]

Perhaps even more threatening to fringe lenders is the increase in information the Bureau will have about businesses

174 Alexander, *supra* note 136, at 20 ("Congress's enactment of a flexible definition of abusive, coupled with Congress's clear dissatisfaction with the Fed's narrow interpretation of its powers to reach abusive practices suggests that the CFPB should adopt a broad, expansive interpretation of its powers to address abusive practices.").

175 Dodd-Frank § 1052.

176 Dodd-Frank § 1053(b).

177 Dodd-Frank § 1054(a).

178 Dodd-Frank § 1055(a)(3).

179 Dodd-Frank § 1055(a)(2)&(b).

180 Dodd-Frank § 1055(c)(2).

181 *Id.*

violating federal consumer protection law. A primary function of the Bureau is "collecting, investigating, and responding to consumer complaints."[182] One mechanism the Bureau will have for learning about violations is a consumer hotline for complaints established by the Act.[183] In her work establishing the Bureau, Warren has pledged to use new technologies, such as crowdsourcing,[184] to enhance the amount of information that the Bureau gathers from consumers.[185] After gathering this information, the Bureau will establish procedures to "provide a timely response to consumers . . . to complaints against . . . a covered person . . . ."[186] Both the powers to gather information and to act on that information give the Bureau the power to take definite action to affect fringe lenders who violate federal rules and statutes.

E. The Act's Relation to State Law

New federal laws and rules governing the fringe economy add to an extensive, diverse array of existing state law. In light of the fact that most fringe banking regulations currently are based in state law, this section analyzes the relationship the Act has to that important body of law and demonstrates that the

182 Dodd-Frank § 1021(c)(2).

183 Dodd-Frank § 1013(b)(3)(A).

184 Crowdsourcing is "the act of a company or institution taking a function once performed by employees and outsourcing it to an undefined (and generally large) network of people in the form of an open call." Jeff P. Howe, *Crowdsourcing: A Definition*, CROWDSOURCING (June 2, 2006, 10:30 AM), http://crowdsourcing.typepad.com/cs/2006/06/crowdsourcing_a.html. This alternative model of peer production allows for "companies to engage with and harness the crowd for help." John Winsor, *Crowdsourcing: What It Means for Innovation*, BUS. WEEK, June 15, 2009, *available at* http://www.businessweek.com/innovate/content/jun2009/id20090615_946326.htm; Daryl Lim, *Beyond* Microsoft*: Intellectual Property, Peer Production and the Law's Concern with Market Dominance*, 18 FORDHAM INTELL. PROP. MEDIA & ENT. L.J. 291, 301–04 (2008).

185 Eileen Ambrose, *Elizabeth Warren: Three Top Goals for New Consumer Protection Agency*, CONSUMING INTERESTS (Nov. 10, 2010, 2:22 PM), http://weblogs.baltimoresun.com/business/consuminginterests/blog/2010/11/elizabeth_warren_three_top_goa.html (noting that one of Warren's top three priorities of the Bureau is "using technology to tap into the experience of millions of consumers so the bureau can develop a rapid response to problems"); Bill Swindell, *Warren Outlines Sweeping New Approach to Consumer Financial Protection*, NATIONAL J. (Oct. 26, 2010), http://www.nationaljournal.com/daily/warren-outlines-sweeping-new-financial-protection-approach-20101026 ("In an interview on Tuesday with *National Journal*, Warren said new techniques like crowd-sourcing—scaled-up variations on Wikipedia—make it possible to collect valuable information from millions of ordinary consumers who report problems as they arise. Using new systems to organize and find patterns in all that information, Warren said, the bureau could be able to spot new enforcement targets in a matter of days—an unheard-of response time for traditional regulators . . . . Under her vision, Warren imagines a subset of Americans reporting on a specific problem, such as extraneous fine print included in a bank's checking account statement, documenting it through use of a camera phone, and then emailing it to the bureau within seconds. The bureau would use such data to target its enforcement.").

186 Dodd-Frank § 1034(a).

Bureau will only add regulations to fringe credit markets, not take any away.

i. The Effect of Existing State Laws on Rulemaking

Several provisions in the Act suggest that the Bureau will be less involved in regulating industries that are already covered by extensive state regulation.[187] For instance, in determining how to supervise nondepository firms like fringe bankers, the Bureau will consider "the extent to which such institutions are subject to oversight by State authorities for consumer protection."[188] Presumably, if transactions are heavily regulated by states, the Bureau will be disinclined to promulgate additional rules.

One problem the Bureau will encounter in following these provisions is the disparate approach states have taken to regulating fringe credit. As just one example, some states outlaw, either explicitly or implicitly, title lending,[189] while others permit it with virtually no restraints.[190] Thus, it is not entirely clear whether title loans are "subject to oversight by State authorities" because it depends entirely on the state. If the Bureau does not create rules on these sorts of transactions, then people in many states are left unprotected; if the Bureau does create rules, the rules may impose duplicative requirements on firms.

ii. Coordination

The Act attempts to mitigate the effects of duplicative requirements on businesses by requiring the Bureau to coordinate with state regulators. For instance, with the express goal of minimizing regulatory burden, the Bureau must coordinate its supervisory activities with state regulators, "including establishing their respective schedules for examining

187 *See, e.g.*, Dodd-Frank § 1022(b)(3) (instructing the Bureau to consider the extent of state regulation when determining if an industry should be exempt from its rules).

188 Dodd-Frank § 1024(b)(2)(D).

189 For an example of a state explicitly banning title lending, see LA. REV. STAT. ANN. § 37:1801(D) (2010). For an example of states that effectively ban title lending by capping interest rates at a level that prevents firms from operating in the state, see COLO. REV. STAT. § 5-2-201(2) (2010) (capping loans under $1000 at 36% APR); VT. STAT. ANN. tit. 9, § 41a(4) (2010) (capping loans secured by vehicles at 20% APR).

190 For instance, New Mexico sanctions small dollar loans and does not place a cap on the interest lenders can charge either in the small loan statute or general state law. *See generally* N.M. STAT. ANN. § 58-15-17 (2010). Section 56-8-3 sets out that interest rates in the state generally "in the absence of a written contract fixing a different rate, shall be not more than fifteen percent annually," but it does not prevent the parties agreeing in a written contract to a higher interest rate. N.M. STAT. ANN. § 56-8-3 (2010). The end result is that title lenders have restrictions on the interest rate they can charge, and title borrowers have no specific protections beyond those afforded to borrowers generally in the Uniform Commercial Code.

persons . . . and requirements regarding reports to be submitted by such persons."[191] Additionally, in setting capital requirements for supervised nondepositories "the Bureau shall consult with State agencies regarding requirements or systems (including coordinated or combined systems for registration), where appropriate."[192] Finally, the Act mandates that the Bureau coordinate with states when setting up registration requirements for all business it monitors.[193] To the extent this coordination is successful, it will obviously reduce demands on fringe banking firms, but it is again questionable how the Bureau will be able to coordinate with states that have different requirements. While it might be simple to harmonize the federal requirements with a single state, it seems impossible to do so with several states that have different registration requirements, for example.

iii. Powers Given to State Governments

The Act actually confers some powers on state regulators. First, states can prompt the Bureau to consider proposing a rule if a majority of states enact a resolution supporting a rule.[194] Second, in addition to clarifying that states still have the authority to enforce their own consumer protection laws,[195] the Act empowers states to file suits in consultation with the Bureau[196] to enforce Bureau regulations,[197] except against national banks and federal savings associations.[198] These provisions should increase the potential that fringe banking businesses will face enforcement actions of the Bureau's rules—even beyond the augmentation of general enforcement powers

191 Dodd-Frank § 1024(b)(3).

192 Dodd-Frank § 1024(b)(7)(D).

193 Dodd-Frank § 1022(c)(7)(C).

194 Dodd-Frank § 1041(c)(1) ("The Bureau shall issue a notice of proposed rulemaking whenever a majority of the States has enacted a resolution in support of the establishment or modification of a consumer protection regulation by the Bureau.").

195 Dodd-Frank § 1042(d)(1).

196 Dodd-Frank § 1042(b).

197 Dodd-Frank § 1042(a)(1) ("[T]he attorney general (or the equivalent thereof) of any State may bring a civil action . . . to enforce provisions of this title or regulations issued under this title, and to secure remedies under provisions of this title or remedies otherwise provided under other law. A State regulator may bring a civil action or other appropriate proceeding to enforce the provisions of this title or regulations issued under this title with respect to any entity that is State-chartered, incorporated, licensed, or otherwise authorized to do business under State law . . . and to secure remedies under provisions of this title or remedies otherwise provided under other provisions of law with respect to such an entity."). States are limited from enforcing the Bureau's rules against exempt merchants, just as the Bureau cannot enforce those rules. Dodd-Frank § 1027(a)(2)(E) ("To the extent that the Bureau may not exercise authority under this subsection with respect to a merchant, retailer, or seller of nonfinancial goods or services, no action by a State attorney general or State regulator with respect to a claim made under this title may be brought under subsection 1042(a) . . . .").

198 Dodd-Frank § 1042(a)(2).

discussed above—because state attorneys general will have a new tool to combat what they perceive to be sharp practices.

iv. Preemption

The Act specifies that it does not relieve lenders from complying with applicable state laws. The statute asserts that state laws remain in effect "except to the extent that any such provision of law is inconsistent with the provisions of this title."[199] State laws are not inconsistent with the Act if "the protection that such statute, regulation, order, or interpretation affords to consumers is greater than the protection provided under this title."[200]

Several federal statutes contain language that is similar to the Act's language permitting states to offer consumers greater protections.[201] In discussing these statutes, courts have used the requirement that states provide greater consumer protection to be a one-way ratchet to enforce state laws that offer heightened restrictions on businesses' conduct; only laws that further restrict businesses are said to offer consumers greater protection.[202]

Having a federal law that regulates fringe banking but does not preempt state law is the worst-case scenario for fringe lenders because it involves an expansion of regulatory control over their activities. Many people in the fringe banking industry have pushed for federal laws, but their purpose in doing so is to prevent less favorable state laws from limiting their activities. For example, the rent-to-own industry trade association has

199 Dodd-Frank § 1041(a)(1).

200 Dodd-Frank § 1041(a)(2).

201 *See* 12 U.S.C. § 2616 (2006) ("The Secretary may not determine that any State law is inconsistent with any provision of this chapter if the Secretary determines that such law gives greater protection to the consumer."); 15 U.S.C. § 1692n (2006) ("For purposes of this section, a State law is not inconsistent with this subchapter if the protection such law affords any consumer is greater than the protection provided by this subchapter."); 15 U.S.C. § 1691d(f) (2006) ("The Board may not determine that any State law is inconsistent with any provision of this subchapter if the Board determines that such law gives greater protection to the applicant."); 12 U.S.C. § 2805(a) (2006) ("The Board may not determine that any such law is inconsistent with any provision of this chapter if the Board determines that such law requires the maintenance of records with greater geographic or other detail than is required under this chapter, or that such law otherwise provides greater disclosure than is required under this chapter.").

202 *See* Washington Mut. Bank, FA v. Superior Court, 75 Cal. App. 4th 773, 783 (1999) (approving of a state law that offers consumers remedies beyond those given in federal laws); Pirouzian v. SLM Corp., 396 F. Supp. 2d 1124, 1131 (S.D. Cal. 2005) (holding a federal law does not preempt a state law if the state law expands the coverage of the law against additional businesses); Sibley v. Firstcollect, Inc., 913 F. Supp. 469, 473 (M.D. La. 1995) (approving of a state law that prohibits additional conduct beyond that prohibited by federal laws); Desmond v. Phillips & Cohen Assocs., Ltd., 724 F. Supp. 2d 562, 567–68 (W.D. Pa. 2010) (upholding a state law that furthered the goals of a federal law).

supported a federal law on rent-to-own called the Consumer Rental Purchase Agreement Act.[203] This law sets out a variety of rules for rent-to-own and even includes similar language to the Consumer Financial Protection Act regarding state laws that provide greater protection for consumers.[204] But, the bill clarifies that no state law can regulate rent-to-own as a credit sale or require businesses to disclose interest rates.[205] These two rules have historically been of overwhelming importance to rent-to-own companies,[206] so the passage of the bill would be a major victory because it would prevent states from enacting these disfavored regulations. The new Consumer Financial Protection Act as written, however, does not bring this benefit, it only adds restrictions onto fringe lenders' conduct. As with the other substantive provisions on fringe banking, the sections discussing preemption reveal a profound new power the federal government now has to govern the fringe economy. The next part asks a more basic question: Is this power justified?

III. THE RATIONALES BEHIND THE BUREAU REGULATING FRINGE BANKING

As the previous two parts have indicated, it is difficult to predict what the Bureau will do when it begins promulgating rules and enforcing federal consumer protection laws. And, even if we knew exactly what it intended to do, it is impossible to understand all of the effects of the Bureau's conduct before those effects play out. Thus, the primary way to assess the Bureau's import before it begins significantly intervening in the fringe economy is to assess the rationales for the Bureau. As David Skeel points out:

> We can't really know in advance whether these costs will materialize, of course. Moreover, the answer will depend on how the Consumer Bureau pursues its regulatory mandate, which will be different at different times in the Bureau's life. For now, the chief question is simply whether the new consumer champion is justified.[207]

This part takes up that inquiry.

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203 Association of Progressive Rental Organizations, *RTO Legislative Activity—Why the Rent-to-Own Industry is Seeking Federal Legislation*, RTOHQ.COM, http://www.rtohq.org/apro-seeking-the-support-of-congress.html (last visited Mar. 22, 2011); Consumer Rental-Purchase Agreement Act of 2009, S. 738, 111th Cong. (2009) [hereinafter Consumer Rental Purchase Agreement Act] (the text of the bill as proposed by the Association of Progressive Rental Organizations is available at http://www.rtohq.org/pdfs/RTOBillText.pdf).

204 *See* Consumer Rental Purchase Agreement Act § 1018(a)(3).

205 Consumer Rental Purchase Agreement Act § 1018(b).

206 *See* Hawkins, *supra* note 50, at 2101–09.

207 SKEEL, *supra* note 98, at 113.

In order to assess the rationales offered for the Bureau regulating fringe credit, it is important to group different rationales into categories. This part categorizes the diverse reasons that popular press, government officials, and academics have proffered to justify the Bureau's control over fringe banking products. To describe the rationales, I draw primarily on two of Elizabeth Warren's articles proposing the Bureau.[208] Although these two articles are not the only academic works advocating for the Bureau, they are significant because the President appointed Warren as a special advisor to oversee the creation of the Bureau[209] and these two articles are widely considered the academic work that propelled the Bureau into existence.[210]

To understand how prominent and significant these justifications were in public statements about the Bureau and its relationship to fringe banking, three research assistants and I read virtually every article that mentioned both the Bureau and fringe banking that was found in LexisNexis' "News, All" source from January 2007, before the Bureau was proposed, to May 21, 2010, the day the President signed the Act into law.[211] This source draws from more than 4650 news outlets across the United States and a variety of countries. The search terms we entered generated 1520 results, and we reviewed 1496 of those results.[212]

We assessed and coded each result to record: (1) the nature of the source (news article, editorial, or government publication);

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208 Elizabeth Warren, *Unsafe at Any Rate*, DEMOCRACY, Summer 2007, at 1; Bar-Gill & Warren, *supra* note 128.

209 *Warren's Appointment Rankles GOP*, CREDIT UNION J., Sep. 27, 2010, at 39.

210 *See* SKEEL, *supra* note 98, at 50–51, 100 ("The agency had been conceived by Harvard law professor and TARP Oversight Committee head Elizabeth Warren, first in a short 2007 article whose title—"Unsafe at Any Rate"—consciously linked her to the Ralph Nader crusades of the 1960s, and then a more detailed, co-authored article a year later . . . . With a few exceptions, the legislative blueprint for the new Consumer Bureau reads as if it came straight from these two articles, as in many respects it did."); Michael Tomasky, *The Elizabeth Warren Story*, GUARDIAN (July 20, 2010, 21:05 BST), http://www.guardian.co.uk/commentisfree/michaeltomasky/2010/jul/20/obama-administration-finreg-consumers-warren (describing Warren's article in *Democracy* as the first call for an agency to oversee consumer financial protection).

211 We ran the following search: "(fringe-bank! or fringe-financial-service or alternative-financial-service or nonbank-lend! or payday-l! or pawn! or rent-to-own or title-l! or refund-anticipation-loans) and ((consumer-financial-protection w/3 bureau) or (consumer-financial-protection-agency.)".

212 I say we read virtually every article that appeared in this database because during the time we performed the study (September 2010–November 2010), the number of results from the search jumped from 1520 to 1560 as additional articles were added. This change in the number of results combined with the fact multiple people were working on different sections of the result led to twenty-four results being coded twice and twenty-four not being coded at all. I eliminated the twenty-four results that were coded twice from the database because it only represented 1.5% of the total results. In the end, we reviewed 1496 stories instead of the 1520 that were originally generated by the search.

(2) the extent of the coverage (provides no coverage, merely mentions the Bureau and fringe banking, merely explains the law, or offers justifications for the Bureau regulating fringe banking); and (3) the justification, if any, offered for the Bureau governing fringe banking. The coding information was imputed into a custom-designed Microsoft Excel database. Each researcher underwent a training class and received detailed written coding protocols about how to code the results, and we met periodically to ensure we were uniformly carrying out the coding protocol. I reviewed each researcher's data to lessen the chance of a coding error.

Of the 1496 results we reviewed, 897 were unique articles, and 599 of the results repeated an earlier article verbatim. Of the 897 unique results, 539 were newspaper articles, 121 were newspaper editorials, and 237 were government documents. The government documents consisted of press releases from Congressmen and women and transcripts of hearings.

The majority of the results did not mention any arguments in favor of the Bureau regulating fringe banking. Twenty-one of the results were false positives—they were not actually about the Bureau and fringe banking. Five hundred ninety-eight of the results merely mentioned fringe banking and the Bureau or explained the Act, and thirty-eight of the results presented arguments against the Bureau regulating fringe banking. The remaining 240 results offered arguments for the Bureau regulating fringe lenders, either directly in the case of press releases, testimony at hearings, and editorials, or indirectly by reporting the views of others. For each result that coded a justification, the researcher pasted the text of the article related to the justification in a separate cell of the spreadsheet. Table 1 summarizes the results, which are discussed in more depth below:

TABLE 1

Prominence of Justifications for the Bureau Regulating Fringe Banking		
	Percent of Articles Discussing This Justification	Number of Articles Discussing This Justification[213]
Fringe Banking Relies on Deception	19%	46
Fringe Banking Is Too Costly	28%	68
Fringe Banking Causes Financial Distress	15%	35
Fringe Banking Is Unregulated	49%	118
Fringe Banking is Abusive or Predatory	55%	133

In addition to describing the rationales offered for the Bureau's power over fringe banking, this part evaluates whether these rationales can sensibly be applied to fringe credit products. Some of the justifications are plainly inapplicable to fringe banking transactions, while others accurately point out problems the Bureau could correct in fringe credit markets. One goal of this part is to focus regulators' attention on the real problems the Bureau could solve in fringe markets and urge the Bureau not to act to "fix" problems that evidence has not demonstrated exist in fringe credit industries.

A. Deception

A central focus of those justifying the Bureau has been the confusing and deceptive consumer credit contracts that borrowers face when borrowing money. Warren has introduced a catchy phrase to sum up the problem, "tricks and traps,"[214] that has been repeated over and over in the media.[215] Our study of news sources regarding the creation of the Bureau found that 19

213 These numbers add up to more than 240 because some results had more than one justification in them.

214 *See* Warren, *supra* note 208, at 9 ("Lenders have deliberately built tricks and traps into some credit products so they can ensnare families in a cycle of high-cost debt.").

215 For instance, a search for "(tricks w/3 traps) and consumer-financial-protection" in LexisNexis' "News, All" source yielded 379 results on October 24, 2010.

percent (n=46) of the stories provided deception as a reason the Bureau should regulate fringe credit.[216] Some of the sources noted that payday loan documents are "incomprehensible"[217] and hide terms in fine print,[218] while others simply stated the Bureau will be able to prevent deceptive payday loans.[219] This section discusses the two ways supporters of the Bureau claim credit contracts are deceptive: the terms of the contracts themselves and the credit products' designs.

i. Tricks and Traps in Contracts

First, consumer credit contracts themselves came under fire from those seeking to establish the Bureau. Warren's first article proposing the Bureau emphasized how credit contracts have become extremely long and complicated in order to hide unfavorable terms:

> Part of the problem is that disclosure has become a way to obfuscate rather than to inform. According to the *Wall Street Journal*, in the early 1980s, the typical credit card contract was a page long; by the early 2000s, that contract had grown to more than 30 pages of incomprehensible text. The additional terms were not designed to make life easier for the customer. Rather, they were designed in large part to add unexpected—and unreadable—terms that favor the card companies. Mortgage-loan documents, payday-loan papers, car-loan terms, and other lending products are often equally incomprehensible.[220]

The sheer length and complexity of the contract makes it prohibitively costly for borrowers to understand the terms of the transaction or compare different lenders' terms.[221]

Warren even uses a payday lending contract as an example of the sort of "devilishly complex financial undertakings" the

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216 We determined a result used deception as a justification for the Bureau regulating fringe credit if the result discussed (1) consumers being tricked in any way by the fringe bankers or (2) consumers making poor decisions when evaluating fringe banking products.

217 Tomasky, *supra* note 210.

218 Ronald D. Orol, *Why Washington Can't Agree on Consumer Protection*, MARKETWATCH (Mar. 4, 2010, 12:56 PM), http://www.marketwatch.com/story/why-washington-cant-agree-on-consumer-protection-2010-03-04 ("A consumer agency could cap the interest rate that pay-day lenders charge and require these companies to disclose their fee structure that is often hidden in the fine print.").

219 *See, e.g.*, Robert Weissman, *Congress Passes Financial Reform, Consumer Protections; Much More Must Be Done to Rein in Wall Street*, COMMONDREAMS.ORG (July 15, 2010, 4:53 PM), http://www.commondreams.org/newswire/2010/07/15-22 ("This bureau will have the authority to crack down on unfair, deceptive and abusive practices in connection with consumer products such as payday loans, credit cards and mortgages by using new rules and enforcement powers.").

220 Warren, *supra* note 208, at 11–12.

221 Bar-Gill & Warren, *supra* note 128, at 13–14.

Bureau would police.[222] She claims that payday lenders hide "a staggering interest rate" in "the tangle of disclosures," giving the example of one contract which only listed the interest rate in a page of disclosures and not on the fee page.[223] In a subsequent article, Warren and her co-author, Oren Bar-Gill, point out that payday borrowers frequently know the finance charge for the loan but do not know the interest rate,[224] presumably because it is hidden.

To evaluate whether this rationale is a persuasive basis for the Bureau regulating the fringe economy, I collected contracts from several different fringe banking transactions. Surveying the characteristics of these contracts casts serious doubt on the Bureau regulating fringe credit because of the opaque nature of its contracts.

The first contract I evaluated was a rent-to-own contract used by a regional rent-to-own company headquartered in the Midwest.[225] Its rent-to-own agreement is two pages long, written in ten point font, and contains approximately 2000 words; 576 of those words relate to the mandatory arbitration clause. All of the costs of the transaction are written in a separate box near the top of the first page of the contract. There are several ways to evaluate the complexity of a writing, but under any of these standards, this contract seems basic. Consider the following paragraph which is written in a similar manner as the rest of the contract:

> Reinstatement: If you fail to make a rental renewal payment by the renewal date, this Agreement terminates and we are entitled to the immediate return of our property. To reinstate, you must return the property to us as soon as we ask you to. Then, you can reinstate this agreement by making all payments due to us within 21 days of the renewal date if you pay weekly or within 90 days if you pay monthly. If you reinstate, we will provide you the same merchandise, or with substitute merchandise of comparable quality and conditions.

The reader can judge whether this term is comprehensible, but it seems like a significant stretch to call this contract "incomprehensible text."

Similarly, Rent-A-Center, the nation's largest rent-to-own company, has a contract that is two pages long, but unlike the first rent-to-own company's contract, Rent-A-Center has a separate arbitration agreement in addition to these two pages. Like the

222 Warren, *supra* note 208, at 10.

223 *Id.* at 13.

224 Bar-Gill & Warren, *supra* note 128, at 30.

225 In exchange for me using its contract, the company asked it not be identified in my paper.

other rental agreement I discussed, Rent-A-Center's agreement discloses all costs on the first page of the contract and is written at a similar level of complexity. Rent-A-Center is currently rewriting its rental agreement in New York because of recent changes in the law, and the General Counsel is explicitly attempting to write the contract at a seventh grade reading level.[226]

In addition to rent-to-own contracts, I secured a pawnshop contract from A Plus Pawn Shop, a stand-alone pawnshop located in Houston, Texas.[227] A Plus' contract is a double sided, half-page document. The font of the text is small, around six point font, and the entire contract contains probably 1000 words. The back page of the contract has two dense paragraphs of text. The following is the entire second paragraph:

> If you pay the loan we will return the property to you in the same condition we received it. If we lose your property or if it is damaged while in our possession, we will replace it with identical or similar property or similar property of the same kind and quality or have your property restored to its condition at the time it was deposited with us. All replacements are subject to approval by the Consumer Credit Commission. Any person who possesses this payment ticket may pay us the amount due and we must give that person the pledged goods if we have not been notified in writing that this ticket has been stolen. IF THIS TICKET IS LOST OR STOLEN, YOU MUST NOTIFY US IN WRITING TO PROTECT YOUR PLEDGED GOODS. Fee for lost ticket and statement.

The contract's front page has very little text, but instead is separated out into numerous boxes that state the amount financed, the finance charge, the APR, and a description of the pawned good, among other things.

The final contracts I obtained were from Speedy Cash, a payday lending company that originated in California and has over ninety locations.[228] Speedy Cash has different payday loan contracts for each state in which it operates to comply with state regulations. The contract from Kansas is five pages long and has 4415 words.[229] The Truth in Lending Act disclosures are on the first page of the contract and in separate boxes, with the APR and finance charges highlighted. The majority of the text is in ten point font, and most of it—2822 words—is an arbitration

226 Telephone Interview with Ron Demoss, General Counsel, Rent-A-Center, Nov. 13, 2010.

227 A+ PAWN SHOP, http://apluspawnshop.com/ (last visited Mar. 22, 2011).

228 SPEEDY CASH, Store Locations, http://www.speedycash.com/payday-loan-store/ (last visited Mar. 22, 2011).

229 I also reviewed the contract from California, which is similar to the Kansas contract.

agreement. One thousand three hundred twenty of the words of the contract are definitions and various terms.[230] In addition to payday lending, Speedy Cash also does auto-title loans. Its auto-title loan documents are similar to its payday loan contracts but they have a single additional paragraph relating to the vehicle as collateral for the loan.[231]

These contracts certainly appear different than the contract Warren refers to in her article in *Democracy* arguing for the need to regulate payday lending contracts.[232] Without a survey of every payday lender's contract in America, it is impossible to know the extent of the conduct Warren observed, or that I report here. But, my analysis of these fringe banking contracts reveals that Warren's observation is not ubiquitous in the payday lending industry or across fringe banking products, suggesting at least a need for more study to make the claim that payday lending contracts are misleading.

More to the point, the contract Warren discusses is already an illegal contract under the Truth in Lending Act (TILA). First, having an APR hidden in the contract violates the TILA provision requiring the APR to be more conspicuous than other disclosed terms.[233] Additionally, an APR disclosure in a place other than the fee page does not follow the tabular format mandated by the TILA.[234] Courts have already found at least one payday lender and one pawnshop to have violated this provision of TILA. In *Turner v. E-Z Check Cashing*, the payday lender's APR disclosure was even more conspicuous than the one Warren

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230 The following paragraph is representative of the level of complexity:

> **Telephone Calls—Monitoring:** You agree that if you are past due or in default, you will accept calls from us or a third party we have contracted with regarding the collection of your Account. You understand these calls could be automatically dialed and a recorded message may be played. You agree such calls will not be unsolicited calls for purposes of state and federal law. If you provide us with a wireless or cellular telephone number, you agree that we may place calls to that number which may result in charges from your wireless or cellular carrier. You also agree that, from time to time, we may monitor telephone conversations between you and us to assure the quality of our customer service.

231 Rent-A-Center also provided me with its payday loan contract from Kansas. It is seven pages long and has similar font and contents to Speedy Cash. Like Speedy Cash, it also has the Truth in Lending Act disclosures prominently on the first page of the agreement.

232 Warren, *supra* note 208, at 13 ("For example, buried in a page of disclosures for one lender (rather than on the fee page, where the customer might expect to see it) was the note that the interest rate on the offered loan was 485.450 percent.").

233 15 U.S.C. § 1632(a) (2006) ("The terms 'annual percentage rate' and 'finance charge' shall be disclosed more conspicuously than other terms, data, or information provided in connection with a transaction, except information relating to the identity of the creditor.").

234 15 U.S.C. § 1632(c).

reports because it was in a block of fee disclosures, but a court in Tennessee found it violated the TILA because "EZ's disclosure document uses the same typesize, font, and boldness in listing the terms 'annual percentage rate' and 'finance charge' as it does in listing other terms, data, and information; thus these terms are no more conspicuous than others."[235] Similarly, in a case involving a contract very similar to the one Warren reports, the court held a pawn ticket violated the TILA because the term "APR" was "contained in the middle of a paragraph in the smallest print on the pawn ticket" and because "this section is similar in appearance to a section entitled 'Customer Information' and is less conspicuous than the section setting forth information on the vehicle used for collateral which is outlined in a box."[236]

Thus, we cannot justify the Bureau because of a need for additional rules for fringe banking contracts because the contracts to which Warren objects are already illegal. It is possible the Bureau's enforcement powers are needed to enforce the existing laws to a greater extent than other existing agencies have been able to do in hopes of eliminating illegal contracts from the market, but before reaching this conclusion, at least we need more evidence of how widespread confusing terms are used in fringe credit markets.

ii. Tricks and Traps in Product Design

Another basis for the Bureau regulating fringe banking is that fringe banking transactions are designed in a way to deceive borrowers. Bar-Gill and Warren make the argument that people taking out payday loans expect to pay them off in a short period of time, but they actually have to roll the loans over repeatedly.[237] Borrowers are overly optimistic about the likelihood they will be able to pay off the loan, Bar-Gill and Warren contend, so they underestimate the cost of the loan and the risk of nonpayment.[238]

This rationale for regulating payday lending reflects some evidence of how people use payday loans. Studies report a significant number of people rollover their loans, ranging from the modal number of payday loans per year being one or two, an

235 Turner v. E-Z Check Cashing of Cookeville, TN, Inc., 35 F. Supp. 2d 1042, 1050 (M.D. Tenn. 1999).

236 Yazzie v. Ray Vicker's Special Cars, Inc., 12 F. Supp. 2d 1230, 1233 (D.N.M. 1998).

237 Bar-Gill & Warren, *supra* note 128, at 55–56.

238 *Id.* *See* Karen E. Francis, Note, *Rollover, Rollover: A Behavioral Law and Economics Analysis of the Payday-Loan Industry*, 88 TEX. L. REV. 611, 612, 617–18 (2010).

estimate that is likely too low,[239] to customers averaging 12.5 loans a year.[240] Similarly, a study from Tennessee found that "25% [of active title loans in the state] had been renewed one (1) time and 49% were renewed between two and nine times. Fourteen percent (14%) renewed 10 or more times."[241]

Critical to proving that people are tricked into rolling over their loans at a higher rate than they intended to at the start of the transaction, however, is proof that people did not anticipate rolling over their loans when they took them out. A study from economists Marianne Bertrand and Adair Morse attempts to offer proof that people make mistakes when they take out payday loans, such as rolling over loans at a rate higher than they anticipate.[242] Bertrand and Morse provided four different types of information to different payday lending customers as they were taking out their loans.[243] The information caused borrowers to borrow with reduced frequency than the control group, suggesting that the control group would have acted differently with more or better information about the loan product.[244]

The problem with this study, however, is that it does not offer any conclusions about why borrowers changed their behavior, so it fails to identify any specific cognitive defect that would cause people to rollover at a higher rate than anticipated.[245] Also, Bertrand and Morse do not report whether people anticipated rolling over their loans at a rate lower than their actual rollover activity, so we still do not have a direct answer to the central empirical question: Do borrowers underestimate the likelihood they will rollover their payday loan? Finally, even if we did have evidence payday borrowers acted overly optimistically, this rationale is inapplicable to other forms of fringe credit, like rent-to-own leases, which do not have short-term contracts, and refund anticipation loans, which only involve a single loan based on tax refunds without the possibility of rolling over the principle.

239 FDIC SURVEY, *supra* note 1, at 31.

240 Steven M. Graves & Christopher L. Peterson, *Predatory Lending and the Military: The Law and Geography of "Payday" Loans in Military Towns*, 66 OHIO ST. L.J. 653, 663 (2005).

241 TENN. DEP'T. OF FIN. INST., THE 2008 REPORT ON THE TITLE PLEDGE INDUSTRY 6 (2008).

242 Marianne Bertrand & Adair Morse, *Information Disclosure, Cognitive Biases and Payday Borrowing* (Chicago Booth School of Bus., Working Paper No. 10-01, 2010), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1532213.

243 *Id.* at 11–13.

244 *Id.* at 33–35.

245 *Id.* at 9.

Despite these limitations, the case for intervening in payday lending markets because of mistakes people make about rollovers is slightly more persuasive than the case for deceptive contracts because at least some studies have documented high numbers of rollovers in payday lending markets.[246] But, direct evidence of over optimism in payday lending markets simply does not exist at this point, so it is troubling to think that the Bureau would act on mere speculation about how borrowers use payday loans.

B. Cost

A second basis for the Bureau regulating fringe banking is the high cost involved in these transactions. Twenty-eight percent of the articles and documents we reviewed (n=68) that offered justifications for the Bureau regulating fringe credit cited the cost of fringe credit. Sources said things such as payday loans have "high,"[247] "astronomical"[248] and "outrageous" rates.[249] Refund anticipation loans were claimed to be "high-cost"[250] and involve "super-high-interest,"[251] and sources reported that rent-to-own and payday loans rates are so high they are surprising[252] and that fringe services are usurious.[253] Some sources made the point just by stating the interest rate: "Exhibit A: payday loans and their just-as-evil twin, car title loans . . . . [A] typical borrower will pay $500 in interest on a $300 loan."[254]

246 *See* Graves & Peterson, *supra* note 240, at 663.

247 *Administration Takes Aim at Fine Print*, LEWISTON MORNING TRIBUNE (IDAHO), July 1, 2009, at 3A ("The agency would be dedicated to protecting consumers when buying mortgages, using credit cards and taking out high-rate 'payday loans.'").

248 Hector Becerra, *Payday Advance Lenders Targeted*, L.A. TIMES, Mar. 8, 2008, at B1.

249 President Barack Obama, Weekly Address: Time for Action on Financial Reform for the Economy, Mar. 20, 2010, *available at* http://www.whitehouse.gov/the-press-office/weekly-address-president-obama-urges-action-financial-reform.

250 *Predatory Lending and Reverse Redlining: Are Low-Income, Minority and Senior Borrowers Targets for Higher-Cost Loans?: Hearing Before the Joint Econ. Comm.*, 111th Cong. 13 (2009) (statement of Sarah Bloom Raskin, Comm'r of Fin. Regulation, State of Md.).

251 Jon Green, *Proposal Offers Vital Consumer Protection*, HARTFORD COURANT (CONNECTICUT), Jan. 12, 2010, at A11.

252 *Regulatory Restructuring: Enhancing Consumer Financial Products Regulation: Hearing Before the Comm. on Fin. Servs.*, 111th Cong. 48–49 (2009) (statement of Luis V. Gutierrez, H. Comm. on Fin. Servs., State of Ill.) ("So I just wanted to say to Professor Warren, Ms. Seidman, and others, I would like to put a floor on payday lending, a national one, so that at least we have some minimum standard. I would like for the remitters to have somebody nationally, you know a federal regulator, I would like to see people maybe not buy an $800 TV and 3 years later pay $2,400 for it, or people to kind of, I don't know, escape to installment loans at 500 and 600 percent. Some people might be surprised that happens. It happens.").

253 *Perspective and Proposals on the Community Reinvestment Act: Hearing Before the Subcomm. on Fin. Inst. and Consumer Credit of the Comm. on Fin. Servs.*, 111th Cong. 10 (2010) (statement of Cy Richardson, V.P. Hous. And Cmty. Dev.).

254 Elizabeth Palmberg, *Ground Rules: Troubled Assets on Main Street*, SOJOURNERS

Warren's work exhibits a general concern that trusting lenders can cause consumers to pay a high price.[255] She points to payday lending specifically as a product with abusive pricing, citing several examples of individuals who paid a lot to service payday loans, and concluding, "In total, the cost to American families of payday lending is estimated to be $4.2 billion a year"[256] and "each year, predatory payday lending practices cost U.S. families $3.4 billion in excess fees and charges."[257] More significant than just pointing out the high cost of payday loans, however, is Warren's forecast that the Bureau would allow people to get short-term, small-dollar loans for lower costs.[258] With the Bureau in place, Warren predicted, "An older person who needed a little cash to make it until her Social Security check arrived would have a manageable loan, not one that would escalate into thousands of dollars in fees."[259]

The claim that fringe financial services are very expensive is undeniably true. While there may be some debate about whether these high costs are justified,[260] no one argues that fringe banking transactions involve low or even moderate cost products. Thus, if policymakers believe price alone is a reason to prevent credit transactions, this rationale represents a strong reason for the federal government to intervene in fringe credit markets.[261]

Yet, despite the relevance of this justification for the Bureau's activity, it is difficult to see what the Bureau can do to affect the cost of fringe credit. The most significant barrier is the Act's provision preventing the Bureau from setting a usury limit: "No provision of this title shall be construed as conferring authority on the Bureau to establish a usury limit applicable to an extension of credit offered or made by a covered person to a consumer, unless explicitly authorized by law."[262] Indeed, some

MAGAZINE, Jul. 2009, at 12, 13.

255 Warren, *supra* note 208, at 9.

256 *Id.* at 13.

257 Bar-Gill & Warren, *supra* note 128, at 56–57; Warren, *supra* note 208.

258 Warren, *supra* note 208 at 19.

259 *Id.* at 19.

260 *Compare* Aaron Huckstep, *Payday Lending: Do Outrageous Prices Necessarily Mean Outrageous Profits?*, 12 FORDHAM J. CORP. & FIN. L. 203, 230–31 (2007) (concluding payday lenders' profits are not highly profitable), *with* Nathalie Martin, *1,000% Interest—Good While Supplies Last: A Study of Payday Loan Practices and Solutions*, 52 ARIZ. L. REV. 563, 571 (2010) ("While some scholars have questioned the profitability of the industry and the industry sometimes denies that its returns are excessive, the mere existence of such a large number of lenders belies the conclusion that these loans are not highly profitable.").

261 I have argued elsewhere that high prices alone are a poor reason to regulate fringe credit. *See* Hawkins, *supra* note 50, at 2041.

262 Dodd-Frank § 1024(o).

reports suggest this provision was added under pressure from payday lenders.[263]

While the Bureau may be able to limit some fees, such as late fees or fees for products bundled with loans like credit insurance, fringe bankers can easily reprice the loan with a higher interest rate to compensate for any lost revenue.[264] There are many examples of businesses doing repricing, but one recent example from the Credit Card Accountability Responsibility and Disclosure Act of 2009 is illustrative.[265] This act limits upfront fees for secured credit cards, a form of fringe credit lending, but in response at least one card issuer has dramatically increased the interest rate on its secured card to offset losses from lower fees.[266] Thus, without being able to limit both pricing mechanisms, the Bureau may have trouble affecting the cost of fringe credit.

One way the Bureau may reduce the cost of credit to the poor is less direct. The Bureau is required to study mechanisms for encouraging people in the fringe economy to use mainstream financial services.[267] It is possible the Bureau will be able to move some borrowers from fringe credit sources into mainstream credit sources that have lower costs. The FDIC has done a pilot program to encourage banks to supplant payday lenders,[268] and the results are mixed, with payday lenders seeing the experiment

263 Timothy Noah, *Legal Usury*, SLATE (Oct. 5, 2010, 6:53 PM), http://www.slate.com/id/2270044/ ("Indeed, one of the sketchier provisions in Dodd-Frank affirmatively *prohibits* Warren's new agency from setting a maximum interest rate on payday loans. This was inserted at the behest of Senator Bob Corker, R.-Tenn. (The payday-loan business was reportedly born in Corker's home state and continues to thrive there.)"). Skeel, on the other hand, implies that credit card issuers were behind the ban on usury limits. SKEEL, *supra* note 98, at 109.

264 *See generally* Todd J. Zywicki, *The Economics of Credit Cards*, 3 CHAP. L. REV. 79 (2000) (discussing the market operations of credit card companies in the context of bankruptcy law).

265 15 U.S.C. 1637 (2006).

266 Adam Levitin, *New Credit Card Tricks, Traps, and 79.9% APRs*, CREDIT SLIPS (Dec. 18, 2009, 3:48 PM), http://www.creditslips.org/creditslips/2009/12/new-credit-card-tricks-traps-and-799-aprs.html (last visited Mar. 22, 2011) ("Currently, a First Premier card bears a 9.9% purchase APR, a $250 line of credit and at least $256 in fees in the first year, $179 of which are immediately applied. The $256 is divided among four different fees. First Premier is apparently now using direct mailing offers to test a new product that conforms with the Credit CARD Act. This new card has $75 in fees and a $300 credit line, but a 79.9% purchase APR.").

267 Dodd-Frank § 1013(d)(2)(C). *See also* Dodd-Frank § 1073(c) (mandating that other agencies regulating commercial banks and credit unions find ways to encourage people to move from the fringe economy to mainstream institutions).

268 *See Small-Dollar Loan Pilot Program*, FDIC, http://www.fdic.gov/smalldollarloans/ (last visited Mar. 22, 2011) (noting the program was "designed to illustrate how banks can profitably offer affordable small-dollar loans as an alternative to high-cost credit products, such as payday loans").

as a flop[269] and consumer advocates judging the experiment to be a success.[270] To the extent that the Bureau can lower the cost of credit by matching borrowers with less expensive alternatives, it will add significant value to the welfare of borrowers, but it will be a long time before we know if this feat is possible.

C. Financial Distress

The potential end result of high costs and deception—financial distress—is the third justification offered for the Bureau governing fringe credit. Fifteen percent of sources we found arguing for the Bureau to regulate fringe credit (n=35) asserted that fringe banking causes financial distress.[271] Sources described the effect fringe credit has on the entire economy, on individual borrowers who declare bankruptcy because of fringe credit, and on borrowers who are trapped in debt because of fringe credit. For instance, sources mentioned that payday lending, along with mortgages, "not only cause harm to individual consumers [but] can have a cumulative effect on our economy that is nothing short of devastating."[272] Testimony to Congress stated that "[o]ne in two consumers who get payday loans default within the first year, and consumers who receive these loans are twice as likely to enter bankruptcy within two years as those who seek and are denied them."[273] Finally, numerous sources described payday loans as a debt trap.[274]

Warren also states plainly that payday lending causes people to experience financial ruin, noting examples of people hounded by payday lenders until they declare bankruptcy,[275] and

269 *See FDIC Small Loan Program Doesn't Live up to the Hype*, PAYDAY PUNDIT (Aug. 12, 2008), http://paydaypundit.org/2008/08/12/fdic-small-loan-program-doesnt-live-up-to-the-hype/ (arguing the program has been unsuccessful and the FDIC is "still trying to figure out how to make it work").

270 *See FDIC's Small-Dollar Loan Pilot Shows Banks Can Offer Alternatives to High-Cost, Short-Term Credit for Small-Dollar Loans*, LOANSAFE.ORG (June 24, 2010), http://www.loansafe.org/fdics-small-dollar-loan-pilot-shows-banks-can-offer-alternatives-to-high-cost-short-term-credit-for-small-dollar-loans (claiming the FDIC's program has been highly beneficial for both banks and consumers).

271 We coded a source as claiming that the Bureau is justified in regulating fringe banking if it said fringe banking causes people to declare bankruptcy, causes people to suffer under unmanageable debt loads, causes people to lack the ability to make ends meet, or caused the current economic crisis.

272 Green, *supra* note 251.

273 Consumer Federation of America Legislative Director Travis B. Plunkett Prepared Testimony Before the Senate Banking, Housing and Urban Affairs on Creating a Consumer Financial Protection Agency: A Cornerstone of America's New Economic Foundation, as Released by the Committee, July 15, 2009.

274 National Consumer Law Center Managing Attorney Lauren Saunders Testifies Before the House Financial Services Subcommittee—Final, FD (Fair Disclosure) Wire, July 16, 2009; *Local Voices*, CHI. TRIB., Dec. 2, 2009.

275 Warren, *supra* note 208, at 13.

explaining that payday loans with individuals can impose costs on third parties:

> Credit cards, subprime mortgages, and payday loans can lead to financial distress, bankruptcy, and foreclosure. Economic losses can be imposed on innocent third parties, including neighbors of foreclosed property, and widespread economic instability may affect economic growth and job prospects for millions of families that never took on a risky financial instrument.[276]

Bankruptcy is an unlikely result for a consumer who simply pays a small fee, Bar-Gill and Warren note, but "[t]he problem lies with the substantial subset of consumers who take out multiple advances and pay the $30 fee many times over."[277] Things will be different under the Bureau, Warren asserts, because "[r]ollovers that can turn a simple loan into a mountain of debt would stop."[278]

I have argued at length in another article that this rationale for regulating fringe banking is flawed.[279] Two major features of fringe transactions make it highly unlikely that they cause borrowers to become overindebted and experience financial distress. First, most forms of fringe credit are self-liquidating—if the borrower does not make payments on the loan, the lender sells the collateral and does not seek a deficiency from the borrower, so it is literally impossible to become overindebted because the borrower is not personally liable for the debt.[280] Second, all forms of fringe credit involve people borrowing small amounts of principle. Unlike credit cards and mortgages, which can lead to significant amounts of debt, fringe credit transactions all involve very limited debt loads, so the effect of the transactions on the people using them and the economy as a whole is small, especially relative to other credit products.[281] Because of the dubious link between fringe banking and financial distress, the Bureau is on shaky ground regulating fringe credit on this basis.

D. Unregulated Markets

A fourth justification offered for the Bureau regulating fringe credit markets is the claim that these markets are currently

276 Bar-Gill & Warren, *supra* note 128, at 3.

277 *Id.* at 44.

278 Warren, *supra* note 208, at 19.

279 *See generally* Jim Hawkins, *Regulating on the Fringe: Reexamining the Link Between Fringe Banking and Financial Distress*, 86 IND. L.J. (forthcoming 2011), *available at* http://papers.ssrn.com/sol3/Delivery.cfm/SSRN_ID1649094_code600329.pdf?abstractid=1554768&mirid=5.

280 *Id.* (manuscript at 33–35).

281 *Id.*

unregulated. In the results from our study of rationales for the Bureau governing fringe banking, we repeatedly found claims that fringe banking is currently unregulated. Forty-nine percent (n=118) of the results presenting arguments for the Bureau claimed that fringe banking transactions currently operate under little regulation.[282] Some sources contended that fringe lenders have escaped regulation entirely[283] or that they operate in the Wild West of financial services with little oversight.[284] Other sources noted the inconsistency in state regulations that left some consumers completely unprotected,[285] and others asserted that no federal regulator governed fringe credit before the Bureau.[286]

Warren's foundational articles take a much more sophisticated position, although at times in making her argument, she seems to suggest that credit markets "follow a *caveat emptor* model."[287] She points out that there are some state and federal regulations, but she posits that these regulations of credit products are insufficient because they are not structured to adapt to frequently changing credit markets[288] and they are too diffuse—merely "a loose amalgam of common law, statutory prohibitions, and regulatory-agency oversight . . . structurally incapable of providing effective protection."[289] These sorts of

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282 We coded sources as justifying the Bureau because fringe banking products are unregulated if the source said fringe transactions are unregulated either by state or the federal governments. We did not code the source as saying fringe credit is unregulated merely because the source stated something like "we need a new regulator or cop devoted to consumers." The source had to say affirmatively that fringe banking products have few regulations now.

283 Ronald D. Orol, *Why Washington Can't Agree on Consumer Protection*, MARKETWATCH (Mar. 4, 2010, 12:56 PM), http://www.marketwatch.com/story/why-washington-cant-agree-on-consumer-protection-2010-03-04 ("They want the agency to cover a hodge-podge of financial companies that, so far, have escaped regulation of any sort. These include pay-day lenders, who offer high-risk, short-term cash loans to low-income individuals, the predatory rent-to-own industry, the mortgage modification consultants, and smaller state and local mortgage brokers, who originated many of the worst mortgages.").

284 *The Rachel Maddow Show* (MSNBC television broadcast Mar. 9, 2010) (Heather McGhee, Director, Washington Office of Demos, stated: "But at the consumer level, there's just a new Wild West situation out there where the banks, the payday lenders, the rent-to-own stores, the used auto dealers have just basically had very little oversight and they've profited from that regime").

285 *Regulatory Restructuring: Enhancing Consumer Financial Products Regulation: Hearing Before the H. Comm. on Fin. Servs.*, 111th Cong. 16 (2009) (statement of Ellen Seidman, Senior Fellow, New Am. Found.).

286 John Ydstie, *Overhaul Rules Stuck On Financial Protection Agency*, NATIONAL PUBLIC RADIO (Mar. 11, 2010), http://www.npr.org/templates/story/story.php?storyId=124559223.

287 Warren, *supra* note 208, at 14.

288 *Id.* at 9.

289 Bar-Gill & Warren, *supra* note 128, at 6. Another argument Warren makes to support the claim that credit markets are insufficiently regulated is that states lack the

arguments have been made by others as well, who point out that current federal regulation of credit markets fall to seven different regulators, none of whom have consumers as their central focus.[290] Having divided missions resulted in agencies, like the Federal Reserve, neglecting consumer protection: "It never made sense to simply include consumer protection among the Fed's other tasks, for instance, since the Fed's primary concern is maintaining the stability of the banking system, which stands in considerable tension with consumer protection."[291]

The common claim that fringe banking operates in a regulatory vacuum is easy to dismiss as a faulty reason for the Bureau regulating fringe credit. In every state and under federal law, lending activity is subject to some general regulations, such as the Truth in Lending Act[292] or the state equivalent.[293] Moreover, for many fringe credit transactions, state statutes aimed specifically at that type of transaction govern fringe credit.[294]

Warren's claim that state and federal regulations are not effective at countering innovative creditor malfeasance is much more applicable to fringe banking markets. Many commentators have noted how adept fringe creditors are at avoiding restrictive regulations.[295] The recent change in the payday lending law in Arizona provides an example. In Arizona, a specific statute enabled payday lenders to operate above the thirty-six percent usury cap in the state for ten years, but in 2010, that statute

power to set rate caps on credit products. *See* Warren, *supra* note 208, at 13–14. ("While states still play some role, particularly in the regulation of real-estate transactions, their primary tool—interest rate regulation—has been effectively destroyed by federal legislation. Today, any lender that gets a federal bank charter can locate its operations in a state with high usury rates (e.g., South Dakota or Delaware), then export that states' interest rate caps (or no caps at all) to customers located all over the country. As a result, and with no public debate, interest rates have been effectively deregulated across the country, leaving the states powerless to act."). This rationale is plainly inapplicable to fringe banking products. Numerous states have capped rates for payday loans, pawn loans, auto-title loans, and rent-to-own transactions. *See* Leah A. Plunkett et al., *Small Dollar Loan Products Scorecard—Updated*, NAT'L CONSUMER L. CTR. (May 2010), http://www.nclc.org/images/pdf/high_cost_small_loans/payday_loans/cu-small-dollar-scorecard-2010.pdf.

290 Levitin, *supra* note 138, at 3.

291 Skeel, *supra* note 98, at 15.

292 15 U.S.C. § 1601 et seq. (2006).

293 *See, e.g.*, MASS. GEN. LAWS ch. 140D (2010).

294 Proof of this claim would result in an article-long footnote, but for a few examples, see LA. R.S. 37:1801(D) (2010) ("Under no circumstances shall the practice commonly referred to as motor vehicle 'title only' pawn transactions be allowed in this state."); Martin, *supra* note 260, at 564 (noting payday lending is legal in only thirty-five states); ALA. CODE § 5-19A-3 (West 2010) (requiring pawn tickets to contain extensive amounts of information); OHIO REV. CODE ANN. § 1351.05(A) (West 2010) (requiring rent-to-own dealers to reinstate rental agreements even after default).

295 Johnson, *supra* note 31, at 18–21.

sunset, effectively making payday lending illegal.[296] In response to the rate cap, some payday lenders are operating as they did before the sunset, but are now essentially offering payday loans disguised as auto-title loans, which remain legal in the state.[297] Before the law even sunset, 200 payday lenders filed for licenses to operate as title lenders, and the Attorney General of Arizona believed that "a lot of people are [getting] ready by telling their customers to shift to auto-title loans, even if they don't have a car."[298] Lenders can offer payday-like loans to customers with cars by extending the loan based on the person's paycheck and taking a second-lien position on the car without ever intending to use the vehicle as collateral.[299] If Arizona really intended to ban payday lending, it appears to have failed. To truly eliminate payday lending, the legislature will have to pass another law altering the title loan statute to prevent the conduct described here.

The Bureau, however, will be able to learn about and act on subterfuge more quickly than a legislative body. Instead of going through the complex steps to pass a law and have it approved by the executive branch, the Bureau will be able to make rules to clarify the consumer protection laws and rules it enforces. If the Arizona situation had happened under the Bureau's watch, the Bureau could have drafted a rule that prevents lenders from taking a second lien position on the title loan or making a title loan to someone without a vehicle. Although the rulemaking process may take some time, the Bureau would be much more nimble and able to respond to problematic practices. Given the penchant some fringe creditors have shown for evading

296 Allison S. Woolston, Law & Policy Note, *Neither Borrower Nor Lender Be: The Future of Payday Lending in Arizona*, 52 ARIZ. L. REV. 853, 854–55 (2010).

297 A similar thing happened in Virginia when it banned payday lending. *See* Korey Clark, *States Put Brakes on Auto Title Lending*, STATE NET CAPITOL J., July 26, 2010, at 6 ("In fact, industry lobbyists and consumer groups in Arizona expect payday lenders to switch to car title lending as a result of the ban imposed on payday lending this past spring, because that's exactly what has happened in Virginia since it restricted payday lending. 'They moved to the car title model because they realized there were hardly any requirements,' said Dana Wiggins of the Virginia Poverty Law Center, an advocacy group for low-income people that pushed for the payday lending restrictions. 'It was kind of like a newfound treasure trove. You saw all of these folks who used to have payday loans were being moved into car title loans by payday lenders.'").

298 Michelle Price, *Payday Lending Expires in Arizona, Officials Keeping an Eye on Loan Practices*, THE GAEA TIMES (June 29, 2010), http://business.gaeatimes.com/2010/06/29/payday-lending-expires-in-arizona-officials-keeping-an-eye-on-loan-practices-74739/.

299 Dale Quinn, *Industry Shifting to New Services as Payday Lending Becomes Illegal*, ARIZ. DAILY STAR, June 27, 2010, at A1 ("Auto-title loans should be given only to the owner of the vehicle being used as collateral. If a lender says ownership of the vehicle and its value are not important, the borrower should proceed with caution and consider contacting the Attorney General's Office, said Goddard, who is running for governor.").

regulation, the Bureau has an important opportunity to ensure lenders actually comply with federal regulations.

E. Predatory and Abusive Lending

Finally, our study recorded instances where results described fringe banking products as abusive, unfair, or predatory without any further explanation. Most sources, fifty-five percent (n=133), discussing justifications for the Bureau regulating fringe credit appealed to this rationale. The results decried fringe creditors as unscrupulous,[300] rapacious,[301] notorious,[302] unconscionable,[303] like crack,[304] and the worst actors,[305] along with simply abusive[306] and predatory[307]. Warren almost completely avoids merely characterizing fringe banking as predatory without additional details.[308]

It appears that these statements, although common, do not assert separate bases for regulating fringe credit from those already discussed but instead operate as either simply vacuous attacks or summaries of other reasons for regulating fringe credit. Unless the Bureau acts with the least amount of

300 *Proposed Consumer Financial Protection Agency: Implications for Consumers and the FTC*, *Hearing Before the Subcomm. On Commerce, Trade, & Consumer Protection of the H. Comm. on Energy & Commerce*, 111th Cong. (2009) (statement of Michael Barr, Asst. Sec'y for Fin. Inst.) ("A wide range of credit products are offered—from payday loans to pawn shops, to auto loans and car title loans, many from large national chains—with little supervision or enforcement. Closely regulated credit unions and community banks with straightforward credit products struggle to compete with less scrupulous providers who appear to offer a good deal and then pull a switch on the consumer.").

301 Congresswoman Carolyn B. Maloney Holds a Hearing on the Economic Outlook, CQ Transcriptions, LLC, Apr. 14, 2010 ("Payday lenders, rent to own, debt collectors, these are some of the most rapacious people. They prey on the poor.").

302 Bill Swindell, *Payday Lenders Hope to Win Changes By Blaming Banks*, CONGRESSDAILY (May 4, 2010), http://www.nationaljournal.com/member/daily/payday-lenders-hope-to-win-changes-by-blaming-banks-20100504 (subscription required).

303 David Lazarus, *Payday Lenders Pressure Borrowers to Get Political*, L.A. TIMES, May 7, 2010, at B1.

304 David Lazarus, *Payday Lenders Sink Loan Limits*, L.A. TIMES, May 21, 2010, at B1.

305 Sen. Richard J. Durbin (D-IL), *Durbin Statement on the Passage of Sweeping Wall Street Reform Bill* (July 15, 2010), http://durbin.senate.gov/showRelease.cfm?releaseId=326420; Victoria McGrane, *Dodd Moving Ahead with Reform*, POLITICO.COM (Jan. 15, 2010), http://www.politico.com/news/stories/0110/31548.html.

306 Mike Lillis, *Dodd (Alone) to Unveil Financial Reform Bill Monday*, WASHINGTON INDEPENDENT, Mar. 11, 2010, https://washingtonindependent.com/78978/dodd-to-unveil-financial-reform-bill-monday.

307 *Mind the Gap: Discriminatory Practices, Public Policies Foster Accelerating Wealth Disparity*, HOUSTON CHRONICLE, Jun. 3, 2010, at B8.

308 The only instance I found was Warren's claim that the change in law protecting military personnel from payday lending "will protect military families from payday lenders, but it will leave all other families subject to the same predatory practices." Warren, *supra* note 208, at 14. This assertion, however, is probably just a summary of the other arguments she had already made against payday loans and not a stand-alone point.

reflection, it is unlikely these blanket assertions will have any influence on its behavior. Because this category is merely a rehash of earlier rationales, I do not discuss it in further detail here.

CONCLUSION

This Article has argued that the Dodd-Frank Act gives the Bureau the power to intervene in a substantial way in fringe credit markets for the first time. The Consumer Financial Protection Bureau will amass a lot of information about how fringe creditors operate and about market failures in these industries. Moreover, it will have unprecedented power and resources to enforce and promulgate rules restricting fringe banking activities.

The justifications for the Bureau intervening in fringe credit markets are a very mixed lot—some plainly misunderstanding the nature of the markets, and others offering a real opportunity for the Bureau to improve the experience consumers have with these financial services. My fear is that the Bureau will regulate in view of the former instead of the latter. If the Bureau works to restrict fringe credit on the erroneous assumption that fringe credit contracts are deceptive or lead borrowers to financial distress, consumers may lose access to financial services that they desperately need and already understand. Or, in a less extreme scenario, the Bureau could focus its attention on reforming the form of the contracts and miss the opportunity to actively detect and police creditors evading existing laws.

The final part of this Article hopes to urge the Bureau to carefully consider its rationales for regulating fringe credit before undertaking studies, promulgating rules, or engaging in enforcement actions. By ensuring that it acts in response to problems that have been demonstrated with evidence, the Bureau can work to improve credit for those who have been excluded from mainstream financial services without jeopardizing the welfare-enhancing function fringe creditors can have.

Dodd-Frank: Toward First Principles?

Reza Dibadj[*]

INTRODUCTION

When confronting a major crisis, tinkering at the margins of policy will likely do precious little either to ameliorate the system or avert the next catastrophe. Rather, lawmakers need to return to first principles by examining the underlying causes of the crisis and stemming them. Participating in a symposium over two years ago, well before the advent of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank"),[1] I argued that to mitigate, or perhaps even avoid, future disasters, policymakers should focus on remedying four pernicious facilitators to scandal: (1) the dissemination of information that is false or misleading; (2) the ability to abuse regulatory gaps; (3) the willingness to exploit credulous consumers; and (4) the use of corporate size to privatize profits and socialize losses.[2] This Article, written a few months after the passage of Dodd-Frank, builds on this prior work to assess whether the statute effectively addresses these four root causes of our financial meltdown.

Mapping the statute against these four facilitators, I argue that while a positive step forward in some respects, Dodd-Frank exhibits more of an intricate reaction to our last financial crisis than a concise attempt to address fundamental flaws in how Wall Street is regulated. To some degree, this might be unsurprising, given that regulators were reacting *ex post* to a crisis rather than averting it *ex ante*.[3] Yet Dodd-Frank makes surprisingly few important decisions. Fascinatingly, along each of these four

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1 *See* Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010) [hereinafter Dodd-Frank].

2 *See* Reza Dibadj, *Four Key Elements for Successful Financial Regulatory Reform*, 6 HASTINGS BUS. L.J. 377, 377 (2010).

3 *Cf.* John C. Coffee, Jr., *Bail-Ins Versus Bail-Outs: Using Contingent Capital to Mitigate Systemic Risk* 2 (The Ctr. for Law and Econ. Studies, Columbia Univ. Sch. of Law, Working Paper No. 380, 2010), *available at* http://ssrn.com/abstract=1675015 [hereinafter Coffee, *Bail-Ins*] ("Just as generals fight the next war in the terms of the mistakes made in the last war, so do financial regulators focus (possibly obsessively) on the immediate causes of the last financial contagion in planning for the future.").

dimensions, the Act almost exclusively defers to agency rulemaking or the creation of a new organization. Of perhaps even greater concern is the statute's postponement of essential reforms to further study.[4] Dodd-Frank's ornate 848 pages are a far cry from Glass-Steagall's 34 pages;[5] ironically, the extra bulk diminishes rather than enhances the law's effectiveness.

This Article is structured into two principal sections. In Part I, I outline each facilitator and examine what a first principles-based response might encompass; then, I analyze what Dodd-Frank did. Each time, I find that while Dodd-Frank might contain some positive provisions, it ultimately fails to address the root causes of financial crisis. To the extent there is a mismatch between first principles and the legislation, Part II asks why sophisticated lawmakers would choose largely to defer these issues rather than confront them more simply and directly. While there are benefits to statutory vagueness and delegation to agencies and courts, the main factor underlying voluminous legislation that ironically postpones the major questions lies in the political economy of twenty-first century Congressional action and the jostling among interest groups. This Article concludes by suggesting that a path forward may lie in structural reforms pertaining to the legislative process.

I. FOUR FACILITATORS

As I have argued in detail elsewhere, four phenomena have facilitated our current crisis: (1) the dissemination of information that is false or misleading; (2) the ability to abuse regulatory gaps; (3) the willingness to exploit credulous consumers; and (4) the use of corporate size to privatize profits and socialize losses.[6] Below, I argue that Dodd-Frank does not adequately address any of these facilitators.

A. Dissemination of False or Misleading Information

The first facilitator to crisis has been the dissemination of false or misleading information. A very simple, though too often glossed-over, principle animating financial regulation is that markets must process information into prices for securities and

4 *See* Edward J. Kane, Missing Elements in US Financial Reform: A Kübler-Ross Interpretation of the Inadequacy of the Dodd-Frank Act 27 (Aug. 24, 2010) (unpublished manuscript), *available at* http://ssrn.com/abstract=1654051 ("In the end, many controversial issues were designated as subjects for further study.").

5 *See* Banking (Glass-Steagall) Act of 1933, Pub. L. No. 73-66, 48 Stat. 162 (1933).

6 *See* Dibadj, *supra* note 2, at 377.

assets. Inaccurate information leads the system to break down.[7] Two principal causes of inaccurate information have been the delegation of credit-rating functions to conflicted private actors unaccountable to the public, and a sharp curtailment of the ability to bring private antifraud lawsuits.

Our current credit rating model, central to the economic collapse,[8] suffers from two central infirmities. First, given that issuers themselves pay for the securities to be rated, there is an inherent conflict of interest at the heart of the business model; after all, "banks and other issuers have paid rating agencies to appraise securities—a bit like a restaurant paying a critic to review its food, and only if the verdict is highly favorable."[9] Second, "the credit rating system is one of capitalism's strangest hybrids: profit-making companies that perform what is essentially a regulatory role."[10] In parallel, antifraud mechanisms have been watered down over the past several years as both federal statutes and federal common law have made it increasingly difficult to bring private securities antifraud lawsuits against disclosures that either finesse or obfuscate the truth. While even a cursory glance at securities filings indicates that there is ample disclosure, such disclosures can be useless, perhaps even harmful, unless there is some mechanism to ensure their truthfulness.[11]

Beginning in the mid-1990s, a triad of securities reform statutes began making it increasingly difficult to bring private

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7 *Id.* In the parlance of computer programmers, "garbage in, garbage out." *Id.* at 379.

8 *See, e.g.*, William A. Birdthistle, *Breaking Bucks in Money Market Funds*, 2010 WIS. L. REV. 1155, 1185 ("If there is widespread consensus on the profound failure of any single component of the U.S. financial system during the recent crisis, surely it is with these ratings agencies that continued to assign their highest ratings to securitized bundles of ultimately worthless subprime mortgages.").

9 David Segal, *Debt-Rating Agencies Avoid Broad Overhaul After Crisis*, N.Y. TIMES, Dec. 8, 2009, at A1. *See also* Andrea J. Boyack, *Lessons in Price Stability from the U.S. Real Estate Market Collapse*, 2010 MICH. ST. L. REV. (forthcoming 2011) (manuscript at 27), *available at* http://ssrn.com/abstract=1665124 ("Today, the issuer of securities pays credit rating agencies to rate its product. But this structure is fraught with conflict of interest and resulted in systematic over-rating of securities."); Roger Lowenstein, *Triple-A Failure*, N.Y. TIMES, Apr. 27, 2008 at MM36 (noting that in structured finance deals, "the banks pay only if Moody's delivers the desired rating . . . . If Moody's and a client bank don't see eye to eye, the bank can either tweak the numbers or try its luck with a competitor like S.&P., a process known as 'ratings shopping.'").

10 Segal, *supra* note 9, at A22. *See also* Steven L. Schwarcz, *Private Ordering of Public Markets: The Rating Agency Paradox*, 2002 U. ILL. L. REV. 1, 3–4 (2002) ("Rating agencies, however, are private companies. They are not substantively regulated by the United States or any other major financial-center-nation.").

