A JUDICIAL RESPONSE TO THE SUBPRIME LENDING CRISIS

Robert A. Kubica[*]

I. Introduction

During 2008, the mortgage foreclosure rate in the United States increased by 81%.[1] The ripple effect from the subprime residential mortgage crisis has been felt from the largest investment banks[2] to the streets of every city or town. The fallout, however, was not limited to subprime residential mortgage providers and the individuals receiving subprime mortgages to buy or refinance their homes. In the wake of this crisis, the global economy has been reshaped leaving lawmakers and the courts with the task of restoring the residential lending market. Action is being taken at all levels and in some states – Massachusetts, for example – the judicial system has intervened to protect borrowers from losing their homes without a fair fight.

As foreclosure rates rise, the federal government and many states have acted to reduce the potential consequences that could stem from amplified foreclosure filings. Specifically, new legislation and recent judicial decisions may ease the burden on individuals who entered into subprime residential mortgages which were originated through predatory

*Mr. Kubica is an associate at Bingham McCutchen, LLP, where he practices in the areas of commercial real estate and corporate law. The author gratefully acknowledges the contributions of Jon Albano, Henry Healy and Richard Toelke, and the Northeastern University Law Journal for the opportunity afforded by the Shelter from the Storm Symposium. Thanks also to Hannah Burrows for testing these theories in real time.

1 Les Christie, *Foreclosures Up a Record 81% in 2008*, CNNMoney, Jan. 15, 2009, http://money.cnn.com/2009/01/15/real_estate/millions_in_foreclosure/index.htm at 2, (citing RealtyTrac, 2008 Year-End Foreclosure Market Report (2009), http://www. realtytrac.com/ContentManagement/Realty TracLibrary.aspx?channelid=8&ItemID=5814 (reporting that 861,664 families lost their homes in 2008)).

2 On September 21, 2008, Goldman Sachs and Morgan Stanley requested to change their entity structure from investment banks to bank holding companies effectively ending the investment bank era on Wall Street for the time being. *See generally* Andrew Ross Sokin & Vikas Bajaj, *Shift for Goldman and Morgan Marks the End of an Era*, N.Y. Times, Sept. 22, 2008, at A1.

lending practices or were "doomed to foreclosure" because of the terms of the loan documents.[3] For example, the United States Congress passed the Mortgage Forgiveness Debt Relief Act of 2007.[4] The Act allows a taxpayer to exclude from taxable income the income he or she is deemed to have received from forgiveness of mortgage debt on a principal residence resulting from a mortgage restructuring, as well as mortgage debt forgiven in connection with a foreclosure.[5] In the first quarter of 2009, California had the third highest rate of foreclosures per total households.[6] However the recently enacted California Foreclosure Prevention Act gives borrowers additional time to work out loan modifications and exempts mortgage loan servicers that have implemented a comprehensive loan modification program.[7] The California Foreclosure Prevention Act requires an additional ninety day period beyond the period already provided by California foreclosure law that will allow all parties to pursue a loan modification.[8]

---

3 Commonwealth v. Fremont Inv. & Loan, 897 N.E.2d 548, 554 (Mass. 2008) (noting that loans which contained certain characteristics were "'doomed to foreclosure' unless the borrower could refinance the loan at or near the end of the introductory rate period, and obtain in the process a new and low introductory rate." (omission without ellipsis in original) (quoting Commonwealth v. Fremont Investment & Loan, 23 Mass. L. Rptr. 567, 571 (Mass. Super. Ct. 2008))).

4 I.R.C. § 108 (2006).

5 *Id.* § 2 (attempting to encourage lenders and borrowers to restructure loans before foreclosure). The Mortgage Forgiveness Debt Relief Act also contains the following restrictions: (a) the amount of forgiven debt is limited to up to $2 million or $1 million for a married person filing a separate return; (b) the tax break only applied to mortgage debt discharged by a lender in 2007, 2008 and 2009; and (c) the loan must have been taken out to buy or build a primary residence. *Id.*

6 Louis Aguilar, *Michigan Foreclosure Rate is Nation's Sixth Highest*, The Detroit News, Apr. 16, 2009, at 1. The states with the highest foreclosures per total households in the first quarter of 2009 were the following: (1) Nevada; (2) Arizona; (3) California; (4) Florida; (5) Illinois; and (6) Michigan. Press Release, RealtyTrac, Foreclosure Activity Increases 9 Percent in First Quarter (Apr. 16, 2009), http://www.realtytrac.com/ContentManagement/PressRelease.aspx?ItemID=6180.

7 Cal. Civil Code § 2923.5 (West 2009). The California Foreclosure Protection Act went into effect on June 15, 2009.

8 Cal. Civil Code § 2923.52 (West 2009).

In *Commonwealth v. Fremont Investment & Loan*,[9] the Massachusetts Supreme Judicial Court barred a lender, Fremont Investment and Loan ("Fremont"), from foreclosing on 2,500 subprime loans without first obtaining a court order. In this December 2008 decision, the court upheld a preliminary injunction against Fremont holding that certain types of variable rate interest mortgage loans with "teaser" interest rates are "presumptively" illegal under the Massachusetts Unfair and Deceptive Practices Act.[10] The preliminary injunction restricted Fremont's ability to foreclose on loans that contained a combination of the following four characteristics:

- An adjustable rate mortgage with a "teaser" interest rate period of three years or less;
- A teaser rate at least 3% lower than the fully indexed rate;[11]
- A debt-to-income ratio of more than 50% indexed over the term of the loan; and
- A loan-to-value ratio of 100%, or a prepayment penalty that is either "substantial"[12] or extends beyond the introductory rate period.[13]

As a practical matter, requiring a court order to foreclose on certain types of loans should provide a lender with a powerful incentive to modify or rewrite a loan before initiating foreclosure proceedings. While it is too early to determine the implications of the *Fremont* decision, the court has sent a clear message to subprime mortgage lenders. The residential mortgage lending environment has changed and so too must

---

9 *Fremont*, 897 N.E.2d 548 (Mass. 2008).

10 *Id.* at 562. The court cited the Massachusetts Unfair and Deceptive Practices Act. Mass. Gen. Laws ch. 93A (2006).

11 *Id.* at 553, n.11 ("The 'fully indexed rate' refers to the interest rate that represents the London Interbank Offered Rate (LIBOR) rate at the time of the loan's inception plus the additional rate specified in the loan documents . . . .").

12 *Id.* at 554. The judge defined a "substantial prepayment penalty" as a penalty that was greater than the "conventional prepayment penalty" defined in section 2 of the Massachusetts Predatory Home Loan Practices Act. Mass. Gen. Laws ch. 183C, § 2 (2008). For a further explanation of a "conventional prepayment penalty," *see infra* note 69 and accompanying text.

13 For an analysis of the four characteristics the Massachusetts Supreme Judicial Court used in its analysis to restrict Fremont's ability to foreclose, *see infra* notes 69-79 and accompanying text.

residential lending practices. Nevertheless, with 3.1 million foreclosure filings in 2008, it remains clear that there is still a substantial amount of work and policy change needed to clean up the mess left in the wake of the subprime lending boom.[14]

The thesis of this paper is that the *Fremont* decision (and subsequent settlement) provides a reasonable solution to the current rise in foreclosures in Massachusetts. Part II reviews the many factors that contributed to the subprime mortgage crisis and follows the Fremont litigation over the three years leading up to the decision.[15] Part III analyzes the *Fremont* decision setting forth the Massachusetts Supreme Judicial Court's holding that certain residential mortgage loans are "presumptively" illegal under the Massachusetts Unfair and Deceptive Practices Act.[16] Part IV evaluates the practical effects of the *Fremont* decision and its potential to change the landscape of the future residential mortgage model.[17] Part V concludes that, although not ideal, judicial proceedings, such as the *Fremont* decision, provide the best solution for working through many of these subprime loans because the court can determine the applicable "unfairness" standard to be applied.[18]

II. Subprime Lending: The Calm Before the Storm

A. *A Brief Overview of Subprime Lending*

The practice of subprime lending is not a concept that is new to this decade. Subprime lending – providing high interest loans to individuals who would be considered too risky for conventional loans[19]

14 Christie, *supra* note 1.

15 For a discussion on the factors that led to the *Fremont* decision, see *infra* notes 19-68 and accompanying text.

16 For an analysis of the *Fremont* decision and the factors that were addressed by the court, *see infra* notes 69-104 and accompanying text.

17 For rationales on whether the *Fremont* decision will change the practice of marketing and providing subprime residential mortgages, *see infra* notes 105-126 and accompanying text.

18 For a summary of the potential role of the judicial system in the foreclosure process, *see infra* Section V.

19 John Atlas and Peter Dreier, *The Conservative Origins of the Sub-Prime Mortgage Crisis*, The American Prospect, Dec. 18, 2008, *available at* http://www.prospect.org/cs/articles?article=the _conservative_origins_of_the_subprime_mortgage_

– can be traced back as far as lending in general. Nevertheless, the initial groundwork of the current subprime lending market was laid in the early 1980s. In 1980, the federal government enacted new lending laws, which allowed lenders to charge high interest rates and fees, as well as provide loans with variable interest rates and balloon payments.[20] Under the new lending laws, lenders had a greater incentive to extend loans to borrowers that would otherwise be denied credit. More importantly, these new laws legalized the practice of charging high rates and fees to borrowers.[21]

Homeownership in the United States increased from 64% in 1994 to 69.2% in 2004.[22] From 1997 to 2005, the value of residential real property increased by 124%.[23] Fueling this increase in property values was the availability of credit to subprime mortgage borrowers. It was at this time that a specialized type of mortgage lender emerged as a leading player in the residential mortgage market. These lenders, which are not regulated as traditional banks,[24] marketed higher risk loan options, such as adjustable rate mortgages, interest only mortgages, and "stated income" loans.[25] These lenders were able to produce a high volume of these types of loans because the mortgages could be subsequently bundled and sold

---

crisis.

20 *See generally* Depository Institutions Deregulation and Monetary Control Act of 1980, 12 U.S.C. §§3501-3509 (1982) (expired 1986); Alternative Mortgage Transaction Parity Act of 1982, 12 U.S.C. § 3801-3805 (2006); 12 U.S.C. §226 (2000).

21 Souphala Chomsisengphet & Anthony Pennington-Cross, *The Evolution of the Subprime Mortgage Market*, 88 Fed. Res. Bank of St. Louis Rev., 31, 38 (2006), *available at* http://research.stlouisfed.org/publications/review/06/01/ChomPennCross.pdf (explaining that the combination of the lending laws and the Tax Reform Act allowed homeowners to access the value of their homes through a cash-out refinancing when interest rates were low); *see also generally* Richard Bitner, Confessions of a Subprime Lender: An Insider's Tale of Greed, Fraud, and Ignorance (2008).

22 Katalina M. Bianco, J.D., *The Subprime Lending Crisis: Causes and Effects of the Mortgage Meltdown*, Fed. Banking L. Rep. (CCH), Mortgage Comp. Guide and Bank Dig. (CCH), at 6 (2008), *available at* http://business.cch.com/bankingfinance/focus/news/Subprime_WP_rev.pdf.

23 *Id.* (explaining the housing demand fueled the rise in housing prices and consumer spending).

24 *Id.* at 7 (noting that traditional lenders held 60% of the mortgage market in the mid-1970s as compared to today where such lenders hold about 10%).

25 *Id.* Stated income loans are also called "no doc" or "liar" loans.

as securities in the secondary market.[26]

The creation of a secondary market for subprime loans provided subprime mortgage lenders with an incentive to generate subprime loans in bulk, not loans that were necessarily going to be successful.[27] Subprime mortgage lenders were rewarded for the number of mortgages generated, not the number of "good" mortgages generated. This led to lax lending standards.[28] Profits were often based on the sheer volume of mortgages the lender could originate. Some commentators have noted that these mortgage lenders essentially became originating and servicing businesses.[29] In order to entice borrowers to accept a new loan or refinance an existing loan, many mortgage lenders created products with special rates, such as adjustable rate loans and interest only loans.[30] An adjustable rate mortgage loan is a loan that has an interest rate on the note that can be adjusted periodically based on a published index.[31] Adjustable rate loans would contain low interest rates, many times as low as 4%, for an introductory period (two to three years), after which the interest rate increased significantly.

In 2007, global financial markets began to stumble. The housing bubble was beginning to burst. There was a rapid decrease in home values, which left many homeowners with mortgage debt higher than the value of their homes.[32] As housing prices began to fall, borrowers had less ability

---

26 *See* Posting of Abraham Park to Graziado Business Report Blog, *Why Did Subprime Loans Become Such a Big Deal*, http://gbr.pepperdine.edu/blog/index.php/2008/05/05/29 (May 5, 2008) (explaining that the government enabled agencies like Ginnie Mae, Fannie Mae, and Freddie Mac to buy mortgages in the secondary market which in turn provided the lenders with additional funds to sell more loans).

27 It is important to note that there has been a secondary market for "conforming" loans for fifty or more years. It is only in the past ten to fifteen years that a secondary market has emerged for subprime loans.

28 Vikas Bajaj, *Lax Lending Standards Led to IndyMac's Downfall*, N.Y. Times, July 29, 2008, at A1 (describing lending practices of IndyMac, a mortgage company which was seized by the government on July 11, 2008). *See also* Park, *supra* note 26.

29 Park, *supra* note 26.

30 An "interest only" loan is a loan in which the borrower is allowed to only pay interest on the loan. The option to pay interest only generally lasts for a specified period, usually 5 to 10 years.