11 As Adam Pritchard has observed, "Congress and the SEC focus almost exclusively on disclosure because it reinforces the myths of investor autonomy and sovereignty, a very lucrative myth as far as the financial services sector is concerned." A.C. Pritchard, *The SEC at 70: Time For Retirement?*, 80 NOTRE DAME L. REV. 1073, 1097–98 (2005).

antifraud claims. First, in 1995 the Private Securities Reform Litigation Act (PSLRA) introduced, "*inter alia*, heightened pleading requirements for class actions alleging fraud in the sale of national securities."[12] One year later, in 1996, Congress passed the National Securities Market Improvements Acts (NSMIA) whose "primary purpose . . . was to preempt state 'Blue Sky' laws which required issuers to register many securities with state authorities prior to marketing in the state."[13] Third, the Securities Litigation Uniform Standards Act (SLUSA) in 1998 made "federal court the exclusive venue for class actions alleging fraud in the sale of certain covered securities and by mandating that such class actions be governed exclusively by federal law."[14] In sum, through heightened pleading standards and the preemption of more generous state securities laws, Congress has made it increasingly difficult for private plaintiffs to bring securities actions.

Federal common law has evolved into a more defendant-friendly posture as well. Beginning with two landmark cases in 1975—*Blue Chip Stamps v. Manor Drug*[15] and *Cort v. Ash*[16]—the United States Supreme Court has essentially cabined the federal common law of securities fraud.[17] Over the past five years, and in rapid succession, the Court has placed restrictions on plaintiffs along two principal dimensions. Decisions such as *Dura*,[18] *Tellabs*,[19] and *Stoneridge*[20] move in the direction of imposing heightened pleading requirements on plaintiffs.[21] Moreover, opinions such as *Merrill*, *Lynch*,[22] and *Credit Suisse*[23] have

12 Lander v. Hartford Life & Annuity Ins. Co., 251 F.3d 101, 107 (2d Cir. 2001). *See generally* A.C. Pritchard, *Constitutional Federalism, Individual Liberty, and the Securities Litigation Uniform Standards Act of 1998*, 78 WASH. U. L.Q. 435, 481–83 (2000).

13 *Lander*, 251 F.3d 101, at 108. The securities exempted, called "covered securities," are those nationally listed on the New York or American Stock Exchanges, or on NASDAQ. *See* 15 U.S.C. § 77r(b). Note, however, that the "NSMIA expressly preserved state authority to bring enforcement actions with respect to securities transactions." Stefania A. Di Trolio, *Public Choice Theory, Federalism, and the Sunny Side to Blue-Sky Laws*, 30 WM. MITCHELL L. REV. 1279, 1295 (2004).

14 *Lander*, 251 F.3d at 108.

15 421 U.S. 723 (1975).

16 422 U.S. 66 (1975).

17 *See* Reza Dibadj, *An Uneasy Case for White-Collar "Martyrs,"* 44 U.S.F. L. REV. 505, 522 (2010).

18 Dura Pharmaceuticals, Inc. v. Broudo, 544 U.S. 336 (2005).

19 Tellabs, Inc. v. Makor Issues and Rights, 551 U.S. 308 (2007).

20 Stoneridge Inv. Partners, L.L.C. v. Scientific-Atlanta, Inc., 552 U.S. 148 (2008).

21 *See generally* Todd R. David, Jessica P. Corley & Ambreen A. Delawalla, *Heightened Pleading Requirements, Due Diligence, Reliance, Loss Causation, and Truth-On-The-Market—Available Defenses to Claims under Sections 11 and 12 of the Securities Act of 1933*, 11 TRANSACTIONS: TENN. J. BUS. L. 53 (2010).

22 Merrill, Lynch, Pierce, Fenner & Smith, Inc. v. Dabit, 547 U.S. 71 (2006).

23 Credit Suisse Sec. (USA) LLC v. Billing, 551 U.S. 264 (2007).

effectively given broad preemptive effect to the federal securities regime, to the detriment of state securities and antitrust law, respectively.[24]

A first principles-based approach would reform credit rating agencies and place greater emphasis on policing fraud. First, government could provide public ratings or require investors, rather than issuers, to pay for ratings.[25] At the very least, "upward adjustments and deviations from the CRA's [credit rating agency's] normal valuation model should be the regulatory focus."[26] Second, policymakers would need to reinvigorate private antifraud suits as a deterrent to the dissemination of misleading information—perhaps it is no coincidence that scandals have mushroomed in the post-1995 legal regime. Private enforcement might also be expanded beyond securities to financial regulation generally through mechanisms such as *qui tam* suits.[27]

Sadly, Dodd-Frank achieves precious little on either front. To be sure, it increases internal controls, and provides for greater procedural transparency of credit rating agencies[28]—in a manner reminiscent of Sarbanes-Oxley.[29] It also creates a new SEC "Office of Credit Ratings"[30] while also confirming that there is a private right of action against rating agencies.[31] All this may be fine as far as it goes,[32] but the legislation does not alter the

24 *See generally* Melanie P. Goolsby, Note, Merrill Lynch v. Dabit: *The Case of the Scorned Broker and the Death of the State Securities Fraud Class Action Suit*, 67 LA. L. REV. 227 (2006); Stacey S. Chubbuck, Note, *Securities Law and Antitrust Law: Two Legal Titans Clash Before the United States Supreme Court in* Credit Suisse Securities v. Billing, 62 OKLA. L. REV. 145 (2009).

25 *See, e.g.*, John C. Coffee Jr., *Ratings Reform: The Good, the Bad, and the Ugly* 5 (Eur. Corporate Governance Inst., Working Paper No. 162, 2010), *available at* http://ssrn.com/abstract=1650802 [hereinafter Coffee, *Ratings*] ("Possible such responses include: (1) authorizing an independent body to select the rating agency; (2) mandating (and thereby effectively subsidizing) a 'subscriber pays' model for ratings; and (3) creating a governmental rating agency to issue ratings . . . ."); Schwarcz, *supra* note 10, at 16 ("In theory, a regulation could require investors to pay this fee, or could require an issuer to pay the fee irrespective of the rating ultimately assigned."); Michael Lewis & David Einhorn, *How to Repair a Broken Financial World*, N.Y. TIMES, Jan. 4, 2009, at WK10 ("There should be a rule against issuers paying for ratings. Either investors should pay for them privately or, if public ratings are deemed essential, they should be publicly provided.").

26 Coffee, *Ratings*, *supra* note 25, at 56.

27 *See, e.g.*, Heidi Mandanis Schooner, *Private Enforcement of Systemic Risk Regulation*, 43 CREIGHTON L. REV. 993, 1012 (2010) ("This Article suggests that reforms should include a private enforcement mechanism that directly addresses systemic risk.").

28 *See* Dodd-Frank § 932.

29 *See* Stanley Keller, *Corporate Governance, Disclosure & Capital Raising Provisions of the Dodd Frank Act*, 14 WALL STREET LAWYER 1, 9 (2010).

30 *See* Dodd-Frank § 932(a) (modifying § 15E(p) of the Securities and Exchange Act of 1934).

31 *See* Dodd-Frank § 933.

32 *Cf.* Coffee, *Ratings*, *supra* note 25, at 50–51 ("An obvious (and politically

"issuer pays" business model of rating agencies.[33] Nor does it contemplate making credit ratings a public good. Instead, there will be studies on credit rating agency independence,[34] alternative credit agency business models,[35] the creation of an independent professional rating analyst organization,[36] and assigned credit ratings.[37] Similarly, though the statute clarifies that "recklessness" is sufficient mens rea for SEC "aiding and abetting" actions[38] and expands the SEC's extraterritorial jurisdiction,[39] it does not reinvigorate private antifraud suits. All it does is commission studies on whether private rights of action should be extended extraterritorially[40] or to secondary liability[41]—hardly a bold legislative move.

B. Abuse of Regulatory Gaps

A second facilitator that needs to be thwarted is the abuse of regulatory gaps. There are regrettably too many examples of actors and products that have "fallen through the cracks" of regulatory oversight.[42] Opportunists exploited the fact that banking, securities, commodities, and even insurance are each overseen by a different complex of regulators[43]—agencies that may not even share the same regulatory vision.[44] Significantly

irresistible) approach toward reform of the credit rating agencies is to regulate their internal corporate governance . . . . From a policy perspective, it is difficult to place great hope on these reforms, but they are low cost reforms that may sometimes provide valuable information to experienced regulators.").

33 *See, e.g.*, DAVID A. SKEEL, JR., THE NEW FINANCIAL DEAL: UNDERSTANDING THE DODD-FRANK ACT AND ITS (UNINTENDED) CONSEQUENCES 7 (2011) ("[T]he legislation did not eliminate the 'issuer pays' feature of credit ratings . . . .").

34 *See* Dodd-Frank § 939C.

35 *See* Dodd-Frank § 939D.

36 *See* Dodd-Frank § 939E.

37 *See* Dodd-Frank § 939F.

38 *See* Dodd-Frank §§ 929M(b), 929O.

39 *See* Dodd-Frank § 929P(b).

40 *See* Dodd-Frank § 929Y.

41 *See* Dodd-Frank § 929Z.

42 *See, e.g.*, GILLIAN TETT, FOOL'S GOLD: HOW THE BOLD DREAM OF A SMALL TRIBE AT J.P. MORGAN WAS CORRUPTED BY WALL STREET GREED AND UNLEASHED A CATASTROPHE 62 (2009).

43 *See, e.g.*, Roberta S. Karmel, *Is the Public Utility Holding Company Act a Model for Breaking Up the Banks that are Too-Big-to-Fail?* 27 n.100 (Brooklyn Law Sch. Legal Studies Research Paper Series, Research Paper No. 202, 2010), *available at* http://ssrn.com/abstract=16809887 ("Commercial banking activities are regulated by the bank regulators, securities activities are regulated by the SEC and state securities commissions. Commodity futures and options activities are regulated by the CFTC, and insurance activities would be regulated by multiple state insurance regulators.").

44 *See, e.g.*, Kara Scannell, *Exchanges Offer Varying Views as Regulators Discuss Turf*, WALL ST. J., Sept. 3, 2009, at A21 ("The two agencies [SEC and CFTC] have different philosophies in regulating markets."); Stephen Labaton & Edmund L. Andrews, *As U.S. Overhauls Banking System, Two Top Regulators Feud*, N.Y. TIMES, Jun. 14, 2009, at A1 ("Two of the nation's most powerful bank regulators [Comptroller of the Currency and Federal Deposit Insurance Corporation] were once again at each other's throats.").

and in an era of financial conglomerates, "no agency had regulatory oversight and control of subsidiaries of holding companies that sheltered off-balance sheet liabilities and threatened the viability of its parent and regulated entities."[45] Of particular salience in this regard is the so-called "shadow banking" system: as the Chairman of the FDIC observes, "[t]he principal enablers of our current difficulties were institutions that took on enormous risk by exploiting regulatory gaps between banks and the nonbank shadow financial system, and by using unregulated over-the-counter derivative contracts to develop volatile and potentially dangerous products."[46]

Given these fundamental problems, a first principles-based approach would strive for two basic goals: (1) simplifying and consolidating administrative agencies to resolve jurisdictional boundaries,[47] and (2) regulating the "shadow" financial system.[48]

Dodd-Frank actually achieves precious little toward achieving these goals. To improve coordination, it creates the multi-agency Financial Stability Oversight Council (FSOC)[49] as well as the Office of Financial Research (OFR).[50] While perhaps impressive at first glance, these actions are problematic. Not only have multi-agency oversight bodies been difficult to implement,[51] but the FSOC will be led by Treasury. Similarly, the OFR will be housed within Treasury with no mandate to

45 Karmel, *supra* note 43, at 47.

46 Sheila C. Bair, *The Case Against a Super-Regulator*, N.Y. TIMES, Sept. 1, 2009, at A29. Sadly enough, "shadow" banking also contributed to prior scandals, notably Enron and Refco. *See, e.g.*, Diana B. Henriques, *Commodities: Latest Boom, Plentiful Risk*, N.Y. TIMES, Mar. 20, 2008, at A23; Deborah Solomon & Michael Schroeder, *How Refco Fell Through Regulatory Cracks; Scandal Highlights a System that Didn't Require Much Oversight of the Firm's Units*, WALL ST. J., Oct. 18, 2005, at A4.

47 *See, e.g.*, Gary DeWaal, *America Must Create a Single Financial Regulator*, FIN. TIMES, May 19, 2005, at 13 ("[o]nly by amending its [financial] regulatory system and adopting unitary regulation of financial services can the US ensure it will maintain its supremacy as the home of global financial services participants.").

48 *See, e.g.*, Jackie Calmes, *Both Sides of the Aisle See More Regulation, and Not Just of Banks*, N.Y. TIMES, Oct. 14, 2008, at A15 ("Companies and instruments that currently are not regulated could be brought under the government's thumb; unregulated derivatives, hedge funds, mortgage brokers and credit-rating agencies all have been implicated in the current crisis.").

49 *See* Dodd-Frank § 111. Duties of the FSOC include to "identify gaps in regulation that could pose risks to the financial stability of the United States." Dodd-Frank § 112(a)(2)(G).

50 *See* Dodd-Frank § 152(a).

51 *See* Arthur E. Wilmarth, *The Dodd-Frank Act: A Flawed and Inadequate Response to the Too-Big-To-Fail Problem*, 89 OR. L. REV. (forthcoming 2011) (manuscript at 101), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1719126 ("Moreover, the future effectiveness of the FSOC is open to serious question in light of the agency turf battles and other bureaucratic failings that have plagued similar multi-agency oversight bodies in other fields of regulation . . . ."). As just one example, consider that the FSOC's recommendations when resolving disputes among agencies "shall not be binding on the Federal agencies that are parties to the dispute." Dodd-Frank § 119(d).

report its findings to the public.[52] The FSOC and OFR are thus likely to enhance Treasury's power.[53] While this may not be inherently bad, it does raise several questions: Treasury is neither an independent agency,[54] nor does it face the legislative and judicial scrutiny that most other administrative agencies do.[55] As such, delegation of power to Treasury raises serious issues in administrative law that Dodd-Frank elides.[56]

In terms of agency consolidation, the legislation eliminates the Office of Thrift Supervision (OTS).[57] But jurisdictional ambiguities—between the CFTC and the SEC and the FDIC and OCC, as just two examples—linger. This is not even to mention the irony of Dodd-Frank creating more organizations in an environment where there are already too many regulatory gaps—OFR, Federal Insurance Office (FIO),[58] and Bureau of Consumer Financial Protection (BCFP),[59] to name a few.[60]

Dodd-Frank's most significant attempt to close regulatory gaps is the requirement that some over-the-counter (OTC) derivative swaps[61] be cleared and exchange traded.[62] The

52 *See, e.g.*, Kane, *supra* note 4, at 15 ("The OFR is authorized only to communicate its findings to FSOC and its member agencies and also to 'support' and 'assist' agencies in improving data collection. But it is not specifically authorized or required also to report its findings or concerns to the public.").

53 As David Skeel notes: "Yet the Treasury secretary is given leadership responsibility on the new Financial Stability Oversight Council and in other areas. Dodd-Frank also locates an enormous new research facility—the Office of Financial Research—in the Treasury Department. Control over knowledge is power, of course, which suggests that the ostensibly neutral research facility could become yet another channel of Treasury influence." SKEEL, *supra* note 33, at 12; *but see* Priya Nandita Pooran, *Legislative Advances in Financial Stability in the US—the Wall Street Reform and Consumer Protection Act 2010*, 83 AMICUS CURIAE 21, 24 (Autumn 2010) (noting "greater concentration of supervisory control in the Federal Reserve").

54 *See, e.g.*, SKEEL, *supra* note 33, at 12 ("Because the Treasury secretary is directly responsible to the President, he is the least independent, and the most political, of the financial regulators.").

55 *See* David Zaring, *Administration by Treasury*, 95 MINN. L. REV. 187, 190 (2010) ("Treasury has created for itself an ambit of discretion beyond the reach of the judiciary, and only somewhat within the bounds of congressional oversight. The financial crisis illustrated just how independent Treasury has become.").

56 This is perhaps unsurprising given that the initial blueprint for Dodd-Frank emerged from Treasury. *See generally* U.S. Dep't of Treasury, Financial Regulatory Reform: A New Foundation: Rebuilding Financial Supervision and Regulation (2009), *available at* http://www.treasury.gov/initiatives/wsr/Documents/FinalReport_web.pdf. *See also* SKEEL, *supra* note 33, at 3 ("The Dodd-Frank Act got its start in March 2009, when the Department of the Treasury released a framework it called 'Rules for the Regulatory Road' shortly before a major meeting of the G-20 nations.").

57 *See* Dodd-Frank § 313.

58 *See* Dodd-Frank § 502(a).

59 For a discussion of the BCFP see *infra* notes 113–122 and accompanying text.

60 Consider, for instance, the ambiguities in regulatory authority between the newly-created BCFP and the Federal Trade Commission. *See* Dodd-Frank § 1031.

61 Derivative swaps "trade financial outcomes such as those of changing currency rates or of long-term for short-term interest rates. Some derivatives are effectively

animating principle, of course, is that greater transparency will minimize risk.[63] Even here, though, there are several concerns. First, close reading of the statutory language likely suggests that only standardized swaps will need to be cleared; customized ones would not and would only be subject to capital and margin requirements.[64] As such, one can imagine the temptation to make contracts appear customized.[65] Similarly, trades by non-financial entities that are using swaps to "hedge or mitigate commercial risk" are excluded from the rule provided the CFTC is notified of how the counterparty intends to meet its financial obligations.[66] For its part, the clearinghouse idea itself might be fraught with peril, as Mark Roe summarizes:

> Deep weaknesses afflict the clearinghouse, making it unwise to rely on it primarily, as Dodd-Frank has. First, it's unclear whether the exchange would itself be properly incentivized to handle counterparty risk, particularly if the major derivatives dealers themselves control the clearinghouse.
>
> Second, many types of derivatives just cannot be handled by a clearinghouse, because there's no market price against which the

guarantees of financial performance of a third party. One party . . . promises to pay a risk-avoiding party if a third party defaults on its financial obligations." Mark J. Roe, *The Derivatives Market's Payment Priorities as Financial Crisis Accelerator*, 63 STAN. L. REV. 539, 546–47 (2011).

62 *See* Dodd-Frank § 763. *See also* Michael Greenberger, *Is Our Economy Safe? A Proposal for Assessing the Success of Swaps Regulation under the Dodd-Frank Act* 3 (Univ. of Md. Sch. of Law, Research Paper No. 2010-50, 2010), *available at* http://ssrn.com/abstract=1689174 ("The Dodd-Frank Act transforms the regulation of OTC derivatives by requiring that swaps be subject to clearing and exchange trading as well as capital and margin requirements.").

63 *See* SKEEL, *supra* note 33, at 5 ("Clearing reduces the risk to each of the parties directly, while exchange trading reduces risk to them and to the financial system indirectly by making the derivatives market more transparent.").

64 *See* Willa E. Gibson, *Clearing and Trade Execution Requirements for OTC Derivatives Swaps Under the Frank-Dodd Wall Street Reform and Consumer Protection Act* 8 (Univ. of Akron Sch. Of Law, Research Paper No. 10-12, 2010), *available at* http://ssrn.com/abstract=1710822 ("[T]he Dodd-Frank Wall Street Reform Act creates a bifurcated regulatory system that effectively subjects counterparties with standardized contracts for which a liquid market exists to clearing requirements, while subjecting counterparties that trade customized OTC derivatives swap contracts to certain capital and margin requirements and reporting requirements."). This conclusion likely emerges from a detailed reading of provisions such as section 723 (adding § 2(h)(4)(B) to the Commodity Exchange Act) which discusses swaps that "no derivative clearing organization has listed" and section 731 (adding § 4s(e)(2) to the Commodity Exchange Act) which imposes capital and margin requirements "on all swaps that are not cleared by a registered derivatives clearing organization." Dodd-Frank §§ 723, 731.

65 *See* Gibson, *supra* note 64, at 9 ("[W]ill the bifurcated regulatory system for OTC derivatives swap contracts incentivize market participants to customize their contracts to avoid the clearing requirements to which standardized trades are subject and to avoid the added transparency of exchange trading to which most cleared trades will be subject?").

66 *See* Dodd-Frank § 723 (amending section 2(h)(7)(A) of the Commodity Exchange Act). *See also* Greenberger, *supra* note 62, at 5 ("[R]egulators should carefully consider how they define hedging for commercial risk.").

> clearinghouse employees can mark the cleared but open transaction. Worse, one major class of derivatives—credit default swaps—face 'jump-to-default' risk. They look fine until the underlying security has a credit event and a huge payment is due. Collateralizing these on an exchange or clearinghouse has proven to be difficult thus far and no easy solution is available. [67]

Third, and insidiously, a "clearinghouse ups the ante on 'too-big-to-fail,' *because the clearinghouse will itself be too big to fail*."[68]

In addition, ambiguities in regulatory jurisdiction regrettably still remain,[69] and there is nothing in the statute that requires disclosure of conflicts of interest when trading debt and its derivatives.[70] An approach that is impressive at first glance thus largely dissolves upon closer inspection.

One point that cannot be overemphasized is that the "shadow banking" system remains essentially unregulated. As Gary Gorton & Andrew Metrick point out, "[t]hree important gaps are in money-market mutual funds (MMMFs), securitization, and repurchase transactions ('repo')."[71] Securitization converts debt obligations such as mortgages into pools and allows them to be moved off-balance sheet, away from regulatory and investor scrutiny.[72] Dodd-Frank tries to address this issue by asking a group of regulators to issue regulations on risk retention[73] and disclosure.[74] As expected, there are a variety of exemptions to the risk retention requirements, notably for

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67 Roe, *supra* note 61, at 586–87.

68 *Id.* at 587. *Cf.* Coffee, *Bail-Ins*, *supra* note 3, at 52 (noting how major stock and derivatives exchanges and the new clearinghouses "concentrate risk and so need to devise ways to avoid default.").

69 *See* Dodd-Frank § 712 (asking the SEC and CFTC to "consult and coordinate to the extent possible"). *See also* Gibson, *supra* note 64, at 11 ("[T]he Act allocates the jurisdiction of OTC derivatives swaps between the Securities Exchange Commission (SEC) and the Commodities Futures Trading Commission (CFTC) . . . with the exception of identified banking products, which are within the regulatory jurisdiction of prudential banking regulators.").

70 *See, e.g.*, Jonathan C. Lipson, *Controlling Creditor Opportunism* 2–3, (Univ. of Wis. Law Sch., Legal Studies Research Paper Series Paper No. 1129, 2010), *available at* http://ssrn.com/abstract=1662127 ("The secondary debt market is essentially an unregulated securities market, which Dodd-Frank does not change. Although Dodd-Frank may put some derivatives on exchanges, nothing will force a distress investor to disclose to a troubled borrower—or its other stakeholders—that it simultaneously holds debt and a short, a combination that creates obviously perverse incentives.").

71 Gary Gorton & Andrew Metrick, Regulating the Shadow Banking System 1 (Oct. 18, 2010) (unpublished manuscript), *available at* http://ssrn.com/abstract=1676947.

72 *See* Linda M. Beale, *In the Wake of Financial Crisis*, CURRENT DEV. MONETARY FIN. L. (forthcoming 2011) (manuscript at 3), *available at* http://ssrn.com/abstract=1681577 ("[T]he off-balance sheet treatment of securitization vehicles was a genuine factor in the crisis, and should appropriately be addressed.").

73 *See* Dodd-Frank § 941.

74 *See* Dodd-Frank § 942.

"qualified residential mortgages."[75] As such, the regulations are unlikely to reform the securitization market. True to form, the statute commissions a study on the "macroeconomic effects of risk retention requirements."[76]

For their part, MMMFs appear similar to bank accounts, except for the inconvenient fact that after years of effective lobbying by the mutual fund industry, while MMMFs are allowed to maintain fixed net asset values (NAVs), they do not have to pay depositor insurance.[77] The idea, of course, would be that in exchange for this additional risk, they offer higher returns to investors. Yet, "[w]hen these funds needed insurance during the 2008 debacle, the federal government provided it free of charge, thus rewarding the fund sponsors' apathy."[78] Reform would be rather straightforward:

> [w]ere these [money market mutual] funds required to use the same pricing system [floating net asset values (NAVs)] as every other mutual fund or to contribute the same deposit insurance premia as bank accounts, they would either look a great deal less like those bank accounts or generate materially lower but more risk-appropriate yields.[79]

Dodd-Frank, however, does not adopt either of these approaches.

Finally, there are repurchase agreements, known as "repo" in the jargon.[80] The repo problem is similar to that of MMMFs in

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75 *See* Dodd-Frank § 941 (adding section 15G(e)(4)(B) to the Securities Exchange Act of 1934).

76 Dodd-Frank § 946.

77 The history of how this came to be is not altogether inspiring:

> [T]hroughout the 1970s, sponsors of mutual funds petitioned the SEC for, and received, exemptions to use an alternative to the mark-to-market accounting technique. By using a method known as amortized-cost accounting, money market funds could maintain a stable NAV [net asset value] that looks much more like the valuation of a bank deposit, thus dramatically closing the gap in appearances between the two instruments.

Birdthistle, *supra* note 8, at 1174. *See also id*. at 1170 ("And thus with a switch from floating to fixed pricing was laid the foundation of the massive run on money market funds that occurred during the 2008 financial crisis.").

78 *Id.* at 1162–63.

79 *Id.* at 1161.

80 A repurchase agreement,

> is a sale of a financial instrument, such as a treasury bill, with the seller promising to buy that asset back, often the next day. The agreed repurchase price is a little higher than the sale price, with the difference being the de facto interest. The instrument sold is usually called the collateral, as the transaction is functionally a loan. Repos are typically used to finance a firm, often a financial firm.

Roe, *supra* note 61, at 546. *See also* Beale, *supra* note 72, (manuscript at 4) ("For example, banks (and other firms) conducted 'repo' deals—purported sales transactions with repurchase arrangements that in reality functioned as financings—to make their balance sheets appear less leveraged.").

that both "were initially perceived as safe and 'money-like', but later found to be imperfectly collateralized."[81] The mechanism behind overuse of repo, however, is different: "For large depositors, repo can act as a substitute for insured demand deposits because repo agreements are explicitly excluded under Chapter 11: that is they are not subject to the automatic stay [which protects debtors from creditor actions]."[82] As such, "the bankruptcy 'safe harbor' for repo has been a crucial feature in the growth of shadow banking . . . ."[83] This subsidy—garnered in part through effective lobbying,[84] much like MMMFs' fixed NAVs[85]—"encourages risky, knife's-edge financing, which, when pursued in financially central firms, transfers risks to the United States as the ultimate guarantor of the key firms' solvency. We get more derivatives and repo activity than we would otherwise. Financial resiliency is drained; market discipline, weakened."[86] A straightforward and effective approach would have been for Dodd-Frank to modify the priorities in bankruptcy.[87]

In sum, Dodd-Frank's willingness to close regulatory gaps appears limited: it "conspicuously avoids . . . regulatory consolidation among the nation's illogical morass of financial regulators"[88] while doing precious little to regulate the "shadow banking" system.

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81 Gorton & Metrick, *supra* note 71, at 16.

82 *Id.* at 12. As Mark Roe elaborates:

> Chapter 11 typically bars creditors from collecting on their loans from the bankrupt debtor, requires that creditors who preferentially seize security or get themselves repaid on the eve of bankruptcy return the assets seized or the repayment made, requires that fraudulent conveyances be recaptured by the debtor, and allows the debtor, but not the creditor, to affirm or reject outstanding contracts.
>
> None of these rules apply to a bankrupt's derivatives and repo counterparties. Instead, derivatives and repo players can seize collateral, more widely net out gains and losses on open contracts, terminate contracts, and keep eve-of-bankruptcy preference payments from the debtor that favor them over other creditors. Their privileged capacity to jump the queue can induce a run on the failing financial institution, and such a run may have hit AIG, Bear Stearns, and Lehman, deepening and extending the recent financial crisis.

Roe, *supra* note 61, at 588.

83 Gorton & Metrick, *supra* note 71, at 3.

84 *See* Roe, *supra* note 61, at 548 ("Regulators and lobbyists sought the exceptions when the derivatives market was young, partly to clarify some treatment issues, partly due to effective lobbying of the derivatives players, and partly due to a regulatory belief that such financial markets were sufficiently beneficial to warrant special treatment.").

85 *See supra* note 77 and accompanying text.

86 Roe, *supra* note 61, at 546.

87 *See, e.g.*, *id.* at 549 (claiming it would have been better to have modified the derivatives and repo priorities in the Dodd-Frank financial package).

88 Lawrence G. Baxter, *Did We Tame the Beast: Views on the US Financial Reform Bill*, 2 J. REGULATION & RISK 209, 210 (2010).

C. Exploitation of Credulous Consumers

A third facilitator has been the exploitation of credulous consumers and investors, upon whom an ever-increasing array of financial products and decisions has been foisted. Regrettably, too many consumers are making risky life-changing decisions without having sufficient knowledge of financial basics such as the time value of money or the implications of credit.[89] A first principles-based approach would pay particular attention to the regulation of advisers and funds who too often have not placed their clients' interests ahead of their own, as well as to the self-regulatory organizations (SROs)[90] who, while imposing a significant compliance cost in regulating financial advisers and markets, have remained curiously ineffectual in recognizing and remedying major scandals and crises.[91] It would also seek to improve the financial literacy of the population. Unfortunately, though, while Dodd-Frank does introduce a few arguably positive developments, its provisions are unlikely to do much to stem this facilitator.

When it comes to regulating advisers, the statute does create a category of private advisers who must register with the SEC.[92] Yet one should question the impact such registration will have. After all, registered broker-dealers and investment advisers have been involved in shocking fraud: recall, as just one particularly troubling example, that Bernard Madoff's operations were registered as both a broker-dealer and as an investment adviser.[93] To the extent one argues that such registration is even useful, the statute contains a significant loophole for so-called "foreign private advisers"—defined based on the number of U.S.

89 *See, e.g.,* Thomas F. Cooley, *America's Financial Illiteracy*, FORBES.COM (Jan. 1, 2010, 12:01 AM EST), http://www.forbes.com/2010/01/12/cfpa-financial-illiteracy-credit-cards-opinions-columnists-thomas-f-cooley.html.

90 Perhaps the most prominent contemporary SRO is the Financial Industry Regulatory Authority (FINRA). FINRA was "[c]reated in July 2007 through the consolidation of NASD [National Association of Securities Dealers] and the member regulation, enforcement and arbitration functions of the New York Stock Exchange." *Securities Regulation Resource Guide*, CLEVELAND-MARSHALL COLLEGE OF LAW, http://devel-drupal.law.csuohio.edu/lawlibrary/resources/lawpubs/SecuritiesRegulationResourceGuide.html.

91 As one article in the business press points out, "Wall Street's self-regulators have missed virtually all of the major securities scandals of the past two decades—from troubles that brought down Kidder Peabody, to analysts' conflicts, to favoritism in awarding initial-public-offering shares, to trading abuses at the Nasdaq Stock Market." Laurie P. Cohen & Kate Kelly, *NYSE Turmoil Poses Question: Can Wall Street Regulate Itself?*, WALL ST. J., Dec. 31, 2003, at A1.

92 *See* Dodd-Frank §§ 402-403.

93 *See, e.g.*, Liz Moyer, *How Regulators Missed Madoff*, FORBES.COM (Jan. 27, 2009, 3:20 PM EST), http://www.forbes.com/2009/01/27/bernard-madoff-sec-business-wall-street_0127_regulators.html.

investors and amounts of capital managed on behalf of U.S. investors,[94] but not on U.S. securities holdings.[95] Perhaps unsurprisingly, major issues such as the obligations of broker-dealers,[96] the examination of investment advisers,[97] and investor access to information on investment advisers and broker-dealers[98] are deferred to further study. Similarly the regulation of SROs is essentially limited to giving the SEC authority to restrict pre-dispute arbitration,[99] while calling for more study of whether it would be worthwhile to have SROs for investment advisers[100] or private funds.[101]

Even more troubling is the lack of attention to consumer education. To be sure, the statute does make it more difficult to qualify as an "accredited investor" who has access to unregistered securities products,[102] but to the extent income or net worth is even a proxy for financial sophistication, one could be forgiven for wondering whether tweaking the definition will make any difference. As one might expect, we are treated to a cornucopia of future studies: issues as significant as financial literacy among investors,[103] mutual fund advertising,[104] financial planners and financial designations,[105] the thresholds for accredited investors,[106] credit scores,[107] and person to person lending,[108] are left for another day. In the same vein, one might wonder what impact the new mortgage lending standards outlined in the

94 *See* Dodd-Frank § 402(a). *See also* Michael I. Overmyer, Note, *The "Foreign Private Adviser" Exemption: A Potential Gap in the New Systemic Risk Regulatory Architecture*, 110 COLUM. L. REV. 2185, 2186–87 (2010) ("The WSRCPA [Dodd-Frank] excludes from its registration requirement foreign hedge fund managers whose funds do not meet certain thresholds regarding numbers of U.S. investors or amounts of capital managed on behalf of U.S. investors.").

95 As one observer summarizes it, "[m]anagers of hedge funds based in another country and that lack significant participation from American investors, but which nonetheless could contribute to systemic risk in the U.S. economy, do not need to register." *Id.* at 2213. The suggestion would be that "U.S. law should require managers of foreign hedge funds with a sufficiently large presence in U.S. markets to register with the SEC." *Id.* at 2219.

96 *See* Dodd-Frank § 913. *See also* Reza Dibadj, *Brokers, Fiduciaries and a Beginning*, 30 REV. OF BANKING AND FIN. L. 205 (2011) (discussing the possibility of fiduciary duties for brokers).

97 *See* Dodd-Frank § 914.

98 *See* Dodd-Frank § 919B.

99 *See* Dodd-Frank § 921.

100 *See* Dodd-Frank § 914(a)(2)(B).

101 *See* Dodd-Frank § 416.

102 The new standard excludes an investor's primary residence in calculating the one million dollar net worth threshold. *See* Dodd-Frank § 413(a).

103 *See* Dodd-Frank § 917.

104 *See* Dodd-Frank § 918.

105 *See* Dodd-Frank § 919C.

106 *See* Dodd-Frank § 415.

107 *See* Dodd-Frank § 1078(a).

108 *See* Dodd-Frank § 989F(a)(1).

statute[109] will have and simply note that important topics—reverse mortgages,[110] appraisal methods,[111] mortgage foreclosure rescue scams and loan modification fraud[112]—are once again simply remitted to future study.

Finally, arguably the best hope the statute provides in protecting consumers is the creation of the Bureau of Consumer Financial Protection (BCFP)[113] "for the purpose of ensuring that all consumers have access to markets for consumer financial products and services and that markets for consumer financial products and services are fair, transparent, and competitive."[114] Though it is too early to assess the BCFP's performance, a careful reading of the statute raises some concerns. For example, the BCFP will operate under the auspices of the Federal Reserve System (Federal Reserve),[115] an entity whose primary focus is not consumer protection; its decisions can be set aside by the FSOC,[116] and it is not authorized to impose a usury limit.[117] Furthermore, no private right of action is created to supplement the BCFP's enforcement.[118] Of perhaps greatest concern is that the statutory authority given to the BCFP to address "unfair" practices is actually not one predicated on consumer protection, but mandates a cost-benefit analysis focused on overall economic efficiency.[119] While there might be some hope in the additional "abusive" standard Dodd-Frank articulates,[120] one could be

109 *See* Dodd-Frank § 1411.

110 *See* Dodd-Frank § 1076.

111 *See* Dodd-Frank § 1476(a)(1)(A).

112 *See* Dodd-Frank § 1492.

113 *See* Dodd-Frank § 1011.

114 Dodd-Frank § 1021(a). *See also* SKEEL, *supra* note 33 at 14 (noting that the BCFP was created "to serve as a consumer watchdog with respect to credit card and mortgage practices").

115 *See* Dodd-Frank § 1011(a).

116 *See* Dodd-Frank § 1023.

117 *See* Dodd-Frank § 1027(o).

118 *See, e.g.*, Carey Alexander, *Abusive: Dodd-Frank Section 1031 and the Continuing Struggle to Protect Consumers* 17–18 (St. John's Univ. Legal Studies Research Paper Series, Paper No. 10-193 2011), *available at* http://ssrn.com/abstract=1719600 ("The CFPB [Consumer Financial Protection Bureau], by contrast, does not need to set the bar for abusive conduct nearly as high as the FDCPA [Fair Debt Collection Practice Act] because Dodd-Frank does not authorize a private right of action.").

119 *See* Dodd-Frank § 1031(c)(1).

120 Section 1031(d) states that an "act or practice" cannot be deemed "abusive" unless it:

> (1) materially interferes with the ability of a consumer to understand a term or condition of a consumer financial product or service; or
> (2) takes unreasonable advantage of—
> (A) a lack of understanding on the part of the consumer of the material risks, costs, or conditions of the product or service;
> (B) the inability of the consumer to protect the interests of the consumer in selecting or using a consumer financial product or service; or

forgiven for lamenting that "Congress has, for the first time in recent memory, subordinated the goal of fairness in consumer credit transactions to a new goal of economic efficiency."[121] To the extent the BCFP flexes its muscles, one can only imagine the spate of lawsuits alleging it exceeded its statutory authority. In sum, "the future landscape for the field of consumer financial protection is filled with uncertainty."[122]

D. Use of Corporate Size to Privatize Profits and Socialize Losses

In addition to the dissemination of misleading information, abuse of regulatory gaps, and exploitation of credulous consumers, there is one additional crucial facilitator: the ability to use corporate size to privatize profits and socialize costs. With the creation of corporate behemoths via mergers and acquisitions, industries such as financial services have become increasingly concentrated and oligopolistic.[123]

Large companies become so large and complex that they emerge as "too-big-to-fail" (TBTF)—a clever posture that internalizes profits when things go well and externalizes costs when they do not. It is perhaps easy to forget that the financial actors at the center of the financial meltdown were chasing higher profits by extending subprime loans and trading esoteric financial products. All this may be fine as far as it goes, of course, provided that these same actors suffer the financial repercussions of their risky behavior if things go wrong. Instead, these apparently sophisticated actors turned to the federal

> (C) the reasonable reliance by the consumer on a covered person to act in the interests of the consumer.

Dodd-Frank § 1031(d). *See also* Alexander, *supra* note 118, at 20 ("Congress's enactment of a flexible definition of abusive, coupled with Congress's clear dissatisfaction with the Fed's narrow interpretation of its powers to reach abusive practices suggests that the CFPB should adopt a broad, expansive interpretation of its powers to address abusive practices."); Vincent di Lorenzo, *The Federal Financial Consumer Protection Agency: A New Era of Protection or More of the Same?* 89–90 (St. John's Univ. Legal Studies Research Paper Series No. 10-0182, 2010), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1674016 (explaining that if the "abusive" standard were in practice from 2002–2008 it "would have allowed the Bureau to prohibit or regulate many loan products and practices"); Boyack, *supra* note 9, at 60 ("The addition of the word 'abusive' in the Dodd-Frank Act, however, suggests an expanded definition of liability.").

121 Di Lorenzo, *supra* note 120, at 84. *See also id.* ("Two consequences surface from the embrace by Congress of a net societal benefits standard for future regulatory intervention: (a) the adverse legislative signal created by Congress, and (b) the possibility of a less responsive Consumer Protection Bureau.").

122 *Id.* at 85.

123 *See, e.g.*, Reza Dibadj, *Deregulation: A Tragedy in Three Acts*, WASH. POST, Sept. 13, 2003, at A21.

government for a bailout under the theory that they are simply TBTF.[124]

The culminating affront here, of course, is that it is the individual—the ordinary taxpayer who has already suffered mightily as shareholder and consumer—who is asked to be the insurer of last resort and reallocate resources to financial actors who were imprudent in the first place.[125] Above all, TBTF facilitates hypocrisy: it extols the virtues of free markets and private profits, then conveniently comes begging to Washington to socialize the losses.[126]

At the root of TBTF is antitrust policy that over the past forty years has stood idly by and condoned the creation of large corporate behemoths in a variety of industries, including financial services.[127] Consider that by 1999 advocates of deregulation obtained the formal repeal of the Glass-Steagall Act, which had separated commercial from investment banking—successfully arguing that antitrust laws would forbid mergers unfriendly to consumers.[128] The following decade witnessed an explosion of bank mergers and acquisitions,[129] followed by our current bailout woes.[130]

Simply put, a first principles-based approach would enforce the antitrust laws.[131] Sadly enough, the current ethos has lost

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124 Reza Dibadj, H*ow Does the Government Interact with Business?: From History to Controversies*, 5 ENTREPRENEURIAL BUS. L.J. 707, 722 (2010). *Cf.* Baxter, *supra* note 88, at 212 ("Despite their assertions of efficiencies of scale, these financial conglomerates have long ceased to be as efficient as their smaller counterparts. So their economic value is questionable. What is worse is that the value of the *de facto* public subsidies they enjoy is substantial.").

125 *See e.g.*, Schooner, *supra* note 27, at 1011 ("Ultimately, much of the costs of systemic crisis are borne by the taxpayer.").

126 *Cf.* Alan Freeman & Elizabeth Mensch, *The Public-Private Distinction in American Law and Life*, 36 BUFF. L. REV. 237, 249 (1987) ("Private companies rarely turn down the opportunity to feed greedily at the public trough.").

127 *See, e.g.*, Gary Minda, *Antitrust at Century's End*, 48 SMU L. REV. 1749, 1769 (1995); Frederick M. Rowe, *The Decline of Antitrust and the Delusions of Models: The Faustian Pact of Law and Economics*, 72 GEO. L.J. 1511, 1527–28 (1984). A leading antitrust monograph even declares that the "very ubiquity of merger-created efficiencies is why we evaluate mergers under a fairly benign set of rules." HERBERT HOVENKAMP, THE ANTITRUST ENTERPRISE: PRINCIPLE AND EXECUTION 219 (2005).

128 *See* Aigbe Akhigbe & Ann Marie Whyte, 36 FIN. REV. 119, 120 (2001).

129 *See, e.g.*, Wilmarth, *supra* note 51, (manuscript at 33) ("All of today's four largest U.S. banks (BofA, Chase, Citigroup and Wells Fargo) are the products of serial acquisitions and explosive growth since 1990.").

130 It is fascinating to observe how policymakers enamored of simplistic deregulation were able to assuage critics by casting off responsibility to antitrust. Later, when faced with deregulation's shortcomings, the deregulators could conveniently shift the blame to lax antitrust enforcement like the child's game of "hot potato." *See* Reza Dibadj, *Saving Antitrust*, 75 U. COLO. L. REV. 745, 747 (2004).

131 *See, e.g.*, Beale, *supra* note 72, (manuscript at 23) ("Rather than continue to encourage consolidation of financial institutions, we likely need to revamp our antitrust

sight of the fact that antitrust "was premised upon a political judgment that decentralized market power was essential to a free society."[132] It is time to reconsider whether contemporary antitrust policy should be so demure. To the extent financial conglomerates are already too big, they would be disaggregated.[133] Note, by contrast, that "the emergency acquisitions of LCFIs [large, complex financial institutions] arranged by U.S. regulators have produced domestic financial markets in which the largest institutions hold even greater dominance."[134] The supervening irony, of course, is that taxpayers have unwittingly funded the next round of consolidation.

Perhaps it is unsurprising by now to observe that Dodd-Frank does not take this straightforward structural approach;[135] rather, it is peppered with provisions that seem impressive at first glance but run the risk of being largely ineffectual. Overall, "Dodd-Frank sets forth no comprehensive plan for controlling the size or complexity of the mega-banks."[136] Predictably, issues such as concentration limits[137] and the effect of size and complexity of financial institutions[138] are left to further study.

Reaching this pessimistic conclusion, however, requires a careful reading of Dodd-Frank's multiple provisions that ostensibly seek to stop TBTF. To begin with, there are several measures that would appear to prevent another systemic meltdown by limiting size and enhancing capital requirements.

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policies to recognize that concentrated power in an industry that arises from sheer size, leverage, and interconnectedness may merit the trust-busting power of the anti-trust rules.").

132 Minda, *supra* note 127, at 1755.

133 As two commentators suggest:

> If a failing firm is deemed "too big" for that honor, then it should be explicitly nationalized, both to limit its effect on other firms and to protect the guts of the system. Its shareholders should be wiped out, and its management replaced. Its valuable parts should be sold off as functioning businesses to the highest bidders—perhaps to some bank that was not swept up in the credit bubble. The rest should be liquidated, in calm markets. Do this and, for everyone except the firms that invented the mess, the pain will likely subside.

Lewis & Einhorn, *supra* note 25, at WK10.

134 Wilmarth, *supra* note 51, (manuscript at 34).

135 *See id.* at 2 ("Dodd-Frank fails to make fundamental structural reforms that could largely eliminate the subsidies currently exploited by LCFIs [large, complex financial institutions].").

136 Karmel, *supra* note 43, at 48. *See also id.* at 7 ("[U]nder Dodd-Frank, functional regulation remains in place so that different agencies with different approaches continue to regulate financial institutions and markets, and the largest financial institutions have grown even large than they were before, thus increasing the risks and costs of their failure.").

137 *See* Dodd-Frank § 123.

138 *See* Dodd-Frank § 622 (modifying § 14(e) of the Bank Holding Company Act of 1956).

First, the statute imposes a ten percent nationwide deposit cap.[139] However, a similar cap has been in existence since the 1994 Riegle-Neal Act[140]—Dodd-Frank merely extends the Riegle-Neal limits to mergers involving thrifts and industrial banks.[141] Crucially, as one scholar observes:

> [Section] 623 leaves open the other Riegle-Neal loopholes because (1) it does not apply the nationwide deposit cap to intrastate acquisitions or mergers, (2) it does not apply the statewide deposit cap to interstate transactions involving thrifts or industrial banks or to any type of intrastate transaction, and (3) it does not impose any enhanced substantive or procedural requirements for invoking the failing bank exception.[142]

These loopholes, notably the "failing bank exception," render the benefit of the ten percent cap largely illusory.[143]

Second, the so-called Kanjorski Amendment[144] "provides the FRB [Federal Reserve Board] with potential authority to require large BHCs [bank holding companies] or nonbank SIFIs [systemically important financial institutions] to divest high-risk operations."[145] Unfortunately, however, this power is subject to strict procedural requirements[146] making it very unlikely to ever apply.[147]

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139 *See* Dodd-Frank § 623.

140 *See* Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994, Pub. L. No. 103-328, 108 Stat. 2338 (Sept. 29, 1994).

141 *See, e.g.*, Wilmarth, *supra* note 51, (manuscript at 40) ("Section 623 of Dodd-Frank does extend Riegle-Neal's ten percent nationwide deposit cap to reach all interstate acquisitions and mergers involving any type of FDIC-insured depository institution. Thus, interstate acquisitions and mergers involving thrift institutions and industrial banks are now subject to the nationwide deposit cap to the same extent as interstate acquisitions and mergers involving commercial banks.").

142 *Id.*

143 *See id.* (manuscript at 4) ("Congress did not adequately strengthen statutory limits on the ability of LCFIs to grow through mergers and acquisitions."). Section 622 does impose a ten percent liability cap on mergers and acquisitions of financial companies "[s]ubject to the recommendations" of the FSOC. *See* Dodd-Frank § 622 (modifying § 14(c) of the Bank Holding Act of 1956). This concentration limit, however, maintains the failing bank exception. *See* Dodd-Frank § 622 (modifying § 14(c) of the Bank Holding Act of 1956). In addition, as one author suggests, "LCFIs [large, complex financial institutions] will almost certainly urge the FSOC to weaken or remove the liabilities cap under § 622." Wilmarth, *supra* note 51, (manuscript at 42).

144 *See* Wilmarth, *supra* note 51, (manuscript at 71). *See also* Dodd-Frank § 121(a) (codifying the "Kanjorski Amendment").

145 Wilmarth, *supra* note 51, (manuscript at 71).

146 *See* Dodd-Frank § 121(b) (discussing various notice and hearing requirements).

147 *See, e.g.*, Wilmarth, *supra* note 51, (manuscript at 72) ("The FRB's divestiture authority under § 121 is thus a last resort, and it is restricted by numerous procedural requirements (including, most notably, a two-thirds vote by the FSOC). . . . [Thus,] the prospects for an FRB-ordered breakup of a SIFI seem remote at best.").

Third, the Collins Amendment outlines risk-based and leverage capital standards.[148] Even here, however, there are at least two problems. First, the amendment defers to agencies to establish parameters for both minimum leverage capital[149] and minimum risk-based capital.[150] Second, and more importantly, capital-based regulation has repeatedly been unsuccessful in preventing financial crises.[151] As one might expect, the statute even commissions a study on holding company capital requirements.[152]

Two other provisions, arguably more complex in scope, seek to limit interconnectedness rather than simply size or risky capital. At first glance, "the Volcker Rule generally prohibits banks from engaging in proprietary trading (that is, trading that is on its own behalf and not a customer's) or acquiring or retaining an interest in a hedge fund or private equity fund."[153] Closer reading, however, reveals a number of exceptions: non-bank financial companies,[154] certain financial instruments,[155] and "[r]isk-mitigating hedging activities"[156] are excluded; "proprietary" is a rather loose term of art;[157] and banks are

148 *See* Dodd-Frank § 171.

149 *See* Dodd-Frank § 171(b)(1).

150 *See* Dodd-Frank § 171(b)(2).

151 *See, e.g.*, Wilmarth, *supra* note 51, (manuscript at 100) ("Dodd-Frank (like Basel III) relies primarily on the same supervisory tool—capital-based regulation—that failed to prevent the banking and thrift crises of the 1980s as well as the current financial crisis.").

152 *See* Dodd-Frank § 174. Perhaps the one bright spot is the power given to the Federal Reserve to require financial entities "to maintain a minimum amount of contingent capital that is convertible to equity in times of financial stress." Dodd-Frank § 165(c)(1). *See also* Coffee, *Bail-Ins*, *supra* note 3, at 43 ("Contingent capital achieves two objectives at once: (1) avoidance of default, and (2) alteration of voting power.").

153 Greenberger, *supra* note 62, at 4. *See also* Dodd-Frank § 619 (prohibiting banks from engaging in proprietary trading).

154 *See* Dodd-Frank § 619(a)(2) (amending § 13(a)(2) of the Bank Holding Company Act of 1956).

155 *See* Dodd-Frank § 619 (amending § 13(d)(1)(A) of the Bank Holding Company Act of 1956). *See also* Malcolm S. Salter, *Lawful but Corrupt: Gaming and the Problem of Institutional Corruption in the Private Sector* 23 (Harvard Bus. Sch., Working Paper No. 11-060, 2010), *available at* http://ssrn.com/abstract=1726004 ("The act's ban on proprietary trading also allows banks to engage in trade in several other types of instruments, such as those issued by Ginnie Mae, Fannie Mac, the Federal Home Loan Bank, two federal agricultural banking institutions, and states and municipalities.").

156 Dodd-Frank § 619(d)(1)(C) (amending § 13(d)(1)(A) of the Bank Holding Company Act of 1956).

157 *See, e.g.*, Dodd-Frank § 619(d)(1)(B) (revising § 13(d)(1)(B) of the Bank Holding Company Act of 1956) (permitting "[t]he purchase, sale, acquisition, or disposition of securities and other instruments . . . in connection with underwriting or market-making-related activities, to the extent that any such activities . . . are designed not to exceed the reasonably expected near term demands of clients, customers, or counterparties"); Dodd-Frank § 619(d)(1)(D) (revising § 13(d)(1)(D) of the Bank Holding Company Act of 1956) (permitting "[t]he purchase, sale, acquisition, or disposition of securities and other instruments . . . on behalf of customers."). *See also* SKEEL, *supra* note 33, at 10 ("Although the Volcker Rule is forcing banks to adjust their operations, the concept of

allowed to invest up to three percent of their capital in activities prohibited by the Volcker Rule[158]—a significant amount when it comes to a bank trading on its own behalf.[159] Par for the course, the statute defers to further study the real issues behind bank investment activities[160] and proprietary trading.[161]

The second provision seeking to limit interconnectedness is the Lincoln Amendment or "Push-Out" rule "which prohibits federal assistance to any bank operating as a swap dealer."[162] Yet, once again, the rule contains numerous loopholes.[163]

Beyond these purported attempts to manage TBTF, and presumably as a last resort, Dodd-Frank establishes an orderly liquidation authority (OLA) to mitigate economic fallout if a systemically important financial institution fails.[164] OLA, however, is fraught with both obvious and subtle problems. It "does not require SIFIs [systemically important financial institutions] to pay risk-based assessments to pre-fund the Orderly Liquidation Fund ("OLF"), which will cover the costs of resolving failed SIFIs. Instead, the OLF will have to borrow the necessary funds in the first instance from the Treasury (i.e., the taxpayers)."[165] Like much of Dodd-Frank, OLA operates at the

proprietary trading is so slippery that its application will depend on how, and how strictly, regulators interpret it."). As one example of gamesmanship, consider the "view that the [Volcker Rule] could be gamed by having traders trade in contemplation of potential trades a client may want to do in order to have an inventory of financial assets readily available." Beale, *supra* note 72, (manuscript at 24).

158 *See, e.g.*, Dodd-Frank § 619(d)(4)(B)(ii)(II) ("[I]n no case may the aggregate of all of the interests of the banking entity in all such funds exceed 3 percent of the Tier 1 capital of the banking entity.").

159 *See, e.g.,* Salter, *supra* note 155, at 23 ("The best way to understand the connection is to consider the 3 percent rule as a massive loophole that allows every banking entity in America to skirt the ban on risky proprietary trading by investing as much as 3 percent of their capital in such funds.").

160 *See* Dodd-Frank § 620.

161 *See* Dodd-Frank § 989(b)(1).

162 Greenberger, *supra* note 62, at 4. "Federal assistance is defined broadly to include, *inter alia*, federal deposit insurance or access to the Federal Reserve's discount window." *Id*. *See also* Dodd-Frank § 716(b)(1).

163 As one scholar outlines:

> As enacted, the Lincoln Amendment allows an FDIC-insured bank to act as a swaps dealer with regard to (i) "[h]edging and other similar risk mitigating activities directly related to the [bank's] activities," (ii) swaps involving interest rates, currency rates and other "reference assets that are permissible for investment by a national bank," including gold and silver but not other types of metals, energy, or agricultural commodities, and (iii) credit default swaps that are cleared pursuant to Dodd-Frank and carry investment-grade ratings.

Wilmarth, *supra* note 51, (manuscript at 79–80) (quoting Dodd-Frank § 716(d)).

164 *See* Dodd-Frank § 204(a) ("It is the purpose of this title to provide the necessary authority to liquidate failing financial companies that pose a significant risk to the financial stability of the United States in a manner that mitigates such risk and minimizes moral hazard.").

165 Wilmarth, *supra* note 51, (manuscript at 4–5). *See also id.* (manuscript at 64) ("It is contrary to customary insurance principles to establish an OLF that is funded only

discretion of regulators[166]—notably, the Treasury.[167] More subtly, OLA may end up acting at a point when it is already too late to salvage a firm. John Coffee points out the irony:

> Essentially, it [Dodd-Frank] denies bank regulators the ability to target funds to threatened financial institutions, except in cases where the financial institution is to be liquidated pursuant to the FDIC's resolution authority. Thus, the FDIC can advance funds, or guarantee debts, to those firms under the death sentence of liquidation, but neither it nor the Federal Reserve can do much to help the potentially solvent firm that is teetering on the brink. Because most financial firms are unlikely to concede that they are insolvent (but may readily acknowledge that they need liquidity), the central banker after Dodd-Frank is unlikely to perform its traditional "lender of last resort" function and must act more as a financial undertaker.[168]

In addition, OLA simply creates a parallel bankruptcy regime to Chapter 11. Not only is it unclear exactly to which financial entities OLA will apply,[169] "[b]ut by developing a new system for addressing financial distress, instead of integrating the new system into the existing structure of the Bankruptcy Code, the financial reform act simply recreates the prior problem in a new place."[170] In sum, "contrary to the statute's stated purpose, Dodd-Frank's OLA does not preclude future bailouts for creditors of TBTF institutions."[171] As is typical throughout Dodd-Frank, the issue of a bankruptcy process for financial institutions remains a subject for further study.[172]

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after a SIFI fails and must be liquidated."). The assessments the OLA contemplates are imposed ex post. *See, e.g.*, Dodd-Frank § 210(o)(1)(D).

166 *See, e.g.*, Stephen J. Lubben, *The Risks of Fractured Resolution—Financial Institutions and Bankruptcy* 13 (Seton Hall Univ. Sch. of Law, Pub. Law Research Paper No. 1726944, 2010), *available at* http://ssrn.com/abstract=1726944 ("[T]he new resolution authority is a process that must be invoked by regulators, and thus might be subject to delay or even neglect if the regulators disdain the new procedures.").

167 *See, e.g.*, *id.* at 17 ("The key player in initiation is the Treasury Secretary, an inherently political actor who is unlikely to be able to make commitments that will last beyond any particular Secretary's term in office."). For a discussion of Treasury as regulator, see *supra* notes 51–56, and accompanying text.

168 Coffee, *Bail-Ins*, *supra* note 3, at 30.

169 In the words of one bankruptcy scholar:

> Save for when the Dodd-Frank Act's new resolution authority applies, chapter 11 remains the primary instrument for resolving financial institutions. Unless a specialized regime is in place, such as those for banks or insurance companies, chapter 11 will apply. Thus, hedge funds, private equity funds, investment banks, and the parent companies of banks and insurance companies will all face resolution under chapter 11 unless the entity in question can be resolved under the new resolution authority and the Secretary of the Treasury decides to invoke the authority . . . .

Lubben, *supra* note 166, at 7.

170 *Id.* at 3.

171 Wilmarth, *supra* note 51, (manuscript at 43).

172 *See* Dodd-Frank § 216.

Overall, after Dodd-Frank, financial institutions will still be able to use their size to privatize profits and socialize losses. As David Skeel notes:

> Unlike in the New Deal, there is no serious effort to break the largest of these banks up or to meaningfully scale them down. Because they are special, and because no one really believes the largest will be allowed to fail, they will have a competitive advantage over other financial institutions.[173]

In the words of Lawrence Baxter, a current academic and former bank executive, "as long as these LCFIs [large, complex financial institutions] operate at their current scale and complexity, the financial system will remain fragile and vulnerable to massive sudden shocks."[174] Indeed, Baxter warns that "[i]f Congress, after the kind of crisis we have just been through, cannot itself impose scale limitations on very large financial institutions, I don't think the regulators will ever be in a position to shut them down."[175] Put bluntly, Dodd-Frank does precious little to prevent or even mitigate TBTF.

II. POLITICAL ECONOMY OF FINANCIAL LEGISLATION

Why these ambiguities, deferrals, and further studies? In other words, why would sophisticated lawmakers choose largely to defer issues rather than confront them simply and directly? While there are benefits to delegating to agencies, the main factor underlying this voluminous legislation—which ironically postpones the major questions surrounding the financial crisis—lies in the political economy of twenty-first century politics and the jostling among interest groups.[176] By contrast, a path forward may lie in structural reform of the legislative process.

To begin with, it is important to recognize the potentially important benefits of delegating to administrative agencies. Congress obviously has a full agenda and cannot do everything itself. Agencies have access to information[177] and the resources

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173 SKEEL, *supra* note 33, at 9. *See also* Baxter, *supra* note 88, at 213 ("One obvious way would have been to impose limitations on the size of financial institutions. An amendment proposed by two senators did indeed place such an option squarely before the Senate. Their amendment, however, met fierce opposition from the large banks and the Treasury Department and was eventually defeated."); Wilmarth, *supra* note 51, (manuscript at 101) ("As an alternative to Dodd-Frank's regulatory reforms, Congress could have addressed the TBTF problem directly by mandating a breakup of large financial conglomerates.").

174 Baxter, *supra* note 88, at 211.

175 *Id.* at 214.

176 *See, e.g.*, *Cheques and Imbalances*, ECONOMIST, June 19, 2010, at 33, *available at* http://www.economist.com/node/16380025?story_id=16380025&CFID=165030874&CFTOKEN=60263434.

177 *See, e.g.*, David B. Spence & Frank Cross, *A Public Choice Case for the*

needed to enforce the law,[178] while at the same time being less dependent on the vagaries of election cycles.[179] Theoretically, delegations of power to agencies can help overcome the Condorcet paradox[180] which leads to voting cycles.[181] Indeed, even a cursory glance at economic history suggests an important role for administrative agencies—both domestically[182] and internationally.[183] Phrased starkly, "the maintenance of a

Administrative State, 89 GEO. L.J. 97, 110 (2000) (noting that agencies have "access to the largest amount of accurate information").

178 *See, e.g.*, Felix S. Cohen, *The Problems of a Functional Jurisprudence*, 1 MOD. L. REV. 5, 21 (1937) ("[L]egislation designed to protect an oppressed class will not be effectively enforced unless it sets up some independent agency capable of representing the interests of that class in securing enforcement of the legislation.").

179 *See, e.g.*, STEVEN P. CROLEY, REGULATION AND PUBLIC INTERESTS 305 (2008) ("In contrast to legislators, administrators as [sic] far less dependent upon the types of political resources so valuable to members of Congress. They are therefore less easily enlisted to advance the regulatory preferences of rent-seeking interests offering legislatively valuable resources."); David B. Spence, *A Public Choice Progressivism, Continued*, 87 CORNELL L. REV. 397, 438 (2002) ("The ability to influence legislators' reelection prospects through campaign contributions, issue advertising, and the like, offers well-heeled interest groups much greater leverage over legislators than over agency bureaucrats . . . .").

180 The core of the paradox is that "absent clear majority support for one of three or more options presented to a collective decisionmaking body there may be no rational means of aggregating individual preferences . . . ." Maxwell L. Stearns, *The Misguided Renaissance of Social Choice*, 103 YALE L.J. 1219, 1222 (1994).

181 Jerry Mashaw explains:

> As voting theorists seldom tire of telling us, whenever three or more alternative policies exist there is the ever present possibility of a voting cycle which can be broken only by resort to some form of "dictatorship" result. Legislators must, therefore, often delegate decisive authority somewhere in order to decide. There are any number of ways to deal with this problem—rules committees, forced deadlines, random selection, allocations of vetoes, or the like. Lumping alternatives together in a broad or vague statutory pronouncement and delegating choice to administrators is but another way of avoiding voting cycles through the establishment of dictators.

Jerry L. Mashaw, *Prodelegation: Why Administrators Should Make Political Decisions*, 1 J.L. ECON. & ORG. 81, 98 (1985) (citations omitted).

182 As Steven Croley observes:

> Americans have repeatedly turned to federal regulatory government in times of crisis to address the country's most stubborn problems—from the banking crises and business corruption of the early twentieth century, through the Great Depression, stock market crisis, and labor unrest of the 1930s and 1940s, through the environmental crisis and civil rights revolutions of the 1960s and 1970s, to the threat of terrorism and the creation of the huge new Department of Homeland Security at the beginning of the twenty-first century, to name a few.

CROLEY, *supra* note 179, at 3.

183 *See, e.g.*, EZRA SULEIMAN, DISMANTLING DEMOCRATIC STATES 316 (2003) ("[T]he historical development of the U.S., Britain, France, Japan, Prussia, and, in recent times, Korea, Taiwan, and India indicates that the development of bureaucratic authority accompanied and facilitated the development of the state and the subsequent development of democracy.").

democratic order . . . requires a trained, nonvenal bureaucratic machine."[184]

In the case of Dodd-Frank, however, the concern is that less than noble motivations may underlie the delegations and deferrals. Researchers estimate that the financial services industry hired more than 3000 lobbyists to mold the legislation.[185] One cannot help but wonder what role these lobbyists played in fostering an elaborate, yet perhaps less effective, statute. One might argue that the political economy of financial reform simply involves a well-funded, relatively narrow interest group trumping the interests of widely dispersed groups of investors and consumers. The idea is not new and can be traced back to James Madison's account of how "factions" can organize to push their own agenda to the detriment of society at large.[186] Mancur Olson's research on public choice and group dynamics in the 1960s provides further elaboration:

> The smaller groups—the privileged and intermediate groups—can often defeat the large groups—the latent groups—which are normally supposed to prevail in democracy. The privileged and intermediate groups often triumph over the numerically superior forces in the latent or large groups because the former are generally organized and active *while the latter are normally unorganized and inactive*.[187]

Olson's point is particularly acute as it relates to the financial sector, which funds generous political contributions and benefits from a revolving door between government officials and industry leaders.[188]

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184 *Id.* at 7.

185 *See, e.g.*, *Cheques and Imbalances*, *supra* note 176, at 33 ("The Centre for Public Integrity, a non-partisan research group, reckons the financial-services industries alone hired more than 3,000 lobbyists to influence the financial reform bill now before Congress."). *See also* Salter, *supra* note 155, at 28 ("Lobbying is at the epicenter of most rule-making activities involving business.").

186 Madison defines factions as "a number of citizens, whether amounting to a majority or minority of the whole, who are united and actuated by some common impulse of passion . . . adverse to the rights of other citizens, or to the permanent and aggregate interests of the community." THE FEDERALIST NO. 10, at 57 (James Madison) (Jacob E. Cooke ed., 1961).

187 MANCUR OLSON JR., THE LOGIC OF COLLECTIVE ACTION 128 (1965) (emphasis added). *See also id.* at 142–43 ("The number and power of the lobbying organizations representing American business is indeed surprising in a democracy operating according to the majority rule. . . . The high degree of organization of business interests, and the power of these business interests, must be due in large part to the fact that the business community is divided into a series of (generally oligopolistic) 'industries,' each of which contains only a fairly small number of firms.") (emphasis omitted).

188 *See, e.g.*, Wilmarth, *supra* note 51, (manuscript at 60) ("[A]nalysts have pointed to strong evidence of 'capture' of financial regulatory agencies by LCFIs [large, complex financial institutions] during the two decades leading up to the financial crisis, due to factors such as (i) large political contributions made by LCFIs, (ii) an intellectual and policy environment favoring deregulation, and (iii) a continuous interchange of senior personnel between the largest financial institutions and the top echelons of the financial

As the product of such a political economy, Dodd-Frank's lapses become rather unsurprising. Perhaps the most concise depiction of the problem emerges from the work of Malcolm Salter who, fittingly enough, studies business strategy:

> The Rule-Making (influence) Game involves sending campaign contributions to politicians and then lobbying them to include loopholes in new laws—and then exploiting those loopholes, even when such behavior subverts the laws' intent. More subtly, the Rule-Making Game also involves ensuring that new rules have either ambiguities or overly narrow regulations, offering rich opportunities for businesses to pursue innovative strategies to circumvent the rules in a murky legal environment.[189]

As such, the "game" Salter outlines is doubly advantageous to the financial services industry: taking advantage of existing loopholes[190] while simultaneously lobbying at the administrative agency level to ensure favorable future rulemaking. As one commentator observes: "The Dodd-Frank Wall Street Reform Act has generated more work for lawyers and lobbyists since being signed into law than during even the frenzied days leading up to its passage in the House and Senate last summer."[191] Importantly, deferring important questions to further study is also beneficial to industry interests. Over time, as memories of the crisis fade there is an even greater opportunity for the financial services industry to influence the implementation of recommendations that may emerge from studies—a phenomenon John Coffee has dubbed the "regulatory sine curve."[192]

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regulatory agencies.").