31 John P. Wiedemer, Real Estate Finance 99-105 (8th ed. 2001)

32 Bianco, *supra* note 22 at 3.

to refinance their mortgage loans.[33] This created a particular problem with adjustable rate loans and interest only loans. As home values began to drop, many borrowers were left with little chance to refinance because the value of their home was no longer worth the value of the loan. Given that many of these adjustable rate mortgages were originated between 2004 and 2006, the rate was primed to "adjust" at the impending end of the introductory term.[34] The Massachusetts Supreme Judicial Court faced this particular situation in *Fremont*. While this article only provides a very basic overview of the subprime lending environment over the past several years, a broader outline of subprime lending and securitization is better served by many of the scholarly publications that have originated in the past years.[35]

B. *The Rise of Fremont*

Fremont, a California industrial bank, originated 14,578 loans to Massachusetts's residents between January 2004 and March 2007.[36] Roughly 50% to 60% of Fremont's loans were considered subprime based on the fact that 64% of Fremont's loans were adjustable rate mortgage loans and 38.4% were "stated income" loans.[37] After originating the loans, Fremont subsequently sold these loans into the secondary market.[38] As explained above, the secondary market for these residential mortgages acted to bundle and sell these mortgage loans as securities with the mortgage debt as collateral.[39] Lenders, such as Fremont, could sell these securities on the secondary market. Under the terms of sale, the originating lender's responsibility for problems with the loans was usually

33 *Id.* at 10.

34 *Id.* at 15.

35 *Id.* at 1; *see also* Chomsisengphet & Pennington-Cross, *supra* note 21, at 31; Park, *supra* note 26.

36 Commonwealth v. Fremont Inv. & Loan*,* 897 N.E.2d 548, 551 (Mass. 2008).

37 *Id.* at 552 nn.6-7. The judge made this estimate based on the inference that all of the stated income loans were subprime adjustable rate mortgage loans, and a majority of the remaining adjustable rate mortgage loans were also subprime. A "stated income loan" is a loan in which the borrower provides no documentation of his or her income. *Id.* at n. 7.

38 *Id.* at 552.

39 For a more detailed description of the mortgage backed security market, *see generally* Bianco, *supra* note 22.

very limited, giving these lenders the ability to replenish their funds in order to originate and fund more mortgage loans. Moreover, Fremont generally would not deal with the borrowers directly.[40] Instead, mortgage brokers would find the borrowers, assist the borrowers in selecting one of Fremont's mortgage products and submit the borrower's loan application and credit report to Fremont for approval by Fremont's underwriting department.[41]

Mortgage lenders who sold and securitized these loans had a strong financial incentive to originate as many of these mortgages as possible. This was called the "originate-to-distribute" model.[42] By shifting the risk of default of the mortgages to the secondary market, ensuring that each borrower qualified to pay the loan became less important.[43] As long as housing prices continued to increase – as they had done for the past twenty years between 1986 and 2006[44] – this business was profitable for all parties involved. Moreover, the fees and returns for "risk-based" loan products were better than "conforming"[45] loans, rewarding all stakeholders, including the originators, brokers, servicers, mortgage bankers, investment firms, and investors. It was a successful strategy so long as housing prices did not drop.

In order to generate additional residential mortgage borrowers, Fremont created subprime loan products structured to attract low-income

---

40 *Fremont*, 897 N.E.2d at 552.

41 *Id.*

42 *See* Thomas Simpson, *Massachusetts Supreme Court Puts the Brakes on Subprime Foreclosures by Invoking the State's Unfair and Deceptive Practices Law*, Clarks' Secured Transactions Monthly, Dec. 2008, at 2 (explaining the process of selling mortgage loans to a third party that would package the loans into "mortgage-backed" securities and other forms of collateralized debt obligations).

43 Fremont General Corp., Annual Report (Form 10-K) 6 (2006), *available at* http://www.sec.gov/Archives/edgar/data/38984/0000950129-06-002726-index.idea.htm (supporting comment that Fremont did not share in the risk of loan default for the loans which they originated and distributed to the secondary mortgage market).

44 Christie, *supra* note 1.

45 Wiedemer, *supra* note 31, at 44, 78-86 (explaining that a "conforming loan" is a mortgage loan that conforms to the GSE guidelines for purchase by government sponsored enterprise (GSE)). The Federal Home Loan Mortgage Corporation ("FHLMC") known as "Freddie Mac" is a GSE created in 1970 to expand the secondary market for mortgages in the United States. GSEs are only allowed to buy conforming loans.

borrowers.[46] Fremont would offer adjustable rate mortgages, which featured a fixed interest rate for the first two or three years, then, after the introductory period, the interest rate would adjust every six months to a substantially higher variable rate for the remainder of the loan.[47] In order to determine whether a borrower qualified for one of these loans, Fremont would require that the borrower have a debt-to-income ratio of 50% or less. A borrower's debt-to-income ratio is the percentage of a consumer's monthly gross income that goes toward paying debts.[48] Fremont, however, would calculate a borrower's debt-to-income ratio on the introductory "teaser rate" mortgage payments, as opposed to the "fully indexed" interest rate of the loan resulting from the adjustment that takes place at the end of the "teaser rate" period.[49] When the loan rate jumped to the fully indexed interest rate, the borrower's debt-to-income ratio also increased.[50] As a final feature, Fremont would offer subprime mortgages with no money down.[51] Instead, Fremont financed the full value of the property resulting in a typical "loan-to-value ratio" of 100% at the time the mortgage was created.[52]

Borrowers were not always completely innocent parties in these situations. Some borrowers understood that they were taking significant risks that could have only been successful in a market with rising housing prices and the ability to refinance as needed.[53] Also, as reported

46 Commonwealth v. Fremont Inv. & Loan*,* 897 N.E.2d 548, 552 (Mass. 2008).

47 *Id.* at 553, n.10 (explaining that the variable rate would be based on the six month London Interbank Offered Rate ("LIBOR"), a market interest rate, plus a fixed margin to reflect the risk of the subprime loan). These adjustable rate mortgages were generally for a period of thirty years. *Id.* at 552, n.10.

48 For example, if a borrower earned $2,000 per month and a mortgage payment of $500, taxes of $300 and insurance expenses of $200, the borrower's debt-to-income ratio is 50%.

49 *Fremont,* 897 N.E.2d at 552. Using the example from note 51, when the interest rate increased after the second or third year, so to would the borrower's monthly mortgage payment which would negatively affect the borrower's debt-to-income ratio.

50 *Id.*

51 *Id.*

52 *Id.* at 553. The loan-to-value ratio is calculated as a percentage of the first mortgage lien over the total appraised value of the property. For example, if a borrower receives $200,000 to purchase a house worth $250,000, the loan-to-value ratio is $200,000/$250,000 or 80%.

53 Eric S. Rosengren, President & CEO, Fed. Res. Bank of Boston, Subprime

by BasePoint Analytics,[54] as much as 70% of early payment defaults resulted from borrower's fraudulently misrepresenting information on their loan applications.[55] Nevertheless, in some cases subprime lenders appear to have chosen to ignore or perhaps overlook obvious borrower misrepresentations. Predatory lending appears to have been prevalent in the refinancing market.[56] A cash-out refinancing is the process of taking out a new mortgage loan on the property in an amount that exceeds the existing balance on the current mortgage loan in order to refinance the original mortgage loan and receive additional cash.[57] As a result, cash-out refinancing became a viable mechanism for homeowners to access cash based on the value of their homes. Slightly over 50% of subprime loan originations were related to cash-out refinancing.[58] This allowed borrowers to access the value of their homes on the day of the refinancing. This cash could, in turn, be used to pay for home restorations, a car, a college education, and so on. All of these factors contributed to the stress and unpredictability of the residential lending market, a market that proved to be very unstable.

Unfortunately, instead of home values continuing to increase, the housing bubble burst. The economy began to take a turn for the worse and unemployment rates started to grow. As these events occurred many borrowers, who had borrowed with the assumptions that housing values would only rise and refinancing would be available before the end of the

---

Mortgage Problems: Research, Opportunities, and Policy Considerations (Dec. 3, 2007) (*available at* http://www.bos.frb.org/news/speeches/rosengren /2007/120307.htm).

54 BasePointAnalytics.com, Company Overview, http://www.basepointanalytics. com /companyoverview.shtml (last visited Aug. 4, 2009) (noting Base Point Analytics is a provider of predictive analytic fraud and risk management solutions for the global banking industries).

55 Bianco, *supra* note 22 at 10 (George Mason University economics professor Tyler Cowen said: "There has been plenty of talk about predatory lending, but predatory borrowing may have been a bigger problem.").

56 *What is Predatory Lending*, MortgageNewsDaily.com, http://www.mortgage newsdaily.com/mortgage_fraud/Predatory_Lending.asp (last visited Oct. 18, 2009) (examples of predatory lending in the refinancing market include using inflated and incorrect valuations for the refinancing, charging excessive fees, and providing unnecessary products or insurance).

57 Chomsisengphet & Pennington-Cross, *supra* note 21, at 38.

58 *Id.* (noting that cash-out refinancing was a much more attractive, and available, option when there were low and declining interest rates).

two to three year introductory rate period, began to default. When the Massachusetts Attorney General brought suit against Fremont in 2007, the value of the securities tied to subprime loans had dropped significantly and default was imminent for many borrowers.[59]

C. *Warnings of Clouds in the Distance*

Warnings of a possible price decline in the housing market were first provided in the late 1990s; however, many subprime lenders did not adjust their practices based on these warnings. Although many of these subprime loans were in compliance with banking-specific laws and regulations, state and federal regulatory guidance warned lenders operating in the subprime lending market that their practices could be considered unfair and deceptive.[60] In January 2001, interagency federal guidance published jointly by the Office of the Comptroller of Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation ("FDIC"), and the Office of Thrift Supervision stated, "Loans to borrowers who do not demonstrate the capacity to repay the loan, as structured, from sources other than the collateral pledged are generally considered unsafe and unsound."[61]

---

59 Commonwealth v. Fremont Inv. & Loan*,* 897 N.E.2d 548, 553 n.13 (Mass 2008). At the time the suit was initiated, Fremont indicated that it intended to foreclose on at least 20% of its loans.

60 Thomas Curry, Comm'r. of Banks, Office of Consumer Affairs and Banking Regulation, Div. of Banks, Subprime Lending (Dec. 10, 1997), http://www.mass.gov/?pageID=ocaterminal&L=4&L0=Home&L1=Business&L2=Banking+Industry+Services&L3=Industry+Letters&sid=Eoca&b=terminalcontent&f=dob_subprime&csid=Eoca [hereinafter Subprime Lending] (explaining that banks' policies could be considered unfair and deceptive practices under Mass. Gen. Laws. ch. 93A even though the loans are in compliance with banking laws and regulations); *see also generally,* Interagency Memorandum from Office of the Comptroller of the Currency, et. al., Interagency Guidance on High LTV Residential Real Estate Lending, (Oct. 8, 1999); Memorandum from Richard M. Riccobono, Deputy Dir., Office of Thrift Supervision, Dep't of the Treasury, to C.E.O.'s (Feb. 2, 2001), http://files.ots.treas.gov/ 25137.pdf [hereinafter Riccobono]; Interagency Memorandum from Office of the Comptroller of the Currency, et. al., Credit Risk Management Guidance For Home Equity Lending (May 16, 2005) [hereinafter Credit Risk Management].

61 Riccobono, *supra* note 60, at 11 (stating that subprime lending, when executed correctly, is a sound and profitable business, even though it is generally

Additionally, government agencies warned that subprime lenders were basing loans on the "foreclosure value of the collateral, rather than on the determination that the borrower has the capacity to make the scheduled payments under the terms of the loan . . . ."[62] Through 2006, Fremont continued to offer adjustable rate mortgages with "teaser" introductory interest rate periods.[63] In early 2007, the FDIC brought charges against Fremont for "unsafe and unsound" banking practices related to its subprime lending business.[64] These charges led Fremont to enter into a consent agreement with the FDIC on March 7, 2007, effectively providing that Fremont would "cease and desist" from originating adjustable rate mortgage products that the FDIC had deemed to be unsafe and unsound.[65]

Fremont's next assault came from the Massachusetts Attorney General. On July 10, 2007, Fremont entered into a letter agreement with the Massachusetts Attorney General providing that Fremont would give the Attorney General ninety days' notice before foreclosing on any Massachusetts residential mortgage loan.[66] If the Attorney General objected to the foreclosure, Fremont would agree to negotiate in good faith to resolve the objection. In the event the parties did not resolve the objection, the Attorney General would be provided an additional fifteen days to decide whether to seek an injunction.[67]

In theory, the letter agreement provided the opportunity for Fremont and the Attorney General to work out any potential issues before a foreclosure or judicial proceeding requesting an injunction. In practice, however, the agreement did not operate as either party expected. The Attorney General objected to every proposed foreclosure of a home

---

associated with higher risk levels).

62 Office of the Comptroller of Currency, Advisory Letter, Guidelines for National Banks to Guard Against Predatory and Abusive Lending Practices, AL 2003-2 at 2 (Feb. 21, 2003).

63 *Fremont*, 897 N.E.2d at 551-52.

64 *Id.* at 553.

65 *Id.* (noting that in entering into the consent agreement, Fremont did not admit to any wrongdoing).

66 Simpson, *supra* at note 42, at 2 (providing background to Fremont's dealings with the FDIC and the Massachusetts Attorney General).