189 Salter, *supra* note 155, at 14.

190 *See also* Kane, *supra* note 4, at 10 ("A complete diagnosis of modern financial crises must acknowledge that lobbyists for SIFs [systemically important private firms] have persuaded Congress to maintain a loophole-ridden regulatory structure."). *Cf.* di Lorenzo, *supra* note 120, at 66 ("Research into industry compliance with regulatory standards has demonstrated that greater certainty in statutory or regulatory mandates increases the likelihood of compliance.").

191 Amanda Becker, *Multitudes of Lobbyists Weigh in on Dodd-Frank Act*, WASH. POST (Nov. 22, 2010), http://www.washingtonpost.com/wp-dyn/content/article/2010/11/19/AR2010111906465.html. *See also* Salter, *supra* note 155, at 3 ("[Dodd-Frank] has unleashed massive lobbying by the finance industry to determine how the remaining rules will read and how much 'gaming' these rules will allow."); Kane, *supra* note 4, at 7 ("[T]he legislative framework Congress has asked regulators to implement gives a free pass to the dysfunctional ethical culture of lobbying that helped both to generate the crisis and to dictate the extravagant cost of the diverse ways that the financial sector was bailed out.").

192 *See* Coffee, *Bail-Ins*, *supra* note 3, at 13 ("It posits the inevitability of a 'regulatory sine curve' under which regulatory activism, while intense in the wake of a regulatory crisis, relaxes thereafter, as lobbying and the impact of regulatory arbitrage soften the resistance of regulators."). *See also* Beale, *supra* note 72, (manuscript at 25) ("Moreover, even if there is an attitudinal shift that avoids regulatory capture, re-regulation can be expected to wane in importance over time, as economic conditions improve and memories of the Great Recession recede.").

The overarching problem with all of this is "that gaming crosses the line of acceptability and becomes institutionally corrupt when such institution-sanctioned behavior subverts the intent of society's rules, thereby harming the public interest, or weakens the capacity of the institution to achieve its espoused goals by undermining its legitimate procedures and core values."[193] One could be forgiven for believing that an industry's success should rest on its business acumen, not its ability to manipulate government.[194] Yet regrettably, this simple point remains understudied. As Amitai Eztioni suggests: "The economic literature is replete with references to distortions the government causes in the market. Comparable attention should be paid to manipulations of the government by participants in the market, and the effects of these manipulations on the internal structures of markets."[195] In terms of reform, perhaps the single most urgent change would be to reform campaign finance "in a way that will stop the drift toward a plutocracy of one *dollar*, one vote?"[196] As if the struggle were not difficult enough, recent Supreme Court jurisprudence makes it even more difficult to separate politics from corporate power.[197]

CONCLUSION

At one level, the story of Dodd-Frank is simple. Given its vast delegation to regulators,[198] the legislation's success will rest on how successfully the agencies will be able to implement its

193 Salter, *supra* note 155, at 3–4.

194 *See* AMITAI ETZIONI, NEXT 65 (2001) ("But aside from its being unfair to cut the vulnerable members of the society off the dole while allowing huge corporations to feed from the public trough, one must note that corporate welfare is incompatible with a sound economic environment. It rewards those actors who are best at manipulating the government in their favor (often by providing campaign contributions to members of state and federal legislatures) rather than those who have proven themselves in the marketplace by better R&D, production, or marketing.").

195 AMITAI ETZIONI, THE MORAL DIMENSION 217 (1988). *See also* Warren J. Samuels, *Interrelations Between Legal and Economic Processes*, 14 J.L. & ECON. 435, 442 (1971) ("[T]he critical question is *who* uses the government for *what* ends.").

196 ETZIONI, *supra* note 194, at xi. As Steven Croley points out, if "the relationship between legislators and regulation-seeking interest groups constitutes the real lynchpin of the public choice theory—then reforms in the area of campaigu [sic] finance, for one example, might go far to alleviate the problems that lead public choice theorists to call for deregulation." Steven P. Croley, *Theories of Regulation: Incorporating the Administrative Process*, 98 COLUM. L. REV. 1, 50–51 (1998).

197 *See* Citizens United v. Fed. Election Comm'n, 558 U.S. __ (2010) (slip op. No. 08-205) (Jan. 21, 2010). For an analysis of this opinion, see Reza Dibadj, Citizens United *as Corporate Law Narrative*, __ NEXUS: CHAPMAN'S J.L. & PUB. POL'Y __ (forthcoming 2011).

198 *See* Karmel, *supra* note 43, at 52 ("Much of the implementation of Dodd-Frank has been left to the various functional regulators of financial institutions and some of the more controversial proposed provisions have been relegated to studies.").

provisions and carry out and act upon the results of its innumerable and controversial studies.[199]

Yet, beyond the statute's artful nuances and deferrals, there lies potential for mischief. Dodd-Frank does not provide us with a new regulatory framework,[200] nor does it "sufficiently address the problem of agency discretion generally, or the problem of an agency's discretion to forebear, in particular."[201] As David Skeel has pointed out, such a fuzzy regulatory conception "invites the government to channel political policy through the big financial institutions by giving regulators sweeping discretion in the enforcement of nearly every aspect of the legislation."[202] Indeed, as Skeel asks:

> The special treatment of the largest firms and the reliance on ad hoc intervention raises a perplexing puzzle. Given that this is precisely what so many Americans found offensive about the bailouts of 2008 and were so anxious to reform, how did we end up with legislation that has such similar qualities?[203]

In other words, how did we end up with legislation that in many ways still favors institutions that both precipitated the crisis and are out of public favor? Perhaps the answer lies in the reality that "individual citizens and voters have been steadily edged out of the public sphere"[204] with a concomitant rise in the influence of the financial sector.[205] One might argue that this state of affairs cannot persist in the long-run;[206] put simply, institutions need public trust to survive.

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199 *See, e.g.*, Pooran, *supra* note 53, at 24 ("[T]he true effectiveness of Wall Street Reform lies in the faithfulness of its implementation by national regulatory agencies in the US."); Salter, *supra* note 155, at 24 ("The success of financial reform depends largely on whether regulators write definitions and rules that support the intent of the act, and then, of course, enforce them."); Kane, *supra* note 4, at 3 ("The Act puts responsibility for avoiding future crises squarely on the competence and good intentions of future regulators.").

200 *See, e.g.*, Karmel, *supra* note 43, at 6–7 ("The regulatory reform legislation of 2010 also does not put any new regulatory system in place, but rather attempts to modify and reform the existing system, giving expanded authority to the same regulators that failed to prevent the crisis of 2008.").

201 Schooner, *supra* note 27, at 994.

202 SKEEL, *supra* note 33, at 11. *See also id.* at 8 ("The two themes that emerge, repeatedly and unmistakably, from the 2,000 pages of legislation are (1) government partnership with the largest financial institutions and (2) ad hoc intervention by regulators rather than a more predictable, rules-based response to crises.").

203 *Id.* at 12.

204 Salter, *supra* note 155, at 24.

205 *Cf. id.* at 14 ("If ever a case could be made against such free-wheeling deregulation and confidence by policymakers in industry self-regulation, the 2008–09 financial crisis is it. Yet the veto power of the financial sector over public policy remains remarkably strong even as the sector has lost popular support.").

206 *See* Kane, *supra* note 4, at 16 ("It is unreasonable for an industry to expect to skin taxpayers forever.").

Regardless of this precarious state of affairs, however, it is likely to remain unless more citizens enter the conversation. To be sure, thoughtful commentators have expressed justifiable concern that citizens have become generally disengaged from public discourse.[207] But the relative weight the polity has spent discussing economic issues is particularly troubling. Note, for instance, how much time we have spent considering social issues—abortion, guns, gay marriage, to name just a few. By contrast, observe how stunningly little time we have spent discussing economic issues that affect our everyday livelihood. Granted, economic topics are often not as glamorous as social ones; after all, one might argue, we all have better things to do with our time than worry about something as esoteric as financial reform legislation. Perhaps, but the stakes are simply too high. Our society faces a stark choice: we can continue to let the so-called financial experts make decisions for us as we stand by and await the next crisis. Or we can begin a dialogue by asking some simple questions that might return us to common sense and first principles.[208]

207 *See, e.g.*, SULEIMAN, *supra* note 183, at 314 ("The citizen has been encouraged to view himself as a client purchasing the government's services. What incentives does such a perception provide for participation in associational life?").

208 *Cf.* STEPHEN BREYER, ACTIVE LIBERTY 3 (2005) ("[L]iberty means not only freedom from government coercion but also the freedom to participate in the government itself.").

Dodd-Frank as Maginot Line

Steven A. Ramirez[*]

INTRODUCTION

On May 10, 1940 the German Army opened a massive offensive aimed at France.[1] Five weeks later, on June 14, 1940, the Germans occupied Paris and essentially knocked the French out of World War II.[2] The French defense strategy relied upon a system of fixed fortifications on the French frontier known as the Maginot Line, which ran from Switzerland to Luxembourg.[3] The Germans countered the Maginot Line with a new form of mechanized warfare that allowed them to fly over and drive around the fixed fortifications with airplanes and armored vehicles, through the unfortified Ardennes Forest.[4] The engine-driven warfare of World War II displaced the trench warfare of World War I and rendered the Maginot Line strategically irrelevant. Indeed, the Maginot Line drew massive resources from the French military elsewhere, engendered an illusory sense of security, and enabled the Germans to craft a strategy in full view of the primary French defense deployments.[5] While the Maginot Line would have helped the French effort to win a war like World War I (a catastrophe for all concerned), it did little to prevent France's more catastrophic defeat in World War II, and even hastened the French defeat.[6]

The Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act or Dodd-Frank)[7] may prove as ineffective as the Maginot Line. It will likely foreclose a

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1 Gary Sheffield, *The Fall of France*, BBC (Sept. 8, 2010), http://www.bbc.co.uk/history/worldwars/wwtwo/fall_france_01.shtml.

2 *Id.*

3 *Id.*; JULIAN JACKSON, THE FALL OF FRANCE: THE NAZI INVASION OF 1940, at 26 (2003).

4 JACKSON, *supra* note 3, at 39.

5 *Id.* at 26–27.

6 J. E. KAUFMANN & H. W. KAUFMANN, FORTRESS FRANCE: THE MAGINOT LINE AND FRENCH DEFENSES IN WORLD WAR II 166 (2006); WILLIAM ALLCORN, THE MAGINOT LINE 1928–45, at 57 (2003).

7 *See generally* Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010).

subprime mortgage crisis like the one that nearly crashed global capitalism in the fall of 2008; however, it will not foreclose a future debt crisis that could well eclipse the financial crisis of 2007-2009 in terms of severity and macroeconomic pain.[8] The Dodd-Frank Act does nothing to address the underlying structure of globalization that creates incentives for excessive debt and impairs employment in the United States and throughout the developed world. This renders future debt crises inevitable. Banks have every incentive to enhance their profits (especially short-term profits that may support higher CEO compensation) while being exposed to excessive risks of the financial crisis.[9] Most importantly, the largest American banks continue to benefit from government subsidies under the too-big-to-fail legal construct that permits banks to privatize gains and socialize losses.[10] Banks can continue to manipulate risks and profits through the use of derivatives and securities trading for many years to come.[11] Thus, while Dodd-Frank may prevent another subprime crisis, it will prove unable to prevent a future, more serious debt crisis.[12] Indeed, it may render such a crisis more likely by transforming implicit guarantees for megabanks into explicit guarantees.[13]

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8 According to Noble laureate economist Joseph Stiglitz in an interview by Kerry O'Brien on ABC Australia:

> It can and it almost surely will happen again, because we didn't deal with the problem of too-big-to-fail banks. It is one of the reasons why it will happen again. And we didn't really deal effectively with all the kinds of excessive risk-taking, all the problems of lack of transparency that were at the core of this crisis. And so, yes, we understand what the issues are, we understand the issues better than we did three years ago, but politics intruded the power of the banks, was too great. They're making $20 billion off of derivatives. So rather than lending, they're engaged in all of these kinds of gambling and excessive risk-taking and generating large profits, but it's not helping the American economy and it's putting at risk American taxpayers.

The 7.30 Report: Troubles Ahead for World Economy, ABC (Austl.) (July 27, 2010), http://www.abc.net.au/7.30/content/2010/s2965891.htm.

9 Joseph E. Stiglitz, *Obama's Ersatz Capitalism*, N.Y. TIMES, Apr. 1, 2009, at A31.

10 Simon Johnson, *Banking's 'Toxic Cocktail' Is Too Big to Forget: Simon Johnson*, BLOOMBERG BUS. WK. (Jan. 26, 2011, 9:03 PM), http://www.businessweek.com/news/2011-01-26/banking-s-toxic-cocktail-is-too-big-to-forget-simon-johnson.html (opining that "the situation still is dire").

11 Louise Story, *A Secretive Banking Elite Rules Trading in Derivatives*, N.Y. TIMES, Dec. 12, 2010, at A1.

12 NOURIEL ROUBINI & STEPHEN MIHM, CRISIS ECONOMICS: A CRASH COURSE IN THE FUTURE OF FINANCE 239 (2010) (raising the prospect of sovereign debt defaults among the "risky rich" and concluding that such a crisis "may well take place in a disruptive, disorderly fashion" and, if so, "won't be pretty").

13 John B. Taylor, *The Dodd-Frank Financial Fiasco*, WALL ST. J., July 1, 2010, at A19 ("Effectively the bill institutionalizes the harmful bailout process by giving the

Part I of this article will explore the broad outlines (details will remain elusive) of such a future crisis in order to reveal the challenges facing legal reform. Part II will compare the risks highlighted in Part I with the key elements of Dodd-Frank as well as the gaps left unaddressed in Dodd-Frank. The article concludes that the Dodd-Frank Act will not help avert the next crisis and may well facilitate or exacerbate the next crisis. Much like the Maginot Line, Dodd-Frank encourages complacency, represents a massive diversion of resources and encourages bank managers to strategically flank its proscriptions. Dodd-Frank, unfortunately, limits itself to the last crisis, not to the next crisis.

I. THE CONTINUING PROBLEM OF EXCESSIVE DEBT

Debt continues to plague the global economy. In the United States, for example, while the rate of debt accumulation slowed during the crisis, it now seems poised to reaccelerate to levels that are even higher than those at the outset of the crisis.[14] The United States' current account deficit is increasing again, meaning that the nation continues to borrow hundreds of billions of dollars per annum from abroad.[15] The U.S. economy remains the consumer of last resort for the global economy, thereby fueling growth throughout the developing world. Since dollars earned from selling to the United States exceed those spent on buying from the same, the excess is plowed into U.S. debt instruments.[16] This constant demand for the purchase of U.S. debt instruments induces excessive debt in the United States by lowering interest rates on dollar denominated debt.[17] This debt funds higher consumption in the United States and the only question remaining today is when the next debt bubble will bust.

The former chief economist of the International Monetary Fund (IMF), Professor Simon Johnson, sees future debt problems arising from the recent extension of the Bush-era tax cuts. Specifically, Johnson argues that the recent bi-partisan agreement to extend the so-called Bush tax cuts "moved us closer

government more discretionary power to intervene . . . . The problem of 'too big to fail' remains, and any cozy relationship between certain large financial institutions and the government that existed before the crisis will continue.").

14 *U.S. Current Account Gap Widens*, INVESTOR'S BUS. DAILY, Dec. 17, 2010, at A2.

15 Peter Morici, *Morici: Japan Sound, U.S. Insolvent*, FOXBUSINESS.COM (Jan. 27, 2011), http://www.foxbusiness.com/markets/2011/01/27/peter-morici-japan-sound-insolvent/.

16 Don Lee, *Mountain of Economic Trouble Ahead?*, CHI. TRIB., June 20, 2010, at 3, *available at* http://articles.chicagotribune.com/2010-06-20/business/ct-biz-0620-global-economy-20100620_1_consumer-debt-global-economy-american-consumer.

17 Joseph E. Stiglitz, *Thanks to the Deficit, the Buck Stops Here*, WASH. POST, Aug. 30, 2009, at B3.

to a fiscal crisis, just as the euro zone now is experiencing."[18] The extension of those tax cuts will add $400 billion to the U.S. government's fiscal deficit in 2011, creating the second largest deficit since World War II.[19] The IMF found that the tax cuts would have little stimulative effect given their cost.[20] On January 28, 2011, Moody's threatened to downgrade the credit rating of the United States as early as 2013.[21] Usually, an economic crisis leads to chronic fiscal deficits for governments because an economic contraction means diminished tax revenues.[22] In the United States, the decision to cut taxes, even for the wealthiest, means deeper deficits with minimal countervailing economic benefit.[23]

The United States also faces problematic state and local debts. Like the federal government, state and local tax collections plunged during the financial crash and still hover below the pre-crisis level.[24] Expenditures increased in the face of more economic suffering and needs arising from increased unemployment and poverty.[25] Meredith Whitney, a bank analyst renowned for her prescient prediction of the financial collapse, projects a major crisis in the state and municipal bond markets.[26] Whitney recently claimed that up to one hundred municipal bond issuers may default, leading to hundreds of billions in losses.[27] She terms this problem "the single most important issue in the US, and certainly the largest threat to the US economy."[28] Credit rating agencies now warn that downgrades and increasing yields

18 Simon Johnson, *Tax Cutters Set Up Tomorrow's Fiscal Crisis: Simon Johnson*, BLOOMBERG.COM (Dec. 22, 2010, 6:00 PM), http://www.bloomberg.com/news/2010-12-23/tax-cutters-set-up-tomorrow-s-fiscal-crisis-commentary-by-simon-johnson.html.

19 Damian Paletta et al., *Deficit Outlook Darkens: Stark Warning for 2011 Fuels Battle Over Government Spending and Taxation*, WALL ST. J., Jan. 27, 2011, at A1.

20 Michael R. Crittenden, *IMF Urges U.S. to Take Fiscal Steps to Cut Deficit*, WSJ.COM (Jan. 27, 2011), http://online.wsj.com/article/SB10001424052748704268104576108123476047128.html.

21 Jed Graham, *U.S. Debt Shock May Hit in 2018, Maybe As Soon As 2013*, INVESTOR'S BUS. DAILY, May 6, 2010, at A1, *available at* http://www.investors.com/NewsAndAnalysis/Article.aspx?id=532490.

22 *Sharing the Pain: Dealing with Fiscal Deficit*, THE ECONOMIST, Mar. 6, 2010, *available at* http://www.economist.com/node/15604130.

23 Paul Krugman*, Let's Not Make a Deal*, N.Y. TIMES, Dec. 6, 2010, at A25.

24 Ezra Klein, *How Much Can We Blame on State Pensions?*, WASH. POST (Oct. 12, 2010), http://voices.washingtonpost.com/ezra-klein/2010/10/brooks_draft.html.

25 *Id.*

26 Nicole Bullock, *Spotlight Falls on US Cities' Fundraising*, FIN. TIMES, Jan. 26, 2011, at 4.

27 *Id.*

28 *Id.*

in the state and local bond markets will exacerbate funding challenges state and local governments are facing.[29]

Similarly, student loans will inexorably create more bank losses because of the dearth of job opportunities for graduates. Recently, student loan debt burgeoned past one trillion dollars and now exceeds credit card debt.[30] Unemployment among recent graduates soared in the wake of the financial crisis as salaries fell, with no significant recovery in sight.[31] Many student loans carry punitive, even predatory features.[32] With student debt at a record high, a wave of defaults appears inevitable and already reached an eleven-year high in 2008.[33] The exposure of the financial sector to student loan losses is unclear at best.[34] While many of these loans are guaranteed by the federal government, these losses do not disappear.[35] Rather, they exacerbate the risk of a sovereign debt crisis afflicting the federal government, as discussed above.

Many private student loans are held by the financial system which may well absorb further massive losses to bank capital. For example, according to economist Nouriel Roubini, who famously predicted the financial collapse in the fall of 2008, "one of the most important risks" facing the global economy is the "likely" spread of the Eurozone debt crisis to Portugal, Spain, and Belgium.[36] Moreover, the IMF and the stronger nations of Europe seemingly lack the resources to contain this crisis.[37] In affected nations, the economic crisis holds profound political implications and appears likely to topple governments.[38]

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29 Jeanette Neumann, *Global Finance: Warning From S&P on Munis*, WALL ST. J., Jan. 24, 2011, at C3.

30 Scott Cohn, *Student Loans Leave Crushing Debt Burden*, MSNBC.COM (Dec. 21, 2010, 7:39 PM), http://www.msnbc.msn.com/id/40772705/ns/business-cnbc_tv/.

31 Steven Greenhouse, *'Glimmers of Hope' for Grads*, N.Y. TIMES, May 25, 2010, at B1.

32 Mary Pilon, *The $555,000 Student-Loan Burden*, WALL ST. J. (Feb. 13, 2010), http://online.wsj.com/article/SB10001424052748703389004575033063806327030.html.

33 Hibah Yousuf, *Student Loan Default Rate Creeps Higher*, CNNMONEY.COM (Sept. 13, 2010, 11:47 AM), http://money.cnn.com/2010/09/13/pf/college/student_loan_default_rate/index.htm.

34 Eric Dash, *Citigroup to Sell Unit that Lends to Students*, N.Y. TIMES, Sept. 18, 2010, at B3.

35 *Student Loan Debt Slaves*, LIBERTY INSIGHT (Jan. 13, 2011), http://libertyinsight.com/2011/01/13/student-loan-debt-slaves/.

36 Michael Heath, *Roubini Sees Spread of Europe Debt Crisis Among Key 2011 Risks*, BLOOMBERG (Jan. 17, 2011), http://www.bloomberg.com/news/2011-01-17/roubini-sees-spread-of-europe-debt-crisis-among-key-2011-risks.html.

37 Nouriel Roubini, *Global Risk and Reward in 2011*, PROJECT SYNDICATE (Jan. 13, 2011), http://www.project-syndicate.org/commentary/roubini34/English.

38 Gavin Hewitt, *The Eurozone Crisis and the Voters*, BBC NEWS BLOG (Jan. 25, 2011, 1:05 PM), http://www.bbc.co.uk/blogs/thereporters/gavinhewitt/2011/01/

Currently, the Eurozone holds out hope that restructuring debts can resolve the crisis.[39] Such restructuring, however, is likely to trigger loss realization among Eurozone banks and lead to another source of stress on bank capital. European banks have a total exposure of twice their capital to sovereign debt of so-called peripheral European Union nations.[40] Thus, restructuring may well simply replace one debt crisis with another.

These sovereign credit issues may trigger massive losses throughout the global financial system. Because the government allowed the previous system of financial non-regulation and mis-regulation to fester unabated until the passage of the Dodd-Frank Act on July 21, 2010, bank exposure to these sources of financial losses are largely governed by the pre-Dodd-Frank regime.[41] Most importantly, it is impossible to surmise which banks have what exposure to losses arising from these sources of financial losses. Banks are largely able to gamble with this risk through the derivatives markets on a completely unregulated basis.[42] When losses from these sources are realized, bank capital could be compromised. This is particularly so, given that banks still face massive losses of unknown magnitude from before the period of 2007–2009.[43]

For example, bank capital remains under siege from the massive foreclosure crisis arising from the "utter carelessness" of the banks during the real estate boom.[44] Essentially, banks not only engaged in reckless underwriting of high-risk residential real estate loans, they also failed to document mortgages and repayment rights appropriately (destabilizing middle class

the_eurozone_crisis_and_the_vo.html.

39 *Europe Bends Over to Help Greece Rip Up Debts*, ASSOCIATED FOREIGN PRESS (Jan. 28, 2011), http://www.google.com/hostednews/afp/article/ALeqM5jXmo2b42waHr-ZKyfjOIPOiyQT_w?docId=CNG.6b94de75d88998f6d0176a48ce43503c.191.

40 John Paul Rathbone, *Eurozone Can Learn Grim Latin Lessons*, FIN. TIMES (Dec. 21, 2010, 11:20 PM), http://www.ft.com/cms/s/0/ac9b6954-0d33-11e0-82ff-00144feabdc0.html#axzz1CgfvDT9H.

41 The Dodd-Frank Act was signed into law by President Obama on July 21, 2010. *See Bill Summary & Status*, LIBRARY OF CONGRESS, http://thomas.loc.gov/cgi-bin/bdquery/z?d111:HR04173:@@@R (last visited Mar. 22, 2011). Therefore, the banking industry was governed by pre-Dodd-Frank regime prior to July 21, 2010.

42 David Min & Pat Garafalo, *Regulating Derivatives Traffic: Establishing Speed Limits and Traffic Lights to Improve Derivatives Safety*, CTR. FOR AM. PROGRESS (Apr. 19, 2010), http://www.americanprogress.org/issues/2010/04/derivatives_traffic.html.

43 Martin Jacques, *The New Depression*, NEW STATESMAN (Feb. 12, 2009), *available at* http://www.newstatesman.com/economy/2009/02/financial-crisis-china-banks.

44 U.S. Bank, Nat'l Ass'n v. Ibanez, 941 N.E.2d 40, 55 (Mass. 2011) (Cordy, J., concurring) ("[W]hat is surprising about these cases is not the statement of principles articulated by the court regarding title law and the law of foreclosure in Massachusetts, but rather the utter carelessness with which the plaintiff banks documented the titles to their assets.").

property rights along the way).[45] The entire industry used fictitious mortgagees on recorded mortgage documents to evade state and local recording fees.[46] Banks seem to have lost (or at least failed to negotiate to purchasers) huge numbers of negotiable instruments such that many mortgage debts suffer impaired enforcement.[47] According to bank analyst Chris Whalen, the banks will suffer debilitating losses as a result of this recklessness for years to come akin to a kind of "cancer" on their financial health.[48] This cancer will impair bank earnings and balance sheets for years to come. This will compound losses flowing into the financial sector from the continued meltdown of residential real estate into 2011.[49] Banks still hold exposure to trillions of dollars in residential real estate loans, most of which now suffer from impaired valuation.[50]

As the residential real estate market continues to melt down, banks face numerous other challenges. The commercial real estate market may inflict billions more in losses on the financial sector. Despite bank efforts to "extend and pretend" that commercial loans are not troubled, a record high amount of commercial loans are in default.[51] Nearly one trillion dollars of consumer debt suffers from serious delinquency.[52] Low interest rates impair net interest income as margins shrink.[53] Thus,

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45 Barry Ritholz, *Foreclosure Fraud Reveals Structural & Legal Crisis*, ROUBINI GLOBAL ECONOMICS (Oct. 10, 2010, 12:48 PM), http://www.roubini.com/us-monitor/259737/foreclosure_fraud_reveals_structural___legal_crisis.

46 *See generally* Christopher L. Peterson, *Foreclosure, Subprime Mortgage Lending, and the Mortgage Electronic Registration System*, 78 U. CIN. L. REV. 1359 (2010) (analyzing MERS, a nominee mortgage holder which was created by banking industry to evade recording fees, and how it conflicts with laws and policy).

47 Gretchen Morgenson & Andrew Martin, *Battle Lines Forming in Clash Over Foreclosures*, N.Y. TIMES, Oct. 21, 2010, at A1.

48 Interview by Bloomberg with Christopher Whalen, Managing Director, Inst. Risk Analytics (Oct. 18, 2010), *available at* http://www.bloomberg.com/video/63795070/.

49 Alejandro Lazo, *Home Prices Decline in November*, L.A. TIMES BLOG (Jan. 25, 2011, 6:28 AM), http://latimesblogs.latimes.com/money_co/2011/01/home-prices-declined-in-november.html.

50 Steven A. Ramirez, *Are the Megabanks Insolvent?*, CORPORATE JUSTICE BLOG, (Nov. 23, 2010, 3:36 PM), http://corporatejusticeblog.blogspot.com/2010/11/are-megabanks-insolvent.html.

51 Julie Satow, *'Bad Boy' Guarantees Snarl Billions in Real Estate Debt*, N.Y. TIMES, Jan. 19, 2011, at B9.

52 Christine Ricciardi, *More Current Mortgages Go Delinquent in 3Q as Household Debt Falls*, HOUSINGWIRE, Nov. 8, 2010, *available at* http://www.housingwire.com/2010/11/08/more-current-mortgages-go-delinquent-in-3q-as-household-debt-falls.

53 *See* Joe Rauch, *Corrected: Wells and US Bancorp Profits Up but Margins Squeezed*, REUTERS (Jan. 19, 2011), http://www.reuters.com/article/2011/01/19/us-lvabanks-earnings-idUSTRE70I5SJ20110119?pageNumber=2.

experts evince serious concern that many banks, particularly the most risky megabanks, flirt with insolvency.[54]

Further, economic growth appears unlikely to rescue the banks. Consumer deleveraging will continue to suppress demand for quite some time.[55] While the government seemingly mustered endless resources to save a handful of banks, government programs to help the great mass of American citizens can only be termed modest at best.[56] Unemployment rivals the joblessness during the Great Depression, with little relief expected.[57] Government spending seems destined to contract as austerity rhetoric takes hold.[58] Finally, the banks themselves continue to hoard capital in the form of excess reserves which now total one trillion dollars.[59] Economic pessimism and concerns regarding financial markets caused non-financial firms to hoard nearly two trillion dollars more.[60] All of this suggests continued economic sluggishness, more losses on outstanding debt, and therefore more bank losses.

The United States faces a crisis. Its banking and financial sector fails to lend, and lending plays a crucial role in growth.[61]

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54 William K. Black & L. Randall Wray, *Foreclose on the Foreclosure Fraudsters, Part I: Put Bank of America in Receivership*, HUFFINGTON POST (Oct. 22, 2010, 2:08 PM), http://www.huffingtonpost.com/william-k-black/foreclose-on-the-foreclos_b_772434.html; Simon Johnson, *Time for Some New Stress Tests for Banks*, N.Y. TIMES ECONOMIX BLOG (Oct. 21, 2010, 5:00 AM), http://economix.blogs.nytimes.com/2010/10/21/time-for-some-new-stress-tests-for-banks/. *See also* CONG. OVERSIGHT PANEL, NOVEMBER OVERSIGHT REPORT: EXAMINING THE CONSEQUENCES OF MORTGAGE IRREGULARITIES FOR FINANCIAL STABILITY AND FORECLOSURE MITIGATION 3 (2010), *available at* http://www.gpo.gov/fdsys/pkg/CPRT-111JPRT61835/pdf/CPRT-111JPRT61835.pdf (assessing foreclosure crisis and concluding that "[b]ank regulators should also conduct new stress tests on Wall Street banks to measure their ability to deal with a potential crisis").

55 James Saft, *Good-bye Credit Crunch, Hello Slog*, REUTERS BLOG (Jan. 25, 2011, 9:04 AM), http://blogs.reuters.com/jim-saft/2011/01/25/good-bye-credit-crunch-hello-slog/.

56 Jean Braucher, *Humpty Dumpty and the Foreclosure Crisis: Lessons from the Lackluster First Year of the Home Affordable Modification Program (HAMP)*, 52 ARIZ. L. REV. 727, 787–88 (2010).

57 Ann Saphir, *Cleveland Fed: US Jobless Rate Likely to Stay High*, REUTERS (Jan. 31, 2011), http://www.reuters.com/article/2011/01/31/usa-fed-unemployment-idINN3123119920110131.

58 *See* Martin Crutsinger, *Builders Began Work on Fewer Projects in 2010*, KANSASCITY.COM (Feb. 1, 2011, 9:18 AM), http://www.kansascity.com/2011/02/01/2624194/builders-began-work-on-fewer-projects.html ("Spending on government projects fell in December 2.8 percent. State and local spending dropped 1.8 percent and spending by the federal government plunged 11.6 percent to the lowest level since October 2004.").

59 Silvio Contessi, *Are Bank Reserves and Bank Lending Connected?*, MONETARY TRENDS (Feb. 2011), http://research.stlouisfed.com/publications/mt/20110201/cover.pdf.

60 Justin Lahart, *Companies Cling to Cash: Coffers Swell to 51-Year High as Cautious Firms Put Off Investing in Growth*, WALL ST. J., Dec. 10, 2010, at A1, *available at* http://online.wsj.com/article/SB10001424052748703766704576009501161973480.html.

61 This contraction of credit predictably arose from a financial sector facing capital depletion even after a bailout as incumbent bank managers (who logically should have

Its economy fails to generate jobs.[62] Yet the economy faces a debt burden on par with the level of debt on the eve of the subprime crisis.[63] The financial sector faces staggering losses from a variety of sources. The entire global economy bears too much debt.[64] Another debt crisis appears inevitable. When this crisis hits, creditors will flee for safety and credit costs for the entire economy will soar as they did in 2008. At that point, markets will need to reckon with the fiscal position of the U.S. government. The key issue will be whether the U.S. government will rescue the megabanks again. Dodd-Frank suggests that the government will do precisely that, as shown below.[65] Then, the riskiness of the megabanks will once again privatize gains and socialize losses, which would culminate into a crisis that could make the subprime crisis seem like an appetizer to a far more grand main course.

II. THE FAILURES OF DODD-FRANK

The Dodd-Frank Act creates a toxic mix of affirmatively dangerous statutory law, while at the same time failing to address key structural causes of the financial crisis. The continued presence of toxic debt, for example, is a direct function of a flawed model of globalization that Dodd-Frank (indeed, our entire political leadership) left unaddressed. Under Dodd-Frank, the perverse incentives created by too-big-to-fail and the primary arenas for such incentives will continue to operate unimpeded for at least years to come. Finally, Dodd-Frank leaves the same inept bank managers in power at the apex of our economy and

been terminated in the wake of their reckless stewardship) sought to conceal the full extent of losses and become very risk-averse in order to maintain their incumbency. Steven A. Ramirez, *Subprime Bailouts and the Predator State*, 35 DAYTON L. REV. 81, 96–101 (2009).

62 Jon Hilsenrath, *Messy New Estimates Complicate Explanation for Unemployment Rate Drop*, WSJ.COM BLOG (Feb. 4, 2011, 1:12 PM), *available at* http://blogs.wsj.com/economics/2011/02/04/messy-new-estimates-complicate-explanation-for-unemployment-rate-drop/.

63 Annaly Capital Management, *Charts of the Day: The New Z.1 is Out!*, CREDIT WRITEDOWNS (Sept. 21, 2010, 5:00 PM), http://www.creditwritedowns.com/2010/09/charts-of-the-day-the-new-z-1-is-out.html.

64 Daniel Fisher, *The Global Debt Bomb*, FORBES (Feb. 8, 2010, 12:00 AM), http://www.forbes.com/forbes/2010/0208/debt-recession-worldwide-finances-global-debt-bomb.html.

65 Treasury Secretary Timothy Geithner recently admitted that in the event of another credit crisis "we may have to do exceptional things again." OFFICE OF THE SPECIAL INSPECTOR GENERAL FOR THE TEMPORARY ASSET RELIEF PROGRAM, QUARTERLY REPORT TO CONGRESS 10 (Jan. 26, 2011) ("To the extent that those 'exceptional things' include taxpayer-supported bailouts, his acknowledgement serves as an important reminder that TARP's price tag goes far beyond dollars and cents, and that the ultimate cost of TARP will remain unknown until the next financial crisis occurs.").

financial system despite proof positive of their willingness to inflict massive and reckless risks upon our system in exchange for short-term gains and concomitant compensation payments.[66]

A. Fundamentally Flawed Globalization

The global economy relies upon the U.S. dollar as its reserve currency, and this central flaw means excessive accumulation of debt in the United States and the developed world generally.[67] As issuer of the reserve currency, the United States must act as borrower of last resort and consumer of last resort for the global economy.[68] The problem is that it cannot sustainably fulfill this role any longer and the dollar reserve system is now breaking down in a sea of debt that will trigger serial crises.[69] Over two years after the greatest debt crisis in our history, the global economy is still rigged to create excessive debt within the United States.[70] Further, the dollar reserve system weakens demand within the global economy which contributes to the loss of jobs in the United States.[71] Dodd-Frank fails to address this dynamic in any way whatsoever and therefore can only be termed a failure of political will.[72] This failure of political will, in turn, represents the powerful interests that continue to benefit from this flawed

66 Raghuram Rajan, *Banker's Pay Is Deeply Flawed*, FIN. TIMES (Jan. 8, 2008), http://us.ft.com/ftgateway/superpage.ft?news_id=fto010920081142101282 (noting the incentives for CEOs and financial managers to tolerate excessive risks that increase short-term returns in order to receive immediate compensation).

67 JOSEPH E. STIGLITZ, MAKING GLOBALIZATION WORK 245–68 (2006) [hereinafter STIGLITZ, MAKING GLOBALIZATION WORK].

68 *Id.* at 265.

69 *Id.* at 254–56.

70 Aaron Task, *Cruel Irony: Dollar's Reserve Status Enables U.S. Debt Addiction*, YAHOO! FINANCE (Feb. 3, 2011, 8:00 AM), http://finance.yahoo.com/tech-ticker/cruel-irony-dollar%27s-reserve-status-enables-u.s.-debt-addiction-535886.html. *See also* Joseph Stiglitz, *Towards a New Global Reserve System*, *in* ASIAN DEVELOPMENT BANK, THE FUTURE GLOBAL RESERVE SYSTEM—AN ASIAN PERSPECTIVE 1, 2 (Jeffrey D. Sachs et al. eds., 2010), *available at* http://aric.adb.org/grs/papers/Future_Global_Reserve_System.pdf (showing that "the dollar reserve system contributed to global financial instability and a weak global economy" because "the reserve currency country got increasingly in debt as others held more of its IOUs as part of their reserves" and "the build-up of reserves by surplus countries led to weaknesses in global aggregate demand").

71 *See* Stiglitz, *Towards a New Global Reserve System*, *supra* note 70, at 2.

72 According to Fed Chair Ben Bernanke:

> One way or the other, fiscal adjustments sufficient to stabilize the federal budget must occur at some point. The question is whether these adjustments will take place through a careful and deliberative process that weighs priorities and gives people adequate time to adjust to changes in government programs or tax policies, or whether the needed fiscal adjustments will be a rapid and painful response to a looming or actual fiscal crisis.

Ben Bernanke, Chairman, Fed. Reserve, Speech before the National Press Club: The Economic Outlook and Macroeconomic Policy (Feb. 3, 2011), *available at* http://www.federalreserve.gov/newsevents/speech/bernanke20110203a.htm.

model of globalization—CEOs of transnational corporations, particularly in the United States.[73]

Dodd-Frank fails to address the problems arising from this deeply flawed model of globalization. Indeed, although the Act mandates at least sixty-seven studies from various agencies, it does not require any study of the impact of globalization or the dollar reserve system.[74] This is despite the fact that many prominent economists and other commentators proposed sensible solutions to the problem both before and after the crisis. For example, Joseph Stiglitz recently highlighted a "remarkably simple solution" (first proposed by John Maynard Keynes) to the problem of reserves: allow the IMF to issue Special Drawing Rights (SDRs) to act as a reserve currency so that no single nation would bear the burden of the concomitant debt.[75] I recently expanded upon this proposal and argued that this new issuer of a new reserve currency could act as a bank, and leverage these currency reserves through fractional banking to fund low-cost loans for high pay-off development initiatives that could vindicate economic human rights.[76] This would divert reserves from funding excessive debt in the United States to funding sustainable global growth.

B. Too-Big-to-Fail Endures

If credit markets perceive that a bank will not be allowed to fail due to government intervention or guarantees, then creditors will supply more credit at a lower cost. Further, managers will tolerate excessive risk because they anticipate that gains are privatized while losses are socialized through government backing.[77] Since the enactment of Dodd-Frank, there is

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73 Steven A. Ramirez, *American Corporate Governance and Globalization*, 18 BERKELEY LA RAZA L.J. 47, 63 (2007).

74 The SEC, CFTC, FDIC and Federal Reserve System each maintain websites detailing the reports and studies they issue. *See Reports and Studies*, U.S. COMMODITY FUTURES TRADING COMM'N, http://www.cftc.gov/LawRegulation/DoddFrankAct/ReportsandStudies/index.htm (last visited Mar. 16, 2011); *Implementing Dodd-Frank Wall Street Reform and Consumer Protection Act—Accomplishments*, U.S. SEC. EXCH. COMM'N, http://www.sec.gov/spotlight/dodd-frank/accomplishments.shtml (last visited Mar. 16, 2011); *FDIC and Financial Regulatory Reform*, FED. DEPOSIT INS. CORP., http://www.fdic.gov/regulations/reform/ (last visited Mar. 16, 2011); *Regulatory Reform*, FED. RESERVE., http://www.federalreserve.gov/newsevents/reform.htm (last visited Mar. 16, 2011); Christine Harper, *Crash of 2015 Won't Wait for Regulators to Rein in Wall Street*, BLOOMBERG (Aug. 8, 2010, 5:48 PM), http://www.bloomberg.com/news/2010-08-09/crash-of-2015-won-t-wait-for-regulators-to-buckle-wall-street-safety-belts.html.

75 STIGLITZ, MAKING GLOBALIZATION WORK, *supra* note 67, at 260.

76 Steven A. Ramirez, *Taking Economic Rights Seriously after the Debt Crisis*, 42 LOYOLA U. CHI. L.J. (forthcoming 2011).

77 Ramirez, *supra* note 61, at 82.

increasing skepticism that the Act will prevent future bailouts of large financial firms in a manner different from the ad hoc bailouts of late 2008.[78] The statutory details of the Dodd-Frank Act belie any claim that it ended bailouts for firms deemed too-big-to-fail.[79]

Section 1101 paves the way for the Fed to bail out large banks, so long as it does so pursuant to a program or facility that features "broad-based eligibility."[80] Indeed, the Act directs the Fed and the Treasury to create emergency lending programs and facilities "[a]s soon as practicable."[81] Similarly, section 1105 of the Act directs the FDIC, in consultation with the Secretary of Treasury, to create a "widely available program to guarantee obligations of solvent insured depository institutions or solvent depository institution holding companies (including any affiliates thereof) during times of severe economic distress. . . ."[82] As a result, after Dodd-Frank, virtually every type of bailout pursued by the Fed and the FDIC that occurred between 2007 and 2009 will now be more explicitly and more broadly available.[83] Ironically, Dodd-Frank therefore mandates more "broad-based" and "widely available" bailouts.[84]

Dodd-Frank also includes an "Orderly Liquidation Authority" (OLA) for large, systemically significant firms that appear poised to "default."[85] Such firms may be placed into FDIC receivership, but only upon a vote of at least: (1) 2/3 of the members of the Federal Reserve Board of Governors, (2) 2/3 of the members of the board of directors of the FDIC, and (3) a written recommendation of the Treasury Secretary (made in consultation with the President).[86] As receiver, the FDIC holds

78 *The Ruling Ad-Hocracy*, WALL ST. J., Jan. 21, 2011, at A12.

79 *Text of Obama Remarks on Dodd-Frank*, MARKETWATCH (Jul 21, 2010, 11:43 AM), http://www.marketwatch.com/story/text-of-obama-remarks-on-dodd-frank-2010-07-21.

80 *Title XI Overview: 11.1 Emergency Lending Authority to Be Used Only to Provide Broad-based Liquidity*, AM. BANKERS ASS'N, http://www.aba.com/RegReform/RR11_1.htm (last visited Mar. 21, 2011).

81 Dodd-Frank Act § 1101. Section 1101 amends section 13(3) of the Federal Reserve Act, which operated as the primary mechanism of bailouts through the use of funds supplied by the Federal Reserve System. Christian A. Johnson, *Exigent and Unusual Circumstances: The Federal Reserve and the U.S. Financial Crisis*, 11 EUR. BUS. ORG. L. REV. (forthcoming 2011), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1584731.

82 Dodd-Frank Act § 1105.

83 *See* Johnson, *supra* note 81 ("Under the Dodd-Frank Act amendment, it would appear that the Federal Reserve would have been unable to lend directly to Bear Stearns or AIG unless Bear Stearns or AIG would have otherwise qualified for the terms of a facility or program in place 'with broad-based eligibility.'").

84 Dodd-Frank Act §§ 1101, 1105.

85 Dodd-Frank Act § 203(b).

86 *Id.* Recently President Obama named William Daley, Midwest Chairman of JP

total managerial power and succeeds by operation of law to all powers of the stockholders, officers, and directors.[87] The FDIC thus controls all aspects of a firm's business, including decisions whether to liquidate or sell the company or parts of the company.[88] The FDIC may make loans to guarantee assets or obligations or to purchase assets of any financial company put into FDIC receivership under this authority.[89] This further expands bailout powers.[90] The Act includes provisions designed to conceal this form of bailout; however, in the end creditors do not face a real prospect of loss in a crisis due to government funding.[91] If senior executives or directors of a firm are "substantially responsible" for the failure of the firm, whether by gross negligence or disregard of a duty of care, any compensation they received within two years of receivership may be recouped by the FDIC.[92] This OLA process consequently could dissuade mangers from excessive risk. Nevertheless, most firms will never enter that process due to the multiple approvals necessary to trigger the process and the political influence of the financial sector.[93]

Dodd-Frank also gives regulators the power to break up systemically risky firms. Ultimately, keeping banks from

Morgan Chase & Co., as his new Chief of Staff. Becky Yerak, *William Daley Becomes White House's Business Connection*, CHI. TRIB. (Jan. 31, 2011), http://articles.chicagotribune.com/2011-01-31/business/ct-biz-0131-daley-chase-20110131-137_1_william-daley-jpmorgan-chase-business-connection ("'It's a big plus for the banking industry,' . . . banking analyst Richard Bove said of Daley's move to the White House earlier this month. 'The fact that a banker is chief of staff is going to change the rhetoric dramatically. With Daley there, JPMorgan will benefit, along with every other bank.'").

87 Dodd-Frank Act § 210(a)(1)(A).

88 Dodd-Frank Act § 210(a)(1). Should the government ever muster the political will, this provision paves the way to fragment the megabanks the next time they flirt with insolvency. Unfortunately, the FDIC too often exercises its managerial powers to create even larger banks. *See* David Mildenberg, *Citigroup Agrees to Buy Wachovia's Banking Business*, BLOOMBERG (Sept. 29, 2008), http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aWwkv.J3bhY4.

89 Dodd-Frank Act § 204(d). Under section 206, these actions must be for the purpose of financial stability, not for the benefit of any particular company, and must be approved by the Treasury under section 210(n)(9).

90 *See* Taylor, *supra* note 13 ("The FDIC does not have the capability to take over large, complex financial institutions without causing disruption, so such firms and their creditors are likely to be bailed out again.").

91 Robert J. Shiller, *Bailouts, Reframed as 'Orderly Resolutions'*, N.Y. TIMES, Nov. 14, 2010, at BU5.

92 Dodd-Frank Act §§ 210(f), 203(c)(2)(s).

93 SIMON JOHNSON & JAMES KWAK, 13 BANKERS: THE WALL STREET TAKEOVER AND THE NEXT FINANCIAL MELTDOWN 6 (2010). According to Senate Majority Whip Dick Durbin, the banking industry is the "most powerful lobby" and they "frankly own the place." Representative Collin C. Peterson, the former Chair of the House Agriculture Committee, claims that they "run the place." Ramirez, *supra* note 61, at 81.

growing too large limits their economic and political influence.[94] As a result, commentators greeted this part of the Act with some degree of optimism.[95] However, section 121 requires a determination by the Fed that a firm poses a "grave threat" to financial stability as well as the approval of 2/3 of the newly created Financial Stability Oversight Board.[96] No divestiture can proceed without the Fed finding that other mitigatory actions are "inadequate" for addressing threats to financial stability.[97] Thus, divestiture must be a last resort after all other options are exhausted, and this presumably is subject to judicial review. Notably, all of the too-big-to-fail banks that the government rescued in 2008 are even larger today.[98] Further, they remain dangerously leveraged.[99] As such, they all have proven to pose a grave threat to financial stability, with little or no countervailing economic benefit.[100] Yet no action to mitigate that threat is

94 In fact, the FDIC routinely manages large banks in the context of traditional failed bank receiverships without severe economic or financial consequences. The largest such receivership to date is WaMu Savings Bank with $307 billion in assets, which occurred at the height of the financial crisis with minimal impact. Robin Sidel et al., *WaMu Is Seized, Sold Off to J.P. Morgan, In Largest Failure in U.S. Banking History*, WALL ST. J., Sep. 26, 2008, at A1.

95 Simon Johnson, *A Roosevelt Moment for America's Megabanks?*, PROJECT SYNDICATE (July 14, 2010), http://www.project-syndicate.org/commentary/johnson10/English.

96 *See* Dodd-Frank Act § 121.

97 *See id.*

98 Thomas M. Hoenig, Op-Ed., *Too Big to Succeed*, N.Y. TIMES, Dec. 2, 2010, at A37 ("[T]he five largest financial institutions are 20 percent larger than they were before the crisis. They control $8.6 trillion in financial assets—the equivalent of nearly 60 percent of gross domestic product. Like it or not, these firms remain too big to fail.").

99 Anat R. Admati, *Should Mega Banks Be Broken Apart?: Bankruptcy Is Not an Option*, N.Y. TIMES (Jan. 28, 2011, 4:05 PM), http://www.nytimes.com/roomfordebate/2010/12/07/should-megabanks-be-broken-apart/bankruptcy-is-not-an-option. Numerous studies demonstrate that banks should be required to hold much more capital than they are currently required by law to hold or what they will be required to hold under the Basel III international capital accords. *See generally* David Miles et al., *Optimal Bank Capital, Discussion Paper No. 31,* BANK OF ENGLAND, (Jan. 2011), http://www.bankofengland.co.uk/publications/externalmpcpapers/extmpcpaper0031.pdf; Anat R. Admati et al., *Fallacies, Irrelevant Facts, and Myths in the Discussion of Capital Regulation: Why Bank Equity Is Not Expensive* 4 (Stan. Grad. Sch. of Bus., Research Paper No. 2065, 2011), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1669704. ("Setting equity requirements significantly higher than the levels currently proposed would entail large social benefits and minimal, if any, social costs."). Thus, not only does the United States continue to suffer from too-big-to-fail banks, but these banks are also significantly undercapitalized.

100 Simon Johnson, *Should Megabanks Be Broken Apart?: We Haven't Learned From Ireland*, N.Y. TIMES (Dec. 7, 2010), http://www.nytimes.com/roomfordebate/2010/12/07/should-megabanks-be-broken-apart/we-havent-learned-from-ireland ("There are no economies of scale or scope in banking over about $100 billion in assets. [There is not] a single piece of evidence that society gains from having megabanks at today's scale and with today's leverage.").

pending, much less any break-up. Break-ups consequently appear remote.

Creditors have already concluded that Dodd-Frank preserves the too-big-to-fail subsidies and therefore will fuel the continued growth of such banks with cheaper capital. In fact, due to the presence of government backing, the credit ratings agencies specifically give the megabanks much higher credit ratings than otherwise, notwithstanding Dodd-Frank.[101] Thus, according to Neil Barofsky, the Special Inspector General of the TARP program: "These [too-big-to-fail] institutions and their leaders are incentivized to engage in precisely the sort of behavior that could trigger the next financial crisis, perpetuating a doomsday cycle of booms, busts and bailouts."[102] As economist Simon Johnson puts it: "If the big banks get large enough, we'll become like Ireland today—saving those institutions will ruin us fiscally, destroy the dollar as a haven currency, and end financial life as we know it."[103]

Professor Arthur E. Wilmarth, Jr. also concludes that "Dodd-Frank does not solve the [too-big-to-fail] problem." [104] He concurs that too many avenues remain open for regulators to rescue creditors of large banks, and that those regulators now have a proven track record of indulging powerful banking interests, such as managers of too-big-to-fail megabanks.[105] Finally, Professor Wilmarth echoes economists such as Joseph Stiglitz: "There is an obvious solution to the too-big-to-fail banks: break them up. If they are too big to fail, they are too big to exist."[106] Thus, Congress ignored the thinking of leading academics and economists and instead preserved the economic and political power of the most reckless bankers in U.S. history, despite their

101 Ronald D. Orol, *'Too Big to Fail' a Recipe for Disaster, Watchdog Says*, MARKET WATCH (Jan. 25, 2011, 6:47 PM), http://www.marketwatch.com/story/too-big-to-fail-a-recipe-for-disaster-watchdog-2011-01-26?reflink=MW_news_stmp.

102 *Id.*

103 Simon Johnson, *'Citi Weekend' Shows Too-Big-to-Fail Endures: Simon Johnson*, BLOOMBERG BUS. WK. (Jan. 17, 2011, 9:10 PM), http://www.businessweek.com/news/2011-01-17/-citi-weekend-shows-too-big-to-fail-endures-simon-johnson.html.

104 Arthur E. Wilmarth, Jr., *The Dodd-Frank Act: A Flawed and Inadequate Response to the Too-Big-to-Fail Problem*, 89 OR. L. REV. 3 (forthcoming 2011), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1719126.

105 *Id.*

106 JOSEPH E. STIGLITZ, FREEFALL: AMERICA, FREE MARKETS, AND THE SINKING OF THE WORLD ECONOMY 165–66 (2010). *See also* SIMON JOHNSON & JAMES KWAK, *supra* note 93, at 221 ("The best defense against a massive financial crisis is a popular consensus that too big to fail is too big to exist."); ROUBINI & MIHM, *supra* note 12, at 226 ("[N]ot only are such firms too-big-to-fail; they're too big to exist, and too complex to manage properly.").

central role in causing the crisis.[107] To the extent politicians sold Dodd-Frank as the end of taxpayer-funded bailouts for large financial firms, it may well prove a monumental political fraud.[108]

C. The Derivatives and Hedge Fund Casino is Open Too Late

Derivatives are complex financial contracts that derive their value by reference to some other securities, commodities or debt instruments.[109] Hedge funds are private pools of capital that may invest or speculate in the full range of financial products.[110] Hedge funds and derivatives exposed banks to massive losses that were not transparent to regulators, often because of the fact that much of this activity occurred through unregulated affiliates.[111] A review of Dodd-Frank regarding derivatives and securities prohibitions illustrates that banks may continue to gamble with derivatives and other complex securities and hedge fund "investment" for years to come.[112]

Under section 716, banks are generally prohibited from using derivatives.[113] But, there is an exception for "bona fide hedging and traditional bank activities."[114] This exception apparently would include eighty percent of the derivatives market.[115] The prohibition on derivatives in this section does not even take effect until July 21, 2012.[116] Further, the prohibition regarding bank derivative activities may be extended until July 21, 2014, or possibly as late as July 21, 2015.[117] Finally, banks may continue to trade derivatives through affiliates in accordance with Federal Reserve strictures.[118] Thus, all of the derivative trading that fueled the crisis will continue for at least

107 *See* Arthur E. Wilmarth, Jr., *The Dark Side of Universal Banking: Financial Conglomerates and the Origins of the Subprime Financial Crisis*, 41 CONN. L. REV. 963, 1032–43 (2009).

108 *Watchdog Disputes White House Claim that Wall Street Reform Will End Taxpayer Bailouts*, ABCNEWS (Jan. 27, 2011, 10:02 AM), http://blogs.abcnews.com/thenote/2011/01/watchdog-disputes-white-house-claim-that-wall-street-reform-will-end-taxpayer-bailouts.html.

109 Dodd-Frank Act § 716.

110 *Id.*

111 CCH, DODD-FRANK WALL STREET REFORM AND CONSUMER PROTECTION ACT: LAW, EXPLANATION AND ANALYSIS 30–31 (2010).

112 *Id.* at 28.

113 Dodd-Frank Act § 716.

114 *Id.*

115 Orrick, *Wall Street Transparency and Accountability Act of 2010*, FINANCIAL MARKETS ALERT, July 21, 2010, at 3–4, *available at* http://www.orrick.com/fileupload/2833.pdf.

116 Dodd-Frank Act § 716(h).

117 Dodd-Frank Act § 716(f).

118 Dodd-Frank Act § 716(c).

four years, and most derivatives trading will be permissible for banks thereafter. Moreover, during that hiatus, banks can be counted on to use their considerable political influence to further dilute the derivatives prohibitions.[119]

Section 723 mandates that derivatives transactions be cleared, but regulators have one year for promulgating a process by which determinations are made for which derivatives must be cleared and which ones may remain over-the-counter.[120] Specifically, the U.S. Commodity Futures Trading Commission and the Securities Exchange Commission must "review each swap, or any group, category, type, or class of swaps to make a determination as to whether the swap or group, category, type or class of swaps should be required to be cleared."[121] The following factors, among others, bear upon this determination: (1) liquidity for given type of derivative, (2) pricing data, and (3) effect on systemic risk. If no facility wishes to clear a type of derivative then no clearing is necessary.[122] Thus, highly customized derivatives likely need not be cleared. Again, the exceptions threaten to swallow the rule, and much depends upon regulatory rule-making.[123] Further, the clearinghouses themselves may now be too-big-to-fail because if they were to fail the banks would be exposed to huge losses.[124] To the extent that the large banks that control a huge portion of derivatives trading are the most influential members of the new derivatives exchanges, the entire effort to shift counterparty risk of default to the clearinghouses could lead to even bigger bailouts.[125] Rather than controlling risk through clearing of derivatives, Dodd-Frank may give the large banks even more power.

The Act's approach to securities trading and bank hedge fund activities similarly proves relatively toothless. Under section 619, banks cannot engage in proprietary trading or invest in hedge funds.[126] The Fed, however, may permit bank

119 John Carney, *Blanche Lincoln Is Gone. Will Dodd-Frank Derivatives Rules Be Next?*, CNBC (Nov. 4, 2010, 11:44 AM), http://www.cnbc.com/id/40007299/Blanche_Lincoln_Is_Gone_Will_Dodd_Frank_Derivatives_Rules_be_Next.

120 Dodd-Frank Act § 723.

121 *Id.*

122 *Id.*

123 Aline Van Duyn, *Derivatives Still in Flux as Dodd-Frank Deadline Looms*, FIN. TIMES (Jan. 28, 2011, 9:19 PM), http://www.ft.com/cms/s/0/6211d098-2b07-11e0-a65f-00144feab49a.html#axzz1HJV8vyP3.

124 Gretchen Morgenson, *Count on Sequels to TARP*, N.Y. TIMES, Oct. 3, 2010, at BU1.

125 Louise Story, *A Secretive Banking Elite Rules Trading in Derivatives*, N.Y. TIMES, Dec. 12, 2010, at A1.

126 Dodd-Frank Act § 619(a).

investments in illiquid hedge funds or private equity funds until 2022.[127] Liquid funds may be held until 2017.[128] Indeed, nothing changes at all until October of 2012, and no divestitures are required until October of 2014, at the earliest.[129] While some transition time may be warranted, a spin-off to shareholders or public investors could certainly occur within a year.[130] In any event, bank capital will continue to be exposed to securities trading and hedge funds for many years notwithstanding the so-called Volcker Rule.[131]

The second problem is the exceptions to the trading and hedge fund ban under section 619.[132] Hedging, underwriting and market-making activities are permissible.[133] Banks may still continue to organize and offer hedge funds and private equity funds. They may still devote up to three percent of their capital to trading and hedge fund investments.[134] The regulators may further permit trading and investments that promote "the safety and soundness of the banking entity . . . and the financial stability of the United States."[135] These exceptions may well operate to swallow the rule when it takes effect in coming years and decades. Even the intellectual father of these rules—former Fed Chair Paul Volcker—remains dissatisfied with the so-called Volcker Rule.[136]

This approach toward securities and derivatives trading exacerbates the fundamental distortion toward risk. The exceptions to the prohibition of derivatives trading within banks swallow the rule. The Act allows banks to trade securities and invest in hedge funds into the next decade. Thus, the Act gives large banks a subsidized cost of capital while largely preserving their ability to gamble in the derivatives and securities markets. CEOs and other senior bank managers therefore face the identical incentives to gorge on risk that they faced before 2008 to ring up short profits without regard to future losses that may

127 Dodd-Frank Act § 619(c)(3)(B). *See also Financial Regulation*, SKADDEN (Jan. 10, 2011), http://www.skadden.com/Index.cfm?contentID=51&itemID=2328.

128 Dodd-Frank Act § 619(c).

129 *Id.*

130 *Id.*

131 Dodd-Frank Act § 619 (implying securities trading and liquid hedge funds are allowed until October 2012).

132 *Id.*

133 *Id.*

134 *Id.*

135 *Id.*

136 Tom Braithwaite, *Volcker Takes Aim at Long Term Investments*, FIN. TIMES (Jan. 20, 2011, 12:30 AM), http://www.ft.com/cms/s/0/2a03c58c-242a-11e0-a89a-00144feab49a.html.

come to fruition only after the payment of incentive-based compensation. Even if a firm approaches insolvency, the payment of golden parachute arrangements further blunts the disincentives senior managers face for excessively risky conduct.

D. CEOs as the New Potentates

Public corporations in the United States are burdened by excessive CEO autonomy.[137] As John Cassidy highlights, economists and others have reached a "rare consensus" that managerial pay played a central role in the financial crisis.[138] The essential problem revolves around the manipulation of risk to achieve artificially high profits today, at the expense of long-term solvency.[139] Ultimately, Dodd-Frank fails to disrupt this reality in the foreseeable future, despite including some positive steps.

For example, section 951 gives shareholders a say on pay via non-binding shareholder resolutions to approve executive compensation including severance pay.[140] Section 952 requires all listed companies to have independent compensation committees with the power to directly retain compensation advisers, including independent legal counsel.[141] Section 953 directs the SEC to issue rules requiring more expansive disclosures to shareholders regarding executive compensation, "including information that shows the relationship between executive compensation actually paid and the financial performance of the issuer, taking into account any change in the value of the shares of stock and dividends of the issuer and any distributions."[142] Section 954 mandates the SEC to promulgate rules requiring national securities exchanges and associations to prohibit the listing of issuers that do not comply with their own compensation recovery policies.[143] In these policies, issuers must set forth requirements on recovery of executive compensation in

137 Steven A. Ramirez, *Lessons from the Subprime Debacle: Stress Testing CEO Autonomy*, 54 ST. LOUIS U. L.J. 1, 1–2 (2010) [hereinafter Ramirez, *Lessons from the Subprime Debacle*].

138 John Cassidy, *Wall Street Pay: Where is the Reform?*, NEW YORKER (July 23, 2010), http://www.newyorker.com/online/blogs/johncassidy/2010/07/wall-street-pay.html ("Despite widespread anger on the part of the public, and a rare consensus among economists that faulty compensation structures were partly responsible for the financial crisis, the U.S. political system has failed to rise to the challenge.").

139 Paul Krugman, Op-Ed., *Banks Gone Wild*, N.Y. TIMES, Nov. 23, 2007, at A37, *available at* http://www.nytimes.com/2007/11/23/opinion/23krugman.html.

140 Dodd-Frank Act § 951.

141 Dodd-Frank Act § 952.

142 Dodd-Frank Act § 953.

143 Dodd-Frank Act § 954(a).

the event there was a material noncompliance that led to an accounting restatement.[144] Further, under these policies, the issuers must be able to recover up to three years worth of executive compensation from the date of an accounting restatement.[145] Due to the perception that financial CEOs manipulated risk to enhance their compensation, Congress directed the Fed to issue rules creating independent risk management committees at large bank holding companies.[146] Each of these laudatory initiatives mitigates the control of the CEO and senior management over the public firm, yet even taken together, they will not alter the autonomy of CEOs over the proxy machinery and the board of directors.

Other sections do, in fact, address this core source of CEO power. Section 957 now requires rules of exchanges to prohibit broker votes without shareholder direction in all "significant matter[s]," including executive compensation and election of members of the board of directors.[147] This is a significant step toward real corporate democracy. Uninstructed broker votes distort election results, thereby benefiting managers because they "almost always are cast in favor of management's proposals and candidates for board seats," according to the Council of Institutional Investors.[148] This new rule ensures that biases in favor of management are removed in contested elections or proxy contests.

Section 971 could operate to create more contested elections, as it explicitly gives the SEC the power to permit shareholders to use companies' proxy solicitation materials to nominate directors.[149] The struggle for shareholder access to management's proxy for the purpose of director elections lingered for decades prior to Dodd-Frank.[150] The SEC's exercise of this power could hardly warrant the term radical; the SEC rule

144 Dodd-Frank Act § 954(b).

145 *Id.*

146 Dodd-Frank Act § 165.

147 Dodd-Frank Act § 957.

148 *Broker Voting*, COUNCIL OF INSTITUTIONAL INVESTORS, http://www.cii.org/resourcesKeyGovernanceIssuesBrokerVoting (last visited Mar. 22, 2011). *See also* Proposal to Eliminate Broker Discretionary Voting for the Election of Directors, to Elizabeth M. Murphy, Securities and Exchange Commission (Mar. 19, 2009), *available at* http://www.cii.org/UserFiles/file/resource%20center/correspondence/2009/CII%20Broker%20Voting%20Comment%20Letter%20(File%20Number%20SR-NYSE-2006-92).pdf (advocating strongly for the elimination of uninstructed broker voting and detailing the partial results of this type of voting).

149 Dodd-Frank Act § 971.

150 Laurenz Vuchetich, *The Rise and Fall of the Proxy Access Idea: A Narrative*, 1 HARV. BUS. L. REV. ONLINE 18, 18 (2010), *available at* http://www.hblr.org/wp-content/uploads/2010/11/Laurenz-Rise-and-Fall-of-Proxy-Access.pdf.

allows shareholders with three percent ownership or more that have held such ownership for at least three years to nominate directors to stand for election through management's proxy statement.[151] Nevertheless, the SEC unexpectedly stayed the effectiveness of its own rule in response to lobbying efforts from business interests.[152] Therefore, at least until 2012, this rule remains mired in litigation.[153] In the meantime, as I have argued elsewhere, the current managers hold too much sway over board members, who in turn are subject to insufficient accountability under law.[154]

In all, these changes hold the potential for a real revolution in corporate governance. Yet, that revolutionary change will take years to take root. The power of the CEO in the public firm has receded in the past ten years with respect to key elements of the public firm such as the audit committee and the nominating committee.[155] The Dodd-Frank Act constitutes another step in the federal redesign of corporate governance to stem excessive CEO autonomy. Nevertheless, it will take years for these changes to take root in the boardroom. Even after the litigation challenging shareholder proxy access ends, it will take many years for boards to truly exercise independence from the CEO in the face of long-standing institutional barriers to independent monitoring.[156] Simply put, deeper and more fundamental reform of corporate governance is needed to take effect more rapidly. The Act offers a package of reforms on this front that will likely prove to be too little too late in order to fundamentally change managerial incentives for at least the next decade.

E. Winning the Subprime War

Dodd-Frank effectively stems predatory lending and holds the potential to reduce the prospect of exploitative debt generally.

Under section 1403: "[N]o person shall pay to a mortgage originator . . . compensation that varies based on the terms of the loan (other than the amount of the principal)."[157] Section 1404

151 Facilitating Shareholder Director Nominations, 75 Fed. Reg. 179 (Sept. 16, 2010) (to be codified at 17 C.F.R. pts. 200, 232, 240, 249).

152 Vuchetich, *supra* note 150, at 19.

153 *Id.*

154 Ramirez, *Lessons from the Subprime Debacle*, *supra* note 137, at 30–34.

155 Steven A. Ramirez, *The End of Corporate Governance Law: Optimizing Regulatory Structures for a Race to the Top*, 24 YALE J. ON REG. 321, 343 (2007).