67 *Fremont*, 897 N.E.2d at 553 (acknowledging that the negotiation period would provide sufficient time for Fremont and the Attorney General to possibly modify the loan).

that was owner-occupied as it was her understanding that Fremont would negotiate loan modifications and refinancing proposals for most of the loans.[68] Concluding that the two sides would not be able to negotiate loan modifications, the Massachusetts Attorney General filed a motion for preliminary injunction prohibiting Fremont from foreclosing on owner-occupied properties without first obtaining court approval.[69] Fremont subsequently terminated the letter agreement in December 2007, explaining that the Massachusetts Attorney General had "no intention of engaging in a meaningful review process on a borrower-by-borrower basis."[70]

III. A Unique Approach: Subprime Lending and Unfair or Deceptive Business Practices Law

A. *Loans That Are "Doomed for Foreclosure"*

Chapter 93A of the Massachusetts General Laws declares that, "unfair methods of competition and unfair or deceptive acts or practices in the conduct of any trade or commerce" are unlawful.[71] The Attorney General may bring an action in the name of the Commonwealth against any person that he or she has reason to believe is using a method, act, or practice that is unfair or deceptive provided the proceedings are in the public interest.[72] In *Fremont*, Massachusetts Attorney General, Martha Coakley, sued Fremont in the name of the Commonwealth, claiming that Fremont had "violated G. L. c. 93A in originating and servicing certain 'subprime' mortgage loans."[73]

---

68 Simpson, *supra* at note 42, at 2 (explaining that the Massachusetts Attorney General expected Fremont would deliver proposals with "significant concessions for borrowers, only foreclosing on loans where there was no other option).

69 *Fremont,* 897 N.E.2d at 553. The Massachusetts Attorney General filed a motion for injunctive relief on October 4, 2007.

70 *Id.* (noting in the same letter that Fremont stated that it would continue to seek to avoid foreclosure and provide the Attorney General with loan files prior to foreclosure).

71 Mass. Gen. Laws ch. 93A, § 2 (2006) (allowing the attorney general to "make rules and regulations interpreting the provisions of subsection 2(a) of [Chapter 93A]").

72 *Id.* § 4.

73 *Fremont*, 897 N.E.2d at 550-51 (outlining the purpose of the Attorney General's

The trial judge determined that the Commonwealth was likely to prevail on the merits of its claim and, therefore, granted a preliminary injunction restricting Fremont's ability to foreclose on loans with features that were "presumptively unfair." In it's finding, the trial court determined that loans were "presumptively unfair" if they contained (1) an adjustable rate mortgage with a "teaser" interest rate period of three years or less; (2) a teaser rate at least 3% lower than the fully indexed rate; (3) a debt-to-income ratio of more than 50% indexed over the term of the loan; and (4) a loan-to-value ratio of 100%, or a prepayment penalty that is either "substantial"[74] or extends beyond the introductory rate period.[75] Provided that the loan contained the four characteristics, the trial court determined that in originating these residential mortgage loans, the borrower would almost certainly not be able to make the mortgage payments, therefore leading to a default under the loan and subsequent foreclosure.[76]

The trial court judge went on to explain that loans that contained this package of four characteristics were "doomed to foreclosure." The court noted:

> Given the fluctuations in the housing market and the inherent uncertainties as to how that market will fluctuate over time . . . it is unfair for a lender to issue a home mortgage loan secured by the borrower's principal dwelling that the lender reasonably expects will fall into default once the introductory period ends unless the fair market value of the home has increased at the close of the introductory period. To issue a home mortgage loan whose success relies on the hope that the fair market value of the home will increase during the introductory period is as unfair as issuing a home mortgage loan whose

---

Chapter 93A claim).

74 *Id.* at 554. Under section 2 of the Massachusetts Predatory Home Loan Practices Act, a "conventional prepayment penalty" is "any prepayment penalty or fee that may be collected or charged in a home loan, and that is authorized by law other than this chapter, provided the home loan (1) does not have an annual percentage rate that exceeds the conventional mortgage rate by more than 2 percentage points; and (2) does not permit any prepayment fees or penalties that exceed 2 per cent of the amount prepaid." Mass. Gen. Laws ch. 183C, § 2 (2008).

75 *Id.*

76 *Id.* at 550.

> success depends on the hope that the borrower's income will increase during that same period.[77]

Fremont appealed, and the Massachusetts Supreme Judicial Court granted the Commonwealth's application for direct appellate review.[78] The Massachusetts Supreme Judicial Court affirmed the lower court ruling granting the preliminary injunction against Fremont, essentially requiring the lender to obtain a court order to foreclose on any owner-occupied property.[79]

It is notable that the injunction does not relieve borrowers of the obligation to repay their loans.[80] The injunctive order requires Fremont to take the following steps before foreclosing on any property in Massachusetts:

- Provide advance notice to the Attorney General of its intent to foreclose on any of its home mortgage loans;
- As to loans that possess each of the four characteristics of unfair loans described above and that are secured by the borrower's principal dwelling, Fremont is to work with the Attorney General to resolve any differences regarding the foreclosure, presumably through a restructure or work-out of the loan; and

---

77 *Id.* (omission in original) (quoting Commonwealth v. Fremont Inv. & Loan, 23 Mass. L. Rptr. 567, 574 (Mass. Super. Ct. 2008)) (finding a preliminary injunction would serve the public interest when taking into account the balance of harms in granting such injunction).

78 *Id.* at 551. The Fremont decision notes that the Supreme Judicial Court solicited amicus briefs shortly after granting direct appellate review and received amicus briefs filed on behalf of Fremont by New England Legal Foundation and Associated Industries of Massachusetts; the American Securitization Forum and the Securities Industry and Financial Markets Association; and the American Financial Services Association, the Consumer Mortgage Coalition, the Housing Policy Council of the Financial Services Roundtable, and the Mortgage Bankers Association; and on behalf of the Commonwealth by WilmerHale Legal Services Center of Harvard Law School; and National Consumer Law Center, Center for Responsible Lending, AARP, National Association of Consumer Advocates, and National Association of Consumer Bankruptcy Attorneys. *Id.* at n.4.

79 *Id.* at 562 (noting that the case is remanded to the Massachusetts Superior Court for further proceedings).

80 Simpson, *supra* note 42, at 3.

- If the loan cannot be worked out, Fremont is required to obtain approval for foreclosure from the court.[81]

B. *Fremont's Side of the Story*

The Massachusetts Supreme Judicial Court rejected Fremont's two main arguments in concluding that the Attorney General was likely to prevail on the merits of her Chapter 93A claim. First, the court determined that Fremont's loans were not exempt from Chapter 93A because the loans were permitted under federal and Massachusetts laws at the time the loans were originated.[82] Fremont argued that retroactively applying a new standard for whether a loan was "fair" at the time of its origination would represent "bad policy" because it could potentially cause lenders to be more hesitant to lend to subprime borrowers. This, in turn, would hurt Massachusetts's consumers because fewer lenders would be willing to extend credit.[83]

Fremont argued that "the loans were underwritten in the expectation, reasonable at the time, that housing prices would improve during the introductory loan term, and thus could be refinanced before the higher payments [began]."[84] The court pointed out that Fremont had been warned by the Massachusetts Division of Consumer Affairs and Business Regulation that these loans were unfair to the borrower in that they were structured on the basis of unsupportable optimism about future economic conditions.[85] In hindsight, it seems obvious that housing prices

81 *Fremont*, 897 N.E.2d at 555 (explaining that in no way did the injunction relieve borrowers of their obligation ultimately to prove that a particular loan was unfair and foreclosure should not be permitted).