156 MELVIN ARON EISENBERG, CORPORATIONS AND OTHER BUSINESS ASSOCIATIONS: CASES AND MATERIALS 186–88 (2005).

157 Dodd-Frank Act § 1403.

creates broad private remedies for the violation of this prohibition.[158] This should end the steering of prime borrowers into subprime loans.[159] Section 1411 requires mortgage lenders to make a good faith determination that a mortgage loan can be repaid.[160] Section 1413 permits the victim of a loan that does not comply to raise a violation of section 1411 as a defense even against subsequent assignees, and even after the expiration of any statute of limitations.[161] The amount of the defense includes costs and attorney fees. This should end predatory loans.[162] Section 917 requires a study regarding financial literacy.[163] Section 1021 requires the new Consumer Financial Protection Bureau to conduct financial education programs and to promulgate regulations prohibiting abusive and predatory loans.[164]

In aggregate, these provisions reflect Congressional determination to stem abusive and predatory lending which lay at the root of the subprime debacle. Consumer lending will not likely form the center of a future credit crisis as a result of these provisions. Indeed, critics suggest the Dodd-Frank Act essentially abolishes all but "plain vanilla" mortgages.[165]

CONCLUSION

Like the Maginot Line, the Dodd-Frank Act will prove useful in winning the last war—the subprime crisis—but it will not prevent future debt crises. The Dodd-Frank Act can only be

158 Dodd-Frank Act § 1404.

159 This created unnecessary defaults as more borrowers bore the burden of excessive fees and costs. Rick Brooks & Ruth Simon, *Subprime Debacle Traps Even Very Credit-Worthy*, WALL ST. J., Dec. 3, 2007, at A1 *available at* http://online.wsj.com/article/SB119662974358911035.html?mod=hps_us_whats_news (reporting on study that found up to sixty-one percent of subprime borrowers could qualify for prime loans).

160 Dodd-Frank Act § 1411.

161 Dodd-Frank Act § 1413. The fact that the defense can be raised against assignees means that it will now be difficult to securitize predatory loans.

162 Predatory loans sparked the crisis. Indeed, the nation's largest mortgage lender, Countrywide Financial, also settled the largest predatory lending case. Ramirez, *Lessons from the Subprime Debacle*, *supra* note 137, at 24–25.

163 Dodd-Frank Act § 917.

164 Dodd-Frank Act § 1021. It appears that an early effort of the new Consumer Financial Protection Bureau will be to standardize loan disclosure statements to permit earlier comparison shopping by consumers. Carter Dougherty, *Big Lenders May Lose with Simpler Mortgage Disclosure*, BLOOMBERG BUS. WK. (Jan. 14, 2011, 2:44 PM) http://www.businessweek.com/news/2011-01-14/big-lenders-may-lose-with-simpler-mortgage-disclosure.html.

165 Kristie D. Kully & Laurence E. Platt, *Hope You Like Plain Vanilla!: Mortgage Reform and Anti-Predatory Lending Act (Title XIV)*, FIN. SERVS. REFORM ALERT (K&L/Gates), July 8, 2010, *available at* http://www.klgates.com/newsstand/Detail.aspx?publication=6528 (last visited Mar. 11, 2011).

termed an epic failure of policy. The Act includes some positive elements such as the corporate governance reforms and predatory finance prohibitions. Nevertheless, the importance of these reforms pales in comparison to the risks of another financial meltdown, as well as deeply impaired macroeconomic performance far into the future.

The Act allows massive government guarantees of the largest financial concerns to persist and even makes such backstops explicitly available under law.[166] This continues the massive subsidies implicit in the too-big-to-fail problem, and entails a proven means of assuring excessive risk in the financial system. Indeed, the Act formalizes the power of the FDIC and the Fed to bail out systemically critical financial institutions.[167] The orderly liquidation process offers further bailout mechanisms. Dodd-Frank therefore continues regulatory indulgence, even facilitation, of excessive risk in the financial sector.

The Act also allows essentially unbridled derivatives and securities trading for years into the future and beyond.[168] Large banks will in fact likely control any derivatives clearinghouse or exchange which are likely themselves too-big-to-fail.[169] Many derivatives will not be cleared and banks will continue to trade these instruments. Hedge fund investments also continue after the Act.[170] So, the very risky securities and trading activities that culminated in the crisis of 2007–2009 may continue unabated despite the presence of the massive subsidized capital provided by the government.

The Act mitigates these negative elements through the possibility of corporate governance reform. Yet, there is no restoration of private liability and the government continues to act parsimoniously to say the least in pursuing criminal actions and civil enforcement through the SEC. The remaining provisions may well diminish CEO autonomy to saddle the firm with excessive risk as a means of pumping up current profits, but these provisions will not compensate for the basic profit incentives in favor of recklessness and fraud within the boardroom of the public firm. The best hope for changing this

166 Dodd-Frank Act §§ 1101, 1105.
167 Dodd-Frank Act § 203.
168 *See* Orrick, *supra* note 115.
169 *See* Morgenson, *supra* note 124.
170 *See Financial Regulation*, *supra* note 127 and accompanying text.

outcome, shareholder nominees to the board, could take years to hold sway.

The upshot of Dodd-Frank is that it continues and even formalizes massive subsidies and incentives for risk within the financial firm. Managers continue to have the means and the motive to crash the global financial system. Our debt laden economy will certainly provide the opportunity for financial manipulation of risk. The global economy and the U.S. economy remain mired in debt. With continuing financial losses for the banking sector, the credit mechanism seems broken and bankers continue to hoard massive cash. The basic structure of the global economy will continue to generate more debt in the developed world even as growth is impaired. Dodd-Frank seems oblivious to all of this.

Capitalism in America appears destined to continue to degenerate into a rigged game in favor of those controlling the most amounts of wealth. Dodd-Frank may well entrench this pernicious economic reality by allowing it to fester. By any measure, it preserves the power and economic prospects of the very financial elites whose misconduct caused the crisis in the first instance. In my view, the estimated $591 million invested in lobbying (since January of 2009)[171] and the $112 million invested in campaign contributions to the members of the conference committee (since 1989)[172] yielded precisely the returns expected and demanded by our financial elite: the ability to play in the high-risk securities and derivatives markets with continued government backing without any prospect of being broken up.

Dodd-Frank will prevent a crisis in subprime lending from recurring. But, a future credit crisis, one that may well be brewing presently, could deliver a shock to the financial system similar to, if not worse than, that which triggered the crisis of late 2008. Dodd-Frank will be useless against that crisis because it essentially preserves the power of the financial elite that caused the last crisis and preserves the incentives that gave rise to that crisis. Dodd-Frank stands as a monument to a deeply misguided, if not actually corrupt, political and economic elite.

171 Jennifer Liberto, *Lobbyists Swarm as Wall Street Bill Talks Start*, CNNMONEY.COM (June 10, 2010, 11:22 PM), http://money.cnn.com/2010/06/10/news/economy/Wall_Street_Reform/index.htm.

172 *Id.*

Limits of Dodd-Frank's Rating Agency Reform

Claire A. Hill[*]

INTRODUCTION

The history of rating agency reform has not been inspiring. Until recently, it seemed stuck in an ever-repeating cycle of futility. A crisis would spur calls for reform, hearings would be conducted, the SEC would issue proposals and requests for comments, and ultimately, nothing would happen—until the next crisis, when the cycle would begin again. The Enron debacle, in which the rating agencies rated Enron's debt investment grade until four days before Enron declared bankruptcy,[1] did spur some action, including federal legislation and SEC regulations.[2] Whatever else may be said about the Enron-spurred action, it failed to prevent rating agencies from rating low-quality securities as AAA. This misrating was an important cause of the recent financial crisis.[3]

In response to the crisis, the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 ("Dodd-Frank")[4] was passed. Dodd-Frank includes some reforms to the rating agency regulatory regime. In this article, I argue that while Dodd-Frank's rating agency reforms are not bad, they also are not particularly good. They do not sufficiently address the core reasons why rating agencies gave such inflated ratings to subprime securities or why the agencies so grievously misrated

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1 *See Rating the Raters: Enron and the Credit Rating Agencies: Hearing Before S. Comm. on Gov't Affairs,* 107th Cong. 1 (2002) [hereinafter *Enron Hearings*] (statement of Sen. Joseph Lieberman, Chairman, S. Comm. on Gov't Affairs), *available at* http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=107_senate_hearings&docid=f:79888.pdf.

2 *See* Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (codified as amended in scattered sections of U.S.C.); Credit Rating Agency Reform Act of 2006, Pub. L. No. 109-291, 120 Stat. 1327 (codified as amended in scattered sections of 15 U.S.C.).

3 FIN. CRISIS INQUIRY COMM'N, FINANCIAL CRISIS INQUIRY REPORT xxv (2011), *available at* http://www.gpoaccess.gov/fcic/fcic.pdf.

4 Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010).

other instruments, including Enron debt and debt involved in the Asian flu. I then explain the reasons for this conclusion, and make some suggestions for better rating agency reform.

I. WHY HAVE THE RATING AGENCIES FAILED?

A. Two (Extreme?) Possibilities

Rating agencies have often been right in their ratings. Sometimes, however, they have been wrong, even spectacularly wrong. Why have they sometimes been so wrong? Consider the following two possibilities. The first is that the rating agencies are less than cutting-edge in their capabilities. Because of their privileged positions—thanks to government favoritism and market norms effectively requiring their use, something I will explain more in Part II—they have not had to fear large losses of market share. Because credit ratings agencies have not needed to compete vigorously on quality, they have not sought to excel; instead (in the more charitable version of this explanation) they have simply maintained some minimal level of competence. Rating agencies therefore have not needed to be very sophisticated in their financial analyses; they also have not needed to be particularly good at ferreting out fraud.[5]

The second possibility as to why rating agencies have been so wrong at times is that they are corrupt. Because the agencies are paid by the issuers and the issuers can threaten to take their business elsewhere if they cannot get high ratings, the rating agencies have let themselves be bribed into giving high ratings even when such ratings are not warranted.[6]

Many rating agency critics writing before the recent financial crisis seemed to believe the first explanation. Critics writing since the crisis seem to believe the second.

i. Before the Recent Financial Crisis

Notable rating agency fiascos before 2008 include: Enron (corporation's extensive use of financial "techniques" that created a wholly false financial appearance), Orange County (ill-advised bets on interest rates using complex derivatives by county Treasurer Robert Citron, leading to bankruptcy), the Asian Flu (a cascade of recessions in the region leading to massive downgrading), Washington Public Power Supply System ("WPPSS," pronounced "Whoops") (cost overruns and other

5 *See* Claire A. Hill, *Regulating the Rating Agencies,* 82 WASH. U. L.Q. 43, 78–81 (2004) [hereinafter Hill, *Regulating*].

6 *See* Claire A. Hill, *Why Did Rating Agencies Do Such a Bad Job Rating Subprime Securities,* 71 U. PITT. L. REV. 585, 593–96 (2010) [hereinafter Hill, *Bad Job*].

complicating factors led to default on bonds originally rated AAA),[7] and National Century Financial Enterprises (bankruptcy after lying executives "deceive[d] investors and rating agencies about the financial health of NCFE and how investors' money would be used")[8].

Following are some criticisms of the rating agencies in these debacles attributing the bad rating agency performance to incompetence:

As to Enron: Joseph Lieberman, then-Chairman of the Committee on Governmental Affairs, said:

> [T]he credit rating agencies were dismally lax in their coverage of Enron. They didn't ask probing questions and generally accepted at face value whatever Enron officials chose to tell them. And while they claim to rely primarily on public filings with the SEC, analysts from Standard and Poor's not only did not read Enron's proxy statement, they didn't even know what information they might contain.[9]

Approximately one year after Enron, one commentator said: "[t]he rating agencies display the classic characteristics of an entrenched cartel . . . [t]hey're lazy, unresponsive, and ultimately unhelpful. They tend to play catch-up, downgrading ratings only after financial weaknesses are revealed or ferreted out by more enterprising researchers."[10]

As to Orange County, Betsy Dotson, an assistant director with the Government Finance Officers Association said: "[m]any of our members have called us wondering where the rating agencies were. It's a logical question . . . . Some of these losses may have been avoided if the rating agencies had spotted problems earlier."[11] Christopher Cox, then a U.S. Representative (and later SEC Commissioner), said: "[h]ow is it that the rating agencies, the SEC, the entire market, was unable to learn about what [Robert] Citron was doing?"[12]

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7 *See* Claire A. Hill, *Why Did Anyone Listen to the Rating Agencies After Enron?*, 4 J. BUS. TECH. L. 283, 291–92 (2009).

8 Press Release, Federal Bureau of Investigation, Former National Century Financial Enterprises CEO Sentenced to 30 Years in Prison, Co-Owner Sentenced to 25 Years in Prison for Conspiracy, Fraud and Money Laundering (Mar. 27, 2009), *available at* http://www.fbi.gov/cincinnati/press-releases/2009/ci032709.htm; *see also id.*

9 Press Statement of Chairman Joseph Lieberman, *Financial Oversight of Enron: The SEC and Private-Sector Watchdogs,* COMM. ON GOV'T AFFAIRS (Oct. 7, 2002), http://hsgac.senate.gov/public/_archive/100702press.htm.

10 Daniel Gross, *Bust Up the Ratings Cartel,* SLATE (Dec. 23, 2002, 1:27 PM), http://www.slate.com/id/2075959/.

11 Debora Vrana, *Bond Investors Question Abilities of Credit-Rating Services in Debacle,* L.A. TIMES, Dec. 8, 1994, at D1, *available at* http://articles.latimes.com/1994-12-08/business/fi-6631_1_orange-county-s-bankruptcy.

12 Gebe Martinez, *Cox Wonders How Citron Got Past SEC,* L.A. TIMES, Feb. 22, 1995,

As to the Asian flu, one common critique was that the rating agencies were caught unaware (or, as one article memorably said, "with their pants down.")[13] In the same vein is this critique of the rating agencies made in the aftermath of the WPPSS debacle: Moody's Investors Service "simply did not recognize that credit analysis in this new situation required looking upstream to the impact on the venture's sponsors."[14]

ii. Since the Financial Crisis Began

A stark contrast exists between the foregoing picture of rating agencies as hapless dunces and the picture painted of their behavior rating subprime mortgage securities, the securities whose decline in value precipitated the financial crisis. A critical fact is that most rating agencies, including Moody's, Standard & Poor's, and Fitch Ratings (sometimes colloquially known as the "Big Three"), are paid by the issuers whose securities they rate, creating a conflict of interest.[15] A search on Google.com for "rating agency conflict of interest" on April 11, 2011 yielded approximately 688,000 hits.[16] Paul Krugman apparently subscribes to this view. He wrote a column entitled "Berating The Raters" in which he says, "[c]learly the rating agencies skewed their assessments to please their clients."[17] Joseph Stiglitz also emphasizes rating agency conflicts. Stiglitz noted that

> [t]he incentive structure of the rating agencies also proved perverse. Agencies such as Moody's and Standard & Poor's are paid by the very people they are supposed to grade. As a result, they've had every reason to give companies high ratings, in a financial version of what college professors know as grade inflation.[18]

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at B1, *available at* http://articles.latimes.com/1995-02-22/local/me-34793_1_orange-county-investment.

13 *Rating Agencies Caught With Their Pants Down*, EUROMONEY, Jan. 15, 1998, at 51; *see also* G. Ferri, L.-G. Liu & J. E. Stiglitz, *The Procyclical Role of Rating Agencies: Evidence from the East Asian Crisis*, 28 ECON. NOTES 335, 337 (1999) ("Credit rating agencies were caught by surprise by the East Asian crisis.").

14 Willard T. Carleton, Brian Dragun & Victoria Lazear, *The WPPSS Mess, or "What's in a Bond Rating?": A Case Study,* 2 INT'L REV. OF FIN. ANALYSIS 1, 14 (1993).

15 *See* Hill, *Regulating*, *supra* note 5, at 44, 50. Historically, some agencies were paid by their subscribers, but that business model became more difficult when copying machines became readily available. *Id.*

16 Search query of "rating agency conflict of interest," GOOGLE, http://www.google.com (last visited Apr. 11, 2011); *see also* Hill, *Bad Job*, *supra* note 6, at 593 (finding 274,000 hits as of 2010).

17 Paul Krugman, *Berating the Raters*, N.Y. TIMES, Apr. 26, 2010, at A23, *available at* http://www.nytimes.com/2010/04/26/opinion/26krugman.html?dbk.

18 Joseph E. Stiglitz, *Capitalist Fools*, VANITY FAIR, Jan. 2009, at 48, 51.

Former employees of rating agencies, especially Moody's, have given powerful testimony blaming the misratings involved in the financial crisis on this conflict of interest. One Moody's employee, Eric Kolchinsky, testified that

> [i]n my opinion, the cause of the financial crisis lies primarily with the misaligned incentives in the financial system. Individuals across the financial food chain, from the mortgage broker to the CDO banker, were compensated based on quantity rather than quality. The situation was no different at the rating agencies.[19]

B. The (Obvious) Third Possibility

The foregoing indicates an interesting, and largely unnoticed, shift in the reasons given by commentators as to why rating agencies have sometimes spectacularly misrated. Are rating agencies dunces, corrupt, or both? I have argued elsewhere that the agencies are neither, although both their quality and independence need significant improvement. As to the former, I argued that the agencies were not cutting-edge, given that they didn't have to compete vigorously for business.[20] I have disputed, though, the argument that their ratings provide no information whatsoever—that the agencies are complete dunces.[21] Government favoritism and established market practices allowed rating agencies to be slackers (and/or dunces), but only up to a point. Past that point, markets, and probably government, would have intervened.

I have also argued that the agencies were generally not wholly self-consciously corrupt. Rather, they engaged in considerable self-deception and reckless, if not willful, blindness, similar to the self-deception practiced at many investment banks and law firms.[22] Moreover, the agencies are clearly capable of not being corrupted when they are being paid by issuers; their ratings for plain-vanilla debt, for which they are also paid by the issuers, are not generally considered to be compromised.[23] But there are some clear indications of corruption during the recent financial crisis. A few former rating agency employees have described the single-minded pursuit of market share at the

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19 *Wall Street and the Financial Crisis: The Role of Credit Rating Agencies: Hearing Before the Permanent Subcomm. on Investigations of Homeland Sec. and Gov't Affairs,* 111th Cong. 14 (2011) (statement of Eric Kolchinsky, former Team Managing Director, Moody's Investors Service), *available at* http://www.gpo.gov/fdsys/pkg/CHRG-111shrg57321/pdf/CHRG-111shrg57321.pdf.

20 *See* Hill, *Regulating*, *supra* note 5, at 72–81; Hill, *Bad Job*, *supra* note 6, at 600.

21 Hill, *Regulating*, *supra* note 5, *at* 72.

22 *See* Claire A. Hill, *Who Were the Villains in the Subprime Crisis, and Why It Matters,* 4 ENTREPRENEURIAL BUS. L.J. 323, 340–42 (2010).

23 *See* Hill, *Bad Job*, *supra* note 6, at 595.

expense of credit quality.[24] One notorious incident discussed below concerns Moody's' discovery that it had mistakenly applied its rating model so as to give too high a rating to a particular type of instrument.[25] Moody's' response was to change the model so that the instruments would continue to have a high rating.[26]

What accounts for the increasing perception and, to some extent, reality, of greater corruption in rating agencies post-Enron? Very simply, that there was a much higher payoff to being corrupt (or self-deceiving, or recklessly or willfully blind) than had previously been the case, and a higher cost to *not* being so. This is because rating agencies began to compete with one another for business. Previously, the government favoritism and market norms had created what was sometimes called a "partner monopoly" with Moody's and Standard & Poor's as the partners.[27] Another agency, Fitch, gradually became an acceptable alternative.[28] Thus, an issuer's threat to take its business elsewhere became a credible one.

Moreover, the amount of business at issue is near-infinite. The ratings business originally involved rating debt securities for companies that wanted to raise money and found it worthwhile to do so. A "natural" and fairly low limit of such issuances thus exists. By contrast, structured finance securities are made up of other instruments; structuring the securities is itself a business entered into for profit. There is thus incentive and ability to structure more such instruments. The raw materials—the underlying instruments—originally were needed. But as structuring technology and investor appetites got more sophisticated, the need for raw materials ceased to be much of a constraint. Securitization securities could be crafted out of other securitization securities ("collateralized debt obligations cubed," or CDO^3s) and they could be "synthetics," comprised of bets tracking the performance of "real" instruments. Thus, the only "natural" limit to the structure of securities was investors' appetites, and investors proved voracious indeed.

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24 Krugman, *supra* note 17, at A23; *Statement and Testimony by Eric Kolchinsky Before the Financial Crisis Inquiry Commission,* FIN. CRISIS INQUIRY COMM. 1–3 (June 2, 2010), http://fcic-static.law.stanford.edu/cdn_media/fcic-testimony/2010-0602-Kolchinsky.pdf; *Testimony of Mark Froeba Before the Financial Crisis Inquiry Commission*, FIN. CRISIS INQUIRY COMM. 3–4 (June 2, 2010), http://fcic-static.law.stanford.edu/cdn_media/fcic-testimony/2010-0602-Froeba.pdf [hereinafter *Froeba Statement*].

25 Hill, *Bad Job*, *supra* note 6, at 591.

26 *See id.* at 593.

27 *See infra* Part II.

28 Hill, *Bad Job*, *supra* note 6, at 587 n.4 & 590 n.15.

II. SOME INSTITUTIONAL BACKGROUND

Some institutional background is in order. Who are these rating agencies that benefitted from government favoritism, and that are favored by markets? Why are there so few of them? What form did the government favoritism take? What effect did the reforms adopted in response to the Enron debacle have? Below, I briefly discuss some answers to these questions.

The ratings agencies at issue, the Big Three, are Standard & Poor's, Moody's Investors Service, and, to a lesser extent, Fitch Ratings. Standard & Poor's and Moody's both date back to the early 1900s.[29] They have had the vast bulk of the rating agency market for a very long time.[30] Fitch has existed for a considerable length of time as well, and is an amalgam of several smaller rating agencies.[31] Over the years, Fitch has increased its prominence, especially in the area of structured finance securities, the type of securities involved in the financial crisis.[32] Markets have expected issuers to get ratings for their securities from both Standard & Poor's and Moody's (or, in the case of some structured finance securities, one rating from Moody's or Standard & Poor's and the other from Fitch); this expectation apparently may translate into lower buyer valuations for securities issued without their ratings.[33]

Government favoritism is shorthand for two things that, especially in tandem, have contributed to the continuing dominance of Moody's and Standard & Poor's and more recently, Fitch. One is that since 1931, the government has required or encouraged certain types of investors to prefer financial instruments that rating agencies rate highly.[34] The other is that in 1975, the SEC began designating particular rating agencies as "Nationally Recognized Statistical Rating Organizations," or "NRSROs."[35] The government's requirement or encouragement that some investors buy highly rated instruments became a requirement or encouragement that such investors buy instruments rated highly by an NRSRO.[36] There were no set procedures to become an NRSRO.[37] Very few agencies were

29 Hill, *Regulating*, *supra* note 5, at 46–47.

30 *Id.* at 47.

31 *Id.* at 46–47.

32 *See* Hill, *Bad Job*, *supra* note 6, at 587 n.4 & 590 n.15.

33 *See* Hill, *Regulating*, *supra* note 5, at 47 n.17 and accompanying text. For more on Moody's, Standard & Poor's, and the two-ratings norm, see *id.* at 59–62. Despite the two-ratings norm, there are some areas in which the agencies did compete. *See id.* at 63.

34 *See id.* at 53.

35 *Id.* at 53–54.

36 *Id.*

37 *Id.* at 54.

accepted; the SEC noted that not many applied.[38] Prominent among those accepted were Moody's, Standard & Poor's, and Fitch.[39]

Certainly, the process to obtain NRSRO designation was opaque at best. One applicant, LACE Financial, noted that it was only contacted twice by the SEC: once to say its application had been received, and again, eight years later, to say the application had been denied.[40] Another disappointed applicant, Egan-Jones, reported being told by the SEC that the SEC did not want to reveal the criteria for becoming an NRSRO, lest the applicant find a way to meet them.[41]

Why do so few rating agencies have the vast bulk of the market? Many blame the government and the NRSRO designation process for this state of affairs.[42] I have argued elsewhere that the dynamic is more complicated.[43] It is not as though the only agencies receiving the NRSRO designation were Moody's, Standard & Poor's, and Fitch. Issuers could have used other NRSROs, but they typically did not. Moreover, even when regulations only required the use of one agency, issuers might use two.[44] A newspaper article written in 2004 noted that "[i]nvestors expect ratings from Moody's and S&P, each of which controls about 40 percent of the market."[45] The article quoted Dessa Bokides, a former Wall Street banker as saying, "[y]ou basically have to go to Moody's and S&P . . . . The market doesn't accept it if you don't go to both of them."[46] Moody's and Standard & Poor's were the market anointed raters; Fitch made some inroads, especially in structured finance. Nobody had both the will and the way to change this state of affairs. But why two, and why these two? Why was Fitch (and not one or more other agencies) able to make inroads when it did? Nobody has a good answer to these questions, but it is clear that the norms at issue are sticky indeed.

One reason why the rating agency industry is as concentrated as it is may be the difficulty with business strategies that would-be competitors might use. Competing on

38 *Id.* at 54 n.60.

39 *Id.* at 59.

40 *Id.* at 55 n.61.

41 *Id.* at 54–55.

42 *Id.* at 62.

43 *Id.* at 59–64.

44 *Id.* at 66.

45 Alec Klein, *Smoothing the Way for Debt Markets: Firms' Influence Has Grown Along With World's Reliance on Bonds,* WASH. POST, Nov. 23, 2004, at A18, *available at* http://www.washingtonpost.com/wp-dyn/articles/A5573-2004Nov22.html.

46 *Id.*

price is not apt to lure issuers; after all, the ones making the decisions are not bearing the costs themselves. Any benefits issuers might enjoy from saving their companies money would be significantly outweighed by the reputational and financial costs their companies would bear if an issuance were not well-accepted by the markets. Competing on laxity is the more obvious strategy, but it is self-defeating if done too nakedly; the new agency cannot be seen by markets to be easily bribed. Thus, the rating agency needs some credible reason for its apparent laxity. The obvious reason that springs to mind is greater "expertise." This is by some accounts precisely what Fitch did to become the third ranked agency, especially in structured finance.[47] However, Fitch still had to fight perceptions that it was more lax than Moody's and Standard & Poor's, and it developed and carried out a strategy to do so.[48]

So, it is perhaps not surprising that the rating agency industry has been concentrated, with very little competition. The concentration had its costs, but it may also have had an important benefit. As an article on WPPSS notes:

> [t]hese alumni [of the rating agencies who claim that there were insiders who wanted to downgrade WPPSS] are quick to allege a reason for the rating agencies' restraint: they are rating their clients . . . . Whoops, for example, has paid the two agencies more than $400,000 over the past ten years. But since marketing a big bond issue without agency ratings would be unthinkable, it's not clear that paying even substantial fees can buy issuers the upper hand.[49]

Indeed, one important issue flagged in the Enron debacle was the extent to which the accounting firm Arthur Andersen felt it had to do its client's bidding to keep the client, and was willing to do things that were arguably dishonest as a means to that end.[50] When rating agencies misrated Enron's securities, it was not because they were trying to keep Enron's business by helping Enron create a false financial appearance. Rather, the picture painted at the time was that the rating agencies were not canny chicanerers- they were clueless. As a rating agency veteran was quoted in The Economist in 2003 as saying, "[w]e may be incompetent . . . but we're not dishonest."[51]

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47 *Id.*

48 *See* Hill, *Regulating*, *supra* note 5, at 63–64.

49 Peter Brimelow, *Shock Waves from Whoops Roll East*, FORTUNE, July 25, 1983, at 46–47.

50 Daniel Kadlec, *Enron: Who's Accountable?*, TIME (Jan. 13, 2002), http://www.time.com/time/business/article/0,8599,193520,00.html; s*ee also* Hill, *Regulating*, *supra* note 5, at 91.

51 *Exclusion Zone,* ECONOMIST, Feb. 8, 2003, at 65. That rating agencies were completely non-conflicted surely overstates the case; still, they were far less conflicted

That was then. What about now? The Credit Rating Agency Reform Act of 2006 requires the SEC to award NRSRO designations for applicants who meet specified criteria.[52] The Act also requires increased disclosure and oversight.[53] The Act did not prevent rating agencies from disastrously misrating subprime mortgage securities. It has led to the designation of more NRSROs, including LACE Financial and Egan-Jones.[54] By the time the Act was passed, Fitch was becoming a more plausible second (that is, additional) rater than it previously had been, especially in the structured finance arena.[55] Issuers began to play agencies against each other, now being able to threaten credibly (unlike when there had been a partner monopoly consisting of Moody's and Standard & Poor's) that they might take their business elsewhere. Might the two developments be linked? It seems possible, although it also seems possible that Fitch, having marketed itself as a particular expert in structured finance simply succeeded in doing what it had set out to do.[56] Whatever the cause, the effect is clear and disastrous. Former Moody's employee Mark Froeba described the shift in culture at Moody's. According to Froeba, a culture of integrity was replaced

than Arthur Andersen, and certainly, less than they later became once the norm of obtaining both Moody's and Standard & Poor's ratings eroded for subprime securities, and issuers could play both of these agencies off against each other and Fitch.

52 Credit Agency Rating Reform Act of 2006, Pub. L. No. 109-291, § 4, 120 Stat. 1327, 1329–38 (codified as amended in scattered sections of 15 U.S.C.). An impetus for the 2006 Credit Rating Agency Reform Act was apparently lobbying by the "small but vocal" agency Egan-Jones. HERWIG LANGOHR & PATRICIA LANGOHR, THE RATING AGENCIES AND THEIR CREDIT RATINGS 403 (2008).

53 Credit Agency Rating Reform Act of 2006, Pub. L. No. 109-291, § 4, 120 Stat. 1327, 1329–38 (codified as amended in scattered sections of 15 U.S.C.).

54 *See Credit Rating Agencies—NRSROs*, SEC, http://www.sec.gov/answers/nrsro.htm (last visited Apr. 18, 2011). Interestingly, in August of 2010, LACE Financial, was acquired by Julius Kroll, known as a corporate "sleuth." *See* Aaron Lucchetti & Jeannette Neumann, *Kroll Gets A License To Shoot (Bonds*), WALL ST. J., Aug. 31, 2010, at C1, *available at* http://online.wsj.com/article/SB10001424052748704323704575462040422537232.html. Given that one reason Standard & Poor's and Moody's executives gave for not being able to do a better job rating Enron's debt is that they are not experts at looking for fraud, perhaps Kroll can craft a market niche in doing precisely that. *See Enron Hearings*, *supra* note 1, at 7–9. Another newly designated NRSRO, Realpoint, was bought in May 2010 by Morningstar, a "leading provider of independent investment research." *See Morningstar, Inc. Completes Acquisition of Realpoint, LLC,* MORNINGSTAR (May 3, 2010), http://corporate.morningstar.com/US/asp/subject.aspx?filter=PR4498&xmlfile=174.xml. It should be noted that over the years, before the 2006 Act effectively required the SEC to designate more NRSROs, the SEC had designated agencies other than Moody's, Standard & Poor's, and Fitch, but those three agencies ended up buying the other designees. *See* Hill, *Regulating*, *supra* note 5, at 54.

55 *See Fitch Releases U.S. Structured Finance Rating Comparability Study,* BUS. WIRE (Mar. 24, 2006), http://www.businesswire.com/news/home/20060324005359/en/Fitch-Releases-U.S.-Structured-Finance-Rating-Comparability.

56 *See* Hill, *Regulating*, *supra* note 5, at 63–64.

by a culture that single-mindedly pursued market share.[57] Inaccurate ratings were a foreseeable result. In testimony before the Financial Crisis Inquiry Commission, Froeba stated:

> I have tried to show that Moody's managers deliberately engineered a change to its culture intended to ensure that rating analysis never jeopardized market share and revenue. They accomplished this both by rewarding those who collaborated and punishing those who resisted. In addition to intimidating analysts who did not embrace the new values, they also emboldened bankers to resist Moody's analysts if doing so was good for Moody's business. Finally, I have tried to provide you with an example of the extent to which the new culture corrupted the rating process. The adjusted European CLO Rating Factor Table appears to have been adopted for the sole purpose of preserving Moody's European CLO market share despite the fact that it might have resulted in Moody's assigning ratings that were wrong by as much as one and a half to two notches.[58]

III. DODD-FRANK AND THE GOALS OF RATING AGENCY REFORM: RETURNING TO THE STORIES OF DUNCES AND CORRUPTION

Dodd-Frank's rating agency reform was enacted in response to the rating agencies' disastrous misrating of subprime securities.[59] The reform has two important goals.[60] One is to decrease reliance on ratings.[61] Notwithstanding what is often said, the problem is not simply that the rating agencies' ratings were too high. Rather, it is that people invested on the strength of those ratings. We would not need to care what rating agencies did (or how badly they rated) if nobody listened to them. The other goal is to improve the quality of ratings.[62] The drafters of Dodd-Frank presumably recognized that people will continue to be influenced by the agencies, at least in the short- to moderate-term, no matter what the government does. If rating agencies will be influential for some time to come, it behooves government to make them better if at all possible.

How does Dodd-Frank try to achieve these aims? As to the first aim, elimination of reliance on the agencies, it mandates the elimination of references in statutes and regulations to NRSROs.[63] Something else is to replace these references.[64] The

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57 *Froeba Statement*, *supra* note 24, at 4–5.

58 *Id.* at 19.

59 *See* Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 931, 124 Stat. 1376, 1872 (2010).

60 *See, e.g.*, §§ 931–939A.

61 *See* § 939A.

62 *See* § 932 (requiring that, for example, NSRSOs establish internal controls over processes for determining credit ratings).

63 *See* § 939.

64 *Id.*

rationale behind the new law is simple and unassailable. The government has many reasons to care about the quality of financial instruments and firms that hold them; it therefore needs a measure of quality. It has used ratings, but they proved spectacularly unreliable. The problem is that there is no ready alternative. Moreover, the market norms of using ratings from rating agencies—indeed, particular rating agencies—will not disappear even if the statutory and regulatory references are removed. Market practices are sticky, and market actors have strong incentives to abide by them. Even now, after Moody's, Standard & Poor's, and Fitch have done so badly, and when other rating agencies are NRSROs, the Big Three are still highly influential. As the title of an article published when the agencies' misratings should have been fresh in investors' minds indicates, *In Rating Agencies, Investors Still Trust*.[65] All this suggests that at least in the short term and perhaps for the moderate term as well, reliance on NRSRO ratings and in particular, the Big Three's ratings, will continue.

As to the second aim, improving the quality of ratings, Dodd-Frank has a multifaceted approach.

For rating agencies, it provides for:

(1) expanded procedures to deal with conflicts of interest[66]

(2) more independence in their corporate governance[67]

(3) greater internal controls[68]

(4) more expansive and accessible disclosure of ratings and the basis for ratings[69]

(5) increased accountability and liability[70]

(6) a duty to blow the whistle on lawbreaking[71]

Dodd-Frank also provides for more SEC oversight and monitoring of rating agencies.[72]

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65 David Gillen, *In Rating Agencies Investors Still Trust*, N.Y. TIMES, June 5, 2009, at B1, *available at* http://www.nytimes.com/2009/06/05/business/economy/05place.html?dlbk.

66 *See, e.g.*, Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 932, 124 Stat. 1376, 1872–84 (2010).

67 In this regard, section 932(t) requires that at least one half, but not fewer than two, of an NRSRO's board of directors be independent of the NSRSO, including a definition of independence.

68 § 932(a)(2)(B)(3).

69 § 932.

70 §§ 932(a)(1), (2), (3); § 933; § 939G.

71 § 934.

72 § 932.

Will Dodd-Frank succeed in improving rating agency quality? To appraise its prospects for doing so, let us consider again why rating agencies have grossly misrated. I argued above that while some corruption existed, there was also a client-oriented perspective that many have (in my view, mistakenly) characterized as corruption. That perspective was borne of a broader lack of a competitive edge. A true competitive edge would have kept agencies more receptive to receiving disconfirming evidence—evidence that many instruments for which their clients sought high ratings were really junk.

Insofar as we think rating agencies are corrupt, or somewhat so, most of the Dodd-Frank reforms listed above may actually do a better job perfecting concealment than improving quality. Dodd-Frank does not ask rating agencies to guarantee results, only processes.[73] Many skilled and well-meaning professionals are in the business of helping companies document that they are using appropriate processes. It may be harder to do so if the companies are in fact corrupt than if they are not, but it is presumably not impossible. If a corrupt company is trying to hide its corruption, it may be able to do so even from prying eyes of bureaucrats and litigants. And if a company has convinced itself that it is behaving appropriately, there is even less to hide. Moreover, while the corrupt agency will be better at hiding what it does, the more honest yet more incompetent agency may fool bureaucrats too; bureaucrats' monitoring is scarcely cutting-edge, and may catch only egregious errors. The truly incompetent agency may be caught: it may also be incompetent in hiding its non-compliance with regulatory requirements. But by the time a lawsuit is initiated, significant losses may already have been suffered.

But what about the expanded procedures to deal with conflicts of interest and the increased role of independent board members? Here, again, there are several reasons to be wary. These types of approaches have been used before for corporations, without significant positive effect. Certainly, increased independence on corporate boards has scarcely been a panacea;[74] the type of independence that is needed is independent-mindedness, not independence as it is formally

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73 Some commentators have proposed that agencies should get financial rewards for accurate ratings and financial punishments for inaccurate ratings. In my view, such proposals have insurmountable difficulties. *See* Hill, *Bad Job*, *supra* note 6, at 606 n.58 and accompanying text.

74 *See, e.g.*, Sanjai Bhagat & Bernard Black, *The Uncertain Relationship Between Board Composition and Firm Performance,* 54 BUS. LAW. 921 (1999).

defined.[75] Whether a rating agency is (mostly or somewhat) corrupt, less than cutting-edge, or both, it will certainly be able and inclined to use processes that pass muster given the level of scrutiny even a highly technically sophisticated board member is apt to use. It seems unlikely that a highly corrupt agency will be unable to conceal its improprieties. It also seems unlikely that an agency simply engaging in self-serving self-deception would not also manage to fool its director-monitors. Procedures to guard against conflicts have the same types of shortcomings. The thoroughly corrupt agency simply lies, and the self-deceiving agency simply convinces itself all is well. The essential conflict, that the issuer is the client, remains, no matter what formal separations of duties and outside monitoring is mandated.

What is needed in the moderate term is vigorous competition. But in the short term, competition has proven a disaster. Why? Because the Big Three have "issuer pays" as their business model. Their incentives have been to direct their efforts (and for those who were actually corrupt, their guile) at "accommodating" their clients, working with their clients to achieve the desired ratings. If the agencies were simply and straightforwardly corrupt, they might be dissuaded from this course of action by sufficient monitoring and accountability.[76] In the likelier scenario, in which self-deception plays a significant part, the agencies are going through the motions, guided by their highly-paid counselors, and do not really know they are sanitizing ultimately suspect and self-serving conclusions.

The solution is to get away from an "issuer pays" model, in which those paying for ratings are the securities' sellers, and return to "subscriber pays," in which ratings are paid for by people buying research as to securities' quality[77] But how? When an issuer is issuing securities, how can a "subscriber pays" rating be arranged? When the legislation that would become the Dodd-Frank Act was being considered in the Senate, Al Franken proposed an amendment that would have achieved some of the benefits of "subscriber pays" consistent with an "issuer pays" model in the context of ratings that have been particularly catastrophic, those of structured finance securities such as

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75 Claire A. Hill & Erin A. O'Hara, *A Cognitive Theory of Trust*, 84 WASH. U. L. REV. 1717, 1781–88 (2006). Given the enormous difficulty, if not near-impossibility, of measuring independent-mindedness, the formal definitions are used as proxies. But there is ample reason to suppose they are not very good proxies.

76 Or maybe not. Maybe, as suggested above, they would simply direct their efforts at concealment.

77 *See* Hill, *Regulating*, *supra* note 5, at n.32 & n.33 and accompanying text.

subprime securities.[78] The amendment was adopted by the Senate, but dropped in the committee reconciliations of Dodd-Frank.[79] Franken's amendment would have required the creation of a board that would select the rating agency to be used to rate a structured finance issuance.[80] The issuer would not be able to "fire" the agency and select another.[81] It could use a second agency as well, but it would have to contend with the first agency's rating.

One important reason agencies are not presently competing vigorously on quality is that market norms dictating the use of Moody's, Standard & Poor's, and Fitch are sticky. One way to achieve more vigorous competition is by giving Moody's, Standard & Poor's, and Fitch viable competitors—competitors the markets will accept. The government had a real chance in this area. Through the Franken amendment's board, it could have given other agencies more visibility and acceptance in the marketplace by requiring issuers to use them. This probably would not have led to the most vigorous possible competition on quality, however, as there is no reason to suppose the board would have been expert at, or even inclined to, seek the "best" agency. But the board could and would have set minimum standards of competence. The increment of quality beyond that minimum increment is less important than attenuating the tie between issuers and rating agencies, as the bill would have done. The board contemplated by the Franken amendment may yet come into existence, giving us a chance to test its usefulness: Dodd-Frank requires a study into the feasibility of such a board or a like mechanism.[82]

There are other optimistic scenarios, some more likely than others. Investors might be chastened by their experiences in the present financial crisis and become more wary of rating agency ratings, a prospect I consider quite unlikely given that even egregious misratings have not stopped market participants from listening to the rating agencies (recall the New York Times article discussed above, *In Rating Agencies We Still Trust*).[83] The references in the statutes and regulations to rating agency

78 *See* Daniel Indiviglio, *Franken Amendment Would Bring Real Rating Agency Reform*, THE ATLANTIC (May 6, 2010), http://www.theatlantic.com/business/archive/2010/05/franken-amendment-would-bring-real-rating-agency-reform/56346/.

79 *See* Michael Hirsh, *Al Franken Gets Serious*, NEWSWEEK, July 12, 2010, at 38, 40, *available at* http://www.newsweek.com/2010/07/05/al-franken-gets-serious.html.

80 Indiviglio, *supra* note 78.

81 *Id.*

82 Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, Pub. L. No. 111-203, § 939F, 124 Stat. 1376, 1889 (2010).

83 Gillen, *supra* note 65, at B1.

ratings might be replaced with references to far more accurate measures of creditworthiness (also very unlikely-after all, if such measures could readily be developed, they would have been developed and in use already, certainly by market participants if not in regulations). One scenario, perhaps more likely than these, is that other agencies, such as Egan-Jones and now Kroll (the agency that bought one of the post-Enron designated rating agencies, LACE Financial, which is run by a well-known "corporate sleuth") might, through aggressive positioning and perhaps good track records, manage to erode the market norm of using Moody's, Standard & Poor's and Fitch.[84] Egan-Jones and, for some of its ratings, Kroll, are using a different business model from that used by the Big Three, where the subscribers pay rather than the issuers.[85] And for Kroll, even where the issuer is paying, Kroll is effectively touting its critical-mindedness and ability to ferret out fraud—something Moody's, Standard & Poor's, and Fitch stated was not their strength when trying to explain and excuse their ratings of Enron.[86] These are among the optimistic scenarios. The pessimistic scenario is that history, in the form of short investor memories and sticky market norms, repeats itself yet again. Dodd-Frank, as enacted, does not do enough to prevent this from occurring.

84 *See* Lucchetti & Neumann, *supra* note 54, at C1; *see* James Freeman, Editorial, *Where There's Corruption, There's Opportunity*, WALL ST. J., Sept. 4–5, 2010, Weekend Ed., at A13, *available at* http://online.wsj.com/article/SB10001424052748704476104575439841537558182.html#.

85 Freeman, *supra* note 84, at C1; *NRSRO—Nationally Recognized Statistical Rating Agency,* EGAN-JONES, http://www.egan-jones.com/nsrso (last visited Apr. 21, 2011).

86 *See, e.g.*, *Enron Hearings*, *supra* note 1, at 25. Ronald Barone, a Managing Director of Standard & Poor's, explained that Enron "was not a ratings problem. It was a fraud problem." *Id.*

Rethinking Economics for a New Era of Financial Regulation: The Political Economy of Hyman Minsky

Charles J. Whalen[*]

INTRODUCTION

Many policymakers and most of the economics profession failed to anticipate the recent global financial crisis and the subsequent Great Recession—the most severe downturn since the Great Depression. Even worse, many economists did not think such a crisis was possible. "[T]hey positively denied that it would happen," says finance professor Franklin Allen of the Wharton School of the University of Pennsylvania.[1]

In the wake of that crisis, policymakers and economists have begun to take a fresh look at the financial system. Policymakers, for example, enacted the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank), signaling a new era of U.S. financial regulation.[2] That legislation seeks to strengthen and extend financial-system rules and oversight, not only to protect investors and consumers from deceptive and abusive practices, but also to reduce systemic risks that could threaten the economy.[3] Meanwhile, economists and financial analysts have rediscovered the ideas of the late Hyman P. Minsky (1919–1996), a monetary economist who devoted his

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1 *Why Economists Failed to Predict the Financial Crisis*, KNOWLEDGE@WHARTON (May 13, 2009), http://knowledge.wharton.upenn.edu/article.cfm?articleid=2234.

2 Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, Pub. L. No. 111-203, 124 Stat. 1376 (2010).

3 *Id.*

career to the study of financial instability.[4] In fact, Nobel Laureate Paul Krugman presented a mid-2009 lecture at the London School of Economics entitled "The Night They Re-Read Minsky."[5]

This Article takes the ongoing rediscovery of Minsky as its point of departure and presents his ideas in the context of the recent crisis. It explains that Minsky's views provide a way of rethinking economics that fits with the new era of financial regulation. Minsky focused on three features of economic life: the cyclical nature of advanced capitalist economies, the reality of incessant institutional innovation, and the role of public policy in fostering and sustaining economic prosperity.[6] Each feature draws inspiration from the scholarship of earlier economists,[7] and each remains relevant to understanding today's economy and the economic challenges likely to confront policymakers, economists, and the general public in the years to come.

I. THE CYCLICAL NATURE OF ADVANCED CAPITALIST ECONOMIES

Like many of the economists who earned a Ph.D. at Harvard in the early 1950s, Minsky drew inspiration from the economics of John Maynard Keynes.[8] Unlike most of his classmates, however, Minsky was interested in the conception of economic life underlying Keynes's analysis, not merely in Keynes's policy recommendations for coping with severe business downturns. As Minsky explains in his 1975 book, *John Maynard Keynes*, the economics of Keynes derives from a business cycle perspective of the economy: the subject matter is "a sophisticated capitalist economy, whose past and whose future entail business cycles."[9]

4 Minsky taught at the University of California at Berkeley and Washington University before taking up residence at the Levy Economics Institute at Bard College in the last decade of his life. For evidence of the recent rediscovery of Minsky, see, e.g. Justin Lahart, *In Time of Tumult, Obscure Economist Gains Currency*, WALL ST. J., Aug. 18, 2007, at A1; Janet L. Yellen, President and CEO, Fed. Reserve Bank of S.F., President's Speech to the 18th Annual Hyman P. Minsky Conference on the State of the U.S. and World Economies: *A Minsky Meltdown, Lessons for Central Bankers* (Apr. 16, 2009).

5 Paul Krugman, *The Return of Depression Economics III: The Night They Re-Read Minsky*, L.S.E. CENTRE FOR ECON. PERFORMANCE (June 10, 2009), http://cep.lse.ac.uk/_new/interviews/default.asp.

6 *See* HYMAN P. MINSKY, STABILIZING AN UNSTABLE ECONOMY 10 (1986).

7 *See id.* at 8–10 & nn.7–9.

8 *Hyman P. Minsky*, *in* A BIOGRAPHICAL DICTIONARY OF DISSENTING ECONOMISTS 352, 353–55 (Philip Arestis & Malcolm Sawyer eds., 1992) [hereinafter *Minsky*, *in* A BIOGRAPHICAL DICTIONARY OF DISSENTING ECONOMISTS].

9 HYMAN P. MINSKY, JOHN MAYNARD KEYNES 58 (1975) [hereinafter MINSKY, JOHN MAYNARD KEYNES].

The political economy of Minsky builds on Keynes' business cycle perspective.[10] Indeed, Minsky's analyses are rooted in the notion that economic expansions and contractions are an inherent part of advanced capitalist economies.[11] In *John Maynard Keynes*, Minsky defines such economies as characterized by expensive and long-lived capital goods as well as by short-term financing and financial markets (the New York Stock Exchange, for example).[12] These are the economies for which Minsky develops what he calls the "financial instability hypothesis" (FIH).[13]

The FIH can be seen as an alternative to the "efficient market hypothesis" that was popular in academic circles before the recent financial crisis.[14] According to the efficient market perspective, investors, lenders, and other financial-market participants are not, as a group, predisposed to overconfidence or other biases.[15] In contrast, the FIH treats panics and overconfidence—what some have called "irrational exuberance"—as regular features of the economic landscape.[16]

Behind both the conventional economics of Keynes' time and the modern efficient market hypothesis is an assumption that the future can be treated as a matter involving *risk* in the probabilistic sense.[17] In other words, the assumption suggests that outcomes can be anticipated (and therefore managed) by a calculation of probabilities. Keynes, however, dismissed that notion. He argued instead that the economic future most often involves *uncertainty*, for which no assignment of probabilities is possible.[18] For example, Keynes wrote:

> The whole object of the accumulation of Wealth is to produce results, or potential results, at a comparatively distant, and sometimes at an indefinitely distant, date. Thus the fact that our knowledge of the future is fluctuating, vague and uncertain, renders Wealth a peculiarly unsuitable subject for the methods of classical economic theory. This theory might work very well in a world in which

10 *Id.* at 56–57.

11 *Id.* at 57.

12 *Id.*

13 *See Minsky*, *in* A BIOGRAPHICAL DICTIONARY OF DISSENTING ECONOMISTS, *supra* note 8, at 355.

14 CHARLES J. WHALEN, LEVY ECON. INST. OF BARD COLLEGE, THE U.S. CREDIT CRUNCH OF 2007: A MINSKY MOMENT 12 (2009) [hereinafter WHALEN, THE U.S. CREDIT CRUNCH OF 2007].

15 HERSH SHEFRIN, BEYOND GREED AND FEAR 5 (2002).

16 ROBERT J. SHILLER, IRRATIONAL EXUBERANCE 2 (2d ed. 2005).

17 Paul Davidson, Risk and Uncertainty in Economics 3–7 (Feb. 6, 2009) (paper presented at the conference on "The Economic Recession and the State of Economics").

18 John Maynard Keynes, *The General Theory of Employment*, 51 Q. J. ECON. 209, 213–14 (1937).

> economic goods were necessarily consumed within a short interval of their being produced. But it requires, I suggest, considerable amendment if it is to be applied to a world in which the accumulation of wealth for an indefinitely postponed future is an important factor; and the greater the proportionate part played by such wealth-accumulation the more essential does such amendment become.[19]

In short, wealth accumulation in an advanced capitalist economy involves uncertainty rather than risk.

In a world of uncertainty, Keynes argued that the expectations of borrowers and lenders rest on conventions and rules of thumb that are used to assess the hazards accompanying economic decisions.[20] Minsky followed Keynes' lead. Minsky stressed not only that reliance on conventions causes market participants to engage in herd behavior, but also that such reliance is a "flimsy foundation" for economic decisions.[21] Thus, the FIH sees an economy in which expectations are prone to sudden and substantial change.[22]

According to Minsky's FIH, the financial structure of our economy becomes more and more fragile over a period of prosperity.[23] In the early stages of an economic expansion, enterprises in "highly profitable segments of the economy are rewarded for taking on increasing amounts of debt. . . . [T]heir success encourages other firms to engage in similar behavior."[24] Eventually, a number of enterprises—sometimes even many households—begin to pile up so much debt that they require refinancing merely to make interest payments.[25]

That pattern of refinancing was certainly evident in the high-tech sector during the late-1990s and in the housing sector during the early- and mid-2000s.[26] Indeed, construction companies and contractors were not the only ones taking on more

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19 *Id.* at 213.

20 *Id.* at 213–14.

21 *Id.* at 214–15. *See also* MINSKY, JOHN MAYNARD KEYNES, *supra* note 9, at 91.

22 Keynes, *The General Theory of Employment*, supra note 18, at 214–15.

23 Charles J. Whalen, *A Minsky Perspective on the Global Recession of 2009* 3 (Research on Money & Fin., Discussion Paper No. 12, 2009), *available at* http://www.researchonmoneyandfinance.org/media/papers/RMF-12-Whalen.pdf [hereinafter Whalen, *Global Recession*].

24 *Id.*

25 Minsky calls this extraordinary state of affairs "Ponzi finance" because such a situation often recalls the pyramid schemes of infamous financial swindler, Charles Ponzi. Hyman P. Minsky, *The Financial Instability Hypothesis* 6 (Levy Econ. Inst., Working Paper No. 74, 1992), *available at* http://www.levyinstitute.org/pubs/wp74.pdf; *Ponzi Schemes—Frequently Asked Questions*, U.S. SEC, http://www.sec.gov/answers/ponzi.htm (last visited Feb. 26, 2011).

26 Whalen, *Global Recession*, *supra* note 23, at 3. *See also* Kai Tian, *What's the Risk with Interest Only Mortgage?*, EZINE ARTICLES, http://ezinearticles.com/?Whats-the-Risk-With-Interest-Only-Mortgage?&id=3817044 (last visited Feb. 26, 2011).

debt at the start of the new millennium.[27] Homebuyers also accumulated a growing amount of debt "as the housing market began heating up, in part because interest rates were low and the stock market had become less attractive in the wake of the dot-com boom and bust."[28] While it had long been customary for U.S. homebuyers to make a twenty percent down payment on a home, in the last decade, forty-two percent of first-time homebuyers and thirteen percent of non-first-time homebuyers put no money down to acquire homes.[29]

In retrospect, of course, enterprises and homebuyers should have resisted the impulse toward increasing indebtedness, but the incentives at the time were just too great. As economists Gary Dymski and Robert Pollin explained in a 1992 essay, nobody in a robust sector of the economy wants to be left behind due to underinvestment:

> Even if market participants did have full knowledge of the Minsky model, and were therefore aware that financial crises will occur at some point, that still would not enable them to predict when the financial crisis will occur. In the meantime, aggressive firm managers and bank loan officers will be rewarded for pursuing profitable opportunities and gaining competitive advantages. Cautious managers, operating from the understanding that boom conditions will end at some uncertain point, will be penalized when their more aggressive competitors surpass their short-run performance.[30]

As the preceding quote indicates, lenders, as well as borrowers, fuel the tendency toward greater indebtedness during an expansion. The same climate of expectations that encourages borrowers to acquire more risky financial liability structures also eases lenders' worries that new loans might go unpaid.[31] Moreover, it is not just that borrowing and lending expand in the boom. There is also financial innovation (which will be given further attention in the next section). In fact, in a 1992 essay, Minsky wrote that bankers and other financial intermediaries are "merchants of debt who strive to innovate in the assets they acquire and the liabilities they market."[32]

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27 Whalen, *Global Recession*, *supra* note 23, at 3.

28 *Id.*

29 Gloria Irwin, *No Money Down Gains More Buyers*, AKRON BEACON J. (July 31, 2005), http://www.policymattersohio.org/media/ABJ_No_money_down_gains_more_buyers_2005_0731.htm.

30 Gary Dymski & Robert Pollin, *Hyman Minsky as Hedgehog: The Power of the Wall Street Paradigm* 36 (Univ. of Cal. Riverside, Dep't of Econ., Working Paper No. 92-24, 1990).

31 Whalen, *Global Recession*, *supra* note 23, at 3.

32 Minsky, *The Financial Instability Hypothesis*, *supra* note 25, at 6.

A boom cannot continue forever, however. We eventually arrive at what some have called the "Minsky moment."[33] In other words, it eventually becomes clear that some borrowers have become overextended and need to sell assets (or, if possible, secure a government bailout) to make their loan payments. In the recent crisis, early high-profile cases involved the mortgage broker Countrywide, the British bank Northern Rock, and two hedge funds run by Bear Stearns (which itself became a casualty of the crisis some months later).[34]

Then the problem spreads. Since bankers and investors hold subjective expectations about acceptable debt levels, once a shortfall of cash and a forced selling of assets materializes somewhere in the economy, it can lead to widespread reassessment of how much debt or lending is appropriate.[35] Moreover, the buildup can go on for years, but when anything goes wrong the revaluation can be sudden.[36]

When banks decide to rein in their lending, we find ourselves in a credit crunch. It is easy to think of the recent economic crisis as something that began with the worldwide stock-market downturn in the autumn of 2008.[37] In fact, though, the difficulties of 2008 were preceded by a credit crunch that began in the summer of 2007, and signs of trouble—traceable in large part to the subprime mortgage market—were evident as early as March 2007.[38]

Once a credit crunch emerges, financial difficulties are no longer confined to one sector.[39] In fact, a crunch threatens not only business investment, but also household spending (which depends in large part on credit conditions as well as on employment generated by businesses).[40] This means that when a sectoral bubble bursts—as in the high-tech sector a decade ago or in the housing sector more recently—the collapse threatens to trigger an economy-wide recession.[41] That sort of slump is what the United States and much of the world experienced recently.

As the recent crisis demonstrated, a "Minsky moment" can quickly transform into an economic "meltdown." In the United States, that meltdown revealed itself in at least three sectors:

33 Lahart, *supra* note 4.
34 WHALEN, THE U.S. CREDIT CRUNCH OF 2007, *supra* note 14, at 9, 19–20.
35 Whalen, *Global Recession*, *supra* note 23, at 3.
36 *Id.*
37 *Id.*
38 WHALEN, THE U.S. CREDIT CRUNCH OF 2007, *supra* note 14, at 8.
39 FIN. CRISIS INQUIRY COMM'N, FINANCIAL CRISIS INQUIRY REPORT 389 (2011).
40 *Id.*
41 *Id.* at 390.

housing, banking, and the stock market.[42] House prices, on average, fell by more than ten percent between the beginning of the second quarter of 2006 and the end of 2007, when the recent recession began (as determined by the National Bureau of Economic Research).[43] House prices plummeted by another twenty-two percent during the recession—wiping out a total of nearly $6 trillion from the net value of real estate held by households—and have still not recovered as of this writing (January 2011).[44] In addition, the recent housing downturn has been accompanied by record levels of "underwater" mortgages (when a family owes more on their mortgage than their home is worth) and mortgage defaults.[45]

The meltdown in banking slowed considerably after enactment of the federal government's Troubled Asset Relief Program (TARP) in 2008, but the damage has still been substantial in the financial industry.[46] Over 300 financial institutions failed since the beginning of 2007.[47] And, "as of the third quarter of 2010 the Federal Deposit Insurance Corporation (FDIC) identified 860 'problem' banks," the highest number since the savings and loan crisis nearly two decades ago.[48]

The stock market has been recovering since mid-2009, but the initial market decline was stunning, and the loss of household net worth from falling equity prices was even greater than the loss from falling house prices.[49] The Dow Jones Industrial Average, for example, fell thirty-seven percent between March 30, 2007 and April 1, 2009.[50] In fact, "[t]he total value of corporate equities held by households directly or indirectly (through pensions, life insurance companies, government retirement programs, or mutual funds) fell by almost

42 U.S. CONG. BUDGET OFFICE, THE BUDGET AND ECONOMIC OUTLOOK: FISCAL YEARS 2011 TO 2021 32–34 (2011), *available at* http://www.cbo.gov/ftpdocs/120xx/doc12039/01-26_FY2011Outlook.pdf [hereinafter BUDGET AND ECONOMIC OUTLOOK]; *Determination of the December 2007 Peak in Economic Activity*, THE NATIONAL BUREAU OF ECONOMIC RESEARCH 1, http://www.nber.org/cycles/dec2008.pdf (last updated Dec. 11, 2008).

43 BUDGET AND ECONOMIC OUTLOOK, *supra* note 42, at 32.

44 *Id.* at 33.

45 John Gittelsohn, *Home-Price Drop Leaves 27% of U.S. Homeowners Underwater on Loans, Zillow Says,* BLOOMBERG (Feb. 9, 2011), http://www.bloomberg.com/news/print/2011-02-09/home-price-decline-leaves-27-of-u-s-owners-underwater-on-loans.html.

46 CONG. OVERSIGHT PANEL, SEPTEMBER OVERSIGHT REPORT: ASSESSING THE TARP ON THE EVE OF ITS EXPIRATION 3 (2010), *available at* http://cop.senate.gov/documents/cop-091610-report.pdf.

47 BUDGET AND ECONOMIC OUTLOOK*, supra* note 42, at 34.

48 *Id.*

49 *Id.* at 33.

50 Dow Jones Industrial Average Values from March 30, 2007 to April 1, 2009, YAHOO! FINANCE, http://finance.yahoo.com (follow "Dow" hyperlink; then follow "Historical Prices" hyperlink; then search "Mar. 30, 2007" for "Start Date" and search "Apr. 1, 2009" for "End Date").

$8 trillion during the recession."[51] As of the third quarter of 2010, households' equity holdings had only regained about $4 trillion—half of what they had lost.[52]

Looking beyond housing, banking, and equities, one also finds a troubled U.S. labor market. The nation's unemployment rate rose from 4.4% in March 2007 to 10.1% in October 2009 (approaching its post-World War II peak of 10.8%), and in 2010 the jobless rate averaged 9.6%.[53] That rate would have been higher, but many job seekers became discouraged after failing to find work, leaving the labor force, and were thus excluded from the official unemployment count.[54]

Moreover, rates of long-term unemployment observed in 2010 were unprecedented in the post-World War II era. For example, on average, forty-three percent of workers who were unemployed in 2010 were out of work for more than twenty-six weeks.[55] Many economic forecasters expect that it will take a few more years for the unemployment rate to return to less than six percent.[56]

According to Minsky's FIH, a downturn will eventually give way to recovery.[57] An unwinding of the previous credit expansion is usually a precondition of such a turn of events, but that process can take years. Moreover, if pessimistic expectations are allowed to feed on themselves, then a contracting economy can spiral downward (in what Minsky called a "debt deflation") for quite some time.[58] If there is a road to full employment by way of market adjustments alone, Minsky wrote, "it may well go by way of hell."[59]

II. THE REALITY OF INCESSANT INSTITUTIONAL INNOVATION

The political economy of Minsky was inspired by Keynes, but it was also influenced by Minsky's association with Joseph A.

51 BUDGET AND ECONOMIC OUTLOOK, *supra* note 42, at 33.

52 *Id.*

53 Monthly Unemployment Rate from 1948 to 2011, BUREAU OF LABOR STATISTICS, http://data.bls.gov/pdq/SurveyOutputServlet?data_tool=latest_numbers&series_id=LNS14000000 (last visited Mar. 20, 2011) (change output options "from" to 1948); BUDGET AND ECONOMIC OUTLOOK, *supra* note 42, at 29.

54 News Release, U.S. Bureau of Labor Statistics, The Employment Situation—December 2010 (Jan. 7, 2011), *available at* http://www.bls.gov/news.release/archives.empsit_01072001.pdf.

55 BUDGET AND ECONOMIC OUTLOOK, *supra* note 42, at 31.

56 *Id.* at 42.

57 MINSKY, STABILIZING AN UNSTABLE ECONOMY, *supra* note 6, at 175–77.

58 Minsky, *The Financial Instability Hypothesis*, *supra* note 25, at 1.

59 MINSKY, STABILIZING AN UNSTABLE ECONOMY, *supra* note 6, at 177.

Schumpeter, who supervised Minsky's doctoral work until his untimely death in 1950.[60]

While Keynes offered insight into cyclical fluctuations, Schumpeter provided Minsky with insight into structural economic evolution over a series of cycles. That is because Schumpeter—who coined the phrase "creative destruction"—placed the dynamic power of ceaseless structural economic change at the center of his economic analysis.[61] In fact, Minsky underscored an aspect of Schumpeter's concept of "creative destruction" that few others recognized: financial innovation.[62] "[N]owhere is evolution, change and Schumpeterian entrepreneurship more evident than in banking and finance and nowhere is the drive for profits more clearly the factor making for change," wrote Minsky in an article produced in the last few years of his life, a period during which his writings gave increasing attention to Schumpeter's ideas.[63]

In the 1990s, Minsky still believed that the U.S. economy moved along a cyclical path, but he also believed that the system had recently entered a new stage of capitalist development as a consequence of constant institutional change.[64] According to Minsky, the *managerial* era of American capitalism, which matured in the immediate aftermath of World War II, had given way in the 1980s to a stage characterized by emergence of money managers as the nation's dominant economic decision-makers.[65] He called the new era *money-manager* capitalism (MMC).[66]

At least four institutional features of MMC have emerged to play a role in explaining the economic difficulties of the past few years. The origin of the recent global crisis can be traced in large part to the following financial-sector innovations: unconventional mortgages, securitization, the rise of hedge funds, and the globalization of finance.[67]

At the heart of the recent financial crisis are home mortgages that deviate from the traditional U.S. home-loan

60 *Minsky*, *in* A BIOGRAPHICAL DICTIONARY OF DISSENTING ECONOMISTS, *supra* note 8, at 353–54.

61 JOSEPH A. SCHUMPETER, CAPITALISM, SOCIALISM AND DEMOCRACY 87–89 (4th ed. 1952).

62 *Hyman P. Minsky*, *Schumpeter and Finance*, *in* MARKET AND INSTITUTIONS IN ECONOMIC DEVELOPMENT 103, 106 (Salvatore Biasco, Alessandro Roncaglia, & Michele Salvati eds., 1993).

63 *Id.*

64 *Id.* at 111–13.

65 *Id.* at 109–13.

66 *Id.* at 111–12.

67 For a similar analysis, see generally FINANCIAL CRISIS INQUIRY REPORT, *supra* note 39.

arrangement, which involves a long-term loan on fixed-rate terms.[68] Many of these unconventional—some writers call them "exotic"—mortgages have adjustable interest rates and/or payments that balloon over time.[69] Federal law has allowed banks to issue adjustable-rate mortgages since 1982, but their use and complexity exploded starting in 2003.[70] For example, industry experts estimate that a variant called the "option adjustable rate mortgage" (option ARM), which offers a low "teaser" rate and later resets so that minimum payments skyrocket, accounted for about 0.5% of all U.S. mortgages written in 2003, but close to thirteen percent (and up to fifty-one percent in some U.S. communities) in 2006.[71] More precise figures are unavailable because banks have not been required to report how many option ARMs they originate.[72]

Many of these mortgages were created to target less creditworthy customers, including those in what the banking industry calls the subprime market.[73] Others were marketed to people who wanted to speculate in the booming housing market, through buying and then quickly reselling property.[74] However, many unconventional loans were marketed to ordinary working families who could have handled conventional mortgages.[75]

Unfortunately, it was clear from the outset that many of these exotic mortgages could never be paid back.[76] But why did this happen? Why did the mortgage market evolve in this dangerous direction?

This is where securitization comes into the picture. Securitization is simply the bundling of loans—which can include auto loans, student loans, accounts receivable, and of course, mortgages—and the subsequent selling of bundle shares to investors.[77] In the mid-1980s, Minsky returned home from a conference sponsored by the Federal Reserve Bank of Chicago

68 *Id.*

69 Mara Der Hovanesian, *Nightmare Mortgages*, BUS. WEEK, Sept. 11, 2006, at 71–72.

70 *Id.* at 72.

71 *Id.*

72 *Id.*

73 FINANCIAL CRISIS INQUIRY REPORT, *supra* note 39, at 7.

74 *Id.*

75 Bruce Marks, Op-Ed., *Bailout Must Address the Foreclosure Crisis*, BOSTON GLOBE, Sept. 24, 2008, at A17.

76 For an eye-opening look at the aggressive marketing of unconventional mortgages, see Gretchen Morgenson, *Inside the Countrywide Lending Spree*, N.Y TIMES, Aug. 26, 2007, at BU1, 8.

77 Hyman P. Minsky, *The Capital Development of the Economy and the Structure of Financial Institutions* 22 (Levy Economics Institute, Working Paper No. 72, 1992), *available at* http://www.levyinstitute.com/pubs/wp72.pdf.

and wrote that securitization was emerging as a key, new financial innovation: "That which can be securitized, will be securitized."[78] He was right, but way ahead of his time. Securitization of mortgages exploded onto the scene only in the past decade.

After the dot-com bubble burst in 2001, housing in the United States looked like a safer and more attractive investment to many Americans, especially with low interest rates in place due to Federal Reserve policy.[79] Still, returns on conventional mortgages were too mundane to satisfy the aims of most money managers. As a result, what Minsky and Schumpeter might have called the "financial-innovation machine" turned its attention to housing and shifted into high gear.

Securitization of mortgages meant that home loan originators could be less concerned about the creditworthiness of borrowers than in the past.[80] Thus, they had an incentive to steer customers toward the most profitable types of mortgages, even if they were the riskiest (which, of course, they were). The result was the explosive growth in option ARMs and in "no money down" and "no documentation" (of income) loans.[81] Minsky warned of all this in 1992, when he observed that securitization means mortgage originators are rewarded as long as they avoid "obvious fraud."[82]

Securitization worked like magic upon risky mortgages. Instead of "garbage in, garbage out," risky loans went into the process, but out came bundles that received high credit ratings from agencies like Standard and Poors.[83] According to Christopher Huhne, a member of the British Parliament and former rating-agency economist, part of the challenge of rating the bundles was "that financial markets fall in love with new things, with innovations, and the [important] thing about new things is that it is very difficult to assess the real riskiness of them because you don't have a history by definition."[84]

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78 Hyman P. Minsky, *Schumpeter: Finance and Evolution*, *in* EVOLVING TECHNOLOGY AND MARKET STRUCTURE 51, 64 (Arnold Heertje & Mark Perlman eds., 1990).

79 Dean Baker, *The Housing Bubble and the Financial Crisis*, 46 REAL WORLD ECON. REV. 73, 74 (2008), http://www.paecon.net/PAEReview/issue46/Baker46.pdf.

80 FINANCIAL CRISIS INQUIRY REPORT, *supra* note 39, at 8.

81 Baker, *supra* note 79, at 74–76.

82 Minsky, *The Capital Development of the Economy and the Structure of Financial Institutions*, *supra* note 77, at 22–23.

83 Christoper Huhne, quoted on *World Business Review* (BBC World Service Sept. 1, 2007) (on file with author).

84 *Id.*

Another problem is that rating agencies did not verify the information provided by mortgage issuers.[85] Instead, they based their decisions on information received from intermediaries that, as Minsky put it, "did not hazard any of their wealth on the longer term viability of the underlying [loans]."[86]

Moreover, there are so many middlemen in the mortgage securitization game, including a number that have been permitted to operate in a largely unregulated manner, that no one person or organization could be easily assigned blame in the event of default. The chain between the borrower and the investor includes realtors, home appraisers, mortgage brokers, mortgage originators, investment banks that bundled the mortgages, agencies that rated the bundles, and even companies (like American International Group) that "insured" many of the bundles.[87]

Mortgage-backed securities totaling into the trillions of dollars were bundled and sold as shares to investors. In late 2008, Fannie Mae and Freddie Mac alone held $4.1 trillion.[88] Moreover, the private market in "credit-default swaps" (CDS) reached $45 trillion by late 2007.[89] The CDS were used by borrowers and lenders as a hedge against (mortgage-backed) securities losses, as a way to speculate that other companies will experience a loss, or as an arbitrage instrument (that is, they allowed purchasers to take advantage of price differences in the market).[90]

Many of the mortgages underlying mortgage-backed securities are now in foreclosure or headed there. In 2008, 2.3 million U.S. homes went into foreclosure, up 81% from 2007 and

85 OFFICE OF COMPLIANCE INSPECTIONS & EXAMINATIONS, U.S. SEC, SUMMARY REPORT OF ISSUES IDENTIFIED IN THE COMMISSION STAFF'S EXAMINATIONS OF SELECT CREDIT RATING AGENCIES 17–18 (2008).

86 Minsky, *The Capital Development of the Economy and the Structure of Financial Institutions*, *supra* note 77, at 23.

87 Mortgage brokers, who operated without much government regulation, accounted for eighty percent of all U.S. mortgage originations in 2006, double their share a decade earlier. *See* Der Hovanesian, *supra* note 69, at 72.

88 Scott Lanman & Dawn Kopecki, *Fed Commits $800 Billion More to Unfreeze Lending*, BLOOMBERG (Nov. 25, 2008, 3:20 PM), http://www.bloomberg.com/apps/news?pid=newsarchive&sid=ai_aErzotzx8.

89 Phillip A. O'Hara, *The Global Securitized Subprime Market Crisis*, 41 REV. OF RADICAL POL. ECON. 318, 332 (2009).

90 *Id.* at 331–32.

225% from 2006.[91] There were an additional 2.8 million filings in 2009, and 2.9 million more in 2010.[92]

Mortgage delinquencies have also risen to record levels as a result of the financial crisis and recession that followed. In February 2009, for example, seven percent of U.S. homeowners with mortgages were at least thirty days late on their loans, an increase of more than fifty percent from a year earlier.[93] Among subprime borrowers, that month's delinquency rate was 39.8%.[94] According to the latest data available, the delinquency rate on residential properties was just over nine percent of all loans outstanding as of the end of the third quarter of 2010.[95]

There has been much public discussion in the United States over the past few years about reckless homebuyers. Some were, but mortgage seekers did not bring the economy to its knees on their own. Trouble in the housing market would not have generated a crisis of the magnitude we have witnessed in the absence of the financial innovations described above.[96] As Minsky stressed at a pair of professional conferences in the late 1980s and early 1990s, there is a symbiotic relationship "between the growth of securitization and managed money."[97]

From a Minsky perspective, yet another part of the story of the recent crisis is the role of hedge funds and other investment funds—and of investment banks and other financial institutions. Although the following discussion focuses on hedge funds (which not only operated largely outside the realm of financial-system

91 Melinda Fulmer, *Foreclosure's Up 81% in 2008*, MSN REAL ESTATE, http://realestate.msn.com/article.aspx?cp-documentid=16831437 (last visited Mar. 21, 2011). The data is also available from various press releases provided by RealtyTrac in 2009, 2010, and 2011, *available at* http://www.realtytrac.com.

92 Press Release, RealtyTrac, Record 2.9 Million U.S. Properties Receive Foreclosure Filings in 2010 Despite 30-Month Low in December (Jan. 12, 2011), *available at* http://www.realtytrac.com/content/press-releases/record-29-million-us-properties-receive-foreclosure-filings-in-2010-despite-30-month-low-in-december-6309; Press Release, RealtyTrac, Year-End Report Shows Record 2.8 Million U.S. Properties With Foreclosure Filings in 2009 (Jan. 14, 2010), *available at* http://media.oregonlive.com/frontporch/other/RealtyTrac%20Year-End%202009%20National%20Data%20FINAL.pdf.

93 Helen Chernikoff, *U.S. Mortgage Delinquencies Up 50 Percent*, REUTERS UK (Apr. 8, 2009), *available at* http://uk.reuters.com/article/2009/04/08/us-mortgages-delinquencies-exclusive-idUKTRE5374LT20090408.

94 *Id.*

95 Press Release, Mortgage Bankers Ass'n, Delinquencies and Loans in Foreclosure Decrease, But Foreclosure Starts Rise in Latest MBA National Delinquency Survey (Nov. 18, 2010), *available at* http://www.mbaa.org/NewsandMedia/PressCenter/74733.htm.

96 KEITH HENNESSEY ET AL., DISSENTING STATEMENT TO THE FINANCIAL CRISIS INQUIRY COMMISSION REPORT: CAUSES OF THE FINANCIAL AND ECONOMIC CRISIS 417–18 (2010), *available at* http://keithhennessey.com/2011/01/26/the-three-man-fcic-dissent-hennessey-holtz-eakin-thomas/.

97 Minsky, *Schumpeter: Finance and Evolution*, *supra* note 78, at 71.

regulation, but were relatively new to the scene prior to the crisis), investment banks and other institutions played a similar role.[98]

Some of the biggest purchasers of securitized mortgages have been hedge funds. The earliest of these funds were established in the first few decades after World War II for the purpose of seeking absolute returns (rather than beating a benchmark stock market index).[99] They were indeed "hedged" funds, which sought to protect principal from financial loss by hedging investments through short selling (which involves betting that the price of an investment product will fall) or other means.[100]

The number of hedge funds and the assets under their management expanded in the 1990s and grew even more rapidly in the 2000s.[101] At the same time, these assets became increasingly concentrated at the top ten firms, and funds became more diverse in terms of the strategies their managers employed.[102] In mid-2008, the Alternative Investment Management Association estimated that the world's hedge funds (based primarily in the United States) were managing $2.5 trillion, though it acknowledged that other estimates were as high as $4 trillion.[103]

The total value of assets under hedge-fund management is uncertain because such funds are typically restricted to wealthy individuals and institutional investors, which exempts them from most financial-sector reporting requirements and regulation.[104] Taking advantage of their largely unregulated status, managers of hedge funds used mortgage-backed securities as collateral to take out highly leveraged loans.[105] They then purchased an

98 Indeed, since 1999, U.S. banking operated without the Glass Stegall firewall that separated commercial and investment banking for over a half century. *See* Cyrus Sanati, *10 Years Later, Looking at Repeal of Glass-Steagall*, DEALBOOK (Nov. 12, 2009, 3:49 PM), http://dealbook.nytimes.com/2009/11/12/10-years-later-looking-at-repeal-of-glass-steagall/.

99 James E. McWhinney, *A Brief History of the Hedge Fund*, INVESTOPEDIA, http://www.investopedia.com/articles/mutualfund/05/HedgeFundHist.asp (last visited Mar. 21, 2011).

100 *See* Definition of Hedge Fund, INVESTOPEDIA, http://www.investopedia.com/terms/h/hedgefund.asp (last visited Mar. 21, 2011).

101 IFSL RESEARCH, HEDGE FUNDS 2009 (2009), *available at* http://www.thehedgefundjournal.com/research/ifsl/cbs-hedge-funds-2009-2-.pdf; CLARK CHENG, SECURITIZATION & HEDGE FUNDS: CREATING A MORE EFFICIENT MARKET 3 fig. 1 (2002), *available at* www.securitization.net/pdf/rcg_hedge_080602.pdf.

102 *See* ALEXANDER INEICHEN & KURT SILBERSTEIN, ALTERNATIVE INVESTMENT SOLUTIONS, UBS GLOBAL ASSET MANAGEMENT, AIMA'S ROADMAP TO HEDGE FUNDS 17 (2008).

103 *Id.* at 16.

104 Investment Company Act of 1940, §§ 2–3, 15 U.S.C. §§ 80a-2–80a-3 (2010).

105 James Freeman, *How the Money Vanished: A Close Look at the Collapse of Bear*

assortment of financial instruments, including still more mortgage bundles.[106] As a result, the world's hedge funds used securitized mortgages to lay an inherently fragile foundation for a financial "house of cards."[107]

The recent crisis was unmistakably global. It had economic and political ramifications on all continents. Its ripple effect reached even unexpected places including rural China, which saw workers return home from that nation's export-oriented cities when factories cut production.[108]

The global nature of the recent situation would not have surprised Minsky, who stressed early on that money-manager capitalism "is international in both the funds and the assets in funds."[109] Looking ahead to the recent crisis, Minsky wrote: "The problem of finance that will emerge is whether the . . . institutions of national governments can contain both the consequences of global financial fragility and an international debt deflation."[110] He worried that the United States would be unable to serve as "the guardian angel for stability in the world economy" and stressed the need for "an international division of responsibility for maintaining global aggregate gross profits."[111]

In short, the global economy has recently experienced a classic Minsky crisis—one with intertwined cyclical and institutional (structural) dimensions. Its origins were in a housing boom fueled by rising expectations, expanding debt, and financial innovation. Then the bubble burst, creating first a credit crunch, then a broader banking and stock-market crisis, and, ultimately, a recession, the adverse effects of which continue to linger, especially in labor, housing and financial markets.

Since 2007, the global banking industry has seen an unprecedented shakeout, but even in early 2011 there is uncertainty about how much more difficulty lies ahead. There are concerns, for example, that some U.S. banks will be forced to buy back mortgage securities that may have failed to meet

Stearns, WALL ST. J. (Mar. 6, 2009), http://online.wsj.com/article/SB123630340388147387.html.

106 *Id.*

107 Christopher Holt, *A Graphical Look at Hedge Fund Leverage*, SEEKING ALPHA (Mar. 8, 2009), http://seekingalpha.com/article/124783-a-graphical-look-at-hedge-fund-leverage.

108 Don Lee, *Migrant Factory Workers at a Loss as China's Economy Slumps*, L.A. TIMES, Jan. 24, 2009, at C1.

109 Minsky, *Schumpeter: Finance and Evolution*, *supra* note 78, at 71.

110 Hyman P. Minsky, *Longer Waves in Financial Relations*, 29:1 J. ECON. ISSUES 83, 93 (1995).

111 Hyman P. Minsky, *Global Consequences of Financial Deregulation*, *in* 2 MARCUS WALLENBERG PAPERS ON INT'L. FIN. 1, 15, 71 (1986).

certain underwriting standards.[112] The uncertainty regarding institutional exposure to possible mortgage-related financial losses was a contributor to the credit crunch of 2007, and similar uncertainty exists today.[113] In addition, a new threat has emerged in the form of uncertainty about the fiscal stability of entire nations, such as the recent concerns over Greece and Ireland.[114]

III. THE ROLE OF PUBLIC POLICY

The third dimension in the political economy of Minsky is the role of public policy. Before writing about Keynes and studying with Schumpeter, Minsky was a student of Henry C. Simons at the University of Chicago.[115] Simons' influence left an indelible mark on Minsky's approach to public policy.

Simons is remembered today as a critic of Keynes (as was Schumpeter) and founder of the "Chicago School" brand of economics that generally favors a *laissez-faire* approach to economic policy.[116] Nevertheless, his views were complex, and he had a nuanced position on the role of government, one shaped by a career that focused not only on that topic directly, but also on taxation, monetary policy, and other specific aspects of economic policy.[117] Simons favored market decisions over collective action in circumstances where competition prevailed, but he also gave the public sector major responsibilities.[118] These included providing the legal foundation for such competition and acting decisively—and, if need be, permanently—when such conditions could not prevail.[119]

Simons' notion that there is a "division of labor" between what can be left to the market and what needs to be done by the public sector manifests itself in Minsky's overall conception of the role of government, which can be seen perhaps most clearly in his 1986 book, *Stabilizing an Unstable Economy*.[120] Simons'

112 David Indiviglio, *Will Washington Let the Mortgage Put-back Fiasco Escalate?*, ATLANTIC MONTHLY, Oct. 2010, *available at* http://www.theatlantic.com/business/archive/2010/10/will-washington-let-the-mortgage-put-back-fiasco-escalate/64868/.

113 *Id.*

114 *See* RIKSBANK, FINANCIAL STABILITY REPORT 1/2010, 20 (2010), *available at* http://www.riksbank.com/upload/Dokument_riksbank/Kat_publicerat/Rapporter/2010/FSR1/FS_2010_1_eng_box1.pdf.

115 *Minsky*, *in* A BIOGRAPHICAL DICTIONARY OF DISSENTING ECONOMISTS, *supra* note 8, at 354.

116 *Id.*

117 *See generally* George J. Stigler, *Henry Calvert Simons,* 17 J. L. ECON. 1 (1974).

118 HENRY C. SIMONS, ECONOMIC POLICY FOR A FREE SOCIETY 99, 117 (1948).

119 *Id.* at 117; *Minsky*, *in* A BIOGRAPHICAL DICTIONARY OF DISSENTING ECONOMISTS, *supra* note 8, at 354.

120 *See* MINSKY, STABILIZING AN UNSTABLE ECONOMY, *supra* note 6, at 332.

influence also appears in Minsky's attention to specific policy elements, especially Minsky's call for a "structure of industry policy" aimed at preventing institutions from becoming "too big to fail."[121] Against the backdrop of the recent financial crisis and recession, Minsky's approach to public policy can be presented as generating an economic policy strategy aimed at recovery and reform.

A. Recovery

The overall aim of Minsky's strategy for economic recovery is to prevent a recession from becoming another Great Depression.[122] That strategy gives attention to both fiscal policy and monetary policy. Each is considered in turn.

The fiscal policy component of Minsky's strategy centers on what he called Big Government.[123] At the heart of Big Government is a federal budget that tends toward surpluses in inflationary periods and produces deficits large enough to stabilize aggregate profits in recessionary periods.[124] Minsky envisioned that such countercyclical spending would be a "built-in" feature of the budget structure, but he also recognized that discretionary legislative action (the recent American Recovery and Reinvestment Act, for example) would be needed on occasion.[125]

The monetary policy component of Minsky's strategy centers on the stabilizing actions of the central bank. He envisioned that the Federal Reserve (Fed) would intervene as "lender of last resort" in response to the threat of a serious credit crisis and economic contraction.[126] "Central banks are the institutions that are responsible for containing and offsetting financial instability," Minsky wrote in 1986.[127] In that same year, he also contributed an article emphasizing the globalization of finance and calling for international central-bank coordination as a way to prepare for the next big financial crisis.[128]

Much of what Minsky described in his recovery agenda has been pursued by U.S. policymakers during the recent

121 For more on the compatibility of the views of Simons and Minsky with respect to the role of the state, see Charles J. Whalen, *Stabilizing the Unstable Economy: More on the Minsky-Simons Connection*, 25 J. ECON ISSUES 739 (1991).

122 *See* MINSKY, STABILIZING AN UNSTABLE ECONOMY, *supra* note 6, at 18–19.

123 *See id.*

124 *See id.* at 296–97, 302–04.

125 *Id.* at 132, 292.

126 *Id.* at 19.

127 *Id.* at 322.

128 *See generally* Minsky, *Global Consequences of Financial Deregulation*, *supra* note 111.

recession.[129] While fiscal policy already contained automatic stabilizers, major legislative measures were taken to support aggregate demand in 2008, 2009, and again in 2010.[130] Monetary policy has also been engaged in the stabilization effort.

To stabilize the financial sector and overall economy in the wake of the recent financial crisis, the Fed aggressively cut interest rates, allowed financial institutions to borrow from it at nominal rates, and gave banks cash in exchange for risky assets (promising to take on the risk that those assets could prove worthless).[131] The Fed, which students of Minsky sometimes call the "Big Bank," has also engineered bank mergers and worked with other central banks to increase the supply of dollars worldwide.[132] In many ways, Fed Chairman Ben Bernanke has pursued a strategy consistent with Minsky's conception of a Big Bank that provides the monetary-policy complement to the fiscal policy of Big Government.[133]

Legislation creating TARP in 2008 is also broadly consistent with Minsky's conception of the central bank as lender of last resort.[134] However, Minsky admired how the Reconstruction Finance Corporation closed insolvent banks and assisted solvent ones during the Great Depression.[135] Thus, it is likely he would have preferred a more hands-on approach to cleaning up bank balance sheets than that resulting from TARP.

B. Reform

Looking beyond policies designed to address an economic downturn, Minsky's reform agenda included stricter regulation and supervision of the financial system.[136] It also included a national commitment to full employment by means of public-service employment for the jobless.[137] The aim of both was to foster and sustain a period of prosperity as well as lay the foundation for more moderate future downturns.[138]

129 BUDGET AND ECONOMIC OUTLOOK, *supra* note 42, at 34–35.

130 *Id.*

131 *Id.*

132 HYMAN P. MINSKY, STABILIZING AN UNSTABLE ECONOMY xvii (2d ed. 2008) [hereinafter MINSKY, STABILIZING AN UNSTABLE ECONOMY (2d ed. 2008)].

133 For a discussion of the often overlooked link between Minsky's ideas and financial-market research organized by Bernanke at Princeton University, see Justin Lahart, *Bernanke's Bubble Laboratory*, WALL ST. J., May 16, 2008, at A1, A10.

134 On TARP, see BUDGET AND ECONOMIC OUTLOOK, *supra* note 42, at 35.

135 MINSKY, STABILIZING AN UNSTABLE ECONOMY (2d ed. 2008), *supra* note 132, at xxi.

136 MINSKY, STABILIZING AN UNSTABLE ECONOMY, *supra* note 6, at 329–30.

137 *Id.* at 308–12.

138 *Id.*

Minsky believed that those responsible for government regulation and supervision of the financial system are in a constant struggle with financial-market innovators.[139] Any set of regulations can contain financial innovation for only so long; then an updated regulatory framework will be required—and the process begins again. "After an initial interval, the basic disequilibrating tendencies of capitalist finance will once again push the financial structure to the brink of fragility," he explained.[140]

Still, Minsky believed it was necessary for the Fed and regulators to continue the struggle: "The evolution of financial practices must be guided to reduce the likelihood that fragile situations conducive to financial instability will develop."[141] This is where Dodd-Frank would fit into the Minsky framework.

Minsky's financial reform also involved broader corporate reform, which he sometimes called a structure-of-industry policy.[142] This included placing size limits on corporations based on the level of assets and/or employment.[143] These were seen as a way to foster greater competition, reduce the need for lender-of-last-resort interventions, and avoid situations in which specific corporations would be seen as "too big to fail."[144]

Minsky's reform agenda also included an employment policy that envisions government as "employer of last resort."[145] The idea was for public-service employment based roughly on the New Deal Era's Works Progress Administration and Civilian Conservation Corps.[146] This policy would provide able-bodied people with an alternative to joblessness and unemployment benefits; under such a policy, public-service payrolls would rise and fall to offset private-sector demand for workers.[147] In Minsky's view, the policy would help stabilize the economy, but it would also help foster a more humane economy.[148]

CONCLUSION: STANDING ON THE SHOULDERS OF MINSKY

With enactment of Dodd-Frank, financial regulation has entered a new era. The political economy of Minsky can

139 *Id.* at 252.
140 *Id.* at 333.
141 *Id.* at 322.
142 MINSKY, STABILIZING AN UNSTABLE ECONOMY, *supra* note 6, at 330–31.
143 *Id.* at 330.
144 *Id.* at 330–31.
145 *Id.* at xvii, 308–312.
146 *Id.*
147 *Id.*
148 *Id.* at 293.

accompany that era with a fresh approach to economics. In place of the efficient-market hypothesis, Minsky offers a financial-instability alternative. That alternative is consistent with Keynes' observation that business cycles are a characteristic feature of advanced capitalist economies.[149] Minsky's approach also incorporates Schumpeter's recognition of incessant institutional innovation;[150] indeed, recent innovations help explain the first serious financial crisis of the age of money-manager capitalism. In addition, Minsky's approach earns the name "political" economy because, drawing inspiration from Simons, he envisioned an important division of labor between the market and the public sector, one that gives key responsibilities to government in the realm of economic management.[151]

Minsky used to say we should stand on the shoulders of giants to better understand the economy.[152] Just as he stood on the shoulders of Keynes, Schumpeter, and Simons, we can now stand on his shoulders—to not only better understand the recent financial crisis, the Great Recession, and the anemic U.S. recovery, but also to better anticipate what might lie ahead. From a Minsky perspective, explaining current events involves incorporating cyclical and structural dimensions.[153] His perspective also involves devising a policy strategy that gives attention to both recovery and reform.[154]

The recent attention to Minsky's ideas, in the academy and in the practical world of financial decision-making, has enriched our understanding. But Minsky has been "discovered" in the midst of other periods of financial turmoil (in October 1987, for example), only to fall back into obscurity once the economy has recovered. We do ourselves a disservice when Minsky's insights are reduced to an analysis of just a single event (a "Minsky moment") or even of financial instability.

Here is how that can be avoided. Standing squarely on the shoulders of Minsky means recognizing the perennial value of evolutionary and institutionally focused thinking about the economy. It also means giving serious attention not only to business cycles and financial innovation but also to Minsky's

149 MINSKY, JOHN MAYNARD KEYNES, *supra* note 9, at 56–57.

150 *Minsky*, *in* A BIOGRAPHICAL DICTIONARY OF DISSENTING ECONOMISTS, *supra* note 8, at 354–55.

151 *Id.*

152 MINSKY, STABILIZING AN UNSTABLE ECONOMY (2d ed. 2008), *supra* note 132, at xiii.

153 *Id.* at vii–viii.

154 *See, e.g.*, MINSKY, STABILIZING AN UNSTABLE ECONOMY, *supra* note 6, at 290.

effort to guide the further development of the economic system in a more humane direction.[155]

155 For more on the path forward for economics, using analyses inspired by Minsky, see FINANCIAL INSTABILITY AND ECONOMIC SECURITY AFTER THE GREAT RECESSION (Charles J. Whalen ed.) (forthcoming 2011).

Foreclosing on the Federal Power Grab: Dodd-Frank, Preemption, and the State Role in Mortgage Servicing Regulation

Kurt Eggert[*]

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INTRODUCTION

It is telling, but perhaps unsurprising that the legal and regulatory structures that helped cause the subprime mortgage crisis are also making it more difficult to address the resulting flood of mortgage defaults and foreclosures. Securitization lowered underwriting standards by allowing mortgage lenders to sell poorly underwritten loans, leaving investors to deal with the ensuing defaults. Securitization also is making it more difficult to resolve these problem loans, as they were stranded in securitized loan pools, and their resolution is often stymied by servicers' self-interest and unwillingness to spend the resources to modify the loans. Similarly, the deregulatory fever which swept Washington during the Bush Administration made it easier for lenders to reduce their underwriting standards without adequately informing investors.[1] As foreclosures mounted and servicers responded with robo-signing of foreclosure documents and other abusive practices, regulators seemed almost mystified as to who regulated mortgage servicers and how servicers should be regulated. When Congress passed the Home Affordable Modification Program (HAMP), there was so little expertise in regulating servicers among the federal agencies that the job of overseeing HAMP was passed to Fannie Mae and Freddie Mac, who have proven largely unable, and to a great extent even unwilling to rein in servicer misconduct.[2] And so deregulation not only led to the creation of risky loans, it hampered the ability of the federal government to create effective programs to reduce the harm caused by those loans to borrowers, investors, and the public.

A third cause of the mortgage meltdown that has also interfered with cleaning up the resulting foreclosure crisis is federal preemption of state laws. During the subprime boom ending in 2007, federal banking agencies insisted that their regulations preempted the state initiatives that could have slowed predatory lending and the creation of risky home loans. States attempted to curb predatory lending through a variety of state laws.[3] In response, the federally regulated banking

1 For a discussion of how securitization allowed lenders to reduce underwriting standards without adequate disclosure to investors, see Kurt Eggert, *The Great Collapse: How Securitization Caused the Subprime Meltdown*, 41 CONN. L. REV. 1257 (2009).

2 *See* CONG. OVERSIGHT PANEL, 111TH CONG., DECEMBER OVERSIGHT REPORT 82 (2010), *available at* http://cybercemetery.unt.edu/archive/cop/20110402010243/http://cop.senate.gov/documents/cop-121410-report.pdf.

3 For a discussion of the various state statutes directed at halting such predatory lending, see Jessica Fogel, *State Consumer Protection Statutes: An Alternative Approach*

industry sought protection from state regulation by requesting that federal regulators determine that those state laws were preempted and so could be ignored by federally regulated banks and thrifts. Not coincidentally, federally regulated banks and thrifts have seen higher default rates in their mortgages than state regulated banks and thrifts, with lenders regulated by the federal Office of Thrift Supervision (OTS) among the worst offenders. Moreover, states were tempted to loosen their own regulations, or face losing their state banks to a more permissive federal charter.

Just as preemption by federal regulatory agencies helped cause the mortgage meltdown, preemption has been a barrier to state efforts to address the meltdown. Mortgage servicers that are federally regulated banks or their subsidiaries have claimed that they are free from state regulation, whether in the form of state regulators seeking to examine their practices, or state laws and regulations aimed at inducing servicers to modify loans where appropriate.[4] Instead, these mortgage servicers have regularly argued that only federal regulation applies to them. Federal regulation of servicers has been weak and sparse, with few carrots and almost no sticks, and federal regulators have until recently had an almost entirely hands-off attitude toward the servicers. As a result, federally-regulated servicers have engaged in significant misbehavior, including the infamous "robo-signing" scandals, where servicer employees were certifying the debt and defaults for borrowers in notarized statements without personal knowledge of those debts or whether borrowers were even in default.[5] On too many occasions, servicers have attempted to foreclose on homes even when it appears that neither they nor the trust they represent possess the note that would allow such foreclosure.[6] And servicers have regularly piled excessive or unfounded fees on borrowers, at times pushing borrowers into foreclosure with such fees alone.

At the same time, servicers have failed to modify loans where appropriate, and have foreclosed even when a loan modification might have been best for both the borrower and the investors that hold the loans. By attempting to shield

to Solving the Problem of Predatory Mortgage Lending, 28 SEATTLE U. L. REV. 435, 451–53 (2005).

4 *See infra*, Section VI.

5 *See* Lorraine Woellert, *'Robo-signing' Penalties Expected Soon*, BOSTON GLOBE, Feb. 24, 2011, at 11.

6 *See* Gretchen Morgenson, *Guess What Got Lost in the Pool*, N.Y. TIMES, Mar. 1, 2009, at BU1.

themselves with preemption from state regulation, and through the dearth of effective federal regulation, mortgage servicers have been acting as a law unto themselves, to the detriment of both the borrowers they collect from and the investors whom they are supposed to serve.

While there is only limited information regarding the servicing practices of non-federally regulated servicers, it appears that state community banks have avoided at least the worst practices of federally-regulated servicers so far. When the FDIC examined these state-regulated servicers, it did not find evidence of robo-signing or any other serious problems that have appeared industry-wide or that would warrant the FDIC taking formal enforcement action against these much smaller servicers.[7] Furthermore, a recent Treasury Department analysis of mortgage servicers revealed that the three worst offenders were all national banks.

The new Dodd-Frank Act was drafted with recognition of the abuses of preemption in the mortgage industry. The Consumer Financial Protection Act of 2010, which is Title X of Dodd-Frank, calls for a rollback of preemption and for greater state action to prevent future servicing abuses by federally regulated banks and thrifts.[8] The exact contours of this new law of preemption in the banking industry are not clear because Dodd-Frank leaves much of its specific effects to regulations not yet drafted by the respective federal agencies. Moreover, the OTS will disappear and be subsumed into the Office of the Comptroller of the Currency (OCC). A new regulator will appear—the Consumer Financial Protection Bureau (CFPB)—beginning in July, 2011, with the inevitable lag time in any regulations it might enact.[9] With the creation of the CFPB, new turf battles may arise, with the OCC and the CFPB battling to provide mortgage servicer regulations that may defend consumers against banks, or vice-versa.

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7 *See* Carrie Bay, *FDIC Releases Report Detailing Findings of Foreclosure Investigation*, DSNEWS (May 4, 2011), http://www.dsnews.com/articles/fdic-releases-report-detailing-findings-of-foreclosure-investigation-2011-05-04 (explaining that in a 2011 FDIC report, the FDIC has to date failed to uncover any evidence of 'robo-signing' or other problems with state non-member banks which would call for disciplinary action to be taken).

8 *See generally* Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010).

9 Lewis S. Wiener & Evan J. Taylor, *The Consumer Financial Protection Bureau*, SUTHERLAND (Mar. 8, 2011), http://www.sutherland.com/files/News/cce089c9-6087-4cf6-9b87-0094eef8b957/Presentation/NewsAttachment/d7939b30-458d-4ccf-bda2-e3db48c38a97/ACC Financial Services - CFPB Legal Alert - March 2011.pdf.

Federal agencies have, after what appears to be a pro forma investigation of mortgage abuses, issued a report admitting the existence of those abuses and outlined a plan to correct them. However, the plan appears at first blush to be a weak one, with mortgage servicers ordered to correct their own policies and procedures and internal controls, and to hire their own monitor, with the approval of federal regulators, and then report back with what they have done.[10] The federal regulators appear to be punting the regulation of mortgage servicers to outside firms chosen and hired by the servicers themselves.

This article is an attempt to show what went wrong in the previous regulation of mortgage servicing (or lack thereof), and to map the new preemption terrain for mortgage servicing, providing some guideposts on what the new post-Dodd-Frank preemption landscape will look like and where the boundaries for state action might lie. States should not wait for the federal agencies to act. Instead, states should move now to regulate mortgage servicers to deter the abuses servicers have been committing and to encourage appropriate loan modifications that benefit both borrower and investor alike. With the new rules of preemption, states should step boldly into what, even with recent federal action, mostly still is a void: the regulation of mortgage servicing.

I. THE FAILURES OF MORTGAGE SERVICING

Though the abuses and failures of mortgage servicers have long been detailed,[11] it was as if they were discovered anew, first by Congress and the news media, and then belatedly by federal regulators in the fall of 2010. The many failures of mortgage servicers suddenly became a hot topic, both in Congress and in the news.[12] Journalists reported nationwide evidence of "robo-

10 *See Regulatory Actions Related to Foreclosure Activities by Large Servicers and Practical Implications for Community Banks*, FDIC, http://www.fdic.gov/regulations/examinations/supervisory/insights/sise11/foreclosure.html (last visited May 19, 2011).

11 *See generally* Kurt Eggert, *Limiting Abuse and Opportunism by Mortgage Servicers*, 15 HOUSING POL'Y DEBATE 753, 753–84 (2004), *available at* http://ssrn.com/abstract=992095 (discussing abusive behavior of residential mortgage servicers towards borrowers).

12 Congress has defined a "servicer" as "the person responsible for servicing of a loan (including the person who makes or holds a loan if such person also services the loan)." 12 U.S.C.A. § 2605(i)(2) (2011). On the other hand, "servicing" is "receiving any scheduled periodic payments from a borrower pursuant to the terms of any loan . . . and making the payments of principal and interest and such other payments with respect to the amounts received from the borrower as may be required pursuant to the terms of the loan." 12 U.S.C.A. § 2605(i)(3) (2011).

signing," by mortgage servicers seeking to foreclose on homes.[13] One court has defined a "robo-signer" as "a person who quickly signs hundreds or thousands of foreclosure documents in a month, despite swearing that he or she has personally reviewed the mortgage documents and has not done so."[14] One bank admitted to false attestations on 55,000 affidavits.[15] A bank employee who said that she signed up to 8000 affidavits and other foreclosure-related documents a month admitted that she normally did not read any of them.[16] Another servicer employee, this one a supervisor in charge of signing affidavits, stated that she did not know what conditions justified foreclosure, that she could not even define the meaning of necessary terms like "promissory note," and stated, "I don't know the ins and outs of the loan, I just sign documents."[17] The practice of robo-signing appeared so wide-spread that many of the nation's largest mortgage servicers declared moratoriums on foreclosures, either nationally or at least in states that require judicial foreclosure while they investigated their own practices.[18]

Robo-signing constitutes fraud on the court if the resulting affidavits are submitted as evidence. By using robo-signers, banks and servicers can foreclose on borrowers while hiding from courts the flaws or gaps in their loan records regarding mortgage payments or loan modifications, or concealing whether they are missing the loan documents demonstrating whether they even have the right to foreclose. Sadly, servicers have found that some attorneys have been all too willing to play "hide the ball" with courts to obtain foreclosure orders without valid evidence. In one case, a court noted that the legal representation of servicers in foreclosure actions had devolved into a "corrosive 'assembly line' culture of practicing law" and wondered "what kind of culture

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13 *See, e.g.*, Gretchen Morgenson, *Banks' Flawed Paperwork Throws Some Foreclosures Into Chaos*, N.Y. TIMES, Oct. 3, 2010, at A1; David Streitfeld, *3rd Lender Will Freeze Foreclosures in the Courts*, N.Y. TIMES, Oct. 2, 2010, at B1.

14 Onewest Bank, F.S.B. v. Drayton, 910 N.Y.S. 2d 857, 859 (Sup. Ct. 2010). In *Drayton* the court dismissed a foreclosure action without prejudice upon request of plaintiff, with the court noting that the case involved a servicer employee who, in a deposition in another action, had "admitted that she: is a 'robo-signer' who executes about 750 mortgage documents a week, without a notary public present; does not spend more than 30 seconds signing each document; [and] does not read the documents before signing them . . . ." *Id.*

15 Jeff Horwitz, *Wells Joins Robo Club, in its Way*, AM. BANKER, Oct. 29, 2010, at 1.

16 Jenifer B. McKim, *Lenders on Autopilot: Using Robo-Signers to Process Thousands of Foreclosures Opens Banks Up to Legal Risks*, BOSTON GLOBE, Nov. 2, 2010, at 7.

17 Michelle Conlin, *Robo-Signers: Mortgage Experience Not Necessary*, ASSOCIATED PRESS, Oct. 12, 2010.

18 Nelson D. Schwartz, *Foreclosures Had Errors, Bank Finds*, N.Y. TIMES, Oct. 25, 2010, at B1.

condones its lawyers lying to the court and then retreating to the office hoping that the Court will forget about the whole matter?"[19] The Florida Attorney General's office has been investigating claims that foreclosure attorneys in that state have been "fabricating and/or presenting false and misleading documents in foreclosure cases," and reached a $2 million settlement with one prominent firm based on such claims.[20] Even foreclosure attorneys who otherwise might attempt to follow the rules of court are at times being pushed by their servicer clients to engage in mindless, automated court filings, unable to verify if the information contained in their filings is even true because the attorneys are being directed solely by computer software that spits out what documents and claims to file. One court found that a bank servicing its own loans used mortgage servicing software that

> manages, without human interaction, the relationship between [the bank] and its attorneys in the collection of delinquent mortgage loans through automated responses to certain queues" and that the software program "is the mortgage banking industry's most widely used servicing system with more than 50% of all mortgages in the United States serviced on it.[21]

The court seemed astounded to learn that the "entire process occurs without any communication between counsel and the client and for the most part, without any legal judgment by an attorney."[22]

Some argue that a larger problem for mortgage servicers is that often neither they nor the trusts for which they work actually hold some of the notes on which they are attempting to foreclose.[23] There is significant anecdotal evidence that, on a wide scale basis, notes were not validly transferred to the trusts for which servicers work.[24]

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19 *In re* Parsley, 384 B.R. 138, 183–84 (Bankr. S.D. Tex. 2008).

20 David McLaughlin, *Florida Settles with Law Firm in Foreclosure Investigation*, BLOOMBERG (Mar. 25, 2011), http://www.bloomberg.com/news/2011-03-25/florida-law-firm-to-pay-2-million-over-state-foreclosure-investigation.html.

21 *In re* Taylor, 407 B.R. 618, 624 & n.9 (Bankr. E.D. Pa. 2009).

22 *Id.* at 637.

23 Brady Dennis & Ariana Eunjung Cha, *In Foreclosure Controversy, Problems Run Deeper than Flawed Paperwork*, WASH. POST (Oct. 7, 2010), http://www.washingtonpost.com/wp-dyn/content/article/2010/10/06/AR2010100607227.html?sid=ST2010100607251.

24 *See* Morgenson, *supra* note 6, at BU1. *See also* Dale A. Whitman, *How Negotiability Has Fouled Up the Secondary Mortgage Market, And What to Do About It*, 37 PEPP. L. REV. 737, 758 (2010) ("While delivery of the note might seem a simple matter of compliance, experience during the past several years has shown that, probably in countless thousands of cases, promissory notes were never delivered to secondary market investors or securitizers, and, in many cases, cannot presently be located at all. The issue

Consumer advocates complain that robo-signing is just the tip of the iceberg, and that servicers mistreat borrowers much more broadly by charging excessive or inappropriate fees, forcing borrowers to purchase high-cost insurance even though they already have insurance in place, and foreclosing without good cause or when both borrowers and the investors who own the loan would benefit from the borrower obtaining a loan modification.[25] Mortgage servicers can profit greatly from late fees and other charges when borrowers are in default, and industry insiders and other critics have long charged that mortgage servicers withhold some loan modifications that might help investors and borrowers alike so that the servicers can collect greater fees.[26] Another reason servicers have been slow to modify loans is that loan modification is a labor-intensive process, requiring the servicer in essence to re-underwrite the loan to determine how much the borrower can afford.[27] By hiring too little staff to engage in the many appropriate loan modifications requested, servicers can save large sums, as much as $20 billion by one leaked confidential estimate.[28] The existence and nature of loan modifications is a crucial determinant in whether borrowers who go into default are able to save their homes from foreclosure.[29] However, the pace of loan

is extremely widespread, and, in many cases, appears to have been the result of a conscious policy on the part of mortgage sellers to retain, rather than transfer, the notes representing the loans they were selling.").

25 *See Problems in Mortgage Servicing from Modification to Foreclosure: Hearing Before the U.S. S. Comm. on Banking, Hous. & Urban Affairs*, 111th Cong. 1–5 (2010) (testimony of Diane E. Thompson, National Consumer Law Center), *available at* http://banking.senate.gov/public/index.cfm?FuseAction=Files.View&FileStore_id=c1fac0f6-5ac5-4ae5-85cc-e2220255dfd9. *See also Robo-Signing, Chain of Title, Loss Mitigation, and Other Issues in Mortgage Servicing: Hearings Before the H. Fin. Servs. Comm., Subcomm. on Hous. and Cmty. Opportunity*, 111th Cong. 15 (2010) (testimony of Prof. Adam J. Levitin, Associate Professor of Law, Georgetown University Law Center), *available at* http://financialservices.house.gov/Media/file/hearings/111/Levitin111810.pdf; *HAMP, Servicer Abuses, and Foreclosure Prevention Strategies: Hearings Before the Cong. Oversight Panel*, 111th Cong. 1–3 (2010) (testimony of Julia Gordon, Center for Responsible Lending), *available at* http://cop.senate.gov/documents/testimony-102710-gordon.pdfhttp://cop.senate.gov/documents/testimony-102710-gordon.pdf.

26 Peter S. Goodman, *Late-Fee Profits May Trump Plan to Modify Loans*, N.Y. TIMES, July 30, 2009, at A1.

27 *See* Kurt Eggert, *Comment on Michael A. Stegman et al.'s "Preventive Servicing Is Good for Business and Affordable Homeownership Policy": What Prevents Loan Modifications?*, 18 HOUSING POL'Y DEBATE 279, 285 (2007).

28 *See* CONSUMER FIN. PROT. BUREAU, PERSPECTIVES ON SETTLEMENT ALTERNATIVE IN MORTGAGE SERVICING (2011), *available at* http://www.huffingtonpost.com/2011/03/28/big-banks-save-billions-homeowners-suffer_n_841712.html.

29 *See* Sumit Agarwal et al., *Market-Based Loss Mitigation Practices for Troubled Mortgages Following the Financial Crisis* 5 (Fisher Coll. of Bus., Working Paper No. 2010-03-019, 2010), *available at* http://ssrn.com/abstract=1690627 ("In particular, greater

modifications has been glacial, with a recent report that "80% of all non-performing private-label mortgages have not been modified after twelve months."[30] Securitized loans in default are significantly less likely to be modified than loans held in portfolio by a financial institution, showing that servicers are not modifying loans as they would if they owned the loans themselves.[31] The Federal Trade Commission (FTC) recently obtained a settlement for $108 million from two servicer units of Countrywide, now owned by Bank of America. The FTC chairman noted that Countrywide had marked up some fees more than 400% and stated that "[t]he record-keeping of Countrywide was abysmal. . . . Most frat houses have better record-keeping than Countrywide."[32]

Worse yet, this pattern of abusive behavior, along with an inadequate federal response, is not new, as even early in the last decade, servicers had perfected the art of using unfair practices to squeeze fees out of borrowers.[33] For years, courts have found that servicers attempted to foreclose even when it appears that no foreclosure was justified. In the 2002 case, *In re Gorshtein*, the court sanctioned servicers who falsely claimed borrowers were in default, saying that its decision was "provoked by an apparently increasing number of motions in this Court to vacate the automatic stay filed by secured creditors often based upon attorney affidavits certifying material post-petition defaults where, in fact, there were no material defaults by the debtors."[34]

Sadly, such cases continue unabated. In August 2010, a court noted how a servicer, through a combination of

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reductions in loan interest rates (or monthly payments) are associated with sizable declines in redefault rates. As an illustration, a reduction of 1% point in the interest rate is associated with a 3.9% point drop in six-month redefault rate.").

30 *See* Brian Collins, *It's Hard Out There for a Mortgage Servicer...*, MORTGAGE SERVICING NEWS, Jan. 2011, at 6 (citing data from the Amherst Securities Group).

31 Sumit Agarwal, et al., *The Role of Securitization in Mortgage Renegotiation* 1–4 (Charles A. Dice Ctr., Working Paper No. 2011-2, 2011), *available at* http://ssrn.com/abstract=1739915. The authors argue "that the rate of loan modification, which constitutes the lion's share (over 75%) of private renegotiation actions, is also significantly higher for portfolio loans. Specifically, portfolio-held loans are 4.2 to 5.8 percentage points (34% to 51% in relative terms) more likely to be modified." *Id.* at 4.

32 Corbett B. Daly, *B of A's Countrywide Settles with FTC for $108 Million*, REUTERS (June 7, 2010), http://www.reuters.com/article/2010/06/07/us-countrywide-ftc-idUSTRE6563DT20100607.

33 Fairbanks Capital was likely the most notorious mortgage servicer in the years following the turn of the century, and settled an action with the Federal Trade Commission for $40 million. For a discussion of the Fairbanks matter and further evidence of servicing abuse in the era before the mortgage meltdown, see Kurt Eggert, *Limiting Abuse and Opportunism by Mortgage Servicers*, 15 HOUSING POL'Y DEBATE 753, 761–67 (2004), *available at* http://ssrn.com/abstract=992095.

34 *In re* Gorshtein, 285 B.R. 118, 120 (Bankr. S.D.N.Y. 2002).

inappropriate fees and the servicer's own incompetence, attempted to foreclose on two borrowers who had paid their loan like "clockwork."[35] The court stated that the servicer's conduct

> represents the most callous and egregious effort to collect an indebtedness that was never owed that this court has been called upon to review. Succinctly stated, [the servicer's] incompetent servicing tactics converted a loan transaction that was being paid like 'clockwork' to a loan that was virtually impossible to pay, particularly for modest income borrowers.[36]

A study of servicer claims in bankruptcy court found that "[a] majority of mortgage companies' proofs of claim lack the documentation necessary to establish a valid debt. Fees and charges on bankruptcy claims often are identified poorly and sometimes do not appear to be legally permissible."[37] These are filings in bankruptcy court, where a servicer is perhaps most likely to dot i's and cross t's, given the bankruptcy court's oversight. A recent survey of consumer attorneys indicates that a large percentage of the borrowers they represent have had foreclosure proceedings initiated either due to "improper fees or payment processing" or while the borrower is "awaiting a loan modification."[38] The U.S. Trustee's office has been investigating bankruptcy filings by mortgage servicers and has reportedly discovered error rates among those filings that "might be ten times higher" than the one percent error rate claimed by mortgage servicers in Senate testimony.[39] One servicer/bank claimed the borrower owed over $50,000, but when the trustee "asked for documentation, the amount dropped to $3,156."[40] According to the U.S. Trustee director, the flaws in the servicers' processes "undermine the integrity of the bankruptcy system. Many homeowners have been harmed," by such bad practices as submitting inaccurate statements or attempting to foreclose even

35 *In re* Cothern, 442 B.R. 494, 496–97, 499 (Bankr. N.D. Miss. 2010).

36 *Id.* at 499. In *Cothern*, the servicer first wrongly concluded that the borrowers' house was uninsured and so bought force-placed insurance. *Id.* at 496–97. Even when it realized its mistake, the servicer placed the borrowers' payments into a suspense account rather than fixing the problem and in the end tried to collect fees totaling roughly $15,000, made up of attorney's fees, foreclosure fees, and other charges. The court stated that "[t]here is no doubt that the unrelenting actions of [the servicer] drove the Cotherns into bankruptcy." *Id.* at 499.

37 Katherine M. Porter, *Misbehavior and Mistake in Bankruptcy Mortgage Claims*, 87 TEX. L. REV. 121, 124 (2008).

38 *Servicers Continue to Wrongfully Initiate Foreclosures*, NAT'L ASS'N OF CONSUMER ADVOCS. & THE NAT'L CONSUMER L. CTR. (Dec. 15, 2010), http://www.naca.net/_assets/shared/634280136429845000.pdf.

39 *See* Gretchen Morgenson, *A Low Bid for Fixing a Big Mess*, N.Y. TIMES, May 14, 2011, at BU1, *available at* www.nytimes.com/2011/05/15/business/15gret.html.

40 *Id.*

when borrowers are making proper payments on trial loan modifications.[41]

Faced with widespread evidence of servicer malfeasance, fifty state Attorneys General banded together to investigate the robo-signing problem and then expanded this investigation to include problems in the servicing industry more generally.[42] Federal banking regulators, long too silent and passive regarding mortgage servicing, responded by asking servicers "to conduct self-assessments of their foreclosure management processes and correct any deficiencies," but also began their own investigation of mortgage servicers.[43] They have reported significant problems in the servicing industry, noting "critical deficiencies and shortcomings in foreclosure governance processes, foreclosure document preparation processes, and oversight and monitoring of third party law firms and vendors" which resulted in "violations of state and local foreclosure laws . . . and have had an adverse affect [sic] on the functioning of the mortgage markets and the U.S. economy as a whole."[44]

The federal interagency review of the fourteen top servicers included eight national banks regulated by the OCC, four thrifts regulated by the OTS, and two other financial institutions regulated by the Federal Reserve's Board of Governors.[45] The reviewers found "widespread unsafe or unsound operational practices, including missing documents, execution of documents by unauthorized persons, failure to notarize documents in accordance with local law, inaccurate affidavits, and affidavits signed by persons lacking sufficient knowledge of the underlying mortgage loan transactions."[46] The review demonstrated that federal regulators had woefully failed to deter misconduct by mortgage servicers.

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41 *Id.*

42 *See, e.g.*, *Miller Says Foreclosure Investigation is Broad-Based*, DES MOINES SUNDAY REG., Dec. 12, 2010, at 1D.

43 U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-11-433, MORTGAGE FORECLOSURES: DOCUMENTATION PROBLEMS REVEAL NEED FOR ONGOING REGULATORY OVERSIGHT 25 (2011) [hereinafter GAO DOCUMENTATION PROBLEMS REPORT], *available at* http://www.gao.gov/new.items/d11433.pdf.

44 *Testimony of John Walsh Acting Comptroller of the Currency: Hearings Before the U.S. S. Comm. on Banking, Hous., and Urban Affairs*, 111th Cong. 15 (2011), (testimony of John Walsh, Acting Comptroller of the Currency), *available at* http://www.occ.treas.gov/news-issuances/congressional-testimony/2011/pub-test-2011-19-written.pdf.

45 *See* FED. DEPOSIT INS. CORP., REGULATORY ACTIONS RELATED TO FORECLOSURE ACTIVITIES BY LARGE SERVICERS AND PRACTICAL IMPLICATIONS FOR COMMUNITY BANKS 3 (2011), *available at* http://www.fdic.gov/regulations/examinations/supervisory/insights/sise11/SI_SE2011.pdf.

46 *Id.* at 4.

A recent report by the Treasury Department confirms that large national banks are the worst offenders when it comes to mortgage servicing. Of the mortgage servicers featured in the report, only three will have their servicer incentives withheld, because they needed substantial improvement and had no mitigating factors sufficient to justify the disbursement of those payments.[47] All three are the servicing arms of national banks regulated by the OCC.[48]

By comparison, the FDIC's investigation found much better behavior by state-supervised servicers. The FDIC investigated state banks that are not members of the Federal Reserve System to see if they engaged in "robo-signing" or the other deficient practices found by the interagency review of the fourteen largest federally regulated servicers. The FDIC reported that it did not find "serious industry wide problems among state nonmember banks," and that "[t]o date, the review has not identified 'robo-signing' or any other deficiencies that would warrant formal enforcement actions."[49] In other words, the most egregious servicer problems seem concentrated among federally rather than state-regulated mortgage servicers.

While the states' Attorneys General and federal agencies report that they are finding significant evidence of widespread servicer misconduct, they appear to disagree on what punishment mortgage servicers should receive for their misconduct. The regulatory agency most concerned with consumer protection, the "newly created Consumer Financial Protection Bureau[,] is pushing for $20 billion or more in penalties, backed up by the attorneys general and the Federal Deposit Insurance Corporation . . . ."[50] The traditional federal bank regulators, the OCC, and the Federal Reserve Board, reportedly claim that few borrowers were victims of wrongful foreclosures, and so the fines should be much smaller.[51] And so it is possible that even after this apparently widespread misconduct by servicers, they may receive the proverbial slap on the wrist.

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47 *See* U.S. DEP'T OF THE TREASURY, MAKING HOME AFFORDABLE REPORT AND SERVICER ASSESSMENTS FOR FIRST QUARTER 2011, at 16 (2011), *available at* http://www.treasury.gov/initiatives/financial-stability/results/MHA-Reports/Documents/April%202011%20MHA%20Report%20FINAL.PDF.

48 *Id.*

49 *Id.* at 5–6.

50 Nelson D. Schwartz & David Streitfeld, *Officials Disagree on Penalties for Mortgage Mess*, N.Y. TIMES, Mar. 3, 2011, at B1.

51 *Id.* at B1.

In the midst of this servicer misconduct, the mortgage crisis continues. One Federal Reserve governor recently noted that foreclosures had rocketed from about one million in 2006 to 2.8 million in 2009, estimated that the final tallies in 2010 would be about 2.25 million foreclosures, and predicted another two million in 2012, with foreclosure levels thereafter expected to "remain extremely high by historical standards."[52] Roughly a third of the approximately two million homes that were in foreclosure sit vacant.[53] As of the end of 2010, "almost 5 million mortgage loans [were] 90 days or more past due or in foreclosure."[54] Adding to the foreclosure risk are the number of American homeowners with negative equity in their homes, with an estimated 15.7 million homeowners "underwater" at the end of 2010, up nearly two million from just three months before and representing twenty-seven percent of all single-family dwellings with a mortgage.[55] While foreclosures declined somewhat in November of 2010, this decline "likely is due to voluntary foreclosure suspensions put in place in the fall of 2010 in response to the documentation irregularities situation" rather than to any decline in defaults or greater loan modification efforts.[56]

The primary federal response to the foreclosure crisis has been the Making Home Affordable (MHA) program, announced in February 2009 and initially intended to "help as many as 3 to 4 million financially struggling homeowners avoid foreclosure by modifying loans . . . ."[57] The primary component of MHA is the Home Affordable Modification Program. While HAMP was initially designed to modify a million loans per year from its start in 2009, as of November 2010, it had produced fewer than 550,000 permanent loan modifications.[58]

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52 *Statement by Elizabeth A. Duke: Hearings Before the H. Fin. Servs. Subcomm. On Hous. and Comty. Opportunity*, 111th Cong. 5 (2010) (testimony of Elizabeth A. Duke, Governor of the Federal Reserve Board), *available at* www.federalreserve.gov/newsevents/testimony/duke20101118a.htm.

53 *See* Schwartz & Streitfeld, *supra* note 50.

54 *See Statement by Elizabeth Duke*, *supra* note 52, at 5.

55 *See* John Gittelsohn, *Negative Home Equity Rises*, ST. LOUIS POST-DISPATCH, Feb. 10, 2011, at A8.

56 *See* CONG. OVERSIGHT PANEL, 112TH CONG., MARCH OVERSIGHT REPORT 88–89 (2011), *available at* http://cop.senate.gov/reports/.

57 *Home Affordable Modification Program: Overview*, THE DEPARTMENT OF THE TREASURY, https://www.hmpadmin.com/portal/programs/hamp.jsp (last visited May 11, 2011).

58 *Making Home Affordable Program*, THE DEPARTMENT OF THE TREASURY, http://www.treasury.gov/initiatives/financial-stability/results/MHA-Reports/Documents/Nov%202010%20MHA%20Report.pdf (last visited May 11, 2011).

II. THE LACK OF EFFECTIVE FEDERAL REGULATION OF MORTGAGE SERVICING

For too long, mortgage servicing has been relatively unregulated, with no one agency given the task of overseeing servicing and preventing abuses by servicers and no national standards for servicer regulation. Federal regulation of mortgage servicing has been, in the words of the Government Accountability Office (GAO) "limited and fragmented."[59] Federal law provides little protection for borrowers from abusive servicing. Even federal regulators have bemoaned the lack of national servicing standards and the need to develop them.[60] While some have been arguing for national mortgage standards for years, those calls have recently grown louder, and for good reason, given servicer misbehavior.[61]

The primary federal law governing servicing is the Real Estate Settlement Procedures Act (RESPA), which is designed to inform borrowers when the servicing rights to their mortgage have been transferred, to give them some disclosure of how that transfer will affect them, and to provide some protection from late fees during transfer.[62] In addition, RESPA was intended to prevent kickbacks and referral fees that can drive up the cost of settlement services.[63] Furthermore, RESPA allows borrowers to seek some information regarding their loan's payment history and current status and requires servicers to respond to those requests as well as requests that errors in the account be corrected. While RESPA can be useful for borrowers, its usefulness is relatively limited as to protection from abusive servicers and does not reach many of the current issues embroiling the servicing industry.[64]

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59 GAO DOCUMENTATION PROBLEMS REPORT, *supra* note 43, at 14.

60 GAO DOCUMENTATION PROBLEMS REPORT, *supra* note 43, at 54.

61 *See* Alan Zibel, *Regulators Urged to Devise National Loan Servicing Standards*, WALL ST. J. BLOG (Dec. 21, 2010, 10:35 AM), http://blogs.wsj.com/developments/2010/12/21/regulators-urged-to-devise-national-loan-servicing-standards/ (reporting on a letter signed by a group of academics, analysts, and investors urging the establishment of a set of national standards for mortgage servicing).

62 *See* 12 U.S.C. § 2601(a)–(b) (2006).

63 *See* Patricia Quinn Robertson, *Kickbacks, RESPA and the Title Insurance Industry: How to Get a Foot in the (Courthouse) Door*, 36 REAL EST. L.J. 270, 270 (2007) ("Goals of RESPA include the provision of 'more effective advance disclosure to home buyers and sellers of settlement costs' and 'elimination of kickbacks or referral fees that tend to increase unnecessarily the costs of certain settlement services.'" (quoting 12 U.S.C. § 2601(b)(1)–(2) (2000)).

64 *See* Adam J. Levitin & Tara Twomey, *Mortgage Servicing*, 28 YALE J. ON REG. (2011) (forthcoming 2011) (manuscript at 7–8), *available at* http://ssrn.com/abstract=1324023 (noting the lack of rights RESPA grants to borrowers).

Other federal laws regulating servicers also do little to quell abusive practices by servicers. Until recently, the Truth in Lending Act (TILA) affected servicers little. It was amended in 2009, however, to provide servicers some safe harbor from liability to investors should servicers enter into loan modifications with borrowers. The goal was to lessen the effect of "tranche warfare," whereby some investors could claim that their individual interests were harmed by a loan modification, even if the modification helped investors as a whole.[65] While this amendment gives servicers protection against some claims as they modify loans, it does not give borrowers more leverage in obtaining such loan modifications. Recent changes to Regulation Z implementing TILA require prompt crediting of mortgage loan payments and forbid charging late fees on unpaid late fees.[66]

While the existing statutory framework provides little protection for borrowers from the improper fees, shoddy paperwork, and unnecessary foreclosures that have marred the mortgage servicing industry, some federal agencies have the power to sanction servicers for such practices and have on occasion used that power. For example, the Federal Trade Commission has reached significant settlements with mortgage servicers accused of abusive treatment of borrowers, including a 2003 settlement with Fairbanks Capital providing a $40 million fund for injured borrowers, which included a set of "best practice[s] guidelines for mortgage servicing,"[67] a 2007 modification of that settlement with additional guidelines,[68] a 2008 settlement for $28 million with Bear Stearns and its servicers that included the establishment of a data integrity system,[69] and a settlement for $108 million with Countrywide's

65 *See* Helping Families Save Their Homes Act of 2009, Pub. L. No. 111-22, 123 Stat. 1638 (2009). For a discussion of this point, see Levitin & Twomey, *supra* note 64 (manuscript at 56). "Tranche warfare" is the battle between different classes (or "tranches") of investors who may have conflicting interests regarding whether a servicer modifies or forecloses on a loan. For a description of tranche warfare, see Kurt Eggert, *Held Up in Due Course: Predatory Lending, Securitization, and the Holder in Due Course Doctrine*, 35 CREIGHTON L. REV. 503, 560–62 (2002).

66 *See* 12 C.F.R. § 226.36(c)(ii) (2008); Truth in Lending, 73 Fed. Reg. 44, 522 (July 30, 2008).

67 For a discussion of Fairbanks' actions and the FTC litigation against Fairbanks, see Kurt Eggert, *Limiting Abuse and Opportunism by Mortgage Servicers*, 15 HOUSING POL'Y DEBATE 753, 761–67 (2004), *available at* http://ssrn.com/abstract=992095.

68 *See* Press Release, Federal Trade Commission, FTC, Subprime Mortgage Servicer Agree to Modified Settlement (Aug. 2, 2007), *available at* http://www.ftc.gov/opa/2007/08/sps.shtm (announcing the modification of a settlement between the FTC and Fairbanks Capital which provides additional benefits to consumers).

69 *See* Press Release, Federal Trade Commission, Bear Stearns and EMC Mortgage to Pay $28 Million to Settle FTC Charges of Unlawful Mortgage Servicing and Debt Collection Practices (Sept. 9, 2008), *available at* http://www.ftc.gov/opa/2008/09/emc.shtm

loan servicing operation, which the FTC had accused of inflating loan fees.[70] While such actions are helpful and clearly necessary, the FTC's actions have been too limited to have a significant effect on the servicing industry. Furthermore, the FTC's authority does not extend to depository institutions themselves.[71]

Other federal agencies or quasi-federal organizations have the authority to regulate servicing organizations but so far have focused more on the safety and soundness of their regulated institutions or on their own pecuniary gain than on preventing servicer misbehavior that primarily damages borrowers.[72] According to a recent GAO report, "federal banking regulators have not regularly examined servicers' foreclosure practices on a loan-level basis. Instead, previous federal regulatory examinations of mortgage servicers have focused on loan modifications or on the income banks earn from servicing loans."[73]

At a December 2010 Senate hearing, officials from the OCC, the United States Department of the Treasury (Treasury), and the Federal Housing Finance Agency, as well as a governor of the Board of Governors of the Federal Reserve System, all testified about problems in the mortgage and servicing industry.[74] By and large, they acknowledged that they had some authority over mortgage servicing, that there was a significant problem with mortgage servicing, and that they were currently investigating the scope of the problem and hoped to have some idea soon how widespread the problem was and what they could and should do about it.[75]

It is telling that to a great extent this widespread servicer abuse appears to have come as some surprise to these agencies,

(announcing settlement between FTC, Bear Stearns, and EMC Mortgage which requires the installation of a data integrity program).

70 *See* Press Release, Federal Trade Commission, Countrywide Will Pay $108 Million for Overcharging Struggling Homeowners: Loan Servicer Inflated Fees, Mishandled Loans of Borrowers in Bankruptcy (June 7, 2010), *available at* http://www.ftc.gov/opa/2010/06/countrywide.shtm (announcing $108 million settlement due to Countrywide's deceptive loan collection practices).

71 *See* 15 U.S.C. §§ 41, 45(a)(2) & 58 (2006).

72 *See* Oren Bar-Gill & Elizabeth Warren, *Making Credit Safer*, 157 U. PA. L. REV. 1, 92–93 (2008).

73 GAO DOCUMENTATION PROBLEMS REPORT, *supra* note 43, at 17.

74 For the written testimony of these federal regulators, as well as an archived webcast of their oral testimony, see *Problems in Mortgage Servicing from Modification to Foreclosure, Part II*, *U.S. S. Comm. on Banking, Hous., & Urban Affairs*, 111th Cong. (2010), http://banking.senate.gov/public/index.cfm?FuseAction=Hearings.Hearing&Hearing_ID=ea6d7672-f492-4b1f-be71-b0b658b48bef.

75 *Id.*

despite their power to investigate and regulate servicers. John Walsh, Acting Comptroller of the Currency noted:

> The OCC supervises all national banks and their operating subsidiaries, including their mortgage servicing operations. The servicing portfolios of the eight largest national bank mortgage servicers account for approximately 63 percent of all mortgages outstanding in the United States—nearly 33.3 million loans totaling almost $5.8 trillion in principal balances as of June 30, 2010.[76]

The OCC is "the primary regulator for banks that service 78.3 percent of loans serviced by the top 25 servicers."[77] With such broad supervisory powers over such a significant segment of the servicing industry, the OCC should have been in a position to monitor ongoing servicer behavior, to detect servicer misbehavior as it happened, and to administer timely corrective measures, including real sanctions for servicer misbehavior.

Unfortunately, however, the OCC appears to have had far greater interest in preserving the powers of its client banks than in protecting the borrowers/consumers affected by the servicing operations of those banks. First of all, its primary mission is protecting the safety and soundness of its regulated financial institutions, and when the banks' soundness seems threatened by consumer protection, the OCC perpetually seems to opt against consumer protection.[78] Also, as much as ninety-five percent of the OCC's income comes from the banks that it regulates, giving it a financial incentive to protect its client banks.[79] The OCC receives no Congressional funding, and so depends on fees from banks, such as examination or application fees.[80]

It appears that only recently has the OCC made any significant investigation into foreclosure misconduct by servicers. The OCC has acknowledged that until recently, it paid scant attention to servicers' foreclosure activities, abusive or not: "We looked at the final stage of the process and thought of it as one

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76 *Id.* (testimony of John Walsh, Acting Comptroller of the Currency).

77 GAO DOCUMENTATION PROBLEMS REPORT, *supra* note 43, at 17.

78 *See* Arthur E. Wilmarth, Jr., *Written Testimony on the Credit Card Industry Before the Subcommittee on Financial Institutions and Consumer Credit of the House Committee on Financial Services, April 26, 2007* 13–20 (The George Washington Univ. Law Sch. Pub. Law and Legal Theory Working Paper No. 517, 2007), *available at* http://ssrn.com/abstract=1729840 (noting how rarely the OCC has sanctioned any national bank for a consumer protection violation, especially when compared to state banking regulators).

79 *See* Bar-Gill & Warren, *supra* note 72, at 93.