82 *Id.* at 555-56 (arguing that, while the terms of its subprime loans may seem arguably "unfair," they did not violate the applicable mortgage lending industry standards at the time they were originated).

83 *Id.* (summarizing Fremont's argument regarding retroactively applying a new definition for "fairness").

84 *Id.* at 558 (summarizing Fremont's argument that borrowers would be able to refinance before the loan payments increased after the two to three year grace period).

85 Subprime Lending, *supra* note 60 ("[M]ost subprime loans have been originated during robust economic conditions and have not been tested by a downturn in the economy. Management must ensure that the institution has adequate financial operations strength to address these concerns effectively."). *See also*

could not continue to rise indefinitely. If housing prices did not continue to increase, many borrowers would not be able to refinance before the two to three year introductory period concluded.

Similarly, in an amicus brief, the New England Legal Foundation argued that retroactively applying the concepts of unfairness in consumer protection was inconsistent with the fundamental common law principle that conduct must be judged by the standards in place when it occurred and would impermissibly deprive businesses of certainty and predictability with respect to the conduct proscribed by Chapter 93A.[86] Nevertheless, the court further noted that Fremont's consent agreement with the FDIC on March 7, 2007, which ordered Fremont to "cease and desist" from making loans with the four troublesome characteristics, supported the Massachusetts Attorney General's argument that Fremont violated established concepts of unfairness.[87] Under Chapter 93A case law, in order to overturn the trial court's decision, Fremont was required to demonstrate that the regulatory scheme at the time affirmatively permitted the practice that was alleged to be unfair.[88] However, Fremont did not meet this burden as it was unable to prove that loans combining these four features were affirmatively permitted at the time of their origination.[89]

Second, the Supreme Judicial Court determined that the trial judge properly applied the provisions of the Massachusetts Predatory Home Loan Practices Act[90] to the Fremont loans even though the loans are not

---

Credit Risk Management, *supra* note 60 (noting management for financial institutions should "actively assess a portfolio's vulnerability to changes in consumers' ability to pay and the potential for declines in home values").

86 *See* Brief for Fremont Investment & Loan as Amici Curiae Supporting Defendant, Commonwealth of Massachusetts. v. Fremont Inv. & Loan, 897 N.E.2d 548 (Mass. 2008).

87 *Fremont*, 897 N.E.2d at 559 ("[T]he fact that the FDIC ordered Fremont to cease and desist from the use of almost precisely the loan features that are included in the judge's list of presumptively unfair characteristics indicates that the FDIC considered that under established mortgage lending standards, the marketing of loans with these features constitute unsafe and unsound banking practice . . . .").

88 *Id.* at 559-60 (detailing Chapter 93A case law on the issue of whether a Chapter 93A claim is barred because Fremont's actions were permitted by law as it existed at the time of origination).

89 *Id*. at 561.

90 Mass. Gen. Laws ch. 183C (2008).

subject to the Act. The Massachusetts Predatory Home Loan Practices Act prohibits a lender from making a "high-cost" home mortgage loan unless the lender reasonably believes the borrower will be able to make the scheduled payment.[91] The applicable section of the Act states that the borrower is presumed to be able to repay the loan so long as his or her debt-to-income ratio, calculated based on the fully indexed rate associated with the adjustable rate mortgage loan does not exceed 50%.[92] The court agreed that Fremont's mortgage loans were not high-cost mortgage loans as governed by the Massachusetts Predatory Home Loan Practices Act.[93] Nevertheless, the court determined that the conduct the Massachusetts Predatory Home Loan Practices Act prohibits is similar to the unfairness the judge found in Fremont's lending practices.[94] Therefore, even though the plain language of the statute did not apply, the principles of fairness expressed in the statute supported the court's finding that the loans were presumptively unfair and therefore illegal under Chapter 93A.[95]

Interestingly, although the court found that there was no evidence that Fremont encouraged borrowers to misstate their income to qualify for a loan, in October 2007, Morgan Stanley Mortgage Capital Holdings LLC accused Fremont of breaching agreements over residential mortgages.[96] In the suit, Morgan Stanley claimed that some of the Fremont loans misrepresented the income, assets, or employment of the borrower in the loan documents. Morgan Stanley went on to note

91 *Id.* § 4; *see also Fremont*, 897 N.E.2d at 559.

92 For a further explanation of a debt-to-income ratio, *see supra* note 49 and accompanying text.

93 *Fremont*, 897 N.E.2d at 560 (noting that Fremont's loans did not qualify as "high cost home mortgage loan" as defined by G.L. c. 183C, § 2, because a "high cost home mortgage loan" is a loan securing the borrower's principal dwelling and that either exceeds by more than eight percentage points (for a first mortgage) the yield on Treasury securities with a comparable maturity period, or features total points and fees the greater of 5% of the total loan or $400).

94 *Id.* The judge determined that Fremont should have recognized at the outset the borrower was not likely to be able to repay the loan.

95 Simpson, *supra* note 42, at 4 (discussing that the banking industry will take strong exception to the reasoning used by the court).

96 Christie Smythe, *Bankrupt Lender Fremont Settles with Mass., Calif.*, Law360, Apr. 21, 2009, http://bankruptcy.law360.com/articles/97719 (detailing that Morgan Stanley Mortgage Capital Holdings LLC sued Fremont for $10 million).

that many of the loans were made without satisfying the requisite credit score standards.[97] It remains a point of contention whether Fremont, and many subprime lenders in general, misrepresented vital loan information of subprime borrowers in originating many of these loans.

C. *The Settlement: Commonwealth v. Fremont*

The Massachusetts Attorney General and Fremont settled the Chapter 93A suit on April 17, 2009. As part of the settlement, Fremont agreed to pay as much as ten million dollars in damages.[98] Additionally, Fremont agreed to submit to a permanent injunction barring the lender from foreclosing on Massachusetts properties without first notifying the state Attorney General's office.[99] In order to initiate or advance a foreclosure on a mortgage loan in Massachusetts that was deemed to be "presumptively unfair" by the Supreme Judicial Court, Fremont must give the Attorney General forty-five days advance written notice of the proposed foreclosure.[100] This notice must identify the reasons why foreclosure is reasonable under the circumstances.[101] In the fifteen days following the notice, the Attorney General has the right to object to the foreclosure. In the event the Attorney General objects, the Attorney General and Fremont must reasonably attempt to resolve their differences

97 *Id.* (arguing that Fremont did not attempt to obtain the proper credit history information for many borrowers).

98 *Id.* The article also notes that Fremont settled with the State of California insurance commissioner over claims of improper insurance transactions. Fremont agreed to pay the California insurance regulator $5 million in cash and to provide $4.1 million from the proceeds of sales of certain company-owned artwork. *Id.*

99 *See id.* Additionally, Fremont is barred from marketing or extending adjustable rate mortgage products to subprime borrowers in an unsafe and unsound manner.