80 *See About the OCC*, OFFICE OF THE COMPTROLLER OF THE CURRENCY, http://www.occ.gov/about/index-about.html (last visited Apr. 13, 2011).

that would be governed by standards and procedures in internal controls," the OCC chief counsel stated.[81] A GAO report on the servicers and foreclosures noted, "[a]lthough various federal agencies have authority to oversee most mortgage servicers, past oversight of their foreclosure activities has been limited, in part because banking regulators did not consider these practices as posing a high risk to banks' safety and soundness . . . ."[82]

After the robo-signing affair reached the news, the OCC and other federal agencies with banking oversight announced with great fanfare an investigation into the practices of their regulated servicers. They claimed that they sent teams of investigators to pour over the books of the servicers and review their practices, and issued a report that showed that their investigators had discovered "significant problems in foreclosure processing at the servicers" though also that "borrowers subject to foreclosure in the reviewed files were seriously delinquent on their loans."[83]

This report itself disclosed how minimal the inspection of servicers by the federal agencies was, however. The investigation seemed to rely primarily on servicers' self-assessment, as examiners reviewed only "approximately 2,800 borrower foreclosure files" from the two year period ending in December 2010, or about 200 files at each of the fourteen servicers.[84] Even the federal examiners noted that this was "a relatively small number of foreclosure files given the volume of recent foreclosures processed by these servicers . . . ."[85] The reviewers did not examine the "entire cycle of the borrowers' loans or potential mortgage-servicing issues outside of the foreclosure process," and so would have missed foreclosures caused by earlier servicer errors.[86] The report acknowledges that "examiners may not have uncovered cases of misapplied payments or unreasonable fees, particularly when these actions occurred prior to the default," leaving one to wonder what the examiners were looking for if not those basic elements of servicer

81 Zachary A. Goldfarb, *Regulators Lagged in Foreclosure Oversight*, WASH. POST, Nov. 8, 2010, at A1.

82 GAO DOCUMENTATION PROBLEMS REPORT, *supra* note 43.

83 FEDERAL RESERVE SYSTEM, OFFICE OF THE COMPTROLLER OF THE CURRENCY & OFFICE OF THRIFT SUPERVISION, *Interagency Review of Foreclosure Policies and Practices*, 1, 3 (Apr. 2011), *available at* www.federalreserve.gov/boarddocs/rptcongress/interagency_review_foreclosures_20110413.pdf [hereinafter INTERAGENCY REVIEW].

84 INTERAGENCY REVIEW, *supra* note 83, at 1.

85 GAO DOCUMENTATION PROBLEMS REPORT, *supra* note 43, at 25.

86 INTERAGENCY REVIEW, *supra* note 83, at 3.

abuse.[87] The FDIC, in a follow-up report, noted how minimal the interagency examination of servicers was, stating that the examination "did not review allegations of improper servicing or loss mitigation, such as misapplied payments, unreasonable fees, inappropriate force-placing of insurance, failure to consider adequately a borrower for loan modification, or requiring a borrower to be delinquent to qualify for a loan modification."[88]

After this minimal investigation, the federal agencies decreed a minimal enforcement action against the servicers, requiring them mostly to "[r]etain an independent firm to conduct a review of residential foreclosure actions that were pending" during the same time period as the federal agencies' review "to determine any financial injury to borrowers caused by errors" by the servicers' misbehavior "and to remediate, as appropriate . . . ."[89] Servicers are also required to hire a firm to conduct risk assessment for the servicers. In other words, the federal agencies punted their investigation and oversight role to a firm to be hired by each servicer, leaving open the possibility, if not likelihood, that servicers will choose oversight firms that signal a willingness to protect the interests of the servicer itself, rather than the borrowers. Worse yet, the "independent reviews" will not be made public, according to the OCC, so that the public cannot determine whether the reviews have any validity.[90]

The remainder of the agencies' enforcement order is akin to ordering the servicers to come up with better policies and get back to the agencies to let the agencies know what the servicers had done, with little indication what will happen if the servicers' proposed changes do not meet federal approval. Worse yet, federal regulators have not indicated any intention to increase their oversight of servicers following this review. As noted by a GAO report, "[a]lthough regulators have taken enforcement actions against servicers, they have not identified specifically

87 *Id.*

88 Federal Deposit Insurance Corporation, *Regulatory Actions Related to Foreclosure Activities by Large Servicers and Practical Implications for Community Banks*, SUPERVISORY INSIGHTS, May 2011, at 4, *available at* http://www.fdic.gov/regulations/examinations/supervisory/insights/sise11/SI_SE2011.pdf.

89 FEDERAL RESERVE SYSTEM ET AL., INTERAGENCY REVIEW OF FORECLOSURE POLICIES AND PRACTICES 13 (Apr. 2011), *available at* www.federalreserve.gov/boarddocs/rptcongress/interagency_review_foreclosures_20110413.pdf.

90 Jon Prior, *Independent Reviews in Mortgage Servicer Consent Orders to Stay Sealed*, HOUSINGWIRE, May 13, 2011, http://www.housingwire.com/2011/05/13/independent-reviews-in-mortgage-servicer-consent-orders-to-stay-sealed.

how they will change the extent and frequency of future oversight of servicers going forward."[91]

Given the lackadaisical attitude that the OCC and other federal regulators have demonstrated toward servicer misbehavior, it is reasonable to worry that the OCC and others are using their purported investigation of, and enforcement action against, servicers merely as a way to stall for time, and will not take meaningful action to deter and punish servicer misbehavior. Instead, the OCC and other federal regulators may well still be acting primarily to protect bank/servicers' financial soundness and their own turf as banking regulators, to the detriment of homeowners and borrowers.

Another part of the mortgage servicing problem is the role of Fannie Mae and Freddie Mac in overseeing servicers, and their self-interest in performing those roles. Fannie and Freddie, quasi-governmental bodies with their own pecuniary interests at stake, have been given much of the task of regulating servicer conduct, both directly for the loans they have purchased or guaranteed, and through the HAMP program.[92] Treasury granted Fannie and Freddie this power by entering into contracts with them to oversee HAMP.[93] Under those contracts, Fannie Mae was designated as the point of contact for servicers that participate in HAMP, not only to pay them for their HAMP modifications, but also to instruct them how loans should be modified.[94] Fannie Mae was also supposed to "help design and execute a program that implements standardized, streamlined mortgage modifications for all types of servicers, regardless of the risk holder . . . and that lowers monthly payments for qualified borrowers."[95]

Freddie Mac, on the other hand, was hired by Treasury to be its program compliance agent, to examine and investigate mortgage servicers to ensure that servicers comply with the

91 GAO DOCUMENTATION PROBLEMS REPORT, *supra* note 43, at 31.

92 *See* Henry E. Hildebrand III, *HAMP and Your Chapter 13 Practice*, 29 AM. BANKR. INST. J. 12, 74 n.8 (2010) ("Loans that are owned or guaranteed by Fannie Mae and Freddie Mac must be examined for HAMP modification. Loans that are owned by others are encouraged to participate by contract.").

93 *See* Theresa R. DiVenti, *Fannie Mae and Freddie Mac: Past, Present, and Future*, 11 CITYSCAPE: J. OF POL'Y DEV. & RES. 231, 232 (2009).

94 U.S. DEP'T OF THE TREASURY, FINANCIAL AGENCY AGREEMENT FOR A HOMEOWNERSHIP PRESERVATION PROGRAM UNDER THE EMERGENCY STABILIZATION ACT OF 2008, EXHIBIT A 1–2 (2009), *available at* http://www.treasury.gov/initiatives/financial-stability/about/procurement/faa/Financial_Agency_Agreements/Fannie%20Mae%20FAA%20021809.pdf.

95 *Id*. at 1.

published rules of HAMP and to report to Treasury the results of its investigations.[96] Freddie Mac was given the authority to conduct on-site audits of servicers and, in consultation with Treasury, require certain corrective measures by servicers, such as suspending foreclosures. Treasury, through the actions of its MHA Compliance Committee, could impose penalties on servicers that fail to comply with their HAMP obligations, such as withholding or requiring repayment of incentive payments.[97] Treasury has failed to use this power to any significant extent, however. According to the Congressional Oversight Panel's December 2010 report, "Treasury has seemed reluctant to do more than vaguely threaten the potential for clawbacks of HAMP payments. Despite rampant anecdotal stories of servicer errors, to date, no servicer has experienced a clawback or other financial repercussion."[98] The Treasury Department recently announced that the three worst offending mortgage servicers would suffer some financial repercussion, though it is not clear how significant these penalties will be. After finding that four of the nation's largest servicers were in need of substantial improvement to conform to HAMP guidelines, Treasury announced, "[b]eginning this month, Treasury will withhold servicer incentives owed to three of the four servicers requiring substantial improvement until those servicers make certain identified improvements."[99] Thus, even though Treasury's report indicates that the largest servicers needed significant improvement, its only punishment was to withhold some payments until that improvement occurs, when presumably the servicers will be made whole.[100]

It has become apparent that Fannie and Freddie performed their oversight function poorly, likely in large part because their own financial interests conflict with regulating servicer behavior to protect borrowers from abusive practices. The Congressional Oversight Panel (Panel) has noted Fannie and Freddie's self-

96 *See* U.S. DEP'T OF THE TREASURY, FINANCIAL AGENCY AGREEMENT FOR A HOMEOWNERSHIP PRESERVATION PROGRAM UNDER THE EMERGENCY STABILIZATION ACT OF 2008, EXHIBIT A 1–2 (2009), *available at* http://www.treasury.gov/initiatives/financial-stability/about/procurement/faa/Financial_Agency_Agreements/freddie%20mac%20financial%20agency%20agreement.pdf.

97 *See* CONG. OVERSIGHT PANEL, 111TH CONG., DECEMBER OVERSIGHT REPORT 50 (2010), *available at* http://cybercemetery.unt.edu/archive/cop/20110402010243/http://cop.senate.gov/documents/cop-121410-report.pdf.

98 *Id.* at 50.

99 *See* U.S. DEP'T OF THE TREASURY, MAKING HOME AFFORDABLE REPORT AND SERVICER ASSESSMENTS FOR FIRST QUARTER 2011, at 16 (2011), *available at* http://www.treasury.gov/initiatives/financial-stability/results/MHA-Reports/Documents/April%202011%20MHA%20Report%20FINAL.PDF.

100 *Id.*

interest in overseeing HAMP, and how that self-interest may limit Freddie's willingness to engage in aggressive oversight of mortgage servicers. Regarding Freddie Mac, the Panel reported:

> In response to revelations that servicers have been using "robo-signers" to submit false affidavits in thousands of foreclosure cases, Freddie Mac noted that . . . [t]rying to enforce Freddie Mac contractual rights, however, "may negatively impact our relationships with these seller/servicers, some of which are among our largest sources of mortgage loans."[101]

Also weakening the oversight of mortgage servicers has been the voluntary nature of this HAMP oversight. While it is not clear what the servicers' rights are, some have been concerned that if Treasury through Fannie and Freddie were to crack down on servicer behavior, then servicers would attempt to leave the HAMP program to avoid sanction.[102] As a result of this lack of oversight, servicers often have acted as if they were free to violate or simply ignore the HAMP guidelines intended to promote loan modifications.[103]

Because of the great weakness of the current regulation of mortgage servicers, it seems clear that a new system of national mortgage servicer regulation is in order to provide a floor of regulation below which servicers cannot go. A natural agency to draft such regulations would be the new Consumer Financial Protection Bureau, to be established as mandated by the Dodd-Frank Wall Street Reform and Consumer Protection Act. While this Bureau is now ramping up, however, it is not clear how soon it will be in a position to draft national servicing regulations and to enforce them once it officially opens for business in July 2011.

III. FEDERAL PREEMPTION OF STATE REGULATION

While states wait for federal action on mortgage servicer regulation, they could take action on their own. However, to a great extent, state servicer regulation has been hampered by the

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101 *See* DECEMBER OVERSIGHT REPORT, *supra* note 97, at 82. The Panel added that "[t]he Panel condemns this sentiment. If Freddie Mac is hesitant to jeopardize their relationships with servicers to enforce their rights in their own book of business, it is reasonable to worry that they may be similarly unwilling to risk these relationships on Treasury's behalf by aggressively overseeing HAMP servicers." *Id.*

102 *See id.* at 51, 87 n.330.

103 *See Problems in Mortgage Servicing From Modification to Foreclosure: Hearing Before the U.S. S. Comm. on Banking, Hous., & Urban Affairs*, 111th Cong. 3 (2010) (testimony of Diane E. Thompson), *available at* http://banking.senate.gov/public/index.cfm?FuseAction=Files.View&FileStore_id=c1fac0f6-5ac5-4ae5-85cc-e2220255dfd9 ("Advocates continue to report that borrowers are denied improperly for HAMP, that servicers solicit opt-outs from HAMP, and that some servicers persistently disregard HAMP applications.").

fact that many of the largest mortgage servicers are parts of federally regulated financial institutions and have been able to claim that state regulation over them is preempted.[104] Preemption of state law by federal law or regulation comes in many varieties, with the touchstone of all forms being the purpose of Congress.[105] Preemption doctrine has a long and tortured history, with courts and academics grappling with its challenges more or less successfully through the years.[106] Generally, preemption analysis starts with the "assumption that the historic police powers of the States [are] not to be superseded by the [federal law] unless that was the clear and manifest purpose of Congress."[107] Preemption can be expressly stated or implied by statute.[108] Preemption implied by statute can either be through conflict preemption, where state law conflicts with federal law, or field preemption, "where Congress has legislated so comprehensively in a field that it must have intended national uniformity of regulation, and, therefore, its legislation displaces all state regulation" without regard to whether there is a specific conflict with federal law.[109] Another way of describing field preemption is that state law is preempted "where the scheme of federal regulation is so pervasive as to make reasonable the inference that there is no room for state action."[110]

Conflict preemption has two distinct types: (1) direct conflict preemption, where state and federal law directly contradict each other such that it would be impossible to comply with both; and

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104 The OCC oversees over sixty percent of mortgage servicing. *See Problems in Mortgage Servicing From Modification to Foreclosure, Part II: Hearing Before the U.S. S. Comm. On Banking, Hous., & Urban Affairs*, 111th Cong. 13 (2010) (testimony of John Walsh, Acting Comptroller of the Currency), *available at* http://banking.senate.gov/public/index.cfm?FuseAction=Files.View&FileStore_id=c1fac0f6-5ac5-4ae5-85cc-e2220255dfd9.

105 *See* Medtronic, Inc. v. Lohr, 518 U.S. 470, 494 (1996) ("'[T]he purpose of Congress is the ultimate touchstone' in every pre-emption case." (quoting Cipollone v. Liggett Grp., 505 U.S. 504, 516 (1992)).

106 For useful articles on the history and development of preemption doctrine, see Mary J. Davis, *The Battle over Implied Preemption: Products Liability and the FDA,* 48 B.C. L. REV. 1089 (2007); Viet D. Dinh, *Reassessing the Law of Preemption*, 88 GEO. L.J. 2085, 2112–17 (2000); Karen A. Jordan, *The Shifting Preemption Paradigm: Conceptual and Interpretive Issues*, 51 VAND. L. REV. 1149 (1998); Caleb Nelson, *Preemption*, 86 VA. L. REV. 225, 298 (2000).

107 Rice v. Santa Fe Elevator Corp., 331 U.S. 218, 230 (1946). *See also* Jones v. Rath Packing Co., 430 U.S. 519, 525–604 (1977) ("'[W]e start with the assumption that the historic police powers of the States were not to be superseded by [federal law] unless that was the clear and manifest purpose of Congress.'" (quoting Rice v. Santa Fe Elevator Corp., 331 U.S. 218, 230 (1946)).

108 *See* Mary J. Davis, *The "New" Presumption Against Preemption*, 61 HASTINGS L.J. 1217, 1220–21 (2010).

109 *Id.* at 1221.

110 Conference of Fed. Sav. & Loan Ass'ns v. Stein, 604 F.2d 1256, 1260 (9th Cir. 1979) (citing Ray v. Atlantic Richfield Co., 435 U.S. 151, 157 (1978)).

(2) preemption where the state law is "an obstacle to the accomplishment and execution of the full purposes and objectives of Congress."[111] Direct conflict preemption, where it is impossible to comply with both federal and state law, is a rarity, however.[112] Therefore, courts attempting to apply conflict preemption typically grapple with the issue of whether state law or regulation is a sufficient obstacle to federal law or regulation that it should be preempted.

In addition to preemption through federal statute, state law can also be preempted by the action of federal regulatory agencies.[113] "Federal regulations have no less pre-emptive effect than federal statutes."[114] Also, agencies may attempt to preempt state law either through express statements of preemption or by enacting regulations that conflict with existing state law.[115] If the scheme of agency regulation of an area is so pervasive as to leave no room for state action, then field preemption is implied.[116] However, it would upset the balance of federalism to assume blanket preemption simply because of extensive regulation of an area.[117] Because Congressional purpose is the touchstone of preemption, agency power to preempt must come from Congress, which may grant agencies preemption power either directly, stating that agencies have the power to make preemption declarations, or indirectly, giving agencies the power to take actions which, through their conflict with state law, preempt those laws.[118]

A crucial question, and one subject to much current debate, is whether and how much deference courts should give to agency declarations and decisions regarding the preemptive effects of

111 Hines v. Davidowitz, 312 U.S. 52, 67 (1941).

112 *See* Davis, *supra* note 106, at 1244.

113 *See* William Funk, *Judicial Deference and Regulatory Preemption by Federal Agencies*, 84 TUL. L. REV. 1233, 1235–36 (2010). Recognition of agencies' preemptive effect on state law goes back, some argue, at least to *Gibbons v. Ogden*, 22 U.S. 1 (9 Wheat.) (1824). *See* Funk, at 1234–35.

114 Fidelity Fed. Sav. & Loan Ass'ns. v. De la Cuesta, 458 U.S. 141, 153 (1982).

115 *See* Funk, *supra* note 113, at 1235.

116 Rice Bank of Am. v. City & Cnty. of S.F., 309 F.3d 551, 558 (9th Cir. 2002) (citing Rice v. Santa Fe Elevator Corp., 331 U.S. 218, 230 (1947)).

117 *See* John P.C. Duncan, *The Course of Federal Pre-emption of State Banking Law*, 18 ANN. REV. BANKING L. 221, 317–18 (1999) ("To infer pre-emption whenever an agency deals with a problem comprehensively is virtually tantamount to saying that whenever a federal agency decides to step into a field, its regulations will be exclusive. Such a rule, of course, would be inconsistent with the federal-state balance embodied in our Supremacy Clause jurisprudence.").

118 *See* Funk, *supra* note 113, at 1235–36 (explaining how agency regulations may expressly preempt state law or may have the effect of doing so).

their actions.[119] Agencies that seek the greatest latitude in preempting state law would prefer that their preemption decisions be given *Chevron* deference, a standard which requires greater administrative procedure to establish a regulation, but provides an agency with greater deference to its determination, so long as it is reasonable.[120] A lesser standard is *Skidmore* deference, which requires less daunting administrative procedure to establish a regulation, but leaves greater discretion to courts to determine preemption.[121] Some academic commentators have urged against granting federal agencies *Chevron* deference regarding their preemption determinations, arguing, among other things, that federal agencies lack expertise on the effects of preemption, or that agencies lack sufficient political accountability in their consideration of states' interests.[122] Others have urged courts to take a "hard look" at agency declarations of preemption not grounded in express powers granted by Congress.[123]

In the 2009 case, *Wyeth v. Levine*, the Supreme Court indicated that in determining whether state law conflicts with federal regulation, courts should not defer "to an agency's *conclusion* that state law is pre-empted" but instead should attend to the agency's explanation of any such conflict.[124] The Court noted that, absent delegation of preemption powers by Congress, federal agencies possess no inherent "authority to pronounce on pre-emption," though they do "have a unique understanding of the statutes they administer and an attendant

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119 *See, e.g.*, Nina A. Mendelson, *A Presumption Against Agency Preemption*, 102 NW. U. L. REV. 695, 699, 702–03 (2008) (arguing that federal agencies are poorly suited to make preemption decisions, given their "particular stake in validating their own policy decisions," their lack of stake in protecting state autonomy, and the likelihood that agencies would extend preemption of state law far beyond that intended by Congress).

120 *See* Brian Galle & Mark Seidenfeld, *Administrative Law's Federalism: Preemption, Delegation, and Agencies at the Edge of Federal Power*, 57 DUKE L.J. 1933, 1998 & n.268 (2008) (explaining that agency decisions made after formal procedures, such as notice and comment, will receive great deference by the courts).

121 *See* Skidmore v. Swift & Co., 323 U.S. 134, 164 (1944). For a discussion of *Skidmore* deference, see Galle & Seidenfeld, *supra* note 120, at 1998 & n.268.

122 *See, e.g.*, Nina A. Mendelson, *Chevron and Preemption*, 102 MICH. L. REV. 737, 758–98 (2004) (arguing against *Chevron* deference for agency preemption determinations given their lack of expertise regarding the effects of such preemption, and discussing alternative theories regarding agency political accountability).

123 Karen A. Jordan, *Opening the Door to "Hard-Look" Review of Agency Preemption*, 31 W. NEW ENG. L. REV. 353, 359 (2009). The author argues that while appearing deferential to agency preemption decisions, the Supreme Court in *United States v. Shimer*, 367 U.S. 374 (1961), was actually mandating "a hard-look review [that] requires a court to search for the rationale and reasoning underlying the agency's decision." *See id.* at 361.

124 Wyeth v. Levine, 129 S. Ct. 1187, 1201 (2009).

ability to make informed determinations about how state requirements may pose an 'obstacle to the accomplishment and execution of the full purposes and objectives of Congress.'"[125] How much deference to grant agency claims of preemption has become a crucial issue in the banking industry, because federal banking regulators have made extensive claims that their regulation preempts the powers of the states to govern banks' activities.

A The Previous Co-Existence of State and Federal Regulation of National Banks and Thrifts

Many statutes come into play in the effect of federal preemption on the banking industry.[126] Two sets of statutes and regulators are central to the federal preemption for national banks and thrifts: (1) the National Bank Act (NBA), which charters national banks that are overseen by the Office of the Comptroller of the Currency; and (2) the Home Owners Loan Act (HOLA), which charters Federal Savings associations (also known as "thrifts"), that are currently supervised by the Office of Thrift Supervision.[127]

For many decades since the enactment of the NBA in 1863–1864 and HOLA in 1933, these statutes were construed to recognize the importance of the dual federal and state banking system, as well as the extensive role that state law plays in the operation even of federally regulated banks and thrifts.[128] Both the courts and Congress were concerned about preserving the "competitive equality" of the dual state and federal banking system and so strove to keep them on at least somewhat equal

125 *Id.* (quoting Hines v. Davidowitz, 312 U.S. 52, 67 (1941)).

126 Among the federal statutes with the most significant preemptive effect in the mortgage industry are: the National Bank Act of 1864, 12 U.S.C. §§ 21–216 (2006); Home Owners' Loan Act, 12 U.S.C. §§ 1461–70 (2006); Depository Institutions Deregulation and Monetary Control Act of 1980, 12 U.S.C. § 1735f (2006); National Credit Union Administration, 12 U.S.C. § 1757 (2006); and the Alternative Mortgage Transactions Parity Act, 12 U.S.C. §§ 3801–06 (2006). For a more complete description of various federal laws preempting state law in the mortgage and banking industry, see ELIZABETH RENUART & KATHLEEN E. KEEST, THE COST OF CREDIT: REGULATION, PREEMPTION, AND INDUSTRY ABUSES 53–55 (4th ed. 2009).

127 In addition, there is the Federal Credit Union Act (FCUA) providing for credit unions supervised by the National Credit Union Administration (NCUA). However, as credit unions do not loom large in the mortgage meltdown or its aftermath, the NCUA will be little discussed herein.

128 For an extensive discussion of the history of preemption in the banking industry, see generally Arthur E. Wilmarth, Jr., *The OCC's Preemption Rules Exceed the Agency's Authority and Present a Serious Threat to the Dual Banking System and Consumer Protection*, 23 ANN. REV. BANKING & FIN. L. 225 (2004).

footing.[129] On the other hand, national banks and thrifts and federal regulators have vociferously argued that because the federal government has always played a significant role in the regulation of the banking industry, and a dominant one for national banks, there should be no presumption against preemption of state law as to national banks.[130]

Notably, NBA and HOLA are virtually silent regarding whether they preempt state law. The NBA has only one direct assertion of preemption in its text, which is the provision that national banks can abide by either state usury limits or, alternatively, a federal one.[131] The Supreme Court has never held that the NBA occupies the field of law generally regarding regulation of national banks, even though it does occupy the field regarding usury claims.[132]

The Supreme Court commented on the great role state law plays in governing national banks in 1869, stating that national banks:

> are subject to the laws of the State, and are governed in their daily course of business far more by the laws of the State than of the nation. All their contracts are governed and construed by State laws. Their acquisition and transfer of property, their right to collect their debts, and their liability to be sued for debts, are all based on State law. It is only when the State law incapacitates the [national] banks from discharging their duties to the [federal] government that it becomes unconstitutional.[133]

Traditionally, therefore, national banks' "right to collect their debts," which is the core of servicing, is "based on State law."

Decades later, the Court reemphasized the role state law plays in regulating national banks and rejected the idea of field preemption by federal regulation in *St. Louis v. Missouri*.[134] In 1978, however, the Court extended the reach of the NBA's usury

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129 Duncan, *supra* note 117, at 222 ("'Competitive equality' became shorthand in the courts for the complex state-federal balances created by federal banking statutes.").

130 *See* United States v. Locke, 529 U.S. 89, 108 (2000).

131 *See* Lauren K. Saunders, *Restore the States' Traditional Role as "First Responder,"* NATIONAL CONSUMER LAW CENTER, at 4–5 (Sept. 2009), http://www.nclc.org/images/pdf/preemption/restore-the-role-of-states-2009.pdf.

132 *See* Duncan, *supra* note 117, at 223. *See also* RENUART & KEEST, *supra* note 126, at 84 & nn.273–74 (citing Jefferson v. Chase Home Fin., No. C 06-6510 THE, 2008 WL 1883484 (N.D. Cal. Apr. 29, 2008), for the proposition that the NBA does not occupy the field of banking, and Beneficial Nat'l Bank v. Anderson, 539 U.S. 1 (2003), which applies express preemption language to usury claims).

133 *See* Nat'l Bank v. Kentucky, 76 U.S. (9 Wall.) 353, 362 (1869).

134 *See* St. Louis v. Missouri, 263 U.S. 640, 656–61 (1924).

preemption by holding that national banks had "most favored lender" status in their respective home states and decreed that national banks could export their own home states' usury limits to other states in which they do business.[135]

In 1994, Congress appeared to attempt to rein in preemption claims by the OCC when, during the enactment of the Riegle-Neal Act, it directed the OCC, as well as courts, to try to harmonize state and federal law where possible, rather than finding preemption-causing conflict, noting that the OCC should not decide that a state law is preempted unless "the legal basis is compelling and the Federal policy interest is clear."[136] Since preemption is based on and reflects Congressional intent, clear direction such as this should be a guidepost to limit the extent of preemption caused by OCC regulations.

In 1996, the Supreme Court issued its decision in *Barnett Bank of Marion County v. Nelson*, which laid out the Court's view of the preemption effects of federal banking law.[137] In *Barnett*, a national bank sued Florida's Department of Insurance, seeking to enjoin it from enforcing a state statute that prohibited some banks from selling many varieties of insurance, arguing that this statute was preempted by a 1916 federal statute that provided that banks may sell insurance in certain instances.[138] The Supreme Court held that because the federal law granted national banks a power, in this case to sell insurance, that grant of power preempted a state law that would deny such power.[139] However, the Court noted that national banks are still subject to state regulation and provided a standard by which to determine whether state law should be preempted by the NBA and OCC regulation:

> In defining the pre-emptive scope of statutes and regulations granting a power to national banks, these cases take the view that normally Congress would not want States to forbid, or to impair significantly, the exercise of a power that Congress explicitly granted. To say this is not to deprive States of the power to regulate national banks, where

135 *See* Marquette Nat'l Bank v. First Omaha Serv. Corp., 439 U.S. 299, 314 & n.26 (1978).

136 H.R. REP. NO. 103-651, at 53–55 (1994) (Conf. Rep.), *reprinted in* 1994 U.S.C.C.A.N. 2074.

137 *See* Barnett Bank of Marion Cnty. v. Nelson, 517 U.S. 25, 27–28 (1996).

138 *See id.* at 28–29. The federal statute in question was the Act of Sept. 7, 1916 (Federal Statute). *See* 12 U.S.C. § 92 (2006).

139 *See Barnett*, 517 U.S. at 37 ("[W]e conclude that the Federal Statute means to grant small town national banks authority to sell insurance, whether or not a State grants its own state banks or national banks similar approval.").

> (unlike here) doing so does not prevent or significantly interfere with the national bank's exercise of its powers.[140]

This case therefore lays out what the Supreme Court, in 1996, viewed as the appropriate preemption standard for state regulation of national banks. States do have the power to regulate national banks so long as their regulation does not "prevent or significantly interfere with the national bank's . . . powers" or does not "forbid or . . . impair significantly, the exercise of a power that Congress [has] explicitly granted."[141] Congress explicitly adopted the *Barnett* standard by citing it in subsequent legislation.[142]

Like the NBA, HOLA, which governs thrifts, has only very limited preemption language, also specifying that thrifts can choose between state and federal usury limits, and specifying the federal thrift usury limit.[143] Because HOLA and the NBA have such limited preemption language, courts have generally applied the narrower "conflict" preemption analysis to determine if state laws purporting to regulate national banks and thrifts were preempted, rather than the broader field preemption.[144] For example, in the 1986 case *Departmento de Asuntos del Consumidor(DACO) v. Oriental Federal Saving Bank*, a federal district court employed a conflict preemption analysis in finding that local law setting interest rate maximums for retail installment contracts was not preempted, and in doing so rejected the argument that HOLA necessarily preempted local law by occupying the field.[145] That court stated that, despite the fact that HOLA grants the thrift regulator broad powers, which it has used to issue "detailed regulations covering all aspects of every federal savings and loan association 'from its cradle to its

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140 *See id.* at 33.

141 *Id.*

142 The Gramm-Leach-Bliley Act of 1999 limits the states' ability to restrict depository institutions or their affiliates from engaging "in any insurance sales, solicitation, or crossmarketing activity" and expressly states that this limitation is in "accordance with the legal standards for preemption set forth in the decision of the Supreme Court of the United States in Barnett Bank of Marion County . . . ." 15 U.S.C. § 6701(d)(2)(A) (2006).

143 *See* 12 U.S.C. § 1463 (2006). For a discussion of this point see Adam J. Levitin, *Hydraulic Regulation: Regulating Credit Markets Upstream*, 26 YALE J. ON REG. 143, 167 (2009) (noting that except as to national thrifts, HOLA contains no explicit language preempting state law).

144 In 1982, in finding "an actual conflict between federal and state law," the Supreme Court held that it "need not decide whether the HOLA or the Board's regulations occupy the . . . entire field of federal savings and loan regulation." Fidelity Fed. Sav. & Loan Ass'n v. De la Cuesta, 458 U.S. 141, 159 n.14 (1982).

145 Departmento de Asuntos del Consumidor (DACO) v. Oriental Fed. Sav., 648 F. Supp. 1194, 1197 (D.P.R. 1986).

grave,' . . . .most courts have been unwilling to blanketly declare that Congress has occupied the entire field of federal savings and loan association regulation."[146] Another court in 1982 opined in discussing HOLA and its accompanying regulations: "The fact that federal statutes or regulations covering some aspects of a regulated area are, by necessity, complex and detailed, does not imply that Congress intended to occupy the entire field to the exclusion of state law."[147]

B. Federal Regulators Move to Preempt State Regulation of Nation Banks and Thrifts

During the 1980s, as federal "regulatory zeal" declined and states stepped up their regulatory efforts, preemption, which had been a backwater of American law, suddenly gained new importance.[148] Various industries sought to stifle state regulation by seeking federal preemption, so as to trump state action with federal inaction in regulation.[149] In the banking industry, banks and thrifts increasingly sought protection from state regulation by appealing to federal regulators to assert greater preemptive powers.[150]

The OTS struck first in 1996 by issuing regulations claiming that it had the authority to occupy the field regarding any regulation of federal thrifts.[151] Its regulation stated, "[p]ursuant to sections 4(a) and 5(a) of the HOLA, 12 U.S.C. 1463(a), 1464(a), OTS is authorized to promulgate regulations that preempt state laws affecting the operations of federal savings associations . . . . OTS hereby occupies the entire field of lending regulation for federal savings associations."[152] The regulation provides specific illustrations of state law that is preempted, and includes: "Processing, origination, *servicing*, sale or purchase of, or

146 *Id.* (quoting Cal. v. Coast Fed. Sav. & Loan Ass'n, 98 F. Supp. 311, 316 (S.D. Cal. 1951)).

147 Morse v. Mutual Fed. Sav. & Loan Ass'n of Whitman, 536 F. Supp. 1271, 1280 (D. Mass. 1982).

148 Susan Bartlett Foote, *Administrative Preemption: An Experiment in Regulatory Federalism,* 70 VA. L. REV. 1429, 1430–31 (1984).

149 *Id.* ("Until recently, administrative preemption provisions attracted little political, judicial, or scholarly attention. . . . In the last few years, however, the federal government has declined in regulatory zeal, and states and localities have become more protective. Faced with stricter state laws varying from state to state, businesses have begun to lobby for uniform federal regulations that would preempt more protective state laws." (footnotes omitted)).

150 *See* Julia Patterson Forrester, *Still Mortgaging the American Dream: Predatory Lending, Preemption, and Federally Supported Lenders*, 74 U. CIN. L. REV. 1303, 1309 (2006).

151 12 C.F.R. § 560.2 (2011).

152 12 C.F.R. § 560.2(a) (2010) (original version at 12 C.F.R. § 560.2(a) (1997)).

investment or participation in, mortgages."[153] Therefore, with a single regulation, the OTS claimed to eliminate any state power to regulate thrifts engaged not only in lending, but also in servicing loans on behalf of others.

The OTS did note some exceptions to its claimed field preemption in this regulation, preserving state contract law, real property law, tort and criminal law, and any law that "[f]urthers a vital state interest," among others, but only "to the extent that they only incidentally affect the lending operations of Federal savings associations or are otherwise consistent with the purposes of paragraph (a) of this section."[154] The OTS made clear that these exceptions to preemption were meant merely to "preserve the traditional infrastructure of basic state laws that undergird commercial transactions, not to open the door to state regulation of lending by federal savings associations."[155] Furthermore, any exception is "intended to be interpreted narrowly. Any doubt should be resolved in favor of preemption."[156]

The OTS based its field preemption claim on two sections of federal statute, "sections 4(a) and 5(a) of the HOLA, 12 U.S.C. 1463(a), 1464(a)."[157] However, these sections are essentially silent as to any explicit Congressional purpose to grant the OTS the power to preempt. 12 U.S.C. § 1463(a) provides that the OTS, through its director, can issue regulations.[158] 12 U.S.C. § 1464(a) provides that the Director of the OTS can, under regulations the Director prescribes, "provide for the organization, incorporation, examination, operation, and regulation of [Federal savings] associations" and to issue charters for them.[159] Neither provides any expression that Congress' purpose was to have the OTS occupy the field regarding regulation of thrifts, unless one

153 12 C.F.R. § 560.2(b)(10) (emphasis added).

154 12 C.F.R. § 560.2(c). The OTS gave courts instructions on how to apply the preemption doctrine in section 560.2, stating that "[w]hen analyzing the status of state laws under § 560.2, the first step will be to determine whether the type of law in question is listed in paragraph (b). If so, the analysis will end there; the law is preempted. If the law is not covered by paragraph (b), the next question is whether the law affects lending. If it does, then, in accordance with paragraph (a), the presumption arises that the law is preempted. This presumption can be reversed only if the law can clearly be shown to fit within the confines of paragraph (c). For these purposes, paragraph (c) is intended to be interpreted narrowly. Any doubt should be resolved in favor of preemption." Lending and Investment, 61 Fed. Reg. 50,951, 50,966–67 (Sept. 30, 1996).

155 Lending and Investment, 61 Fed. Reg. at 50,966.

156 *Id.* at 50,966–67.

157 12. C.F.R. § 560.2(a).

158 12 U.S.C. § 1463(a) (2006).

159 12 U.S.C. § 1464(a).

takes the position that anytime Congress allows a federal agency to draft regulations, its purpose is to have that agency occupy the field, or that federal agencies directed to regulate an area can merely announce that their regulations occupy the field for that area.

The OTS, somewhat disingenuously, stated in its announcement of the regulations that its preemption regulation did not constitute a change in the law, but merely a clearer restatement of it, arguing that the regulation merely

> restates long-standing preemption principles applicable to federal savings associations, as reflected in earlier regulations, court cases, and numerous legal opinions issued by OTS and the Federal Home Loan Bank Board (FHLBB), OTS's predecessor agency. OTS still intends to occupy the field of lending regulation for federal savings associations.[160]

After the OTS issued regulations purportedly preempting the field of thrift regulation, it was perhaps nearly inevitable that the OCC would do the same for the regulation of national banks. While thrifts and national banks might appear to be different types of entities, in fact the OTS and the OCC were in competition, both with each other and with state regulators, over subject financial institutions.[161] Should the OTS be free to provide its member thrifts freedom from state regulation and the OCC not, then banks would be tempted to switch from being either state chartered institutions or national banks to being national thrifts in order to reduce their regulatory burden, thus starting a "race to the bottom" to see which regulator would mandate the fewest consumer protections and other regulations.[162] Like that of OTS, the budget of the OCC depended largely on fees from the financial institutions it regulated, giving the agencies an incentive to maintain or increase the number of institutions they regulated, and making preemption a valuable tool to lure those institutions away from state charters.[163] Without broad preemption powers, the OCC was no doubt concerned that not only could it not lure banks away from state charters, but that the OTS might lure them into becoming thrifts. The OCC was constrained by the fact that the Supreme Court had, in 1996, stated the standards for preemption governing national banks in the *Barnett* case, and Congress had

160 Lending and Investment, 61 Fed. Reg. at 50,952.

161 Duncan, *supra* note 117, at 318.

162 *Id.*

163 Patricia A. McCoy et al., *Systemic Risk Through Securitization: The Result of Deregulation and Regulatory Failure*, 41 CONN. L. REV. 1327, 1349 (2009).

subsequently expressed approval of those standards, as noted above.[164] However, the OCC brushed such concerns aside.[165]

In 2003, the OCC fired a salvo against state regulation of national banks, issuing a preemption order finding that the Georgia Fair Lending Act, designed to deter predatory lending, did not apply to national banks.[166] In 2004, the OCC moved to preempt state regulation more universally and issued regulations purporting to preempt state law generally in the business of banking for national banks, including for deposit-taking and lending, either with or without mortgages.[167] The OCC's regulation went far beyond the existing *Barnett* standard, whereby state law was preempted as to national banks only to the extent it would "forbid, or to impair significantly" or "prevent or significantly interfere with the national bank's exercise of its powers."[168] Instead, the OCC regulation declared any state law that would "obstruct, impair, or condition, a national bank's ability to fully exercise" its powers as a national bank was preempted.[169] This "obstruct, impair, or condition" is a broader standard than *Barnett*'s "forbid, or to impair significantly" or "prevent or significantly impair" standard, in that the impairment no longer has to be significant. Even state regulation that did not forbid, prevent or significantly impair a national bank's exercise of its powers would be preempted if state law merely "conditioned" the use of those powers, which is vague and broad language. The OCC regulations further widened their preemptive effect by mandating that only a specific set of state laws could apply to national banks, and even then only those that had a mere "incidental" effect on national banks' powers, which the regulation preamble defines as those that "form the legal infrastructure that makes it practicable" for national banks to exist and conduct business and "do not attempt to regulate the manner or content of" the business of banking authorized for national banks.[170]

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164 Barnett Bank of Marion Cnty., N.A. v. Nelson, Fla. Ins. Comm'y, 517 U.S. 25, 33 (1996); 12 C.F.R. § 560.2(a) (2010) (original version at 12 C.F.R. § 560.2(a) (1997)).

165 Bank Activities and Operations; Real Estate Lending and Appraisals, 69 Fed. Reg. 1904, 1904 (Jan. 13, 2004).

166 Preemption Determination and Order, 68 Fed. Reg. 46,264, 46,264 (Aug. 5, 2003).

167 Bank Activities and Operations; Real Estate Lending and Appraisals, 69 Fed. Reg. at 1904; 12 C.F.R. §§ 7.4007–09 (2010). For a discussion of this preemption order, see Christopher L. Peterson, *Federalism and Predatory Lending: Unmasking the Deregulatory Agenda*, 78 TEMP. L. REV.1, 70–71 (2005).

168 *Barnett*, 517 U.S. at 33.

169 12 C.F.R. §§ 7.4007, 7.4009.

170 Bank Activities and Operations, 69 Fed. Reg. 1912 (Jan. 13, 2004); 12 C.F.R. §§ 7.4007(c), 7.4008(e), 7.4009(c), 34.4(b).

The OCC regulations further limited state action by claiming that the OCC has exclusive visitorial powers not only over national banks, but also over their operating subsidiaries.[171] Worse yet, even if a state law is not preempted and does apply to a national bank, the states themselves cannot enforce that law against the national banks, according to OCC's regulations.[172] At most, a state can sue the national bank for declaratory relief, seeking a judgment that the state law does apply to national banks and is not preempted. However, only the OCC, according to its regulations, could then enforce applicable state law, so that the OCC could pick and choose which state law to apply, even among those that are not preempted.[173]

The OCC expanded its powers of preemption in an advisory letter by arguing that not only are national banks protected from state regulation, even their local non-national bank agents are protected from state licensing requirements when they are acting in ways related to the national banks' powers as such.[174]

The reaction against the OCC's preemption expansion was swift and initially futile. All fifty Attorneys General sent a letter opposing the increased federal preemption of state law for national banks, and they were joined by academics and consumer advocates.[175] Unfortunately, they were not immediately joined by the courts, by and large. In the case *Watters v. Wachovia Bank*, the Supreme Court appeared to condone the OCC's expansion of its powers of preemption, agreeing with the OCC that the NBA's preemption extended even to operating

171 Travis P. Nelson, *Preemption Under Title X of the Dodd-Frank Act*, BANKING LAW COMMITTEE JOURNAL, Oct. 2010, at 5, *available at* http://apps.americanbar.org/buslaw/committees/CL130000pub/newsletter/201010/nelson.pdf.

172 Bank Activities and Operations, 69 Fed. Reg. 1895, 1897; 12 C.F.R. § 7.4000 ("The provisions of any State law to which a branch of a national bank is subject under this paragraph *shall been forced*, with respect to such branch, by the *Comptroller of the Currency*.").

173 Bank Activities and Operations, 69 Fed. Reg. at 1899–900. For a discussion of this point, see Wilmarth, *supra* note 128, at 228.

174 Letter from John E. Bowman, Chief Counsel, Office of Thrift Supervision, Authority of a Federal Savings Association to Perform Banking Activities through Agents Without Regard to State Licensing Requirements, P-2004-7 (Oct. 25, 2004), *available at* http://www.ots.treas.gov/_files/560404.pdf. For a discussion of this, and the argument that preemption protection for non-national banks leads to additional predatory behavior, see Christopher L. Peterson, *Preemption, Agency Cost Theory, and Predatory Lending by Banking Agents: Are Federal Regulators Biting Off More Than They Can Chew?*, 56 AM. U. L. REV. 515, 543 (2007).

175 See discussion of the opposition in Peterson, *supra* note 174, at 70–71. For an opposition letter from multiple consumer advocacy groups, see Letter to the Office of the Comptroller of the Currency, (Oct. 6, 2003), *available at* http://www.responsiblelending.org/media-center/press-releases/archives/CRL-OCCsignon100603.pdf.

subsidiaries of national banks as well as to the banks themselves.[176] The Supreme Court stated that national banks have "the power to engage in real estate lending through an operating subsidiary" and that this power of the national banks "cannot be significantly impaired or impeded by state law."[177]

The *Watters* case is interesting both for what it added to the OCC's preemptive powers and for what it withheld. On the one hand, its extension of federal preemption to the operating subsidiaries of national banks, even if those subsidiaries were state-chartered, handed national banks and their subsidiaries an enormous victory against state regulation.[178] At the same time, however, the Court failed to adopt the OCC regulations' more expansive preemption language, and instead cited *Barnett* as finding preemption where "state prescriptions significantly impair" the authority "enumerated or incidental under the NBA."[179] Also, the Court did not rule on the issue of whether the OCC had the power to declare the preemptive effects of its action or seek judicial deference for its preemption declarations.[180] While noting that the OCC had, by regulation, claimed to limit the application of state law to national bank operating subsidiaries only to the same extent such laws applied to national banks, the Court did not decide what level of deference to give those regulations, as its decision was based on the NBA itself.[181]

The OCC's and OTS's efforts to lure financial institutions to their charters through preemption appeared to be successful. Engel and McCoy noted, "[a]lthough landing Countrywide was a huge coup for OTS, the OCC was the biggest beneficiary of charter shopping after 2003," and also quoted the Comptroller as crowing within months of adopting the preemption rule, "the past several months have seen some notable movements of state banks into the national system."[182] The market shares of their regulated institutions grew as well. "Depository institutions and their subsidiaries and affiliates accounted for about half of nonprime loans originated in 2004 and 2005, 54% in 2006, and 79% in 2007."[183] Worse yet is the likelihood that the threat of

176 Watters v. Wachovia Bank, N.A., 550 U.S. 1, 18 (2007).
177 *Id.* at 21.
178 *Id.* at 18.
179 *Id.* at 12.
180 *Id.* at 20.
181 *Id.* at 20–21.
182 KATHLEEN C. ENGEL & PATRICIA A. MCCOY, THE SUBPRIME VIRUS: RECKLESS CREDIT, REGULATORY FAILURE, AND NEXT STEPS 160–61 (2011).
183 Arthur E. Wilmarth, Jr., *The Dark Side of Universal Banking: Financial*

losing financial institutions to a federal charter encouraged states to reduce the regulatory burden on their state-chartered institutions.

During the Bush era, both the OCC and the OTS were preempting state law regarding lending practices, not only to lure banks and thrifts to their charters, but also in order to reduce the total regulatory burden on banks and thrifts, based on the belief that the markets should broadly be left to regulate themselves.[184] The OTS was especially brazen in its lack of regulation for its member thrifts, and laid off sixty-nine thrift examiners, while its director claimed his goal "was 'to allow thrifts to operate with a wide breadth of freedom from regulatory intrusion'" and showed up with a chainsaw at a conference set up to proclaim a reduction of red-tape and regulation.[185] Countrywide switched from a bank to a thrift charter specifically to take advantage of the fact that the OTS was more restrained than the OCC in the application of its guidelines governing alternative mortgage products.[186]

Federal regulators have since claimed that preempting state regulation did not cause the influx of default-prone loans that came after the OCC's 2004 preemption regulation.[187] However, a review of default rates from 2006 to 2008 among depository institutions shows that federally regulated banks and thrifts had significantly higher default rates than those regulated by the states, with federal thrifts by far the worst.[188] As noted by Engel and McCoy, "the best loan performance was at state bank and thrifts, which were subject to both state and federal regulation and did not enjoy preemption."[189]

As a result of the federal preemption of state regulation of national banks and thrifts, those banks and thrifts

Conglomerates and the Origins of the Subprime Financial Crisis, 41 CONN. L. REV. 963, 1018–19 (2009).

184 *See* McCoy, *supra* note 163, at 1349 (stating "[c]oncomitantly, OCC regulators and their federal bank regulator counterparts were true believers in the ability of market structures and new instruments to contain risk. When market innovations could contain risk, the thinking went, why have government regulation?").

185 ENGEL & MCCOY, *supra* note 182, at 175.

186 Barbara A. Rehm, *Countrywide to Drop Bank Charter in Favor of OTS*, AM. BANKER, Nov. 10, 2006, at 1.

187 *See, e.g.*, John C. Dugan, Comptroller of the Currency, Remarks Before Women in Hous. & Fin., Washington, DC (Sept. 24, 2009), *available at* http://www.occ.gov/news-issuances/speeches/2009/pub-speech-2009-112.pdf. Dugan stated, "[i]t is widely recognized that the worst subprime loans that have caused the most foreclosures were originated by nonbank lenders and brokers regulated exclusively by the states." *Id.*

188 ENGEL & MCCOY, *supra* note 182, at 163.

189 *Id.*

understandably became less willing to cooperate with state regulators attempting to resolve consumer complaints. State officials reported a noticeable effect from the preemptive strike by federal regulators, diminishing state consumer protection efforts.[190] Although this perception was not universal, many felt that national banks were less cooperative with state officials and less concerned about consumer complaints.[191] While state officials stated that they had been able, before the assertion of preemption, to informally resolve customer complaints efficiently, once the OCC announced its intent to preempt state regulation, some state agents felt that national banks became significantly less cooperative.[192]

Worse yet, the OCC and OTS were not themselves engaging in significant enforcement action for violations of consumer protection by their regulated institutions. The OCC provided little public evidence that it was sanctioning national banks for consumer protection violations. As Professor Arthur E. Wilmarth, Jr. noted:

> The OCC's record is similarly undistinguished with respect to consumer enforcement actions taken against national banks for violations of consumer protection laws. Since January 1, 1995, the OCC has taken only thirteen public enforcement actions against national banks for violations of consumer lending laws. With two exceptions, all of those actions were taken against small national banks.[193]

IV. PREEMPTION AND SERVICER REGULATION

At the very beginning of the mortgage crisis, it was clear that federal preemption of state law would reduce the states' abilities to investigate or regulate the way national banks serviced loans. In 2007, a group of state bank regulators, concerned that borrowers were being foreclosed upon unnecessarily, requested information from the biggest national banks regarding their foreclosure operations. When two banks refused to cooperate, the state bank examiners sent a letter to the OCC, requesting its aid. Rather than helping, the OCC

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190 U.S. GOV'T ACCOUNTABILITY OFFICE, OCC PREEMPTION RULES: OCC SHOULD FURTHER CLARIFY THE APPLICABILITY OF STATE CONSUMER PROTECTION LAWS TO NATIONAL BANKS, GAO-06-387, at 17 (2006), *available at* http://www.gao.gov/new.items/d06387.pdf.

191 *Id.*

192 *Id.* at 17–21.

193 Wilmarth, *supra* note 78, at 14 (noting how rarely the OCC has sanctioned any national bank for a consumer protection violation, especially when compared to state banking regulators).

insisted that national banks should respond only to inquiries from federal officials, claiming that it was going to collect the information itself and did not want to risk "confusing matters."[194] Rather than "scrutinize the foreclosure operations" of the large national banks, however, the OCC reportedly merely relied on the banks' own internal assessments of their procedures.[195] As foreclosures mounted and state attorneys tried to investigate the causes of the dramatic increase in foreclosures, large servicers regulated by the OCC reportedly refused even to turn over basic servicing data, citing federal preemption.[196]

Federal preemption for national banks is especially significant in the servicing industry because, as previously noted, residential mortgage servicing is dominated by the servicing arms of national banks and thrifts.[197] The four largest servicers are the servicing arms of Bank of America, Wells Fargo, Chase, and CitiMortgage, which between them service over fifty-six percent of the market.[198] Because many of the largest mortgage servicers are the parts of federally regulated financial institutions, the expansion of OTS and OCC preemption and the extension of preemption to the subsidiaries of national banks and thrifts has provided servicers protection from state regulation. Both the OTS and the OCC regulations specifically purport to preempt all state regulation of mortgage servicing by national banks and thrifts. The OTS regulations list, as examples of

> the types of state laws preempted by paragraph (a) of this section . . . state laws purporting to impose requirements regarding. . .
>
> (5) Loan-related fees, including without limitation, initial charges, late charges, prepayment penalties, servicing fees, and overlimit fees;
>
> (6) Escrow accounts, impound accounts, and similar accounts;
>
> . . . .
>
> (10) Processing, origination, servicing, sale or purchase of, or investment or participation in, mortgages.[199]

194 A description of this episode can be found in Zachary A. Goldfarb, *Regulators Lagged in Foreclosure Oversight*, WASH. POST, Nov. 8 2010, at A1.

195 *Id.*

196 Press Release, Office of Sen. Hillary R. Clinton, Sens. Clinton, Bayh Call on Administration, Mortgage Services to Cooperate with State's Efforts to Address Mortgage, Foreclosure Crisis (Apr. 30, 2008), *available at* 2008 WLNR 8047227.

197 Wilmarth, *supra* note 78, at 2.

198 *Firms Ranked by Number of Loans Serviced at 9/30*, MORTGAGE SERVICING NEWS, Feb. 2011, at 1.

199 12 C.F.R. § 560.2(b) (2010).

The OCC regulations also expressly purport to preempt state regulation of mortgage servicing, stating that "[s]pecifically, a national bank may make real estate loans under 12 U.S.C. § 371 and § 34.3, without regard to state law limitations concerning: . . . (10) Processing, origination, servicing, sale or purchase of, or investment or participation in, mortgages."[200]

The federal preemption of state law governing mortgage servicing provided a challenge to courts: while the OTS and OCC seemed to indicate a desire to occupy the field of regulating mortgage servicing, clearly the states had to play some role in providing the legal structure undergirding mortgage servicer behavior. For example, the law governing mortgage foreclosure is primarily a state creation, with some states mandating judicial procedure and others allowing for non-judicial foreclosures.[201] Given that a foreclosure is one of the most extreme steps taken by servicers, federal regulators can hardly be said to occupy all mortgage servicing regulation if they have not regulated how federally regulated servicers foreclose.[202]

Mortgage servicers also needed other forms of state law to apply to their mortgages and loans, including state negotiable instrument law and contract law.[203] Mortgage servicers clearly should not be exempt from criminal law and general tort law, providing liability for torts such as deception.[204] Therefore, contract, tort, and real property law were listed as examples of the kinds of law NOT preempted by the OTS's and OCC's regulation.[205] The challenge for courts attempting to honor the preemption regulations regarding mortgage servicing has been trying to distinguish between permissible state regulation of

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200 12 C.F.R. § 34.4(a).

201 Grant S. Nelson & Dale A. Whitman, *Reforming Foreclosure: The Uniform Nonjudicial Foreclosure Act*, 53 DUKE L.J. 1399, 1403 (2004) (stating that "[m]ortgage foreclosure law is in a state of pronounced disarray. A sizeable number of states mandate judicial foreclosure, while others authorize a nonjudicial 'power of sale' foreclosure proceeding. Additionally, many states impose a variety of postforeclosure restrictions, including statutory redemption and limitations on deficiency judgments, whereas others provide no such protections for debtors."). *See also* Debra Pogrund Stark, *Foreclosing on the American Dream: An Evaluation of State and Federal Foreclosure Laws*, 51 OKLA. L. REV. 229, 230–31 (1998) (describing the interplay between state and federal laws concerning foreclosure).

202 Stark, *supra* note 201, at 230–32.

203 Gibson v. World Sav. & Loan Ass'n, 128 Cal. Rptr. 2d 19, 28 (Cal. Ct. App. 2002) (noting that HOLA does not preempt "duties to comply with contracts and the laws governing them and to refrain from misrepresentation.").

204 *See* Martinez v. Wells Fargo Home Mortg., Inc., 598 F.3d 549, 555–57 (9th Cir. 2010) (stating that "various district courts have held that the [National Bank] Act does *not* preempt a claim of express deception asserted under state law.").

205 12 C.F.R. §§ 560.2(c), 34.4(b) (2010).

foreclosures and tort law on the one hand, and what those regulations list as impermissible state regulation of servicing on the other.

In a 2007 case, Judge Posner attempted to define the demarcation between the arguably preempted regulation of servicing and non-preempted tort and contract law. He noted that a borrower should be free to sue a servicer for breach of contract or for fraud, given the OTS's inability to adjudicate disputes between borrower and servicer, finding that the application of state tort or contract law "would complement rather than substitute for the federal regulatory scheme."[206] The task of a court, therefore, is to determine which state regulation governs lenders and servicers as such, and so would be preempted as to federally regulated institutions, and which regulation is merely part of the general law of the state. The essential question is "which claims fall on the regulatory side of the ledger and which, for want of a better term, fall on the common law side."[207]

Courts have struggled, with inconsistent results, to determine what state law constitutes "regulating servicing" and is therefore deemed preempted by OCC and OTS regulation, and what is merely the general law of the state. One court went so far as to state that any state claim against a federally-chartered thrift involving improprieties in foreclosures would be preempted because such claims would necessarily involve servicing, etc. of the loan, though claims that the servicer misled the borrower as regarding a loan modification were not preempted.[208] Another court reached the opposite result on such deception, finding that all state claims based on a servicer's misrepresentations about loan modifications were preempted because loan modifications are an element of servicing.[209] General consumer protection laws seem to be part of the general law of the state, however, and

206 *In re* Ocwen Loan Servicing, LLC Mortg. Servicing Litig., 491 F.3d 638, 643–44 (7th Cir. 2007).

207 *Id.* at 644. In that case, the court found that, due to the vagueness of the complaint, "the case is largely unripe for a determination of preemption." *Id.* at 648.

208 Ahmed v. Wells Fargo Bank & Co, No. 4:11cv00436, 2011 WL 1751415, at *3–4 (N.D. Cal. May 9, 2011). The court ruled that claims based on allegations that "defendants falsely represented that plaintiff's loan would be modified and that the foreclosure sale had been cancelled" were not preempted, however, because they "arise from a more 'general duty not to misrepresent material facts,' and therefore [do] not necessarily regulate lending activity." *Id.* at *4 (quoting Becker v. Wells Fargo Bank, N.A., No. 2:10cv02799, 2011 WL 1103439, at *8–9 (E.D. Cal. March 22, 2011)).

209 Wittenberg v. First Indep. Mortg. Co., No. 3:10cv00058, 2011 WL 1357483, at *14 (N.D. W. Va. April 11, 2011).

some courts have for that reason held them not to be preempted.[210]

Courts have likewise ruled inconsistently on whether state restraint against unfair business practices should be preempted as to federally regulated servicers. In a case where borrowers alleged that servicers "routinely refused to discuss good faith modifications" regarding their loans, the court determined that, to the extent such actions constituted a violation of California's Unfair Competition Law, any claim based on that violation was preempted by the OTS's regulations.[211] Similarly, where a loan servicer was alleged to have engaged in unfair practices by using inadequate property valuation methods to evaluate short sales and unfair practices in making offers to postpone foreclosures, the court found that simply because those activities "relate entirely" to the defendant's "processing, origination, servicing, sale or purchase of, or investment or participation in, mortgages," the claims were preempted.[212]

By comparison, in a case where borrowers alleged unfair business practices in overcharging for force-placed insurance, the court found that California's Unfair Competition Law was not preempted, because it was a general business law, and even though the subject matter concerned the servicing of loans, the specific claims, that the defendants had made misrepresentations and engaged in deceptive conduct, were not specific to lending.[213]

Courts have similarly considered whether unfair competition laws are preempted by the National Bank Act as to servicers regulated by the OCC.[214] In one case, a borrower alleged that his

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210 See, for example, Smith v. BAC Home Loans Servicing, LP, No. 2:10-cv-00354, 2011 WL 843937, at *10 (S.D. W. Va. 2011), where the court states, "[i]nstead, I look to the intent of Congress, as best demonstrated by the text of the NBA, and conclude that there is no significant federal regulatory objective at play that would merit displacing the generally applicable state consumer-protection claims presented in the Complaint."

211 Biggins v. Wells Fargo & Co., 266 F.R.D. 399, 417 (N.D. Cal. 2009). *See also In re* Ocwen, where the court found that a claim against a servicer pursuant to New Mexico's Unfair Trade Practices Act was preempted because it claimed "'a gross disparity between the value received by the [class] members [in New Mexico] and the price paid,' a charge that clearly is preempted." *In re* Ocwen, 491 F.3d at 647.

212 Grant v. Aurora Loan Servs., Inc., 736 F. Supp. 2d 1257, 1275 (C.D. Cal. 2010).

213 Gibson v. World Sav. & Loan Ass'n, 128 Cal. Rptr. 2d 19, 29–30 (Cal. Ct. App. 2002). *See also*, Binetti v. Wash. Mut. Bank, 446 F. Supp. 2d 217, 221 (S.D.N.Y. 2006) (holding that because the effect on national thrifts was only an incidental part of the state's unfair competition law, that state law was not preempted even as to claims regarding federally regulated thrifts).

214 Wells v. Chase Home Fin., LLC, No. C10-5001RJB, 2010 WL 4858252, at *10 (W.D. Wash. 2010), wherein the court found that claims under the Washington Consumer Protection Act were not preempted even though they concerned misrepresentations regarding foreclosures and borrowers' requests for loan modifications.

servicer had made misrepresentations about whether mortgage prepayments would be applied to principal or held in suspense accounts.[215] The court found that because the borrower relied on a general Unfair Competition Law (UCL) rather than a state law "specifically directed at banking or lending," the borrower's claim was not preempted even though it went directly to how the servicer serviced the loan.[216]

In other cases, where borrowers claimed that a servicer committed an unfair or deceptive act in violation of the state's Unfair and Deceptive Practices Act (UDAP) law, courts have held that because the act consisted of mortgage servicing, the state UDAP law was preempted even though it was a general business law not specifically directed toward servicers.[217] In a California case, a court found that an unfair business practices claim was preempted, stating "each of Plaintiffs' claims specifically challenge the processing of Plaintiffs' loan modification application and servicing of Plaintiffs' mortgage, and fall within the specific types of preempted state laws listed in § 560.2(b)(4) & (10). Accordingly, each of Plaintiffs' claims are preempted by HOLA."[218] Courts have tried to explain these contradictory results by arguing that when it comes to general statutes such as UDAP, the question is not whether the statute will be generally preempted, but rather whether as applied, the statute would impose requirements on lending or servicing and so should be preempted.[219]

In a recent case, the court applied a different standard to judge whether state law was preempted, looking not at whether the state law was a general one but rather at whether there was an applicable federal claim that would preempt the state claim.[220] In that case, a borrower sued a servicer, alleging that the servicer had told him not to make his mortgage payments so that the borrower could become eligible for the HAMP program,

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215 Jefferson v. Chase Home Fin., No. C 06-6510 TEH, 2008 WL 1883484, at *1 (N.D. Cal. 2008).

216 *Id.* at *13–14.

217 James J. Pulliam, *Good Cop, Bad Cop: Market Competitors, UDAP Consumer Protection Laws, and the U.S. Mortgage Crisis*, 43 LOY. L. REV. 1251, 1251 (2010).

218 Zarif v. Wells Fargo Bank, NA, No. 10CV2688-WQH-WVG, 2011 WL 1085660, at *3 (S.D. Cal. 2011).

219 Casey v. Fed. Deposit Ins. Corp., 583 F.3d 586, 593–94 (8th Cir. 2009); Boursiquot v. Citibank F.S.B., 323 F. Supp. 2d 350 (D. Conn. 2004); Moskowitz v. Wash. Mut. Bank, 329 Ill. App. 3d 144, 263 Ill. Dec. 502, 768 N.E.2d 262 (2002); McCurry v. Chevy Chase Bank, F.S.B., 144 Wash. App. 900, 193 P.3d 155 (Wash. Ct. App. 2008); Silvas v. E*Trade Mortgage Corp., 514 F.3d 1001 (9th Cir. 2008).

220 Bennett v. Bank of America, No. 3:11cv00003, 2011 WL 1814963, at *2 (E.D. Va.).

then foreclosed on his house based on non-payment of the loan.[221] When the borrower brought state law claims for breach of contract, fraud, and trespass, the bank/servicer responded by claiming that those state law claims were preempted.[222] The court, however, held that the claims were not preempted because there was no corresponding federal claim that the borrower could bring, noting that "Congress has not provided an alternative claim governing the allegations [the borrower] raises," and therefore neither federal law nor regulation preempted the state claims.[223]

V. THE STATES JUMP IN

States have recently taken more aggressive steps to rein in mortgage servicer abuse and to attempt to induce servicers to make loan modifications that benefit both the borrower and the investor.[224] However, their efforts have at times been met with a preemption defense. For example, in 2008, California passed Senate Bill 1137, also known as the "Perata Mortgage Relief Bill," which requires, among other things, that in order to file a notice of default to start a foreclosure, a servicer or lender must follow a proscribed process of notification, meeting, and consultation with the borrower, to determine whether the servicer/lender and borrower can resolve the default without foreclosure.[225] The idea is to spur direct discussion between the parties for an exploration of alternatives to foreclosure."[226] This requirement is now incorporated in section 2923.5 of the California Civil Code, part of the state's statutory framework for foreclosures.[227]

While section 2923.5 seems to be a minor requirement, merely requiring notice and discussion, but not mandating any loan modifications, federally regulated servicers have challenged it by claiming that it is preempted, at least as to federally regulated thrifts.[228] Some courts have rejected this preemption argument, finding that section 2923.5 requires so little of lenders

221 *Id.* at *1.
222 *Id.* at *1, *3.
223 *Id.* at *5.
224 *Problems in Mortgage Servicing From Modification to Foreclosure Part II: Hearing Before S. Comm. on Banking, Hous., and Urban Affairs*, 111th Cong. (2010) (statement of Kurt Eggert, Professor, Chap. Univ. Sch. of Law).
225 CAL. CIV. CODE § 2923.5 (2010).
226 CAL. CIV. CODE § 2923.5(f) (2010).
227 CAL. CIV. CODE § 2923.5 (2010).
228 Murillo v. Aurora Loan Servs., LLC, No. C 09-00503 JW, 2009 WL 2160579, at *4 (N.D. Cal. July 17, 2009).

and servicers that it is not preempted by federal law.[229] For example, in *Mabry v. Superior Court*, the court found that section 2923.5, at least narrowly construed, did not step over the line that separates the permitted state regulation of foreclosure from the state regulation of loan servicing, which would be preempted as to financial institutions regulated by the OTS.[230] *Mabry* has been cited with approval by several other courts.[231]

Another federal court ruled that because section 2923.5 "imposes a state law mandate about what information must be given to borrowers, and includes a strict time frame for doing so" and other states do not have such requirements, section 2923.5 "concerns the processing and servicing of Plaintiffs' mortgage and is preempted by HOLA."[232] Other federal courts have followed suit,[233] and have even gone so far as to assert that despite the contrary opinions of California courts, "'it is evident that the overwhelming weight of authority has held that a claim under § 2923.5 is preempted by HOLA.'"[234]

Other states have taken more aggressive measures to regulate servicers. Numerous states currently have often competing legislative proposals for servicer regulation. "To date, lawmakers in 41 jurisdictions and the District of Columbia have

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229 Mabry v. Superior Court, 110 Cal. Rptr. 3d 201, 218 (2010).

230 *Id.* at 218–19 ("Finally, to the degree that the 'assessment' or 'exploration' requirements impose, in practice, burdens on federal savings banks that might arguably push the statute out of the permissible category of state foreclosure law and into the federally preempted category of loan servicing or loan making, *evidence* of such a burden is necessary before the argument can be persuasive. For the time being, and certainly on this record, we cannot say that section 2923.5, narrowly construed, strays over the line.").

231 Wienke v. Indymac Bank FSB, No. CV 10-4082 NJV, 2011 WL 871749, at *5 (N.D. Cal. Mar. 14, 2011); Paik v. Wells Fargo Bank, N.A., No. C 10-04016 WHA, 2011 WL 109482, at *3 (N.D. Cal. Jan. 13, 2011); Aguilera v. Hilltop Lending Corp., No. C 10-0184 JL, 2010 WL 3340566, at *4 (N.D. Cal. Aug. 25, 2010); Kariguddaiah v. Wells Fargo Bank, N.A., No. C 09-5716 MHP, 2010 WL 2650492, at *6 (N.D. Cal. July 1, 2010).

232 Odinma v. Aurora Loan Servs., No. C-09-4674 EDL, 2010 WL 1199886, at *8 (N.D. Cal. Mar. 23, 2010).

233 *See* Giordano v. Wachovia Mortg., FSB, No. 5:1-cv-04661-JF, 2010 WL 5148428, at *3–5 (N.D. Cal. Dec. 14, 2010); Taguinod v. World Sav. Bank, FSB, No. CV 10-7864-SVW (RZx), 2010 WL 5185845, at *2–3 (C.D. Cal. Dec. 2, 2010); Ngoc Nguyen v. Wells Fargo Bank, N.A., No. C-10-4081-EDL, 2010 WL 4348127, at *10 (N.D. Cal. Oct. 27, 2010); Pinales v. Quality Loan Serv. Corp., No. 09cv1884 L(AJB), 2010 WL 3749427, at *3 (S.D. Cal. Sept. 22, 2010); Gonzalez v. Alliance Bancorp, No. C 10-00805 RS, 2010 WL 1575963, at *5 (N.D. Cal. Apr. 19, 2010); Parcray v. Shea Mortg., Inc., No. CV-F-09-1942 OWW/GSA, 2010 WL 1659369, at *8 (E.D. Cal. Apr. 23, 2010); Murillo v. Aurora Loan Servs., LLC, No. C 09-00503 JW, 2009 WL 2160579, at *4 (N.D. Cal. July 17, 2009); Murillo v. Lehman Bros. Bank FSB, No. C 09-00500 JW, 2009 WL 2160578, at *5 (N.D. Cal. July 17, 2009).

234 Beall v. Quality Loan Serv. Corp., No. 10-CV-1900-IEG (WVG), 2011 WL 1044148, at *8 (S.D. Cal. Mar. 21, 2011) (quoting Taguinod v. World Sav. Bank, FSB, No. CV 10-7864-SVW (RZx), 2010 WL 5185845, at *7 (C.D. Cal. Dec. 2, 2010)).

introduced legislation regarding foreclosures."[235] New York's Superintendent of Banks issued perhaps the most stringent state mortgage servicing regulations in October 2010, requiring servicers to pursue suitable loan modifications and imposing a "duty of good faith and fair dealing in [the servicer's] communications, transactions, and course of dealings with each borrower . . . ."[236] The regulations limit what fees servicers can charge and requires them to have "adequate staffing, written procedures, resources and facilities to provide timely and appropriate responses to borrower inquiries and complaints regarding available loss mitigation options . . . ."[237] Servicers must provide timely responses to loan modification requests, and where they deny them, must provide the reasons for such denial.[238] They must also provide a process by which borrowers "may escalate disagreements to a supervisory level where a separate review of the borrower's eligibility or qualification for a loss mitigation option can be performed" and provide "special escalation contacts" for use by housing counselors, attorneys and government agents.[239] The regulations also allow the state to require servicers to provide detailed reports of their modification attempts and success.[240]

Nevada responded to the high rates of foreclosure by requiring mortgage servicers to engage in mediation with borrowers who request it. The borrower and the lender/beneficiary split the cost of paying the mediator and the lender/beneficiary must be represented at the mediation by someone with the authority to modify the loan at issue.[241] The parties are required to submit a proposal to "resolve the foreclosure" and financial information that would allow the evaluation of those proposals, and the lender/beneficiary has to submit evidence of possession of the note and deed of trust along with assignments of the note and deed of trust, as well as the "evaluative methodology" used to evaluate the request for a loan modification.[242] Many different types of foreclosure mediation

235 NATIONAL CONFERENCE OF STATE LEGISLATURES, FORECLOSURES 2011 LEGISLATION, http://www.ncsl.org/?tabid=22116.

236 N.Y. COMP. CODES R. & REGS. tit. 3, § 419.2 (effective May 2, 2011).

237 *Id.* at §§ 419.10–419.11.

238 *Id.* at § 419.11(d).

239 *Id.* at § 419.11(g).

240 *Id.* at § 419.12.

241 NEV. FORECLOSURE MEDIATION R. 10(1)(A), *available at* http://www.nevadajudiciary.us/images/foreclosure/adkt435_amendedrules.pdf.

242 NEV. FORECLOSURE MEDIATION R. 11, *available at* http://www.nevadajudiciary.us/images/foreclosure/adkt435_amendedrules.pdf.

programs have sprung up, some at the state level, others mandated by individual court systems.[243]

Utah changed its foreclosure laws to require foreclosures to be conducted by an in-state attorney or title company. One large bank responded by refusing to follow the law, based on the claim that its status as a national bank gave it immunity from this aspect of state foreclosure law, reportedly arguing, "[a]s a national bank, [its] authority to act as trustee is derived from federal law (the National Bank Act)."[244]

One potentially productive step that the states have taken is the joint action by fifty Attorneys General to investigate mortgage servicer abuse and demand change, beginning in October 2010.[245] That investigation was reportedly quite limited, perhaps from fears that the federally regulated mortgage servicers would claim preemption and refuse to cooperate.[246] According to one news report after the coalition had already sent part of a settlement offer, "no witnesses had been interviewed and . . . the coalition had sent out just one request for documents—and it has not yet been answered."[247] The coalition of Attorneys General reportedly have been negotiating with the large banks/servicers to settle claims of widespread improper foreclosures, with at least some Attorneys General initially pushing for a large fund to provide principal reductions for borrowers as well as a set of rules that servicers must follow, while banks are suggesting a much smaller settlement fund, no mandated principal reductions and fewer rule changes. The parties are also bargaining over how much the banks who are the largest servicers should pay to settle with the Attorneys General. At least some of the Attorneys General are reportedly asking for $20 billion and the banks are reportedly offering $5 billion, with the money either going in large part to principal reductions for borrowers, under the Attorney General proposal or to repay borrowers "previously wronged in the foreclosure process and

243 Shana H. Khader, *Mediating Mediations: Protecting the Homeowner's Right to Self-Determination in Foreclosure Mediation Programs*, 44 COLUM. J.L. & SOC. PROBS. 109, 111 (2010).

244 Tom Harvey, *Bank Defies Utah Law on Foreclosures*, THE SALT LAKE TRIBUNE, May 12, 2011, at A6.

245 Ariana Eunjung Cha & Dina Elboghdady, *States to Initiate Joint Foreclosure Probe*, WASH. POST, Oct. 13, 2010, at A13.

246 Gretchen Morgenson, *Swift Deals May Not Be Sound Ones*, N.Y. TIMES, Mar. 12, 2011, at BU1.

247 *Id.*

provide transition assistance for borrowers who are ousted from their homes" under the banks' counteroffer.[248]

VI. THE DODD-FRANK ACT AND ITS EFFECT ON PREEMPTION

Given the recent record of abusive behavior by mortgage servicers and also the harm caused by federal preemption of state law governing mortgage lending, it is no surprise that when Congress decided to reform the financial services industry, it included not only some mortgage servicer reform, but also a roll-back of the preemption effects of OCC and OTS regulation.[249] The 2010 Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) includes Title X, which is separately referred to as the Consumer Financial Protection Act of 2010 (the CFP Act).[250] The Act contains some direct reforms of mortgage servicing. It mandates the use of escrow accounts in certain circumstances and requires disclosure for consumers who waive such accounts.[251] It imposes new duties on mortgage servicers regarding qualified written requests and responses to borrowers, force-placed insurance, and refunds of escrow funds.[252] It requires prompt crediting of loan payments as well as prompt responses to loan payoff requests.[253] And it requires greater transparency in the calculations underlying servicer decisions in the HAMP program.[254]

More importantly, at least in terms of this article, Dodd-Frank significantly limits federal preemption of state consumer financial laws, even as to national banks and thrifts, and in many ways signals an explicit return to the law as it stood in the mid-1990s before the OTS and OCC made their preemption power grabs.[255]

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248 Nathan Koppel, *Banks Willing to Pay $5 Billion to Settle Mortgage Mess*, L. BLOG OF THE WALL ST. J. (May 11, 2011, 10:04 AM), http://blogs.wsj.com/law/2011/05/11/banks-willing-to-pay-5-billion-to-settle-mortgage-mess/.

249 LAUREN SAUNDERS, NATIONAL CONSUMER LAW CENTER, THE ROLE OF THE STATES UNDER THE DODD-FRANK WALL STREET REFORM AND CONSUMER PROTECTION ACT OF 2010, at 2 (2010), *available at* http://www.nclc.org/images/pdf/legislation/dodd-frank-role-of-the-states.pdf.

250 Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010). Title X of Dodd-Frank states, "This title may be cited as the 'Consumer Financial Protection Act of 2010.'" *Id.* at § 1001.

251 *Id.* at §§ 1461–62.

252 *Id.* at § 1463.

253 *Id.* at § 1464.

254 *Id.* at § 1482.

255 *See* Saunders, *supra* note 131, at 5–6. *See also* Michael Hamburger, *The Dodd-Frank Act and Federal Preemption of State Consumer Protection Laws*, 128 BANKING L.J. 9, 11–12 (2011).

Dodd-Frank and the CFP Act constitute a dramatic change in the preemption landscape. Gone are the ideas that the federal banking agencies are the sole regulators of banks and thrifts, and that banks and thrifts can virtually ignore state regulation. Congressional intent is the touchstone for preemption, and Dodd-Frank shows irrefutable Congressional intent to limit and roll back federal preemption of state consumer finance law.[256] The CFP Act's subtitle on preemption is called "Preservation of State Law."[257] The subtitle reasserts the traditional role that states have played in regulating the financial industry, including national banks and thrifts.

Dodd-Frank, drafted in an era when federal preemption of state law looms large as an issue, contains specific and extensive language regarding its own preemptive effect and the preemptive effect of other federal regulations. Dodd-Frank affects federal preemption in four significant ways. First, the CFP Act states explicitly what its own preemption effect is.[258] Second, Dodd-Frank explicitly limits federal preemption of state law by the law governing national banks and thrifts and regulations made pursuant to that law.[259] Third, Dodd-Frank transfers responsibility for much federal financial consumer protection (depending on the size of the financial institution) to the new Consumer Financial Protection Bureau (CFPB), which is much more constrained in how it can preempt state law.[260] Lastly, Dodd-Frank spells out non-preempted powers of states' Attorneys General to enforce state and federal law.[261]

The CFP Act explicitly limits the preemptive power of the CFP Act itself, and therefore, presumably any regulations issued pursuant to that Act.[262] The CFP Act rules out field preemption and limits its preemptive effect to conflict preemption, stating it has preemptive effect only "to the extent that any such provision of law is inconsistent with the provisions of this title, and then only to the extent of the inconsistency."[263] Moreover, the CFP Act also protects states' power to provide greater consumer protection

256 *Id.* at §§ 1041–43.

257 Subtitle D of the Dodd-Frank Wall Street Reform and Consumer Financial Protection Act.

258 Dodd-Frank Wall Street Reform and Consumer Protection Act, §§ 1044–45.

259 *Id.* at § 1043.

260 *Id.* at § 1041.

261 *Id.* at § 1042. For good descriptions of the changes to preemption made by the Dodd-Frank Act, see Saunders, *supra* note 131, at 5–6; Hamburger, *supra* note 255, at 11–12.

262 *Id.* at § 1044.

263 Dodd-Frank § 1041(a)(1).

than its own terms without state regulation necessarily being considered in preemptive conflict with the CFP Act, so that its federal consumer protection constitutes a floor rather than a ceiling.[264]

In addition to abolishing the OTS, Dodd-Frank creates the Consumer Financial Protection Bureau (CFPB), which will have the power "under Federal consumer financial law to administer, enforce, and otherwise implement the provisions of Federal consumer financial law," and to "prescribe rules and issue orders and guidance . . . to administer and carry out the purposes and objectives of the Federal consumer financial laws, and to prevent evasions thereof."[265] This rulemaking authority gives the CFPB broad powers, since the "Federal consumer financial laws" it oversees include not only the CFP Act, but also broad swaths of the consumer law affecting borrowers, such as the Fair Debt Collection Practices Act, the Home Ownership and Equity Protection Act of 1994, and the Real Estate Settlement Procedures Act of 1974.[266] Moreover, the consumer financial protection functions of the Federal Reserve Board of Governors, the OCC, and the OTS are all largely transferred to the CFPB, with other regulators retaining examination and enforcement powers for smaller financial institutions.[267] This transfer of much of the consumer protection function will make it more difficult for the OCC to argue that consumer protection provisions of state law are preempted by OCC regulation.

Next, Dodd-Frank reverses the field preemption claims of OTS regulation and the effective field preemption of OCC regulation,[268] and instead provides that state consumer financial laws are preempted by national banks, thrift laws, and regulations only in three circumstances: (1) if the state consumer financial law would have a "discriminatory effect on national banks" compared to state chartered banks, (2) if "in accordance with the legal standard for preemption in the decision of the Supreme Court of the United States in Barnett Bank . . . the State consumer financial law prevents or significantly interferes with the exercise by the national bank of its powers," and if (3)

264 *Id.* at § 1041(a)(2) ("For purposes of this subsection, a statute, regulation, order, or interpretation in effect in any State is not inconsistent with the provisions of this title if the protection that such statute, regulation, order, or interpretation affords to consumers is greater than the protection provided under this title.").

265 *Id.* at § 1022(a)–(b).

266 *Id.* at § 1002(12).

267 *Id.* at § 1061(b).

268 *Id.* at§ 1044(a).

"the State consumer financial law is preempted by a provision of Federal law other than this title."[269] State laws regulating residential mortgage servicers should necessarily be "state consumer financial laws" given the definition of that term in Dodd-Frank.[270]

Both the text of Dodd-Frank itself and its legislative history signal the return to the *Barnett* "prevent or significantly interfere" standard. Not only does the text directly cite the *Barnett* standard, but Dodd-Frank was specifically amended to include that standard, as a colloquy on the record between Senator Dodd and the senator who proposed the amendment shortly before passage of Dodd-Frank makes clear.[271] Moreover, Congress rejected efforts to substitute the *Barnett* standard with the more wide-ranging preemption standard that would have preempted any state law that merely "hampered" or "impaired" a bank's powers under the National Bank Act.[272]

Dodd-Frank not only rolls back the preemption standard, it also makes it much more onerous and difficult for the Comptroller of the Currency to claim extensive powers of preemption over state consumer financial law, setting up a series of hurdles that the OCC must clear to preempt state law. Dodd-Frank mandates that preemption determinations "may be made by a court, or by regulation or order of the Comptroller of the Currency on a case-by-case basis, in accordance with applicable law."[273] Thus, the statute explicitly provides courts with the power to make preemption determinations and limits the

269 *Id.*

270 According to Dodd-Frank, "The term 'State consumer financial law' means a State law that does not directly or indirectly discriminate against national banks and that directly and specifically regulates the manner, content, or terms and conditions of any financial transaction (as may be authorized for national banks to engage in), or any account related thereto, with respect to a consumer." *Id.* at § 5136C(a)(2).

271 See 156 CONG. REC. S5902 (July 15, 2010), in which after Senator Carper notes with pleasure that his amendment regarding preemption standards was retained "with only minor modifications" by the conference committee, and that his reading of the then current language "indicates that the conference report still maintains the Barnett standard for determining when a State law is preempted," Senator Dodd replies that Senator Carper is correct and "[t]hat is why the conference report specifically cites the Barnett . . . case. There should be no doubt that the legislation codifies the preemption standard stated by the U.S. Supreme Court in that case." See discussion of this point in Hamburger, *supra* note 255, at 11–12.

272 As noted by Lauren Saunders, "Congress did not adopt an amendment by Rep. Bean that would have preempted a state law that 'impairs, or hampers' the business of banking. Amendment 141 to H.R. 4173 at 6 (Offered by Rep. Bean Dec. 9, 2009)." LAUREN SAUNDERS, NATIONAL CONSUMER LAW CENTER, THE ROLE OF THE STATES UNDER THE DODD-FRANK WALL STREET REFORM AND CONSUMER PROTECTION ACT OF 2010 6 (2010), *available at:* http://www.nclc.org/images/pdf/legislation/dodd-frank-role-of-the-states.pdf.

273 Dodd-Frank § 1044(a).

Comptroller of the Currency to making case-by-case determinations, rather than engaging in blanket preemption determinations as the OCC and OTS had previously done. Even if the Comptroller determines that one state's law is substantially similar to another state's law that the Comptroller has already decided is preempted, the Comptroller must consult with the newly established Bureau of Consumer Financial Protection to seek its views regarding whether to extend such preemption to the additional state's law.[274]

The CFP Act forces the Comptroller of the Currency to make the preemption determination personally, and can no longer delegate such determinations to a subordinate, such as the OCC's chief counsel, who had written a series of interpretive letters stating that various state laws were preempted.[275] Furthermore, no preemption finding of the Comptroller shall be valid "unless substantial evidence, made on the record of the proceeding, supports the specific finding."[276] Rather than merely issuing preemption determinations based on its own judgment, the OCC is required to hold some sort of proceeding, keep a record, and admit "substantial evidence" supporting each such determination.[277]

Dodd-Frank also changes the standard of deference courts apply to any OCC determination of preemption.[278] Rather than the deferential *Chevron* standard, asking if there is a rational basis for the agency's determination, instead, a court reviewing an OCC finding of preemption is directed to assess "the validity of such determinations, depending upon the thoroughness evident in the consideration of the agency, the validity of the reasoning of the agency, the consistency with other valid determinations made by the agency, and other factors which the court finds persuasive and relevant to its decision."[279] In essence, this directs courts to use the less deferential *Skidmore* standard in determining what weight to give agency determinations of the preemption of its regulations.[280] Dodd-Frank overrules the

274 *Id.*
275 *Id.*
276 *Id.*
277 *Id.*
278 DAVID H. CARPENTER, CONG. RESEARCH SERV., R41338 THE DODD-FRANK WALL STREET REFORM AND CONSUMER PROTECTION ACT: TITLE X, THE CONSUMER FINANCIAL PROTECTION BUREAU 14–15 (2010).
279 Dodd-Frank, § 1044(a).
280 In *Skidmore* deference, the deference a court grants an agency's decision "will depend upon the thoroughness evident in its consideration, the validity of its reasoning, its consistency with earlier and later pronouncements, and all those factors which give it

primary holding of the *Watters* case by mandating that state law apply to subsidiaries of national banks to the same extent such law would apply to other business entities subject to state law, unless the subsidiaries are also national banks.[281]

Dodd-Frank also protects the powers of states, through their Attorneys General, to enforce applicable state laws even against national banks and thrifts, explicitly codifying the Supreme Court's decision in *Cuomo v. Clearing House Assn*.[282] In other words, the OCC's visitorial powers to supervise national banks and thrifts cannot be seen as preempting the power of states' Attorneys General to sue those financial institutions and seek discovery during such litigation. Furthermore, state Attorneys General can sue national banks and thrifts to enforce regulations made by the CFPB pursuant to the Act.[283] The power of private parties to enforce applicable state and federal law is also explicitly protected.[284]

The CFP Act does provide a protection from the new preemption rules for any contract entered into before its enactment, with the idea that national banks and thrifts should not immediately have all existing contracts overturned based on the new preemption rules.[285] However, it is difficult to see how such a grandfather clause can be applied to mortgage servicers, where these consumer contracts can last for thirty years. Such a rule might leave states free to regulate servicers, but only as to newer loans, which seems to be an unworkable system, and one unintended in the drafting of Dodd-Frank. Much of the state regulation of servicers would affect their operations as a whole, rather than address specific loans. And it would make little sense to have the borrowers who need servicer regulation the most, those who were the victims of the subprime boom and meltdown, be given fewer protections from servicer abuse than newer borrowers. Also, if the grandfathering of contracts

power to persuade, if lacking power to control." Skidmore v. Swift & Co., 323 U.S. 134, 140 (1944). See discussion of this point in Saunders, *supra* note 131, at 7. For a discussion of the difference between the *Chevron* and *Skidmore* standards, and questions regarding the evolution of the *Skidmore* standard, see generally Jim Rossi*, Respecting Deference: Conceptualizing* Skidmore *Within the Architecture of* Chevron, 42 WM. & MARY L. REV. 1105 (2001); Kristin E. Hickman & Matthew D. Krueger, *In Search of the Modern* Skidmore *Standard,* 107 COLUM. L. REV. 1235 (2007).

281 Dodd-Frank § 1044(a).

282 *Id.* at § 1047(a) (stating that its announced rule is "[i]n accordance with the decision of the Supreme Court of the United States in Cuomo v. Clearing House Assn., L. L. C. (129 S. Ct. 2710 (2009))").

283 *Id.* at § 1042(a).

284 *Id.* at § 1047(a).

285 *Id.* at § 1043.

included the servicing of contracts, servicers would be loath to modify existing loans for fear of losing their grandfathered preemption protection.

The OCC has responded to the preemption changes in Dodd-Frank by acknowledging that the preemption landscape has changed, while at the same time attempting, it seems, to minimize those changes.[286] In an interpretive letter, the OCC's Acting Comptroller stated that the OCC planned to rescind its regulations extending preemption to bank subsidiaries. The Acting Comptroller disingenuously claims that the OCC's regulations purporting to preempt any state law that would "obstruct, impair, or condition" national bank powers were merely "the OCC's effort to distill principles from *Barnett* and cases cited in *Barnett* into an abbreviated regulatory standard," even though the regulations clearly were designed to expand preemption far beyond the *Barnett* standard.[287] However, according to the letter, the OCC plans to remove the "obstruct, impair, or condition" standard from its regulations in order to conform to *Barnett*. However, the OCC appears ready to fight a rear-guard action to preserve its expanded preemption claims, arguing that Dodd-Frank's requirement that the Comptroller make preemption determinations on a case-by-case basis should not be applied retroactively so as to "overturn existing precedent and regulations," an argument that seems designed to defend as much as possible the OCC's pre-Dodd-Frank regulation.[288]

The OCC has followed up with a Notice of Proposed Rulemaking (NPR) that attempts to resist some of the preemption changes mandated by Dodd-Frank.[289] The OCC admits in its commentary to the NPR that its regulation claiming preemption for any state law that would "obstruct, impair, or condition" is no longer valid and must be withdrawn.[290] At the same time, the OCC makes the odd claim that existing court precedent based on the withdrawn language is still valid because "[t]his language was drawn from an amalgam of prior precedents . . . . To the extent any existing precedent cited those terms in our regulations, that precedent remains valid, since the

286 Letter from John Walsh, Acting Comptroller of the Currency, to Sen. Thomas R. Carper (May 12, 2011), *available at* http://www.aba.com/aba/documents/press/OCC_preemption_ltrtoSenCarper051211.pdf.

287 *Id.*

288 *Id.*

289 *See* Notice of Proposed Rulemaking, 76 Fed. Reg. 30557 (proposed May 26, 2011) (to be codified at 12 C.F.R. Pts. 4, 5, 7, 8, 28, & 34), *available at* http://www.occ.treas.gov/news-issuances/news-releases/2011/nr-occ-2011-62a.pdf.

290 *Id.* at 30563.

regulations were premised on principles drawn from the Barnett case."[291] In other words, the OCC is attempting to preserve its discredited preemption rule by insisting that the precedent it created is still valid. The OCC should have made a sweeping re-write of its preemption regulations and revisit its previous preemption claims, pursuant to the new marching orders under Dodd-Frank. However, its NPR does not contain such a widespread re-write, and instead appears to constitute a claim that Dodd-Frank did little to alter the preemption landscape for federal bank and thrift regulation. The OCC will not give ground easily on preemption, it appears, even in the face of Dodd-Frank.

CONCLUSION

It is clear that Dodd-Frank is designed to be a dramatic curb on the power of federal agencies, and specifically the OCC, to preempt state law even when it comes to national banks. By rolling preemption back to the *Barnett* standard, Dodd-Frank undoes the OCC's and the OTS's efforts to obtain *Chevron* deference for their insistence that their regulations occupy the field or virtually occupy the field regarding their regulated financial institutions.

The question remains, however, what the states can do with this regained power. While preemption has been rolled back, it has not been eliminated. Tellingly, the OCC retains visitorial power, by far the greatest regulatory power, because visitorial power allows the OCC to demand to see the banks' books without having to file a lawsuit to do so.[292] At the same time, much that had been preempted should now be fair game again. To the extent that states are enforcing the kind of existing best practices and servicing standards that are already contemplated in the FTC's settlements with rogue servicers or in HAMP, it is hard to see how banks or the OCC can claim that such state regulation would "prevent or significantly interfere" with a national banks' exercise of its powers, under the *Barnett* standard for preemption.[293] Similarly, given the longstanding state regulation of debt collection and foreclosure, the two most important duties of a mortgage servicer, it is difficult to see how, absent aggressive OCC and OTS preemption regulations, a court would conclude that servicer regulation was preempted. Now that the financial

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291 *Id.*

292 *Id.* at § 1047(a); Cuomo v. Clearing House Assn., L.L.C., 129 S. Ct. 2710, 2716–17 (2009).

293 Barnett Bank of Marion Cnty., N.A. v. Nelson, Fla. Ins. Comm'r, 517 U.S. 25, 33 (1996).

consumer protection aspects of OCC and OTS regulation have by and large been transferred away from them, their powers to preempt state consumer protection in the area of mortgage servicing should be minimal. State officials should find national banks and thrifts much more willing to cooperate with them, even if informally, for fear that a state Attorney General might bring suit.

Given the lack of federal standards, and the go-ahead from Dodd-Frank, the best strategy by states could well be to plow forward with effective servicer regulation. While we are in the midst of a mortgage foreclosure crisis, this is no time for continued dithering and half measures. States should assert their right to control their own foreclosure processes, and to demand whatever steps they deem appropriate in those processes, including mediation. States should enact best practices standards for mortgage servicers in the state, and argue that such best practices standards should not be preempted because they should not, under the *Barnett* standard, "prevent or significantly interfere with the national bank's exercise of its powers."[294]

It will take federal regulators some time to prepare the regulations called for under Dodd-Frank. It will take courts longer to determine the contours of the new banking law preemption rules. However, given that the mortgage crisis is ongoing, states, especially those that are bearing the brunt of that crisis, should act now.

294 *Id.*

Fighting the Foreclosure Flu: A Proposal to Amend 11 U.S.C. § 1322(b)(2) to Authorize Residential Mortgage Modification in Bankruptcy

Liana Mikhlenko[*]

INTRODUCTION

The days of soaring property values have been dislodged by the devastating collapse of the real estate market in 2007, leaving more than five million homeowners entangled in foreclosure proceedings.[1] Foreclosures in 2009 reached record-breaking heights and are forecast to increase every year.[2] Even the most conservative estimates for the next few years presume at least six million more homes will follow in the foreclosure footsteps.[3] By 2012, predictions contend that 8.1 million homes, or 16% of all residential mortgages, will go through foreclosure proceedings.[4]

Notwithstanding the idea that foreclosures are natural occurrences in a credit economy, the troubling aspect of the

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1 *See* CREDIT SUISSE, FORECLOSURE UPDATE: OVER 8 MILLION FORECLOSURES EXPECTED 2 (2008), http://www.chapa.org/pdf/ForeclosureUpdateCreditSuisse.pdf; Ben S. Bernanke, Chairman, Bd. of Governors of the U.S. Fed. Reserve, Speech at the Federal Reserve System Conference on Housing and Mortgage Markets, Washington D.C. (Dec. 4, 2008), *transcript available at* http://www.federalreserve.gov/newsevents/speech/bernanke20081204a.htm; CONG. OVERSIGHT PANEL, FORECLOSURE CRISIS: WORKING TOWARDS A SOLUTION 5, 7 (2009), *available at* http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=111_senate_hearings&docid=f:47888.pdf (estimating 10% of residential borrowers had been involved in foreclosure proceedings with approximately 2900 homes entering foreclosure every day).

2 *See* Daren Blomquist, *A Record 2.8 Million Properties Receive Foreclosure Notices in 2009*, REALTYTRAC, http://www.realtytrac.com/landing/2009-year-end-foreclosure-report.html?a=b&accnt=233496 (last visited May 17, 2011) (finding foreclosure proceedings on 2.8 million properties in 2009, which was an increase of 21% from 2008 and 120% from 2007).

3 CREDIT SUISSE, *supra* note 1, at 2.

4 *Id.* at 1.

current round of foreclosures is its origin.[5] Whereas preceding foreclosure epidemics resulted from high unemployment and medical infirmity, the prevailing infection is derived from predatory lending practices that qualified subprime borrowers for unconventional mortgage terms without any documentation of income or affordability.[6] Such non-traditional mortgage terms were characterized by ballooned interest rates and recalculated payment obligations.[7] When placed against the backdrop of declining home prices, homeowners were left without any viable means of refinancing unaffordable terms.[8]

Such extensive and widespread foreclosures detrimentally affect borrowers, lenders, and innocent third parties.[9] Borrowers lose their biggest financial expenditure and lenders are forced to sacrifice a significant portion of their investment.[10] Surrounding neighbors and tax bases must also bear the cost of foreclosures.[11] Even adjacent communities bear the burden of depressed real estate values culminating from the lack of maintenance on

5 Ben Steverman & David Bogoslaw, *The Financial Crisis Blame Game*, BUSINESSWEEK.COM (Oct. 18, 2008, 12:01 AM), http://www.businessweek.com/investor/content/oct2008/pi20081017_950382.htm; *see also* Lauren Hassouni, *The Nuts, Bolts, Carrots, and Sticks of the Mortgage and Foreclosure Crisis; and a Suggested Solution, in* NORTON ANNUAL BANKRUPTCY SURVEY 590, 593–97 (William L. Norton Jr. ed., 2010); CONG. OVERSIGHT PANEL, *supra* note 1, at 1.

6 *See* Hassouni, *supra* note 5, at 593–97; *see also* CONG. OVERSIGHT PANEL, *supra* note 1, at 1; *see* ELIZABETH WARREN & JAY LAWRENCE WESTBROOK, THE LAW OF DEBTORS AND CREDITORS 144 (6th ed. 2009).

7 *See* Vikas Bajaj, *For Some Subprime Borrowers, Few Good Choices*, N.Y. TIMES, Mar. 22, 2007, at C1; *see also* Ruth Simon & James R. Hagerty, *1 in 4 Borrowers Under Water,* WALL ST. J., Nov. 24, 2009, at A1 (affirming that almost 11 million borrowers were dealing with negative equity in the 3rd quarter of 2009); *see A Snapshot of the Subprime Market,* CTR. FOR RESPONSIBLE LENDING 1 (Nov. 28, 2007), http://www.responsiblelending.org/mortgage-lending/tools-resources/snapshot-of-the-subprime-market.pdf (determining that 89–93% of subprime mortgages made from 2004–2006 had "exploding" adjustable interest rates); John Eggum, Katherine Porter & Tara Twomey, *Saving Homes in Bankruptcy: Housing Affordability and Loan Modification*, 2008 UTAH L. REV. 1123, 1124 (2008) (noting that homeownership is now a liability rather than what was once considered an individual's most valuable asset).

8 Eggum, *supra* note 7, at 1123–24.

9 CONG. OVERSIGHT PANEL, *supra* note 1, at 6; *see also* Dan Immergluck & Geoff Smith, *The External Costs of Foreclosure: The Impact of Single-Family Mortgage Foreclosures on Property Values*, 17 HOUSING POL'Y DEB. 57, 58 (2006), *available at* http://www.prism.gatech.edu/~di17/HPD_Cost.pdf; *see also* Lorna Fox, *Re-Possessing "Home": A Re-Analysis of Gender, Homeownership and Debtor Default for Feminist Legal Theory*, 14 WM. & MARY J. WOMEN & L. 423, 434 (2008) (noting that losing one's home has a detrimental impact on an individual occupier's quality of life, social and identity status, and personal and family relationships); *see generally* Julia Isaacs & Phillip Lovell, *The Impact of the Mortgage Crisis on Children*, FIRST FOCUS (May 1 2008), http://www.firstfocus.net/sites/default/files/r.2008-5.1.lovell.pdf.

10 *See* CONG. OVERSIGHT PANEL, *supra* note 1, at 9.

11 *Id.*; *see generally* Anthony Pennington-Cross, *The Value of Foreclosed Property*, 28 J. REAL ESTATE RES. 193, 194–95 (2006) (estimating dead-weight losses of foreclosure).

abandoned homes.[12] Local businesses hurt for commercial value while state property and government taxes deteriorate.[13]

In an effort to deal with the broad impact of foreclosures, legislators need to incorporate a federal system designed to deal with economic issues of creditors and debtors. Fortunately, bankruptcy was instituted with such a purpose.[14] Bankruptcy was enacted to provide an orderly forum, guided by the legal process, within which the economic market manages the problems arising from unaffordable debt burdens.[15] Bankruptcy encourages the reconciliation of losses by creditors and incentivizes debtors to remain productive members of society.[16]

Currently, the Bankruptcy Code permits modification and bifurcation of secured interests in personal property and secured interests in real property for vacation homes, investment properties, and multi-family residences.[17] Appallingly, the most common real property security interest—a mortgage on a principal residence—is absent from this list.[18] In fact, the only permissible effect bankruptcy may have on a residential mortgage is allowing the debtor to cure defaults through a court-supervised repayment plan.[19] This provision leaves the debtor with an effectively higher monthly obligation because the debtor is required to maintain regularly scheduled monthly payments in addition to the plan payments.[20] As such, § 1322(b)(2) undermines the legal mechanism on which the market depends for sorting through debt relationships. Rather than assisting debtors in retaining their family home, § 1322 of the Bankruptcy Code condones the unaffordable and unconventional lending

12 *See* Immergluck, *supra* note 9, at 58.

13 John Kroll, *Foreclosure Study Says Vacant Properties Cost Cleveland $35+ Million*, BLOG.CLEVELAND.COM (Feb. 19, 2008, 12:29 AM), http://blog.cleveland.com/metro/2008/02/foreclosure_study_says_vacant.html; *see also* IHS GLOBAL INSIGHT, THE MORTGAGE CRISIS: ECONOMIC AND FISCAL IMPLICATIONS FOR METRO AREAS 2 (2007), *available at* http://www.fox5vegas.com/download/2007/1128/14716194.pdf; William C. Apgar & Mark Duda, COLLATERAL DAMAGE: THE MUNICIPAL IMPACT OF TODAY'S MORTGAGE FORECLOSURE BOOM 4 (May 11, 2005), http://www.995hope.org/content/pdf/Apgar_Duda_Study_Short_Version.pdf.

14 *See* Adam J. Levitin, *Resolving the Foreclosure Crisis: Modification of Mortgages in Bankruptcy*, 2009 WIS. L. REV. 565, 570–71 (2009).

15 *Id.*

16 *Id.*

17 11 U.S.C. § 1322(b)(2) (2006).

18 *Id.*

19 *See id.* § 1322(b); *see e.g.*, Eggum, *supra* note 7, at 1131 (showing an example of an unaffordable loan from origination by comparing the interest rate on an adjustable mortgage at origination, 7.99%, with the rate the consumer faced seven months before declaring bankruptcy, 10.99%).

20 *See* Scott F. Norberg & Andrew J. Velkey, *Debtor Discharge and Creditor Repayment in Chapter 13*, 39 CREIGHTON L. REV. 473, 477–78 (2006).

practices of financial institutions that targeted a weak subprime market.[21]

This Comment advocates amending 11 U.S.C. § 1322(b)(2) to empower bankruptcy judges with authority to modify primary residential mortgages. Amplifying bankruptcy with this power presents potentially the most helpful medication to the current foreclosure flu.[22] The revolutionary changes to the structure of the mortgage industry over the last thirty years created an entirely new lending model emphasizing mortgage securitization.[23] Lenders responded to this model by providing exotic and unaffordable loan terms to subprime borrowers.[24] As the unaffordability of their loans became clear, borrowers became unable to make their mortgage payments.[25] Facilitating the use of bankruptcy will counteract the inefficiencies and failures of previous voluntary programs and legislative proposals.[26] The infrastructure of the current bankruptcy system is well suited to provide relief: it could provide a decrease in losses to creditors, tackle the disincentives of voluntary modifications, and actually address the non-traditional mortgage terms that directly caused the current foreclosure epidemic.[27] This approach would be effective, equitable, and immediate without using taxpayer funds.[28]

Part I will discuss the history and purpose of bankruptcy law in relation to secured interests and will set forth the modern

21 *See* Nandinee K. Kutty, *A New Measure of Housing Affordability: Estimates and Analytical Results*, 16 HOUSING POL'Y DEB. 113, 123–24 (2005) (defining the term "house-induced poverty" and determining that 4.3% of American households not in poverty were living in house-induced poverty which means that after paying necessary housing costs, they were unable to afford even the poverty basket of non-housing goods delineated by the Department of Health and Human Services' standards); *see also* Levitin, *supra* note 14, at 572.

22 J. Peter Byrne & Michael Diamond, *Affordable Housing, Land Tenure, and Urban Policy: The Matrix Revealed*, 34 FORDHAM URB. L.J. 527, 543–44 (2007).

23 *See* Kurt Eggert, *The Great Collapse: How Securitization Caused the Subprime Meltdown,* 41 CONN. L. REV. 1257, 1259 (2009).

24 *See id.* at 1272–73.

25 *See id.* at 1273.

26 *See* 11 U.S.C. § 707 (2006); 11 U.S.C. § 1325 (2006); U.S. DEP'T OF JUSTICE, U.S. TRUSTEE PROGRAM: ANNUAL REPORT OF SIGNIFICANT ACCOMPLISHMENTS FISCAL YEAR 2005, at 9 (2005), *available at* http://www.justice.gov/ust/eo/public_affairs/annualreport/docs/ar2005.pdf.

27 *See generally* OFF. OF THE COMPTROLLER OF THE CURRENCY, OCC MORTGAGE METRICS REPORT: ANALYSIS AND DISCLOSURE OF NATIONAL BANK MORTGAGE LOAN DATA (2008), *available at* http://www.occ.gov/publications/publications-by-type/other-publications/mortgage-metrics-q1-2008/mortgage-metrics-q1-2008-pdf.pdf; Anna Gelpern & Adam J. Levitin, *Rewriting Frankenstein Contracts: The Workout Prohibition in Residential Mortgage-Backed Securities*, 82 S. CAL. L. REV. 1075, 1088–89 (2009); CONG. OVERSIGHT PANEL, *supra* note 1, at 37–44; *see* Michelle J. White, *Bankruptcy: Past Puzzles, Recent Reforms, and the Mortgage Crisis*, 11 AM. L. & ECON. REV. 1, 20–21 (2009).

28 Levitin, *supra* note 14, at 647.

mechanisms available to debtors hoping to modify secured debt. Part II will explain how the development of the current mortgage industry revolutionized lending practices through unconventional mortgage terms and weak underwriting standards and their effect on the current financial crisis. Part III will outline the federal and legislative efforts introduced to deal with the foreclosure crisis and explanations of why they have all proven to be ineffectual. Part IV will highlight the benefits of using bankruptcy as a means of dealing with the current crisis. Part V will propose an addition to current legislative proposals that would require a recalculation of affordability and mandatory lender mediation.

I. THE PURPOSE OF BANKRUPTCY AND ITS CURRENT UTILITY

Bankruptcy is the most useful mechanism for dealing with competing credit interests and is regarded as a prime factor in helping the U.S. economy grow into one of the leading economies in the world.[29] Presently, secured interests are regarded with priority and are protected to the extent that the value of their collateral is equal or greater than the amount of the loan. Within a Chapter 13 bankruptcy, many other types of secured interests are permitted to be modified, but the financial institutions have limited the ability for a homeowner to substantially change any terms on a principal residence mortgage.

A. History and Purpose of Bankruptcy in Relation to Secured Interests

Following the codification of the Bankruptcy Code in 1978, bankruptcy has become the leading device for solving financial hardships.[30] The federal system formulates a legal process that enables the market to manage problems created when borrowers are encumbered with insurmountable debt.[31] While the

29 *See* WARREN & WESTBROOK, *supra* note 6, at 339. "[B]y the early 2000s, in a single year more people filed for bankruptcy than were diagnosed with cancer. More declared bankruptcy than graduated from college. And, as a reminder of the fallout from these bankruptcy decisions, we note that more children lived through their parents' bankruptcy than their parents' divorce." *Id.* at 144; s*ee also id.* at 338 (calling bankruptcy a "form of social safety net, supplementing unemployment insurance, public medical care, and the rest").

30 Bankruptcy Reform Act of 1978, Pub. L. No. 95-598, 92 Stat. 2549 (codified as amended at 11 U.S.C. § 101 et seq. (2006)); *see* White, *supra* note 27, at 2–3; *see* S. Rep. No. 95-989, at 141 (1978) ("Chapter 13 is designed to serve as a flexible vehicle for the repayment of part or all of the allowed claims of the debtor."); H.R. Rep. No. 95-595, at 118 (1977) ("The benefit to the debtor of developing a plan of repayment under chapter 13, rather than opting for liquidation under chapter 7, is that it permits the debtor to protect his assets.").

31 Levitin, *supra* note 14, at 570–71.

bankruptcy process is indubitably a trying ordeal for every party involved, the bankruptcy framework authorizes creditors to collectively manage their portion of loss and encourages the debtor to be socially and economically productive.[32] Otherwise, a debtor buried by debt has disincentives to work since all possible income would be dispersed to creditors.[33] Furthermore, the existence of the federal bankruptcy system offers a venue where collective reformulations of debt may take place.[34]

Homeowners in jeopardy of losing their homes or becoming delinquent on mortgage payments have turned to bankruptcy to save their residences from impending foreclosures.[35] The utility of bankruptcy in this regard has been the automatic stay trigger afforded upon filing a voluntary petition.[36] A foreclosure proceeding, by definition, is a direct attempt to collect the mortgage deficiency through a forced sale, the proceeds of which pay off a portion of the loan balance for the benefit of the lender.[37] Therefore, the filing of a bankruptcy petition would halt the foreclosure proceeding and enable debtors to stay in their home.[38]

The Bankruptcy Code affords debtors various means of dealing with indebtedness.[39] Bankruptcies essentially fall into two categories: liquidations and payout plans.[40] Consumer debtors, however, are generally drawn toward two specific chapters. Chapter 7 provides the path for liquidation by requiring debtors to relinquish all non-exempt assets to a court-appointed Trustee.[41] Chapter 7 debtors

32 *Id.*; *see also* WARREN & WESTBROOK, *supra* note 6, at 141 (stating that"[t]he debtor gets back to work or starts a new business, flat broke and without much in the way of assets, but knowing that the benefits of tomorrow's hard work can be used to put groceries on the table instead of ending up in the pockets of old creditors").

33 *See* WARREN & WESTBROOK, *supra* note 6, at 141.

34 *Id.* at 102 (reflecting that creditors recognized "that a workable bankruptcy system, providing orderliness to the collection process and encouraging debtors to make some payments, even at the cost of permitting debtors a discharge, was in their interest as well").

35 *See id.* at 301 (indicating that "[f]or more than half the debtors . . . their single biggest asset is their home.").

36 11 U.S.C. § 362 (2006).

37 *Foreclosure,* BUSINESS DICTIONARY.COM, http://www.businessdictionary.com/definition/foreclosure.html (last visited May. 18, 2011).

38 *See* 11 U.S.C. § 362(a); *c.f.* 11 U.S.C. § 1322(b)(5) (2006).

39 Individuals may file under Chapter 7 liquidation, Chapter 11 reorganization, Chapter 12 for family farmers and fisherman, and Chapter 13 reorganization. 11 U.S.C. § 109(d)–(f) (2006). Chapter 9 is for municipalities. § 109(c). Chapter 11 requires more expensive filing and attorney fees, but can be beneficial if debtors exceed the debt limits of Chapter 13. § 109(e); *See Bankruptcy Filing Fees,* U.S. COURTS, http://www.uscourts.gov/FederalCourts/Bankruptcy/BankruptcyResources/BankruptcyFilingFees.aspx (last visited May 18, 2011).

40 WARREN & WESTBROOK, *supra* note 6, at 115.

41 *See generally* 11 U.S.C. § 704 (2006) (discussing the duties of trustees);

> essentially freeze their assets and debts when they file for bankruptcy. Their assets become the property of the bankruptcy estate" and "[i]n return for liquidating all non-exempt assets, the debtor is relieved of any future obligations to pay dischargeable, pre-bankruptcy debts, and all the debtor's subsequent earnings are free from the reach of pre-petition creditors.[42]

As such, debtors filing under Chapter 7 accomplish the fundamental objectives of any bankruptcy: "fair distribution of the debtor's assets for the benefit of all creditors and a 'fresh start' for the debtor."[43]

Unlike Chapter 7, Chapter 13 "focuses on using [the debtors'] future earnings, rather than accumulated assets, to pay creditors."[44] As such, Chapter 13 presents the payout plan option, which gives the debtor an opportunity to reorganize debts into a feasible repayment plan.[45] Chapter 13 debtors are permitted to remain in possession of their property.[46] In exchange for the privilege of keeping the property, the debtor promises to devote all disposable future income to the payment of debt obligations.[47] The Trustee administers this repayment according to the specific court-approved repayment plan for a duration of three-to-five years.[48] Therefore, this chapter is more suited to debtors desiring to keep their home.[49]

Under the Chapter 13 plan, a debtor may cure arrearages on a mortgage through the court-approved repayment plan.[50] This innovation in the 1978 Code was an intentional and significant departure from the Bankruptcy Act of 1898, which expressly prohibited interests secured by real and personal property to be

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11 U.S.C. § 726 (2006) (discussing distribution of property of the estate).

42 WARREN & WESTBROOK, *supra* note 6, at 275.

43 *Id.* at 115.

44 *Id.* at 275.

45 *Id.* at 115.

46 11 U.S.C. § 1303 (2006).

47 WARREN & WESTBROOK, *supra* note 6, at 115; 11 U.S.C. § 1322 (2006) (discussing the requirements of the contents of the plan); 11 U.S.C. § 1325 (2006) (explaining confirmation of the plan).

48 11 U.S.C. § 1325(b)(4).

49 Because a Chapter 7 debtor must surrender all non-exempt assets in order to be distributed to creditors, a Chapter 7 debtor generally will not be able to retain their home. Conversely, since a Chapter 13 debtor is not required to surrender property, but is instead required to devote all disposable income over the life of the plan, Chapter 13 typically provides a means of keeping residential property. Levitin, *supra* note 14, at 579; WARREN & WESTBROOK, *supra* note 6, at 143 (stating that "Chapter 13 provide[s] a unique opportunity to get current on a home mortgage that was in arrears, a chance to keep more property, and a discharge that covered certain debts that could not be discharged in Chapter 7").

50 11 U.S.C. § 1322(b)(5) (enabling debtors to cure defaults on secured claims through the repayment of loan arrearages over time).

considered as a claim in bankruptcy.[51] Congress sought to improve a debtor's ability to repay mortgage creditors and increase the likelihood of continued home ownership.[52] The provision also benefitted creditors by enabling lenders to retain secured interests in the property.[53]

B. General Rules and Restrictions Regarding Modification of Secured Interests Within the Current Bankruptcy Framework

Secured claims are afforded greater protection in Chapter 13 cases due to the extensive duration of the reorganization plan.[54] A secured claim is guaranteed protection up to the value of the collateral securing the creditor's interest.[55] While modification of some mortgages is permitted, the current Bankruptcy Code prohibits the modification of a mortgage secured by a principal residence.[56]

i. Valuation of Secured Claims within Bankruptcy

Notwithstanding the particular chapter under which a debtor may choose to file, secured creditors maintain superior protection against their unsecured counterparts.[57] Pursuant to § 541 of the Bankruptcy Code, non-exempt unsecured assets become part of the bankruptcy estate, are sold, and the proceeds distributed pro-rata to unsecured creditors.[58] Secured interests, on the other hand, are protected and may survive the bankruptcy untouched.[59] According to § 506, however, an interest is secured only to the extent of the collateral's value.[60] The deficiency is

51 Eggum, *supra* note 7, at 1154–55.

52 *Id.* at 1155 (indicating that "[t]he new chapter 13 bankruptcy system was designed to provide individuals with the opportunity to repay debts, in full or in part, while retaining assets").

53 *See* Richard K. Green & Susan M. Wachter, *The American Mortgage in Historical and International Context*, 19 J. ECON. PERSP. 93, 97 (2005) (observing that while fixed rate mortgages paid between 5–6%, yields for short-term Treasury bills never exceeded 4% from 1945 to 1966).

54 *See Secured Claims and Liens in Bankruptcy,* LAWYERS.COM, http://bankruptcy.lawyers.com/consumer-bankruptcy/Secured-Claims-and-Liens-in-Bankruptcy.html (last visited May 18, 2011).

55 11 U.S.C. § 506 (2006).

56 11 U.S.C. § 1322(b)(5).

57 *See* 11 U.S.C. § 541; *compare* 11 U.S.C. § 506 (dealing with secured claims), *with* 11 U.S.C. § 507 (dealing with unsecured claims).

58 *See* 11 U.S.C § 541 (keeping in mind that even exempt assets are considered estate property).

59 Susan E. Hauser, *Cutting the Gordian Knot: The Case for Allowing Modification of Home Mortgages in Bankruptcy,* 5. J. BUS. & TECH L. 207, 212 (2010).

60 "An allowed claim of a creditor secured by a lien on property in which the estate has an interest . . . is a secured claim to the extent of the value of such creditor's interest in the estate's interest in such property . . . and is an unsecured claim to the extent that the value of such creditor's interest . . . is less that the amount of such allowed claim." 11 U.S.C § 506(a)(1).

treated as an unsecured claim and is subject to the pro-rata distribution afforded to general unsecured creditors.[61] Taken together, § 506 and § 541 state that undersecured interests are to be "stripped down" to the value of the collateral resulting in a bifurcation of claims: a secured interest to the extent of the collateral's value and an unsecured claim for the deficiency.[62] These provisions further the policy that a creditor should not receive better treatment within bankruptcy than it would outside bankruptcy.[63]

ii. Chapter 13 Provides Permissible Modifications of Secured Claims

Chapter 13 creditors are afforded increased protection because debtors are entitled to retain all assets and repay the secured portion of the debt through a three-to-five year court-approved repayment schedule.[64] This payment schedule allows the debtor to keep the property regardless of current default with the ability to defer missed payments over time.[65] Chapter 13 also provides debtors with a unique opportunity to modify secured claims.[66] Section 1322(b)(2) explicitly empowers debtors to modify the rights of certain secured creditors by altering interest rates, amortizing loans, decreasing monthly payments, reducing

61 11 U.S.C. § 506(d). For example, assume that Lender gave Borrower a $10,000 auto loan secured by the vehicle. After 3 years, Borrower files bankruptcy and the vehicle is worth $5,000. Disregarding any pay down of the principal loan amount, Lender would have a $5,000 secured claim and $5,000 unsecured claim. However, stripdown is precluded under Chapter 7. Dewsnup v. Timm, 502 U.S. 410, 410 (1992).

62 11 U.S.C. § 506(d); *see also* Enewally v. Wash. Mut. Bank (*In re* Enwally), 368 F.3d 1165, 1167 (9th Cir. 2004) (referring to bifurcation of secured and unsecured claims as "lien-stripping"). A creditor's claim is undersecured when the value of the collateral is less than the amount of the debt. *See, e.g.*, Tanner v. FirstPlus Fin., Inc. (*In re* Tanner), 217 F.3d 1357, 1357 n.1 (11th Cir. 2000).

63 Outside bankruptcy, a creditor is afforded remedies through the collection process. A creditor that is undersecured would only receive proceeds from the repossessed collateral. U.C.C. § 9-601 (2005). The creditor, however, would still be entitled to pursue the borrower for a deficiency by going through the state court collection system. *Id.*

64 *Compare* 11 U.S.C. § 506 (explaining that default results in a transfer of property used to secure the debt to the creditor), *with* 11 U.S.C. § 109(e), *and* 11 U.S.C. § 1325 (allowing certain debtors to keep possession of property used to secure debt; like Chapter 13 in general, the privilege of making deferred payments is available only to consumer debtors with regular income to devote to a Chapter 13 plan).

65 11 U.S.C. §§ 506, 109(e), 1325; *see* Dumont v. Ford Motor Credit Co. (*In re* Dumont), 581 F.3d 1104, 1108 (9th Cir. 2009) (explaining that a debtor may continue to make payments on the secured debt as if the bankruptcy never occurred, and the creditor is prohibited, by the automatic stay, from repossessing the property unless there is an event of default).

66 *Cf.* U.C.C. § 9-601 et seq. Bankruptcy provisions in Chapter 13 are implicit in every security agreement, but remain dormant until the debtor files a Chapter 13 petition. 11 U.S.C. § 1322(b); 11 U.S.C. § 542 (requiring property of the estate to be turned over to the trustee); Di Pierro v. Taddeo (*In re* Taddeo), 685 F.2d 24, 26–27 (2d Cir. 1982) (empowering debtors with the ability to cure defaults on secured debts under § 1322(b)(5), allowing borrowers to reinstate accelerated loans).

principal amounts, and extending the terms of the loan.[67] Section 1325 allows a debtor to strip-down the secured claim to the value of the collateral and bifurcate the deficiency into an unsecured claim.[68] Put into context, a borrower with a debt exceeding the value of the underlying collateral obtains the most value from this strip-down provision. By providing a reduction in the principal amount of the loan, strip-down could invariably have an effect on other terms of the loan such as interest.[69] Inversely, an undersecured creditor stands to lose a substantial portion of its security interest through the conversion from a secured to an unsecured creditor. This significant fact has resulted in tremendous limitations on its applicability to specific debts.[70]

iii. The Limited Availability of Mortgage Modification within Chapter 13

Chapter 13 is advantageous to debtors that have fallen behind on mortgage payments because debtors may utilize the plan to cure prior defaults and arrearages.[71] Unfortunately, the Bankruptcy Code is unfavorable to borrowers aspiring to modify the actual structure of the principal residence mortgage.[72]

67 *See* Till v. SCS Credit Corp., 541 U.S. 465, 475 (2004) (finding that with regard to secured interests in personal property, 11 U.S.C. § 1322(b)(2) clearly gives authority to the courts "to modify the number, timing, or amount of the installment payments from those set forth in the debtor's original contract"). Debtors can modify wholly unsecured second mortgages on their principal residences as well as loans secured by yachts, aircraft, jewelry, household appliances, furniture, or any other type of personal property. *See* 11 U.S.C. § 1322(b)(2). One recent exception the successful effort of secured vehicle creditors, limits the applicability of this provision on vehicles. Since October 17, 2005, purchase money loans secured by motor vehicles bought for personal use may not be stripped down in their first two-and-a-half years. 11 U.S.C. § 1325(a).

68 11 U.S.C. § 1325; 11 U.S.C. § 506.

69 A borrower is "underwater" if the amount of the secured debt exceeds the value of the underlying collateral. *See* Dumont v. Ford Motor Credit Co. (*In re* Dumont), 581 F.3d 1104, 1108 (9th Cir. 2009).

70 Part of 11 U.S.C. § 1325(a) has notoriously been referred to as the "hanging paragraph" underscoring the overwhelmingly unclear amendment to the Bankruptcy Code. *See generally* Simone Jones, *Who's Left Suspended on the Line?: The Ominous Hanging Paragraph and the Seventh Circuit's Interpretation in* In re Wright, 3 SEVENTH CIRCUIT REV. 1 (2007), *available at* http://www.kentlaw.edu/7cr/v3-1/jones.pdf. The "hanging paragraph" lacks a section number but provides, "section 506 shall not apply . . . if the creditor has a purchase money security interest . . . , the debt was incurred within the 910-day preceding the date of the filing of the petition, and the collateral for that debt consists of a motor vehicle . . . acquired for the personal use of the debtor." 11 U.S.C. § 1325(a).

71 *See* Taddeo, 685 F.2d at 26–27 (discussing the legislative purpose of § 1322(b)(5) in permitting borrowers to cure defaults and return the mortgage to pre-default conditions); Nobleman v. American Savings Bank, 508 U.S. 324, 332 (1993) (The United States Supreme Court held that § 1322(b)(2) restricts a borrower's abilities to modify a lender's claim where it is only secured by the principal residence).

72 11 U.S.C. § 1322(b)(2); WARREN & WESTBROOK, *supra* note 6, at 301 (stating that "[t]he only relief in Chapter 13 as to a home mortgage is to 'cure and maintain,' that is, to

Section 1322(b)(2), conveniently termed the "anti-modification" provision, explicitly prohibits the modification of secured claims "secured only by a security interest in real property that is the debtor's principal residence."[73] This anti-modification provision prevents debtors from using Chapter 13 strip-down methods and bifurcation to modify most mortgages.[74] Additionally, this provision creates an egregious loophole. Examining the plain language of the provision, the restriction is inapplicable to mortgages attached to vacation homes, commercial, rental, and investment property, or mortgages that are secured by collateral other than, or in addition to, the principal residence.[75]

For most Chapter 13 debtors, the opportunity to cure arrearages on home mortgages does not provide a useful means of keeping their residences because current bankruptcy law fails to address the severe unaffordability of the loan itself.[76] Not only is the absence of legislative history or empirical evidence supporting the provision disturbing, records indicate that the legislation was simply a compromise of competing versions.[77]

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catch up on the past-due arrearage while making current payments on the mortgage as they come due").

73 11 U.S.C. § 1322(b)(2).

74 Taddeo, 685 F.2d at 26–27 (discussing the legislative purpose of § 1322(b)(5) in permitting borrowers to cure defaults and return the mortgage to pre-default conditions); *Nobleman*, 508 at 332 (The United States Supreme Court held that § 1322(b)(2) restricts a borrower's abilities to modify a lender's claim where it is only secured by the principal residence).

75 Hauser, *supra* note 59, at 215 (noting that obvious obstacles exist with actually modifying such properties, including debt limits and adequate protection); *see, e.g.*, Scarborough v. Chase Manhattan Mortg. Corp. (*In re* Scarborough), 461 F.3d 406, 408 (3d Cir. 2006) (taking an interest in other income-producing property, such as rental property, falls outside of the anti-modification provision).

76 *See* Eggert, *supra* note 23, at 1259 (explaining that the securitization of the subprime market dynamically changed the underwriting process from protection to production); OFFICE OF POLICY DEV. AND RESEARCH, U.S. DEP'T OF HOUS. & URBAN DEV., TRENDS IN WORST CASE NEEDS FOR HOUSING, 1978–1999, at 1 (2003), *available at* http://www.huduser.org/publications/PDF/trends.pdf (defining severe housing as when housing and rental costs are in excess of 50% of gross income).

77 The Bankruptcy Reform Act of 1978 amounted to a compromise between the Senate and House bills. Senate Bill 2266 prohibited any modification of claims secured by any real estate. S. 2266, 95th Cong. (2d Sess. 1978). House Bill 8200 allowed modification of all secured claims. H.R. 8200, 95th Cong., (1st Sess. 1977). Both bills were reconciled through a variety of floor amendments and resulted in a restriction on modification of loans that were only secured by the debtor's principal residence. The Congressional record has no policy discussion behind the prohibition provision. In fact, discussion of the rationale is only evidenced in the Senate hearings. The Bankruptcy Reform Act of 1978, Pub. L. No. 95-598, 92 Stat. 2549 (codified as amended at 11 U.S.C. § 101 et seq. (2006)). *See also* Levitin, *supra* note 14, at 575 (finding that any economic rationale behind the legislation is misplaced because the underlying assumption of market sensitivity to impacts of modifications has been unfounded. In fact, the study presented "a variety of original empirical evidence from mortgage, origination, insurance, and resale market to show that mortgage markets are indifferent to bankruptcy-modification risk."); *see also* S. REP. NO. 95-989, at 141 (1978); *see also* H.R. REP. NO. 95-595, at 429 (1977) (explaining that the Senate bill provided that a debtor's plan could modify secured rights except

This provision merely serves to protect investments of lenders promulgating exotic loans more than thirty years after the legislation's enactment, rather than utilizing bankruptcy as an alternative forum to consolidate overwhelming debt burdens.[78]

II. SECURITIZATION AND FINANCIAL DE-REGULATION

More than three decades have passed since the enactment of the Bankruptcy Code, and the mortgage industry has developed into a securitized market, encouraging the implementation of unconventional loans and loose underwriting standards.[79] Accordingly, a corresponding change in the Bankruptcy Code is vital to the health of the economy.

A. Structure of Mortgage Industry

The conventional lending strategies that previously occupied the residential mortgage market have been supplanted by the modern originate-to-distribute model.[80] While the traditional lending model was characterized by mortgages originated and serviced by a single financial institution, the modern mortgage securitization structure involves loan originators, secondary market securitizers, government sponsored entities, mortgage backed securities, and servicers.[81]

The increasing popularity of mortgage securitization incentivized investment bankers, mortgage brokers, and even the federal government to enter the housing market by purchasing

claims by wholly secured real estate mortgages, and the House bill allowed modification of all unsecured and secured claims. This broad approach was quickly shot down by the savings and loan institutions that were dominators of the residential mortgage market in the 1970s); *see also* Barbara Randolph, *Finally, the Bill Has Come Due*, TIME, Feb. 20, 1989, at 68 (noting that savings and loan institutions were funded from federally insured deposits which created substantial liability for the federal government).

78 Levitin, *supra* note 14, at 586–93 (refuting the concept that residential mortgage modifications would affect the market). Although one would expect that if a borrower could potentially modify a mortgage, the lender would place a higher risk premium. A comparison of modifiable mortgages against non-modifiable mortgages failed to represent such a premium. This undercuts the economic rationale of the anti-modification provision. *Id.*

79 Eggum, *supra* note 7, at 1157 (stating that"[e]fforts to protect the savings and loan industry and expand the availability of credit in the late 1970s were replaced by concerns about the growth of abusive lending practices in the late 1980s and early 1990s").

80 *See* Cynthia Angell & Clara D. Rowley, *Breaking New Ground in U.S. Mortgage Lending*, FDIC OUTLOOK, Summer 2006, at 21–24, *available at* http://www.fdic.gov/bank/analytical/regional/ro20062q/na/t2q2006.pdf.

81 Levitin, *supra* note 14, at 583; *see* Lei Ding, Janneke Ratcliffe, Michael A. Stegman & Roberto G. Quercia, *Neighborhood Patterns of High-Cost Lending: The Case of Atlanta*, 17 J. AFFORDABLE HOUS. & CMTY. DEV. L. 193, 194 (2008) (finding that the subprime securitization of "mortgage loans increased over forty-fold, from $11 billion to more than $483 billion in 2006, accounting for more than 80% of all subprime lending").

and securitizing mortgages.[82] Although the complexity inherent in the mortgage securitization market will not be extensively illuminated in this Comment, a brief overview of the process is beneficial. Following the origination of the mortgage to the homeowner, the lender typically sells the mortgage to a government sponsored entity or private investment bank.[83] These entities and banks subsequently pool mortgages originated by various lenders and undertake a multi-seller conduit securitization.[84] The securitizer keeps a relationship with the mortgages through a pooling and servicing agreement (PSA), binding all parties involved.[85] Thereafter, a servicing agent is ordained with the task of managing the account, collecting the monthly loan payments, and is responsible for all communication with borrowers regarding the loan.[86] Thus, a homeowner's mortgage may be reassigned multiple times throughout its lifetime, even though the servicer or originator remains constant.[87]

The real trouble ensues, however, because this servicer is the primary decision-maker as to whether a delinquent loan goes to foreclosure or is eligible for modification.[88] Sadly, extra fees and increased compensation, coupled with PSA restrictions, incentivizes servicers to prefer foreclosures over a mutually beneficial modification.[89] Servicers, as part of their fee structure, receive compensation for collecting default fees and collect

82 *See* Alan C. Weinstein, *Current and Future Challenges to Local Government Posed by Housing and Credit Crisis*, 2 ALB. GOV'T L. REV. 259, 260–61 (2009) (arguing that the availability of credit to homeowners, combined with relaxed government regulation, played a significant role in the current foreclosure crisis).

83 *See Problems in Mortgage Servicing From Modification to Foreclosure Part II: Hearing Before the S. Comm. on Banking, Hous., and Urban Affairs*, 111th Cong. 5–6 (2010) [hereinafter Eggert Testimony] (testimony of Kurt Eggert, Professor, Chap. Univ. Sch. of Law), *available at* http://banking.senate.gov/public/index.cfm?FuseAction=Files.View&FileStore_id=2ab0a78e-12ee-4cf8-bb70-745d0d0372ab; *see also* Levitin, *supra* note 14, at 584 (recognizing that financial institutions may also decide to directly securitize the loan in the secondary market).

84 Levitin, *supra* note 14, at 584.

85 Eggert Testimony, *supra* note 83, at 6. For an in-depth analysis of Pooling and Service Agreements see generally Gelpern, *supra* note 27.

86 Eggert Testimony, *supra* note 83, at 6; Eggert, *supra* note 23, at 1266.

87 Levitin, *supra* note 14, at 585.

88 *See* Eggert Testimony, *supra* note 83, at 4.

89 *Foreclosure Prevention and Intervention: The Importance of Loss Mitigation Strategies in Keeping Families in Their Homes: Hearing Before the Subcomm. on Hous. and Cmty. Opportunity of the H. Comm. on Fin. Services*, 110th Cong. 168–69 (2008) [hereinafter Twomey Testimony] (written testimony of Tara Twomey, Counsel, National Consumer Law Center); *see also* Katherine M. Porter, *Misbehavior and Mistake in Bankruptcy Mortgage Claims*, 87 TEX. L. REV. 121, 152–155 (discussing how servicers sneak fees into their claims against bankrupt debtors); Adam J. Levitin & Tara Twomey, *Mortgage Servicing,* 28 YALE J. ON REG 1, 69–71 (2011) (delineating the compensation of servicers for mortgage defaults).

additional payment for a successful foreclosure.[90] On the other hand, because servicers are unable to collect default fees from loan modifications, servicers are forced to incur additional costs without receiving a corresponding increase in compensation.[91]

B. Non-Traditional Loans and Weak Underwriting

In light of the modern mortgage industry structure, lenders began implementing unconventional and exotic loan terms to subprime borrowers because increased risks were externalized in the thriving securitized market.[92] Lenders were protected from defaulting and foreclosed borrowers because rising home values meant that a foreclosure proceeding would yield a sale in excess of the mortgage amount, thus allowing the lender to fully recover.[93] Some loans so predatory in nature lead critics to suggest that foreclosure was the desired goal.[94] When the real estate bubble burst, declining home prices and increased interest rates ensued, leaving borrowers obligated to pay mortgages in excess of the property value.[95] Consequently, lenders' motivations to modify were eliminated because the sale of the underlying debt had already been externalized through the secondary markets.[96]

The main culprits of the unconventional mortgage terms were adjustable rate mortgages (ARMs) and option-ARMs.[97] An ARM is characterized by an initial fixed interest rate for a specified period of time.[98] Upon the expiration of this period, the

90 Levitin, *supra* note 89, at 70–72 (describing the compensation of servicers for mortgage defaults).

91 *Id.*

92 Kristine M. Young, *The Aging Population and Maturing Mortgage Loans: Ensuring a Secure Financial Lifeline for the Elderly Through Mortgage Lending*, 16 ELDER L.J. 477, 483 (2008) (noting that the standardization of mortgage documents reduced transaction costs and allowed the lenders to avoid interest rate fluctuations by providing a continuous flow of cash); *see also* WARREN & WESTBROOK, *supra* note 6, at 114 (stating that "evidence is . . . clear that many credit issuers have deliberately taken big risks in lending to consumers, because of the large profits available from the difference in interest rates between what a bank has to pay to get money and what it can charge for lending it to willing consumers").