100 *Final Judgment by Consent, Commonwealth of Massachusetts v. Fremont Inv. & Loan and Fremont General Corporation*, Civil Action No. 07-4373-BLS1 (Mass. Dist. Ct. June 9, 2009) (also providing that Fremont may not sell, transfer, or assign any mortgage loan originated by Fremont that is secured by any residential property in Massachusetts or the legal obligation to service any mortgage loan originated by Fremont that is secured by any residential property in Massachusetts, unless Fremont first gives the Attorney General notice of such assignment at least five (5) days before such assignment). *See id.*

101 *Id.*

regarding the foreclosure. If the differences are not resolved, Fremont may proceed with the foreclosure only with the prior approval of the Massachusetts Superior Court.[102]

Nevertheless, the Fremont decision, arguably the first of its kind, may be remembered more for the subsequent effect of the ruling as opposed to the ruling itself. On May 7, 2009, the Commonwealth of Massachusetts and Goldman Sachs & Company ("Goldman")[103] entered into a settlement agreement regarding certain subprime mortgages originated in Massachusetts.[104] The Massachusetts Attorney General commenced an investigation of Goldman's practices of backing subprime mortgage lenders. For instance, Security and Exchange Commission filings show Fremont maintained a line of credit of at least $500 million with Goldman. In connection with the settlement agreement, Goldman agreed to resolve any potential claims stemming from the Massachusetts Attorney General's investigation by providing loan restructuring valued at approximately fifty million dollars to Massachusetts subprime borrowers.[105] Additionally, Goldman agreed to pay the Commonwealth of Massachusetts ten million dollars. Under the settlement agreement, Goldman agreed to write-down principal to allow approximately 700

---

102 *Id.* (explaining it will be the Superior Court's determination whether the loan is (a) actually unfair and secured by the borrower's primary residence that is both inhabited and inhabitable, (b) whether Fremont has taken reasonable steps to "work-out" the loan and avoid foreclosure, and (c) whether there is any fair or reasonable alternative to foreclosure).

103 The settlement agreement covered Goldman Sachs and Company on behalf of itself and its affiliates Goldman Sachs Mortgage Company and GS Mortgage Securities Corp.

104 Press Release, Office of the Attorney General of the Commonwealth of Massachusetts (May 11, 2009) (on file with author). The agreement stated that the Massachusetts Attorney General's investigation concerned:

> (1) Whether securitizers may have facilitated the origination of "unfair loans" under Massachusetts law;
> (2) Whether securitizers may failed to ascertain whether the loans purchased from originators complied with the originators' stated underwriting guidelines;
> (3) Whether securitizers may failed to take sufficient steps to avoid placing problem loans in securitization pools; and
> (4) Whether securitizers may have been aware of allegedly unfair or problem loans.

105 *Id.*

Massachusetts homeowners to refinance or sell their homes.[106]

The Goldman settlement adds a new layer to this situation. While the Massachusetts Supreme Judicial Court determined that Fremont was at fault for originating loans that were "presumptively unfair," the Goldman settlement extends past the originators to the underwriters of these subprime mortgage loans. Effectively, the Goldman settlement has indicated that securitizers may be held accountable for purchasing subprime loans from originators such as Fremont without ensuring that the loans that they were buying for securitization were sound. Extending accountability could very well lead to additional trouble for banks that backed subprime mortgage lenders.

IV. The Practical Effects and Ramifications of *Fremont*

As a legal matter, the *Fremont* decision froze the foreclosure proceedings for 2,500 Fremont originated loans in Massachusetts. As a practical matter, *Fremont* could potentially reshape the foreclosure process and open the door to additional unfair or deceptive business practices actions brought against other subprime mortgage providers in Massachusetts and in other states with similar legislation. In turn, subprime mortgage lenders may have an added incentive to modify or rewrite loans that contain the four troublesome characteristics because of the potential that the loans will be frozen in the foreclosure process.[107]

A. *The Issues Stemming from the Originate-to-Distribute Model*

In order to create a solution for handling the fallout from the subprime mortgage crisis, it is important to determine the relevant parties. While Fremont originated nearly 15,000 mortgage loans in Massachusetts between January 2004 and March 2007, the Chapter 93A suit involved only 2,500 subprime loans that Fremont continued to own

---

106 *Id.* (noting that Goldman agreed to reduce principal of first mortgages by up to 25-35% and second mortgages by 50% or more).

107 Commonwealth v. Fremont Inv. & Loan, 897 N.E.2d 548, 552 (Mass. 2008) (the "preliminary injunction granted . . . restricts, but does not remove, Fremont's ability to foreclose on loans with features that [are] 'presumptively unfair.'").

or service.[108] As of July 2007, Fremont owned and serviced approximately 290 loans in Massachusetts and serviced, but no longer owned, 2,200 other Massachusetts loans.[109] Similar to other lenders that generated a large number of subprime mortgage loans in the early-to-middle part of the decade, Fremont no longer held or serviced many of the mortgages that it originated.

A frequently suggested solution to an impending mortgage default is to modify or rewrite the loan. In order to do this, the borrower must first determine the current holder and servicer of the loan. The growth of the subprime lending market was fueled by the availability of the secondary market.[110] Financial institutions and mortgage brokers, such as Fremont, were less concerned with the financial condition of the borrower because the risk of default was outsourced to the secondary market.[111] After many of these loans were generated and sold, the servicing of the mortgages were assigned to servicing companies, which collected the mortgage payments.

Generally, the servicer is the primary contact for borrowers who are behind in loan payments. Servicers, however, are bound by an agreement with the trustee bank which sets forth the responsibilities of the servicer and controls what a servicer can do to assist borrowers who are behind in their payments. The agreements governing the servicer's actions often limit the servicer's ability to modify existing loans in a mortgage pool. Therefore, at the outset, it is often difficult for borrowers to find a party with the authority to make substantive modifications to their mortgage. Further, in Massachusetts, eight out of the ten largest subprime loan originators are no longer lending.[112] Fremont, for example, stopped

---

108 *Id.* (outlining the process for a subprime mortgage loan after Fremont originated the loan).

109 *Id.* at 552 n.6.

110 Park, *supra* note 26 (noting that the size of the mortgage market became bigger than the size of the mortgage originations).

111 Simpson, *supra* note 42, at 2.

112 Rosengren, *supra* note 53. Mr. Rosengren provides the following statistics:

lending in the subprime market when federal regulators contended that the company did not adequately ensure that borrowers would be able to repay their loans.[113] Fremont then attempted to "rebrand" itself as a commercial real estate lender in late 2007. Nevertheless, Fremont's past caught up with the company and it subsequently filed a voluntary petition under Chapter 11 of the U.S. Bankruptcy Code on June 18, 2008.

Therefore, the initial hurdle to a loan work-out is to find the loan holder and the servicer. Once an individual finds the servicer, the next obstacle is determining whether the servicer has the authority to negotiate substantive loan terms with the borrower. Even if the borrower finds the servicer, there is the chance, as in the *Fremont* case, that the loan holder has gone bankrupt and any legal work-out will be subject to the bankruptcy proceedings. In sum, attempting to obtain a loan modification could potentially bring about more questions than solutions. The answer to these troubled loans may rest in court proceedings and new legislation.