93 *Cf.* CONG. OVERSIGHT PANEL, *supra* note 1, at 1; Weinstein, *supra* note 82, at 262–63.

94 Eric C. Seitz, *U.S. Subprime Crisis: H.R. 3915—A Far-Sighted Solution to the Mortgage Crisis*, 14 LAW & BUS. REV. AM. 759, 760 (2008).

95 Weinstein, *supra* note 82, at 263; *see also* Rachel D. Godsil & David V. Simunovich, *Protecting Status: The Mortgage Crisis, Eminent Domain, and the Ethic of Homeownership*, 77 FORDHAM L. REV. 949, 959–63 (2008) (presenting an example of the impact a subprime mortgage has when a substantial down payment is not required); CONG. OVERSIGHT PANEL, *supra* note 1, at 1.

96 Norton, *supra* note 5, at 2.

97 *See* Eggum, *supra* note 7, at 1159.

98 *Id.*; *see* Beverlea (Suzy) Gardner & Dennis C. Ankenbrand, *Hybrid ARMs: Assessing the Risks, Managing the Fallout,* 5 FDIC SUPERVISORY INSIGHTS 14, 14

interest rate is adjusted every six months for the remainder of the loan.[99] Whereas the mortgage payment structured by the teaser rate is reasonable, the adjustment period results in an increase in the payment structure such that the mortgage payment becomes extremely unaffordable.[100] This drastic increase in payment, aptly referred to as "payment shock," comprised eighty-one percent of the securitized subprime market in 2006.[101]

Option-ARMs, the "ugly sister" of the ARM, present the borrower with various methods of calculating a mortgage payment for the initial period.[102] The borrower may choose a minimum monthly payment, interest-only payment, or a fully amortized principal and interest payment.[103] Amongst the façade of feasible options displayed, the minimum payment is usually the only affordable choice for most borrowers and generates the majority of option-ARMs.[104] The minimum payment option, however, is entirely misrepresentative because it fails to adequately offset the accrued monthly interest.[105] Consequently, despite making continuous payments for months or even years, unpaid interest added to the loan balance forces the borrower to create debt rather than equity.[106] This is also referred to as negative amortization.[107] Similar to ARM's payment shock at the termination of the teaser period, option-ARMs contain trigger points compelling full amortization of mortgage payments resulting in an extravagant increase in payment.[108]

Aggravating the non-traditional nature of these mortgage loan terms, weak underwriting practices barely required

(Summer 2008), *available at* http://www.fdic.gov/regulations/examinations/supervisory/insights/sisum08/sisum08.pdf; *see also* Scott Frame et al., *A Snapshot of Mortgage Conditions with an Emphasis on Subprime Mortgage Performance*, FED. RES. SYS. ONLINE 2–3 (Aug. 27, 2008), http://federalreserveonline.org/pdf/MF_Knowledge_Snapshot-082708.pdf.

99 Eggum, *supra* note 7, at 1159.

100 *Id.*

101 *Id.*

102 *Id.* at 1159–60.

103 *Id.*; Adam J. Levitin, *The Worsening Foreclosure Crisis: Is It Time to Reconsider Bankruptcy Reform?*: *Hearing Before Subcomm. on Admin. Oversight and the Courts of the S. Comm. on the Judiciary*, 111th Cong. 135 (2009) [hereinafter Levitin Testimony] (written testimony of Adam J. Levitin, Professor, Georgetown University Law Center).

104 *See* Eggum, *supra* note 7, at 1159–60; *see also* Levitin Testimony, *supra* note 103, at 135.

105 Eggum, *supra* note 7, at 1159–60.

106 *Id.*

107 *Id.*

108 *Id.* (describing two types of trigger points: a time trigger, usually five years, recasts at a certain year interval and a loan balance trigger, usually 110%, recasts when the loan balance exceeds a certain percentage of the original loan amount).

documentation to assure payment affordability.[109] In fact, lenders solely considered the affordability of the ARMs' initial teaser rate or the selected option for the option-ARM.[110] Low documentation, no documentation, and income underwriting standards failed to require any verification of ability to repay the loan.[111] Unsurprisingly, further review found major inconsistencies when compared to actual income.[112] While a Chapter 13 bankruptcy presents the borrower with the right to repay arrearages and cure defaults on a mortgage over time, this remedy fails to address the inevitable increase in monthly payments that most homeowners face in light of the non-traditional loans originated in the last decade.[113]

III. FAILED ATTEMPTS AT CURING THE FORECLOSURE FLU

As the probability of defaulting borrowers increased and the magnitude of the housing catastrophe catapulted, lawmakers continuously proposed a variety of remedies including voluntary federal agency programs, federal funding of government and mortgage agency programs, and legislative acts.[114]

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109 Gardner, *supra* note 98, at 14, 17; *see* Eggert, *supra* note 23, at 1263–64; *see also* WARREN & WESTBROOK, *supra* note 6, at 114 (stating that the credit industry "has expanded and grown more profitable by steadily extending credit solicitations to include people who were once considered too risky for such loans").

110 Gardner, *supra* note 98, at 17; Statement on Subprime Mortgage Lending, 72 Fed. Reg. 37,569 (July 10, 2007).

111 *See* CHARLES CALOMIRIS & JOSEPH MASON, HIGH LOAN-TO-VALUE MORTGAGE LENDING: PROBLEM OR CURE? 11 (The AIE Press ed., 1999), *available at* http://www.aei.org/doclib/20021130_71252.pdf (noting how HLTV lenders "turned away from traditional mortgage lending standards in favor of underwriting standards similar to those used for unsecured (primarily, credit card) loan products."); *see also* CREDIT SUISSE, MORTGAGE LIQUIDITY DU JOUR: UNDERESTIMATED NO MORE 38 (2007), *available at* http://seattlebubble.com/blog/wp-content/uploads/2007/10/2007-03-credit-suisse-mortgage-liquidity-du-jour.pdf (estimating that by 2006 no or low-documentation loans accounted for 49% of mortgage loans originated in the US.); Deryn Darcy, *Credit Rating Agencies and the Credit Crisis: How the "Issuer Pays" Conflict Contributed and What Regulators Might Do About It*, 2009 COLUM. BUS. L. REV. 605, 614–15 (noting that in 2001, almost 30% of borrowers were unable to "verify information about employment, income, or other credit-related data. This figure increased to nearly 51% in 2006. . . . [M]ortgage brokers and bankers allegedly engaged in fraudulent and/or lax practices by submitting false information to qualify borrowers or by failing to document or verify relevant information.").

112 *See* Vikas Bajaj & Jenny Anderson, *Inquiry Focuses on Withholding of Data on Loans*, N.Y. TIMES, Jan. 12, 2008, at A1.

113 *See* CALOMIRIS, *supra* note 111, at 11.

114 *See* Homeowner Assistance and Taxpayer Protection Act, S. 3690, 110th Cong. § 103 (2008); Helping Families Save Their Homes in Bankruptcy Act of 2007, S. 2136, 110th Cong. § 101 (2007); Emergency Home Ownership and Mortgage Equity Protection Act of 2007, H.R. 3609, 110th Cong. § 4 (2007); Foreclosure Prevention Act of 2008, S. 2636, 110th Cong. § 101 (2008); Home Owners' Mortgage and Equity Savings Act, S. 2133, 110th Cong. § 2 (2007); Home Owners' Mortgage and Equity Savings Act, H.R. 3778, 110th Cong. § 202 (2007); *see* Eggum, *supra* note 7, at 1157 ("Efforts to protect the savings and loan industry and expand the availability of credit in the late 1970s were replaced by

A. Voluntary Programs and Federal Funding

On account of the housing collapse increasing the number of defaulting and delinquent homeowners in 2007, the Bush administration implemented HopeNow.[115] Designed for subprime borrowers current on their mortgage but facing subsequent increases in adjustable rates, HopeNow was largely a disappointment because narrow applicability requirements failed to substantially affect borrowers or the increasing rate of foreclosures.[116] Other programs enacted by the administration such as FHASecure and Hope for Homeowners were likewise ineffectual.[117] Attempting to directly respond through federal funding of local mortgage counseling programs, purchasing abandoned properties, and borrower financing, the administration enacted the Housing and Economic Recovery Act of 2008.[118] Another piece of legislation targeted at encouraging home sales was the Mortgage Forgiveness Debt Relief Act of 2007, which amended the Internal Revenue Code to permit an exclusion for taxpayers on cancelled mortgage debt on a principal residence.[119] Despite these valiant efforts, unfavorable tax

concerns about the growth of abusive lending practices . . . ."); *see generally* Anna T. Pinedo & Amy Moorhus Baumgardner, *Federal Mortgage Modification and Foreclosure Prevention Efforts*, 41 UCC L.J. 319 (2009) (delineating the legislative, policy and program efforts of the government); R. Travis Santos, Comment, *The Legal Way to Defeat Optimus Sub-Prime*, 25 EMORY BANKR. DEV. J. 285, 313–29 (2008) (describing Congress's efforts towards fixing the sub-prime mess).

115 Santos, *supra* note 114, at 313–14; Press Release, Hope Now, Hope Now Alliance Created to Help Distressed Homeowners (Oct. 10, 2007), *available at* http://www.fsround.org/media/pdfs/AllianceRelease.pdf.

116 Ruth Simon & Tom McGinty, *Earlier Subprime Rescue Falters: December Plan Has Done Little to Help Borrowers in Dire Circumstances*, WALL ST. J., Feb. 13, 2008, at A1.

117 Press Release, U.S. Dep't of Hous. & Urban Dev., Bush Administration to Help Nearly One-Quarter of a Million Homeowners Refinance, Keep Their Homes (Aug. 31, 2007), *available at* http://archives.hud.gov/news/2007/pr07-123.cfm. The guidelines were too strict, requiring at least 3.5% equity in the home and no more than two missed payments at the time of application. Karina Hernandez, *FHA Secure Program to Help Homeowners in Distress*, EHOW (Oct. 5, 2010), http://www.ehow.com/about_7293798_fha-secure-program-homeowners-distress.html. Consequently, the majority of homeowners needing help because they were already affected by plummeting home prices and interest rate adjustments were largely ineligible under FHASecure. *Id.* Additionally, Hope for Homeowners' inefficiency "was attributed to high fees, high interest rates, the need for a reduction in principal on the part of the lender, and the requirement that the federal government receive 50% of any appreciation in value of the house." *Hope for Homeowners*, FIN. RELIEF L. CTR. (June 3, 2009, 12:54 PM), http://lawcenter.com/blog/?p=31. As a result, only 451 applications had been received and 25 loans were finalized as of February 2009. This was a far cry from the estimated 400,000 homeowners originally expected to participate. *Id.*

118 Housing and Economic Recovery Act of 2008, Pub. L. No. 110-289, 122 Stat. 2654 (2008).

119 Mortgage Forgiveness Debt Relief Act of 2007, Pub. L. No. 110-142, 121 Stat. 1803 (2007) (amending 26 U.S.C. § 108(h) (2006)).

consequences are still in effect pertaining to securitization modifications.[120]

In an effort to manage the economic crisis on a pervasive level, the Emergency Economic Stabilization Act of 2008 (EESA) was enacted.[121] This $700 billion legislation authorized the purchase of troubled assets from financial institutions.[122] The Troubled Asset Relief Program (TARP) was created and progressively expanded to include mortgage modification and foreclosure provisions.[123] As emphasized by Chairman of the Senate Committee on Banking, Housing, and Urban Affairs, Christopher Dodd, the primary objective of the Act was to strengthen home ownership: "This is not an ancillary objective; it is inherent, in my view, to our efforts to resolve this economic crisis."[124] Accordingly, the Obama administration pledged at least $50 billion of TARP funds for foreclosure prevention programs with the Financial Stability Plan.[125] The funds were to be used mainly through two programs.[126] First, the Making Home Affordable program expanded the availability of modifications for government-funded mortgages.[127] Second, the Home Affordable Modification Program (HAMP) provided structured guidelines for modifying mortgages and included compensation incentives for servicers, lenders, and investors in the pursuit of modification.[128]

Regrettably, Making Home Affordable and HAMP have been mostly unsuccessful.[129] Some critics suggest that mortgage

120 Pinedo, *supra* note 114, at 334–35.

121 Emergency Economic Stabilization Act of 2008, Pub. L. No. 110-343, 122 Stat. 3765 (2008).

122 § 101.

123 Emergency Economic Stabilization Act of 2008, Pub. L. No. 110-343, 122 Stat. 3765, 3774-3775 (2008). See generally Cong. Budget Office, The Troubled Asset Relief Program: Report on Transactions through December 31, 2008 (2009), available at http://www.cbo.gov/ftpdocs/99xx/doc9961/01-16-TARP.pdf (explaining that the EESA created the Troubled Asset Relief Program (TARP) encouraging the Treasury Department to purchase troubled assets, while the foreclosure and modification provisions in the EESA expanded the authority to manage and modify all mortgage related assets purchased with TARP funds).

124 Peter Cockrell, *Subprime Solutions to the Housing Crisis: Constitutional Problems With the Helping Families Save Their Homes Act of 2009,* 17 GEO. MASON. L. REV. 1149, 1161 (2010).

125 *Id.*

126 *Id. See also, e.g.*, *Financial Stability Plan Fact Sheet*, U.S. DEP'T OF THE TREASURY, http://www.treasury.gov/initiatives/financial-stability/about/Documents/fact-sheet.pdf.

127 Cockrell, *supra* note 124, at 1161–62.

128 *Id.*

129 *Id.*; Peter S. Goodman, *U.S. Loan Effort Is Seen as Adding to Housing Woes*, N.Y. TIMES, Jan. 2, 2010, at A1; *see also* Jonathan Hoenig, *The Plan to Stop Foreclosures Has Failed*, SMARTMONEY (Feb. 18, 2010), *available at* http://www.smartmoney.com/investing/economy/the-plan-to-stop-foreclosures-has-failed.

servicers mislead borrowers by promising affordable modified rates.[130] Other critics fault the purely procedural nature of the program as the primary reason for its inevitable failure.[131] Indeed, no mechanism exists to reprimand mortgage servicers that refuse to conform to HAMP guidelines.[132] Instead, servicers require excessive documentation, fail to conduct modification reviews prior to foreclosure proceedings, and decline to provide substantiated reasons for modification denials or calculation methods.[133] Taking a broader approach, voluntary programs such as HAMP will continue to be ineffective because they inherently fail to address the actual problem that promulgated the housing crisis—unaffordable loans.[134]

B. Legislative Proposals

Another crucial approach to the foreclosure crisis is aimed at revising the Bankruptcy Code.[135] Since defaulting homeowners are not attenuated from possible bankruptcy, Congress recognized a potential antibiotic in Bankruptcy Code reform.[136] With the support of the Obama administration, advocates for mortgage modification proposed two bills that were originally refused by the Bush Administration.[137] House Bill 200 was introduced by John Conyers, Jr. of Michigan and House Bill 225 by Brad Miller of North Carolina.[138] Senator Richard Durbin of Illinois organized its companion, Senate Bill 61.[139] Whereas a secured claim subject to strip-down must be paid in full according to the duration of the Chapter 13 plan, the proposed bills authorized a bankruptcy court to extend mortgage payments beyond the life of the plan, provided for a freeze or a reduction in interest rates and entitled the debtor to a reduction in principal

130 James R. Hagerty, *Mortgage-Rescue Program Benefits More Homeowners*, WALL ST. J., Mar. 13, 2010, at A2 (stating that a large number of homeowners drop out of the program because the modified payment is still unaffordable).

131 Levitin, *supra* note 14, at 627–28.

132 *Id.*

133 *Id.*

134 *Id.* at 619–20 (explaining that while voluntary options permit the struggling homeowner to cure within a 90-day period, this is only beneficial for borrowers that were in default due to an isolated event or unexpected expense. Realistically, this type of voluntary option merely delays the inevitable foreclosure).

135 Ryan Grim, *Cramdown Is Back: Banks Against Homeowners, Round 2*, HUFFINGTON POST (Sept. 8, 2009), http://www.huffingtonpost.com/2009/09/08/cramdown-is-back-banks-v_n_280126.html.

136 Cockrell, *supra* note 124, at 1163.

137 *Id.* at 1161–63.

138 Helping Families Save Their Homes in Bankruptcy Act of 2009, H.R. 200, 111th Cong. (2009); Emergency Homeownership and Equity Protection Act, H.R. 225, 111th Cong. (2009).

139 Helping Families Save Their Homes in Bankruptcy Act of 2009, S. 61, 111th Cong. (2009).

balance based on the fair market value of the property.[140] Accordingly, the secured claim would be based on the lowered amount, decreasing the debtor's monthly mortgage payments.[141] Such combination of an extension of the loan terms with an interest rate adjustment or a reduction in principal amount would actually allow the debtors to cure arrearages and avoid foreclosure.[142]

House Bill 200—the Helping Families Save Their Homes in Bankruptcy Act of 2009—was subsequently incorporated into House Bill 1106—the Helping Families Save Their Homes Act of 2009—and passed the House of Representatives on March 5, 2009.[143] The legislation, while permitting a modification of the residential mortgage, was subject to a few strict limitations. Instead of proposing a permanent amendment to the Bankruptcy Code, eligibility was confined to loans originated prior to the passage of legislation and currently subject to foreclosure.[144] The addition of subsection (g) to section 1322 would have entitled lenders to recapture appreciation in property value if the debtor sold the property and subsection (h) would have forced the debtors to pursue voluntary lender modifications before filing a bankruptcy petition.[145] The bill came before the Senate as part of Senate Bill 896, the Helping Families Save Their Homes Act of 2009, which included several housing initiatives of the Obama Administration.[146] Lamentably, while Senate Bill 896 was signed into law on May 20, 2009, the proposal to amend § 1322 was rejected on April 30, 2009 by a vote of 45-51 amidst forceful opposition from the financial services industry.[147]

Although the amendments and proposals were rejected, congressional backers and legislators continue to pursue the

140 Helping Families Save Their Homes in Bankruptcy Act of 2007, S. 2136, 110th Cong. § 101(a)(3) (2007); *see also* Foreclosure Prevention Act of 2008, S. 2636, 110th Cong. § 412 (2008) (providing for waiver of counseling requirement when homes are in foreclosure); Emergency Home Ownership and Mortgage Equity Protection Act of 2007, H.R. 3609, 110th Cong. § 4 (2007) (allowing for modification of claims secured by debtors' principal residence); *see* 11 U.S.C. § 1322(d). The bankruptcy court would be able to recalculate the interest rate so that it was equal to the most recent mortgage yield published by the Board of Governors of the Federal Reserve System and a reasonable premium for risk. Eggum, *supra* note 7, at 1161.

141 *Id.* at 1163.

142 *Id.* at 1164.

143 Vote results available at http://clerk.house.gov/evs/2009/roll104.xml.

144 Helping Families Save Their Homes Act of 2009, H.R. 1106, 111th Cong. § 103 (2009).

145 *Id.*

146 Helping Families Save Their Homes Act of 2009, S. 896, 111th Cong. (2009).

147 Dierdre Keady, *Mortgage Cramdowns: With the Rainbow Gone, Is the Pot of Gold Still Attainable?*, 2009 NORTHEAST BANKRUPTCY CONFERENCE 542 (Am. Bankr. Inst., 2009), *available at* http://www.abiworld.org/committees/newsletters/consumer/vol7num5/cramdown.pdf; *see* Eggum, *supra* note 7, at 1161–64.

revision of the Bankruptcy Code to permit some sort of strip-down provision.[148] Though House Financial Services Committee Chairman Barney Frank emphasized a similar provision would be incorporated in the financial regulatory reform bill, the passage of the bill did not include such a provision, denoting the success of the financial services lobby.[149]

IV. BENEFITS OF MODIFICATION WITHIN BANKRUPTCY

As evidenced by the persistence of its supporters, the rationale bolstering a bankruptcy-based solution as an alternative remedy for managing foreclosures is deep and broad.[150] Bankruptcy presents the greatest foundation for an instantaneous and enduring means of relief for struggling homeowners;[151] the existing framework of bankruptcy fosters administrative efficiency, and court-ordered participation would override servicer disincentives and encourage more voluntary modifications.

A. Mechanism Already in Place

Modification through bankruptcy utilizes a dependable framework that already contains screening mechanisms to ensure that the system is not abused.[152] When Congress amended the Bankruptcy Code to encourage more Chapter 13 filings in 2005, a means test was put in place to administer a strict mechanical standard forcing borrowers to pay as much of their debts as possible.[153] Additionally, proposed Chapter 13 plans would be subject to the feasibility and good faith provisions on the part of the debtor in order to be confirmed.[154] On account of the screening techniques and mandatory provisions within the Bankruptcy Code as it is currently written, development of independent precepts for loan modification eligibility would be unnecessary.[155]

Administrative efficiency of a bankruptcy-based resolution would not require development of a regulatory commission or

148 *See*, Levitin, *supra* note 103, at 8.

149 Grim, *supra* note 135.

150 *See* Press Release, Committee on the Judiciary, Conyers and Eight Others Introduce Amendment to Provide Mortgage Modification Relief to Struggling Homeowners (Dec. 7, 2009), *available at* http://judiciary.house.gov/news/091207.html.

151 *Id.*

152 *See* Eggum, *supra* note 7, at 1165.

153 *See* 11 U.S.C. §§ 707(b)(2), 1325(b)(3); *see also* White, *supra* note 27, at 10.

154 11 U.S.C. § 1325(a)(3) (requiring that proposed plans must be submitted in good faith).

155 11 U.S.C. § 109(e) (defining the strict eligibility requirements to initially qualify as a bankruptcy debtor).

expansion of existing departments.[156] Rather, existing judges, U.S. Trustees, and panel trustees possess extensive knowledge regarding creditor and debtor disputes, and essential administrative personnel are already hired, trained, and supervised.[157]

B. Override Disincentives and Encourage Voluntary Modifications

The securitization of mortgages creates a multi-party relationship resulting in difficulty interacting with servicers, identifying authorized agents, and maintaining a reliable contact with the lender.[158] Collectively, these factors present an impervious hurdle to effective voluntary modifications.[159] Despite persistent opposition to mortgage modification, the mortgage industry concedes that voluntary loan programs lack the communication required for success.[160] The bankruptcy structures for communication and negotiation provide a much needed setting to override such systematic errors.[161] The securitization of mortgages imposes financial incentives for servicers to prefer foreclosures and pooling, and servicing agreements restrict the ability of servicers and lenders to perform voluntary modification.[162] Providing involuntary modifications pursuant to a bankruptcy proceeding and court-order would invalidate the liability potential that undoubtedly is a factor in lender and servicer reluctance.[163]

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156 *See* Letter from the Chief Legal Officers of Twenty-Two States and the District of Columbia to Nancy Pelosi, Speaker of the House, and John Boehner, House Minority Leader (Jan. 6, 2009), *available at* http://www.mass.gov/Cago/docs/press/2009_01_06_bankruptcy_code_attachment1.pdf (recommending modification of mortgages as a cost-efficient solution). It is likely, however, that the hiring of extra staff for ease of administration might be beneficial.

157 *See* Eggum, *supra* note 7, at 1165.

158 *See* Twomey Testimony, *supra* note 89, at 168.

159 *Id.* ("From the homeowner's perspective one of the biggest obstacle[s] to loan modification is finding a live person who can provide reliable information about the loan account and who has authority to make loan modification decisions.").

160 *Straightening Out the Mortgage Mess: How Can We Protect Home Ownership and Provide Relief to Consumers in Financial Distress? Part II: Hearing Before Subcomm. on Commercial and Administrative Law of the H. Comm. on the Judiciary*, 110th Cong. 10 (2007) (statement of David G. Kittle, Chairman-Elect, Mortgage Bankers Ass'n), *available at* http://www.mortgagebankers.org/files/StoptheBankruptcyCramDown/StatementofDavidKittle.pdf (admitting the consistent failure of servicer-borrower communication amounted to more than 50% of foreclosed homeowners).

161 Eggert Testimony, *supra* note 83, at 6–10 (describing the extent of servicer abuse of borrowers).

162 *See* Levitin, *supra* note 14, at 585; *see also* Diane E. Thompson, *Why Servicers Foreclose When They Should Modify and Other Puzzles of Servicer Behavior*, NAT'L CONSUMER L. CENTER, Oct. 2009, at 8, *available at* http://www.nclc.org/images/pdf/foreclosure_mortgage/mortgage_servicing/servicer-report1009.pdf.

163 *See* Eggum, *supra* note 7, at 1167.

Bankruptcy modification will likely have the counter-intuitive effect of increasing the facilitation of voluntary modifications between lenders and borrowers.[164] While bankruptcy modification will dictate a binding workout plan determined by the judge, lender involvement and control of the modification process would be limited.[165] As such, lenders may be expected to prefer voluntary workouts with the borrower in order to maintain added control over both the process and results.[166] Concurrently, borrowers may also choose to abide by consensual workouts in order to bypass the significant current and future monetary expenses of filing bankruptcy and negative impact on credit reports which increase costs of future credit.[167] Additionally, strict scrutiny of a court-supervised budget and dealing with the consequences of financial records being a matter of public record should dissuade defaulting borrowers from filing bankruptcy when a lender is willing to participate in a workout plan.[168]

C. Makes Economic "Cents"

Bankruptcy offers unrivalled benefits to borrowers and lenders while curtailing third party externalities. Mortgage modification expedites homeowner retention and continual payments which is in the common interest of borrowers and lenders. Likewise, communities and taxpayers retain the benefits from foreclosure reduction rates, balancing neighborhood property values and tax-bases, and increasing creditor accountability.[169]

i. Assisting Borrowers in Keeping Their Homes

Mortgage modification within bankruptcy offers an expansive and concentrated mechanism of assisting homeowners with impending foreclosures.[170] Currently, a bankruptcy petition is only beneficial to a borrower in terms of halting an incomplete foreclosure or reinstating an accelerated mortgage by curing arrearages over time through the Chapter 13 plan.[171] Infusing

164 *See* Thompson, *supra* note 162, at 8; Eggert Testimony, *supra* note 83, at 11-12; *see also* Rod Dubitsky et al., *Bankruptcy Law Reform—A New Tool for Foreclosure Avoidance* 1 (2009), http://judiciary.house.gov/hearings/pdf/Suisse090126.pdf.

165 *Id.*

166 *Id.*

167 *Id.*

168 *See* Eggum, *supra* note 7, at 1165.

169 *See generally*, Immergluck, *supra* note 9 (describing the external costs of foreclosure on communities); *see also* White, *supra* note 27, at 14 (explaining the monetary and psychological costs of foreclosures for a homeowner).

170 Hauser, *supra* note 59, at 222.

171 11 U.S.C. § 362 (2006).

the bankruptcy court with the discretion to modify principal residence mortgages would counteract the inherent poisons of the current housing epidemic that previous programs and proposals failed to address: adjusting above rate mortgages resulting from predatory lending and deterring grossly disproportional mortgages in relation to the underlying property value.[172]

First, interest rate reductions on above-market adjustable rate mortgages would allow conversion of an unaffordable ARM to a more manageable fixed interest rate, thereby counter-acting the payment shock from non-traditional subprime loans.[173] Second, strip-down of undersecured mortgages into a bifurcated payment schedule would create an incentive to continue making mortgage payments since the accumulation of equity finally becomes a reality.[174] While some critics believe that such bifurcation is a windfall, such hesitation is misplaced.[175] Strip-down by definition merely results in zero-equity, not positive equity.[176] Most notably, bankruptcy compels the debtor to endure the severe consequences of the bankruptcy process like incurring filing and attorney fees, suffering with the negative effects on credit history, and enduring the public stigma accompanying bankruptcy.[177]

ii. Providing Substantial Economic Benefits to Lenders

Lenders will undoubtedly recover more of the outstanding balance from a defaulting borrower with a mortgage modification than a foreclosure.[178] Foreclosures are both time and cost intensive.[179] The average duration of the foreclosure process from the first delinquent payment to the actual sale of the property is almost one year.[180] Actual expenses of the foreclosure can run lenders over $50,000 per property for a mere thirty

172 Hauser, *supra* note 59, at 223–24.

173 *Id.*; FED. DEPOSIT INS. CORP., INTEREST-ONLY MORTGAGE PAYMENTS AND PAYMENT-OPTION ARMS: ARE THEY FOR YOU? 1, *available at* http://www.fdic.gov/consumers/consumer/interest-only /mortgage_interestonly.pdf (defining payment shock as when "[y]our payments go up a lot—as much as double or triple—after the interest-only period or when the payments adjust.").

174 Hauser, *supra* note 59, at 224.

175 *Id.* at 233.

176 Levitin, *supra* note 14, at 642.

177 *See* Melissa B. Jacoby, *Bankruptcy Reform and Homeownership Risk,* 2007 U. ILL. L. REV. 323, 330–31 (2007).

178 *See* White, *supra* note 27, at 14 (explaining that by the time foreclosed homes are sold, lenders lose fifty percent of the original loan value).

179 Jacoby, *supra* note 177, at 330–31.

180 Andrew J. Kazakes, *Protecting Absent Stakeholders in Foreclosure Litigation: The Foreclosure Crisis, Mortgage Modification, and State Court Responses,* 43 LOY. L.A. L. REV. 1383, 1396 (2010).

percent loan recovery.[181] A lender only derives the market value of the property reduced by administrative costs and fees. Conversely, mortgage modification would add value to the lender's bottom line if aided by the bankruptcy system.[182]

The guidelines of Chapter 13 generate a larger and broader depth of recovery for lenders.[183] The plan allows the lender to receive principal and interest payments on the secured portion of the loan based on the value of the collateral plus a corresponding payment for the unsecured bifurcated fraction of the loan.[184] When a junior lien holder is deemed to have a wholly unsecured interest, the senior lenders are enriched because the subject collateral will only be used to satisfy the senior debt.[185] Moreover, this cash flow is protected because debtors are forced to comply with a strict court-ordered budget requiring formal court approval to incur new debts.[186] Allowing the debtor to retain possession of the property places the burden of maintenance and upkeep in the hands of the homeowner rather than the lender.[187] The lender can eliminate the costs associated with a foreclosure sale and resale because the bankruptcy system is funded by the debtor.[188]

An added bonus of a bankruptcy-based solution is that any subsequent default of a plan payment would result in a dismissal of the entire bankruptcy case, allowing the creditor to recapture any appreciation in value of the property.[189] For future creditors, the temporal period of eligibility for debtors to file bankruptcy is

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181 STAFF OF JOINT ECONOMIC COMMITTEE, 110TH CONG., SHELTERING NEIGHBORHOODS FROM THE SUBPRIME FORECLOSURE STORM 14 (2007). Foreclosures incur principal loss on the loan, property maintenance, appraisal fees, legal fees, lost revenues, insurance, marketing, and clean up. FED. HOUS. ADMIN. ECONOMIC IMPACT ANALYSIS OF THE FHA REFINANCE PROGRAM FOR BORROWERS IN NEGATIVE EQUITY POSITIONS 2 (2010), *available at* http://www.hud.gov/offices/adm/hudclips/ia/ia-refinancenegativeequity.pdf.

182 Hauser, *supra* note 59, at 225–26 ("When a mortgage is undersecured, the beneficial holder of the note, whether a lender or an investor, will always realize a loss when the property is liquidated. Economically, the loss realized on cramdown should be roughly equivalent to the loss realized when the property is sold at foreclosure—indicating that the creditor's bottom line will remain similar in both procedures.").

183 *See* White, *supra* note 27, at 10–14 (detailing how the 2005 changes to the Bankruptcy Code affected Chapter 13 filings and lenders).

184 *Id*. at 13.

185 *See* Nobleman v. American Savings Bank, 508 U.S. 324, 332 (1993) (holding that the anti-modification provision of 1322(b)(2) does not affect modification of an undersecured residential mortgage).

186 *See* 11 U.S.C. § 1325.

187 *See* Immergluck, *supra* note 9, at 57 (describing the negative costs associated with foreclosed properties).

188 Elizabeth Warren, *Bankruptcy Policymaking in an Imperfect World,* 92 MICH. L. REV. 336, 365 (1993).

189 Helping Families Save Their Homes Act of 2009, H.R. 1106, 111th Cong. § 103 (2009).

broader and longer than the time a foreclosure stays on a credit report.[190] Mortgage modification within bankruptcy generates a greater return on a lender's investment as compared to a foreclosure.[191]

iii. Alleviating the Pressure on Community and Financial Markets

Foreclosures function like a contagious virus infecting surrounding neighborhoods and community tax bases.[192] Unoccupied homes remain unimproved and unmaintained and decrease the value of adjacent properties.[193] Not only do declining home values contribute to a reduction in tax revenue for cities and counties,[194] it also presents incentives for homeowners to abandon their grossly disproportionate mortgages while having a continually detrimental effect on surrounding homes.[195]

As a matter of justice, the bankruptcy solution places the financial burden and the blame on both proponents of the housing crisis.[196] Borrowers willing to commit to a subprime loan are forced to shoulder the costs and burdens of bankruptcy filing and must promise to devote all disposable income to the repayment plan.[197] Contrarily, lenders supporting irresponsible lending practices and weak underwriting decisions that chose to ignore high risks of default in lieu of short-term profits are obligated to accept the economic consequences of their actions.[198] Enlarging bankruptcy relief to permit mortgage modifications would not necessitate any taxpayer financial support because of the self-funding nature of bankruptcy.[199]

190 Levitin, *supra* note 14, at 643 ("[T]he minimum time between repeat Chapter 13 filings is longer than the time a foreclosure stays on a credit report.").

191 *Id.* at 647.

192 *See generally* Immergluck, *supra* note 9 (discussing the negative impact foreclosures have on property values).

193 *Id.* at 57.

194 *Id.* at 58 ("[C]ities, counties, and school districts may lose tax revenue from abandoned homes.").

195 *Id.* at 57 (explaining how foreclosed properties "contribute to physical disorder in a community, create a haven for criminal activity, discourage the formation of social capital, and lead to further disinvestment.").

196 Hauser, *supra* note 59, at 228–29.

197 Press Release, Mortgage Bankers Ass'n, MBA's Kittle Challenges Bankruptcy Myths at Hearing (Jan. 29, 2008). *available at* http://www.mortgagebankers.org/NewsandMedia/Press/59656.htm.

198 Hauser, *supra* note 59, at 229.

199 *See* Warren, *supra* note 188, at 365 ("While the general taxpayer obviously contributes to the costs of keeping a bankruptcy court open, the fees imposed on those who use the system minimize the taxpayer costs.").

V. A BANKRUPTCY BASED ALTERNATIVE IS BOTH NECESSARY AND TIMELY

Voluntary measures to encourage mortgage modification during this housing epidemic have turned out to be largely ineffectual and inefficient failures.[200] Every economics class recognizes that merely rewarding positive behavior fails to achieve the desired goal.[201] Rather, a countervailing punishment which acts to substitute the reward for negative behavior leads to the greatest level of cooperation.[202] When such positive and negative incentives are attached to the desired goal, intended results are more probable.[203] The proposal endorsed in this Comment is the addition of a negative incentive to mortgage lenders that may be instituted by borrowers when the positive incentives fail. This negative incentive will take the form of legislation that amends Bankruptcy Code § 1322(b)(2) to permit modification of residential mortgages within a bankruptcy proceeding. Compounding on other proposals initiated, this Comment endorses an alteration in measuring affordability to reflect the dynamic relationship between income and expenses and imposes a mandatory foreclosure and modification program prior to any mortgage modification within bankruptcy.

A. Affordability Standard

Most voluntary program configurations are based on standards of the Department of Housing and Urban Development.[204] The HUD concept of affordability reflects the percentage of income a household spends on housing costs.[205] Affordable housing costs subsume, at most, 30% of gross income.[206] Unaffordable housing commits 30%–50% of gross income.[207] Housing costs greater than 50% of gross income are deemed severely unaffordable.[208] The problem with such a static standard for measurement is its failure to consider the inherent fluctuations in income and expenses.[209] The more appropriate and realistic standard that should be taken into account is that of

200 *See* discussion *supra* Part III.
201 Hassouni, *supra* note 5, at 600.
202 *Id.*
203 *Id.*
204 *See* Eggum, *supra* note 7, at 1135–36.
205 *Id.*
206 *Id.*
207 *Id.*; *see also* U.S. DEP'T OF HOUS. & URBAN DEV., TRENDS IN WORST CASE NEEDS FOR HOUSING, 1978–1999, at 1 (2003), *available at* http://www.huduser.org/publications/PDF/trends.pdf (describing moderate housing problems as costs exceeding 30% of reported income, but less than 50% of income).
208 *See* Eggum, *supra* note 7, at 1135.
209 *Id.* at 1136–37.

residual income.[210] Residual income would factor in necessary housing costs and related expenses prior to any determination of affordability.[211] This idea of residual income can be directly intertwined with a Chapter 13 plan because of the disposable income requirement necessary for a confirmable plan.[212] This standard reflects the reality that certain objectively necessary expenses are incurred by all individuals regardless of income level and should not be sacrificed in order to make an unaffordable mortgage payment.[213]

B. Mandatory Foreclosure and Modification Programs

Upon filing a bankruptcy petition, implementing a mandatory foreclosure and modification negotiation program facilitated by the bankruptcy court would provide transparency, accountability, and judicial supervision to the modification process that is currently absent from consensual voluntary modifications.[214] A structured forum to discuss alternatives to foreclosure that are mutually beneficial to borrowers and lenders would counteract the major problems intrinsic in government programs such as HAMP.[215] Attorneys and judicial supervisors would eliminate the problems inherent with pro se and pro per homeowners tending to misunderstand obligations arising from loan modification programs.[216] Moreover, these supervisors could alleviate the lack of communication by servicers and lenders failing to attend to struggling borrowers.[217]

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210 *See id.* (explaining the shortcomings of the HUD standards in accounting for changes in income and costs).

211 *See, e.g.*, Steven C. Bourassa, *Measuring the Affordability of Home-Ownership*, 33 URB. STUD. 1867, 1868–69 (1996) ("The [ratio] test, however, is unsatisfactory in that households at the bottom of the income distribution will have insufficient residual income no matter how little they spend on housing, while those at the upper parts of the distribution are likely to have more than adequate residual income even if they spend more than the specified percentage of income on housing.").

212 11 U.S.C. §§ 1322, 1325 (2006).

213 *See* Eggum, *supra* note 7, at 1139–40 (describing that regardless of income level, individuals require clothing, medicine, and food).

214 *See generally* ANDREW JAKABOVIC & ALON COHEN, CENTER FOR AM. PROGRESS, IT'S TIME WE TALKED: MANDATORY MEDIATION IN THE FORECLOSURE PROCESS 9 (2009), *available at* http://www.americanprogress.org/issues/2009/06/pdf/foreclosure_mediation.pdf. (exploring the use of mandatory foreclosure mediation between debtors and lenders).

215 *Id.*

216 *See* Grace B. Pazdan, *How Foreclosure Mediation Legislation Can Keep Vermonters In Their Homes (And Money In The Pockets of Mortgage Holders),* 36-SPG VT. B. J. 24, 26–27 (2010).

217 *Id.*

CONCLUSION

The time has come to empower bankruptcy law with the authority to cure the foreclosure flu that has infected the housing market for too long. The skyrocketing foreclosure rate threatens the fundamental concept of homeownership. Despite continuous efforts designed to remedy the downturn, the apparent inadequacy of those programs necessitate a reworking of the system to truly cure the economy of this burden. These expensive programs have cost taxpayers billions of dollars without providing a corresponding benefit. Section 1322(b)(2) was created in 1978 to preserve mortgage financing and lending models that are outdated and of no relevance to the current representation of the industry. In the face of the modern mortgage structure, the provision is misused by servicers and lenders to defend predatory lending practices that would have been inconceivable in 1978. In its current form, the Bankruptcy Code fails to address the ongoing battle with loan affordability affecting the entire economy. Amending the Bankruptcy Code to authorize treatment of residential mortgages as any other secured interest would deal neatly and cleanly with the impediments to loan modification absorbing the economy.

CHAPMAN UNIVERSITY SCHOOL OF LAW

TRANSCRIPTION OF 2011 *CHAPMAN LAW REVIEW* SYMPOSIUM: "FROM WALL STREET TO MAIN STREET: THE FUTURE OF FINANCIAL REGULATION"

KEYNOTE ADDRESS: "EX ANTE VERSUS EX POST APPROACHES TO FINANCIAL REGULATION"*

FRIDAY, JANUARY 28, 2011

KEYNOTE SPEAKER:

*STEVEN L. SCHWARCZ***

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In a financial context, regulation can have two impacts. First, it can help to prevent financial failures. I will call this an ex ante, or 'preventive,' approach to financial regulation. Second, regulation can help to mitigate the harm from financial failures. I will call that an ex post, or 'mitigative,' approach to financial regulation.

Some commentators frame an ex ante/ex post regulatory distinction around conduct: regulation that targets bad conduct before it occurs is deemed ex ante, whereas regulation that targets bad conduct after it occurs is deemed ex post.[1]

It makes sense to frame the distinction around conduct if one assumes, as do those commentators, that bad conduct will be deterred if targeted with appropriate regulatory penalties, whether ex ante or ex post. In the context of my talk, however, regulators do not and (I show) *cannot* know all the conduct that leads to financial failures. Moreover, factors other than conduct can lead to financial failures.[2]

Framing the ex ante/ex post distinction around conduct would thus be misleading. I therefore frame the distinction around the impact of the regulation (again, ex ante regulation focuses on preventing financial failures, ex post regulation focuses on mitigating the harm from financial failures).

INTRODUCTION

Ideal financial regulation would work ex ante, to prevent financial failures. Once a failure occurs, there may already be economic damage, and it may be difficult to stop the failure from spreading and becoming systemic.

The reality, though, is that preventing financial failures should be only one role for regulators. Even an optimal prophylactic regulatory regime cannot anticipate and prevent every failure. For example, financial panics are often the failures

1 The choice of ex ante versus ex post regulatory penalties will depend on such factors as the policing capacity of ex ante penalties, the cost of consequences resulting from the conduct compared with the cost of preventing the conduct, and the ability to know what conduct leads to bad consequences. *See, e.g.*, STEVEN SHAVELL, FOUNDATIONS OF ECONOMIC ANALYSIS OF LAW 87–91, 428–30, 479–82, 492–520, 572–78 (2004); Christopher Boerner & Barak D. Richman, *A Transaction Cost Economizing Approach to Regulation: Understanding the NIMBY Problem and Improving Regulatory Responses*, 23 YALE J. ON REG. 29, 58–66 (2006) (offering a way to compare alternative regulatory regimes).

2 And, regulation that helps mitigate the consequences of financial failures, such as creating financial safety nets, might even perversely affect conduct, fostering moral hazard in parties that believe they are too big to fail. *See infra* Part II.A.

that trigger systemic collapse.[3] But regulation aimed at preventing financial panics cannot anticipate all the causes of the panics.[4] And even when identified, panics cannot always be averted easily because investors are not always rational.[5]

One might also argue that some failures could be avoided by reducing leverage in the financial system. Reducing leverage reduces the risk that a financial institution will default and also reduces the likelihood that a default at one financial institution will cause defaults at other institutions.[6] But regulation limiting leverage could create significant costs. Some leverage is good, enabling a firm to operate efficiently and grow; and there is no optimal across-the-board leverage ratio that is right for every financial firm.[7]

Analysis of financial failures underlying the recent global recession further indicates that ex ante regulation cannot anticipate and prevent every failure. These failures can be attributed conceptually to at least four market imperfections: (1) conflicts of interest; (2) complacency of investors and other market participants; (3) complexity of financial markets and of the securities traded therein; and (4) "a type of tragedy of the commons" in which "the benefits of exploiting finite capital resources accrue to individual market participants," each of whom is motivated to maximize use of the resource, whereas the costs of exploitation are distributed more widely.[8] Government can probably manage conflicts, and it can also reduce the tragedy of the commons (such as by creating a systemic risk fund to which systemically important firms are required to contribute, thereby internalizing costs and motivating a degree of self-monitoring by those firms—both individually and collectively—against externalities).[9]

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3 Steven L. Schwarcz, *Systemic Risk*, 97 GEO. L.J. 193, 214 (2008) [hereinafter Schwarcz, *Systemic Risk*].

4 *Id.* at 216.

5 Iman Anabtawi & Steven L. Schwarcz, *Regulating Systemic Risk: Towards an Analytical Framework*, 86 NOTRE DAME L. REV. (forthcoming 2011) (manuscript at 38), *available at* http://scholarship.law.duke.edu/cgi/viewcontent.cgi?article=2924&context=faculty_scholarship.

6 Schwarcz, *Systemic Risk*, *supra* note 3, at 223.

7 *Id.* at 224.

8 Steven L. Schwarcz, *Understanding the Subprime Financial Crisis*, 60 S.C. L. REV. 549, 561–62 (2009) (quoting Steven L. Schwarcz, *Protecting Financial Markets: Lessons from the Subprime Mortgage Meltdown*, 93 MINN. L. REV. 373, 406 (2008)).

9 This approach was originally in the Dodd-Frank Act, but it was taken out at the last minute because of opposition by politicians who believed (in my opinion, wrongly) that it would increase moral hazard by institutionalizing bailouts. A privately-funded systemic risk fund not only can mitigate systemic externalities, but also can help minimize the potential for risky behavior caused by institutions that believe they are too big to fail. The too-big-to-fail problem is effectively an externality imposed on government

But government *cannot* fully manage problems of increasing complexity, which makes disclosure an inadequate means of reducing information asymmetry.[10] Furthermore, complex financial markets innovate more quickly than regulators can adapt. Nor can government fully manage problems of complacency; human nature is hard to change, and investors and other market participants do not (even absent a panic) always rationally evaluate risk.

Complete ex ante financial regulation, whereby regulators prevent every failure, is thus a futile goal. And even if it were feasible, it would not necessarily be desirable. Ex ante regulation can provide an incentive for regulatory arbitrage.[11] Furthermore, any ex ante regulation that attempts to prevent all financial failures may end up being too chilling, thereby dampening economic growth.[12] Ex post remedies will therefore always be needed to try to prevent financial failures—when they inevitably occur—from spreading and becoming systemic.

Chaos theory supports this type of reactive approach. In complex engineering systems, failures are inevitable.[13] Therefore, it is important to try to break the transmission of these failures[14] and to limit their systemic consequences.

I first will discuss how to break the transmission of financial failures and thereafter will examine how to limit their systemic consequences. In my analysis, I stand partly on the shoulders of

(and ultimately taxpayers) by an institution engaging in such risky behavior. A privately-funded systemic risk fund would help to internalize that externality. Furthermore, the ability of government to require additional contributions to this type of fund should motivate contributors to the fund to monitor each other to reduce the potential for such risky behavior. The IMF appears to be using the European Commission's recent proposal to tax the financial sector as a platform to announce that new taxes on banks [are] needed to provide an insurance fund for future financial meltdowns and to curb excessive risk-taking.

10 *See* Anabtawi & Schwarcz, *supra* note 5, (manuscript at 40–41). *Cf.* Kathryn Judge, Fragmentation Nodes: A Study in Financial Innovation, Complexity and Systemic Risk 82 (Dec. 14, 2010) (unpublished manuscript) (on file with author) (explaining why market observers and regulators failed to observe the "most pernicious forms of complexity" leading to the recent financial collapse).

11 *See, e.g.*, Samuel W. Buell, *Good Faith and Law Evasion*, 58 UCLA L. REV. (forthcoming Feb. 2011) (manuscript at 7–10) (on file with the Duke University School of Law Scholarship Repository), *available at* http://scholarship.law.duke.edu/cgi/viewcontent.cgi?article=2943&context=faculty_scholarship.

12 Lawrence G. Baxter, *Adaptive Regulation in the Amoral Bazaar* 11 (Duke Law Working Papers, Paper No. 53, 2010), *available at* http://scholarship.law.duke.edu/cgi/viewcontent.cgi?article=2969&context=faculty_scholarship.

13 Steven L. Schwarcz, *Regulating Complexity in Financial Markets*, 87 WASH. U. L. REV. 211, 248 (2009).

14 As to breaking transmission of failures, see Anabtawi & Schwarcz, *supra* note 5, (manuscript at 4).

Professor Iman Anabtawi of UCLA Law School, with whom I have written about and discussed many of these issues.[15]

I. BREAKING THE TRANSMISSION OF FINANCIAL FAILURES

A. Breaking Transmission Chains

Professor Anabtawi and I have recently examined how regulators can identify and try to break the transmission chains of financial failures.[16] Localized financial failures, by themselves, are unlikely to produce systemic effects; but when these failures are transmitted through financial institutions and markets, even relatively small failures can have systemic consequences.

We posit that two otherwise independent correlations can combine to transmit localized financial failures into broader systemic crises. The first is a correlation between a financial institution's financial condition and its exposure to risk from failures consisting of low-probability adverse events. The second is a correlation across financial institutions and markets. Using four financial crises within the past century, we illustrate that these two correlations have at times combined historically to potentiate the systemic transmission of localized financial failures.

Prior to the global recession, for example, subprime mortgage loans were bundled together as collateral to partially support the payment of complex mortgage-backed securities, which were purchased by banks and other financial institutions worldwide. These securities maintained their value so long as home prices appreciated, as they had been doing for decades and as market observers assumed would continue.

When home prices began falling, some of these mortgage-backed securities began defaulting, requiring financial institutions heavily invested in the securities to write down their value, in turn causing these institutions to appear, if not be, financially risky. This reflected a correlation between low probability risk of failure—that home prices would significantly fall and cause defaults—and an institution's financial condition. The global recession also entailed a correlation across financial institutions and markets—*not only* a tight interconnectedness among banks and non-bank financial institutions, *but also* a

15 *See id.* at (manuscript at 1).

16 *See id.* at (manuscript at 62) (arguing that "one focus of optimal regulation should be on attempting to weaken correlations within the financial system that serve to transmit systemic risk").

tight interconnectedness between financial institutions and markets. These correlations combined to facilitate the transmission of localized financial failures into a systemic collapse.

Professor Anabtawi and I recognize the limitations of our approach: one cannot always anticipate all transmission chains of financial failures;[17] and, even after a transmission chain is identified, regulation cannot always break it. We therefore caution that our approach should be only one focus of optimal regulation.

B. Market Circuit Breakers

Another approach to breaking the transmission of financial failures, at least in the context of securities markets, is to install market "circuit breakers." Although increased speed in data transmission is generally associated with market efficiency, the extreme speeds at which algorithmic trading takes place creates a danger that trading in highly automated financial markets will sometimes cause pricing failures.

Last May, for example, the Dow Jones Industrial Average plunged nearly 1000 points in twenty minutes, a pricing failure precipitated by a trader executing an algorithm to sell approximately $4.1 billion worth of derivatives contracts without regard to time or price. In response, the Securities and Exchange Commission (SEC) adopted a universal circuit breaker rule to halt trading of an individual security across all exchanges for five minutes if its price moves up or down ten percent or more within a five-minute period. Assuming a security's price has been pushed below its intrinsic value, a pause should give traders enough time to recognize the disparity and to respond if they believe the security is mispriced.

Although the adoption of a universal circuit breaker rule is intended to increase stability, that rule—like any other risk-management strategy—will be ineffective to the extent it can be eluded by mistake or design. For example, if traders mistakenly believe that a trading halt is based on fundamental valuation issues, the halt could aggravate problems. Market circuit breakers are thus not panaceas, even in the limited securities-market context in which they operate.

17 Professor Anabtawi and I recognize, for example, that additional financial crises have occurred over the past century and longer, and that a complete study of all such crises might indicate additional correlations within the financial system.

II. LIMITING SYSTEMIC CONSEQUENCES

The systemic *consequences* of financial failures also can be limited. Perhaps the most important way to accomplish this is through financial safety nets.

A. Financial Safety Nets

There are at least three categories of safety nets for financial failures: (1) safety nets for debt defaults by banks and other financial institutions; (2) safety nets for pricing failures in financial markets (focusing here on stabilizing price collapses rather than preventing them ab initio through market circuit breakers); and (3) safety nets for sovereign nation debt defaults. These categories reflect that financial institution failure, financial market failure, and sovereign debt failure could have systemic consequences.

i. Financial Safety Nets for Banks and Other Financial Institutions

Financial safety nets can help protect troubled banks and other financial institutions from default and eventual collapse. In response to bank runs in the Great Depression, the U.S. Congress enacted section 13(3) of the Federal Reserve Act, empowering the Federal Reserve System (Fed) to act as a lender of last resort in "unusual and exigent circumstances" to banks and other financial institutions. Central banks of other nations have similar missions.[18]

The primary concern with these types of safety nets is that anticipation of a bailout will encourage financial institutions to engage in morally hazardous (i.e., fiscally reckless) behavior. Constructive ambiguity—bailing out some institutions but not others, to reduce reliance on bailouts—can mitigate moral hazard; but it can also lead to potential mistakes, such as not bailing out Lehman Brothers.

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18 Although the mission of the European Central Bank (ECB) is to stabilize the price of the European currency, in "exceptional circumstances" the ECB may indemnify national central banks for "specific losses arising from monetary policy operations" taken for the benefit of the central banking system. Protocol on the Statute of the European System of Central Banks and of the European Central Bank art. 32.4, Dec. 16, 2004, 2004 O.J. (C 310) 225, 239. *See also* Duncan Alford, *The Lamfalussy Process and EU Bank Regulation: Another Step on the Road to Pan-European Regulation?*, 25 ANN. REV. BANKING & FIN. L. 389, 392 (2006) ("National governments or related agencies, such as central banks, typically have lender-of-last-resort responsibility for banks operating within their borders."); Steve H. Hanke, *Currency Boards*, 579 ANNALS AM. ACAD. POL. & SOC. SCI. 87, 90 tbl. 2 (2002) (observing that a typical central bank functions, among other things, as a lender of last resort).

Although the tension between financial safety nets and moral hazard may well be unavoidable, the likelihood that financial institutions will engage in morally hazardous behavior may be overestimated. Financial institutions can be liquidated, so an institution that engages in morally hazardous behavior is playing a very dangerous game. Indeed, there is no solid evidence, even in the global recession, that financial institutions have been engaging in that type of behavior.

Lack of evidence aside, because the Fed used section 13(3) to bail out huge financial institutions, like AIG, through (at least initial) taxpayer expense, politicians reacted in the Dodd-Frank Act by limiting that safety net.[19] I have serious doubts whether legislative pre-set limits on a financial safety net should ever replace the judgment of a government agency—especially one as independent as the Fed—to decide, in actual context, whether to extend the safety net.[20]

ii. Financial Safety Nets for Markets

We need to more seriously consider extending safety-net mechanisms to financial markets, *qua markets*. The global recession has demonstrated that panic-driven market pricing failures—exacerbated by such factors as marking-to-market and concerns over counterparty-risk—can have systemic consequences. Experience in that recession supports establishment of *market* liquidity providers of last resort to stabilize market prices.

For example, in response to the collapse of the commercial paper market, the Fed created the Commercial Paper Funding Facility (CPFF) to act as a lender of last resort for that market, with the goal of addressing "temporary liquidity distortions" by purchasing commercial paper from highly rated issuers that could not otherwise sell their paper. The CPFF apparently helped to stabilize the commercial paper market, without fostering moral hazard.[21]

Highly publicized recent governmental purchases of market securities only indirectly constitute safety-net mechanisms for

19 The Dodd-Frank Act limits, among other things, bailouts of individual financial institutions.

20 *Cf.* DAVID SKEEL, THE NEW FINANCIAL DEAL 136–37 (2011) (arguing that the "incentives created by [the Dodd-Frank Act's limitations on the section 13(3) safety-net] are not encouraging").

21 Tobias Adrian, Karin Kimbrough & Dina Marchioni, *The Federal Reserve's Commercial Paper Funding Facility*, FED. RES. BANK N.Y. ECON. POL'Y REV. (forthcoming 2011) (manuscript at 10–12). *See also* Steven L. Schwarcz, *Too Big to Fail?: Recasting the Financial Safety Net*, *in* THE PANIC OF 2008, at 94, 100 (Lawrence E. Mitchell & Arthur E. Wilmarth, Jr. eds., 2010) [hereinafter Schwarcz, *Too Big to Fail?*].

financial markets. For example, European Central Bank purchases of Greek, Irish, and Portuguese bonds[22] are intended to stabilize those nations, not the sovereign bond markets per se; and the Fed's purchases of U.S. Treasury securities (so-called "quantitative easing") are intended to stimulate the economy, not the market for U.S. Treasuries per se. We need to more seriously consider how safety-net mechanisms for financial markets, *qua markets*, can control panic-driven pricing failures that can lead to systemic collapses.[23]

iii. Financial Safety Nets for Sovereign Nations

Even a default by relatively small nations, like Greece, Ireland, and Portugal, can have global repercussions. Financial safety nets therefore should be considered for sovereign nation debt.

Traditionally, the International Monetary Fund (IMF) provides this safety net. But the IMF safety net raises various concerns, including: (1) the potential for moral hazard; (2) the inefficient use of IMF-member-nation (and thus ultimately taxpayer) funds[24]; and (3) the possibility of imposing politically motivated, sometimes harmful, "conditionality" on nations that otherwise would benefit from the safety net.

The IMF safety net could also be viewed as insufficient or even unreliable when a sovereign debt default is likely to cause disproportionately greater regional than international harm. For this reason, observers are increasingly focusing on the possibility of establishing regional safety nets for sovereign nations. In December 2010, for example, I participated in a high-level meeting in Oxford to examine how to create a regional safety net for Euro-zone nations.[25] And not too dissimilarly, there has been increasing concern that some states in the United States, which have many sovereign attributes, may need financial protection from default.

Conceptually, regional safety nets should be no different from global safety nets, except insofar as who provides the

22 *See infra* note 25.

23 For initial analysis of safety-net mechanisms for financial markets, see generally Schwarcz, *Too Big to Fail?*, *supra* note 21, and Anabtawi & Schwarcz, *supra* note 5, (manuscript at 55–58).

24 *See, e.g.*, Steven L. Schwarcz, *Sovereign Debt Restructuring: A Bankruptcy Reorganization Approach*, 85 CORNELL L. REV. 956, 963–66 (2000) [hereinafter Schwarcz, *Sovereign Debt Restructuring*] (demonstrating the cost to taxpayers of IMF member-nation contributions).

25 To some extent, regional safety nets are being spun on an ad hoc basis for sovereign-nation debt, such as through European Central Bank purchases of Greek, Irish, and Portuguese bonds. But that is in a highly politically visible and debt-specific context.

funding.[26] For a regional safety net, the funders are—like the recent European Union response to the debt problems of Greece, Ireland, and Portugal—primarily regional confederations and their member nations.

A conceptual analysis of financial safety nets for sovereign nation debt therefore need not focus, at least in the first instance, on whether the safety net should be regional or international. The fundamental problems are the same for both.

The main problem is that a nation that anticipates being bailed out is likely to engage in morally hazardous behavior. Nations are much more likely than financial institutions to engage in this behavior because nations, unlike firms, cannot be liquidated, and also because governments have strong political incentives (sometimes augmented by popular uprisings, such as the riots in Athens) to avoid reducing services or raising taxes.[27] Another problem with financial safety nets for nations is that bailouts are terribly expensive—in the case of Greece, for example, costing potentially hundreds of billions of euros.

These are growing problems: as global capital markets increasingly (and inevitably) embrace sovereign bonds as a financing tool, a country's debt becomes more tightly linked to the rest of the financial system, making a default more likely to trigger a systemic collapse.

The alternative to a bailout is an orderly debt restructuring, but that is usually impractical for nations because of two market imperfections: a holdout problem and a funding problem.[28] The holdout problem is that any given creditor has an incentive to strategically hold out from agreeing to a reasonable debt-restructuring plan, hoping that the imperative of others to settle will persuade them to allocate the holdout more than its fair share of the settlement or purchase the holdout's claim.

The funding problem is that a country is likely to need to borrow new money to pay critical expenses during the debt

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26 At a December 8, 2010 meeting at the University of Oxford, Dr. Domenico Lombardi, President of The Oxford Institute for Economic Policy, discussed favorably a proposal by Daniel Gros and Thomas Mayer for a European monetary fund. *See* Daniel Gros & Thomas Mayer, *How to Deal with Sovereign Default in Europe: Create the European Monetary Fund Now!*, CENTRE FOR EUR. POL'Y STUD., POL'Y BRIEF, May 17, 2010, at 1, 2. I argued that proposal is nothing more than what scholars have proposed for years in a broader context.

27 The Greek government, for example, did little to impose fiscal austerity even as debts accumulated.

28 *See generally* Steven L. Schwarcz, *Facing the Debt Challenge of Countries That Are Too Big to Fail*, *in* SOVEREIGN DEBT: FROM SAFETY TO DEFAULT (Robert W. Kolb ed.) (forthcoming 2011) (manuscript at 2–3), *available at* http://scholarship.law.duke.edu/cgi/viewcontent.cgi?article=2950&context=faculty_scholarship.

restructuring process, but no lender is likely to be willing to lend such funds unless its right to repayment has priority over existing debt claims.

Any effective solution to the sovereign debt dilemma would have to address both the holdout problem and the funding problem. Given the importance and high media visibility of country debt problems, let me digress a few minutes to examine *how* these problems could be addressed.

Addressing the Holdout Problem. The holdout problem can be addressed by legislating, through international treaty, a form of "super-majority" voting on sovereign debt-restructuring plans, in which a vote by the overwhelming majority of similarly situated creditors can bind dissenting creditors.[29] This is the tried-and-true method by which insolvency law, including Chapter 11 of the U.S. Bankruptcy Code, successfully and equitably addresses the holdout problem in a corporate context and achieves consensual debt restructuring. Because only similarly situated creditors can vote to bind dissenting creditors, and because any outcome of voting will bind all those creditors alike, the outcomes of votes should benefit the claims of holdouts and dissenters as much as the claims of the super-majority.

The IMF actually proposed, some years back, a sovereign debt restructuring mechanism (SDRM) similar to this, based on scholarly research of the problem (including my own research).[30] It was never adopted, however, because of political opposition in the United States by officials in the second Bush Administration, apparently based on philosophical dogma that free-market solutions always ought to trump legislative ones. They instead favored solving the holdout problem contractually, through what are referred to as collective-action clauses, allowing essential payment terms of a loan facility to be changed through super-majority, as opposed to unanimous, voting.

There are, however, two fundamental problems with collective-action clauses. First, collective-action clauses are not always included in sovereign loan and bond agreements. In the Greek debt crisis, for example, ninety percent of the total debt was *not* governed by collective-action clauses. Second, even if every sovereign loan and bond agreement included collective-action clauses, those clauses only work on an agreement-by-agreement basis. Therefore, any one or more syndicate(s) of banks or group of bondholders that fails to achieve a super-

29 *Id.* at (manuscript at 3).

30 Schwarcz, *Sovereign Debt Restructuring*, *supra* note 24, at 956–57.

majority vote would itself be a holdout vis-à-vis other creditors. It thus is unlikely that collective-action clauses can ever effectively resolve the holdout problem in sovereign-debt restructuring.[31]

I therefore believe that an international convention, in which super-majority voting can bind all of a debtor-nation's creditors, is needed to solve the holdout problem.

Addressing the Funding Problem. Such a convention could also address the funding problem. A simple remedy would be to grant a first priority right of repayment to loans of new money made to enable a country to pay critical expenses during the debt restructuring process. Existing creditors can be protected by giving them the right to object to a new-money loan if its amount is too high or its terms—including conditionality deemed appropriate by the lenders—are inappropriate. (Conditionality will therefore be negotiated.) Existing creditors will also be further protected because a country that abuses new-money lending privileges will be unlikely to receive super-majority creditor approval for a debt-restructuring plan.

B. Resolution Mechanisms

Another way to limit the systemic consequences of financial failures is through resolution mechanisms that diminish the impact of the failure. An example of such a resolution mechanism would be a pre-set plan to liquidate an entity or re-arrange its capital structure upon the occurrence of stated events, like insolvency.

Resolution mechanisms are most applicable to financial institutions. They have no direct application to markets. And they have relatively little application to sovereign nations, because sovereign nations cannot politically—and arguably should not morally—be liquidated.

Resolution mechanisms have long been used for non-financial institutions. In that context, these mechanisms are usually called 'bankruptcy' or 'insolvency' laws, and they generally provide legal guidelines for liquidating companies or enabling companies to reorganize when, at least in theory, reorganization would be more efficient than liquidation. (Although I have long argued for a "bankruptcy reorganization" approach to sovereign debt restructuring,[32] I described the core of

31 *Id.* at 960–61.

32 *See supra* notes 24 and 28.

that approach when discussing financial safety nets for sovereign nations).

There is controversy, though, whether bankruptcy-type resolution mechanisms are appropriate for financial institutions, especially when such institutions (like Lehman Brothers) are multinational. This controversy is not surprising; even in the context of domestic bankruptcy for non-financial firms, there is controversy over what should be the fundamental goals.[33]

There are also unanswered questions about incentives to implement bankruptcy-type resolution of financial institutions, especially when the sole resolution option—as under the Dodd-Frank Act—is liquidation. Will regulators, politically, be prepared to pull the trigger? If they do, could that cause larger systemic consequences, as did Lehman Brothers' bankruptcy?[34]

CONCLUSION

Ex ante financial regulation is inherently limited. Regulation cannot anticipate or control every source of financial failure. Ex post regulation is therefore needed to help break the transmission of financial failures and to limit their systemic consequences.

My goal today has not been to identify and critique all possible ex post financial regulatory approaches. Nor has it been to systematically compare ex ante and ex post regulatory approaches.[35] Rather, I have attempted to contrast fundamental differences between the two, as well as to illustrate how ex post approaches can—and arguably should—supplement ex ante approaches as part of a comprehensive financial regulatory framework.[36]

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33 *See, e.g.*, Douglas G. Baird, *Bankruptcy's Uncontested Axioms*, 108 YALE L.J. 573, 576–77 (1998).

34 *Cf.* Judge, *supra* note 10, at 83 (explaining why determining when to intervene can be a "real challenge" for regulators).

35 *Cf.* Schwarcz, *Systemic Risk*, *supra* note 3, at 214–34 (identifying and comparing potential ex ante preventative and ex post reactive approaches to regulating systemic risk).

36 *Cf.* John Armour, *Bank* Resolution Regimes: Designing the Right Model? (Aug. 3, 2010) (unpublished working paper) (on file with author) ("Resolution mechanisms must be seen as just one part of a larger regulatory toolkit, which contains a mix of *ex ante* measures as well as *ex post* resolution tools.").