B. *Potential Outcomes for Court Ordered Work-Outs*

Before the *Fremont* case settled, there was speculation as to the potential damages should Fremont be unsuccessful in its defense.[114]

Mortgage Provider	# of Loans	% of Subprime Mortgages	Status
Option One Mtg. Corp.	11,243	18.6%	Operating
New Century Financial Corp.	5,951	9.9%	Shutdown
Fremont Investment and Loan	5,550	9.2%	Shutdown
Argent Mtg. Co.	3,599	6.0%	Shutdown
Summit Mtg. Co.	3,067	5.1%	Shutdown
Mortgage Lender Net	2,798	4.6%	Shutdown
Long Beach Mtg. Co.	2,520	4.2%	Shutdown
WMC Mtg. Corp.	2,316	3.8%	Shutdown
Accredited Home Lenders	2,174	3.6%	Shutdown
First Franklin Financial	1,896	3.1%	Operating

Note: Mr. Rosengren used this list to show the top ten subprime lenders in terms of number of purchase mortgage originations in Massachusetts from 1993 to 2007.

113 Smythe, *supra,* note 96.
114 Simpson, *supra* note 42, at 4 (outlining the four possibilities discussed in this section).

While the issue of damages proved to be irrelevant to Fremont itself, it remains very relevant in terms of the other mortgage lenders who could be susceptible to a Chapter 93A claim in Massachusetts. Chapter 93A allows the Attorney General to "restore to any person that has suffered any ascertainable loss . . . any moneys or property, real or personal, that may have been acquired by means of such method, act, or practice."[115] The Attorney General may have a number of potential remedies for subprime mortgage loans that the court has determined to be "unfair and deceptive."

1. Rescission of the Unfair Loan

Rescission is a remedy that eliminates the existing loan and restores the parties to their positions prior to entering into the contract.[116] Where a subprime loan is involved, restoring the parties to their prior positions would seem unlikely given that *Fremont* did not alleviate the borrowers' requirement to pay the loan.[117] Moreover, as a matter of policy, allowing borrowers to rescind mortgage loans years after the loan has been in place would provide even more uncertainty in the residential lending market. There are current laws that allow for rescission in the context of residential mortgage loans; however, these laws provide for only a three-day grace period after a loan has been supplied in order to shield borrowers from unscrupulous lenders.[118]

2. Refunding Principal, Interest and Fees Paid by Borrower

The legal concept of restitution governs circumstances where the

---

115 Mass. Gen. Laws ch. 93A, § 4 (2006) (noting that any person that the court finds has employed a method, act, or practice which he knew or should have known to be in violation of Chapter 93A could be required to pay the Commonwealth a civil penalty).

116 Geoffrey Samuel, Law of Obligations and Legal Remedies 150 (2d ed. 2001).

117 *Fremont*, 897 N.E.2d at 555 (Mass. 2008).

118 Truth in Lending Act, 15 U.S.C. § 1641(a)-(b) (2006). Provided the borrower provides notice to the lender within three days after the loan is put into effect, the Truth in Lending Act requires a lender to give up, within twenty days, its claim to the borrower's property as collateral and to refund any fees paid by borrower.

borrower receives a refund of principal, interest, and fees. Restitution serves to compensate the borrower for a sum of money paid related to the illegal act. Where a subprime mortgage loan is involved, if the court were to award restitution damages, the borrower would be reimbursed for the loan and all expenses related to the loan. The mortgage would be terminated and the borrower would no longer own the home. Essentially this would work to put the borrower and lender back in the place they were before the loan was originated.

Applying a pure restitution concept to this situation could have numerous drawbacks. First, similar to a foreclosure, it would take the homeowner out of his or her home. Second, although the borrower may be able to account for the amount paid to the mortgage broker and servicer, the fees and expenses would have been spread among many different companies. A court or similar authority would need to determine exactly which party would be liable for the amount of fees and expenses. Finally, it would be time inefficient and potentially counterproductive to reimburse the borrower for all principal, interest, and fees paid in connection with the loan. Alternatively, some states are taking a "restitution-like" approach, which acts to provide an incentive for loan restructuring.

The Texas Attorney General, Greg Abbott, initiated a $7.46 million restitution program against Countrywide Financial Corp. ("Countrywide") that would make money available for eligible Countrywide residential mortgage customers in Texas.[119] Similar to *Fremont*, the State of Texas brought an action against Countrywide alleging that it "encouraged homeowners to accept loans [that] they could not afford, failed to fully disclose risky loan terms to borrowers, and wrote loans for unqualified borrowers in an effort to increase market share."[120] Under the settlement agreement with Countrywide, eligible homeowners could modify the terms of their loans to make monthly mortgage payments more affordable. The potential modifications included interest rate freezes, interest rate reductions, loan term extensions, conversions

119 *exas Launches Restitution Program for Countrywide Customers*, Consumer Affairs, Feb. 13, 2009, http://www.consumeraffairs.com/news04/2009/02/tx_countrywide_settlement.html [hereinafter *Texas Restitution*] (outlining Texas program for loan work-outs).

120 *Id.* (detailing the terms of the State of Texas' law suit against Countrywide).

from variable to fixed rate loans, and principal reductions.[121] The financial support for such modifications would be funded out of the restitution program.

3. Freezing Foreclosure and Allowing the Homeowner to Stay in the Home

Many large banks in the United States voluntarily instituted foreclosure freezes in late 2008 and early 2009. In February 2009, J.P. Morgan Chase & Co., Citigroup Inc. and Bank of America Corp. committed to weeks-long foreclosure moratoriums in anticipation of the government's financial stability plan.[122] Those moratoriums have started to come to an end as J.P. Morgan Chase & Co., Wells Fargo & Co., and Fannie Mae and Freddie Mac have all noted that they are increasing foreclosure activity as of April 15, 2009.[123] These companies are now determining which troubled borrowers are candidates for government assistance and initiating the foreclosure process for those troubled borrowers not eligible for assistance. Freezing foreclosures is a temporary fix that does not solve the ultimate substantive problem: the loan will either need to be worked out or rewritten. As evidenced by *Fremont*, courts are also entering the picture by instituting foreclosure freezes;[124] however, unless there is a comprehensive plan developed to aid borrowers who are dodging the foreclosure process due to a current freeze, it is only a matter of time before a solution is determined or the foreclosure begins.

4. Requiring Loan Work-outs with Substantial Modifications to the Mortgage Terms

Perhaps the most compelling solution would be legislatively

---

121 *Id.* (stating that eligible borrowers would not be charged late fees, loan modification fees, foreclosure fees, or pre-payment penalties).

122 Meena Thiruvengadam, *Banks Agree to Foreclosure Moratorium*, Wall St, J., Feb. 14, 2009, at A1.

123 Ruth Simon, *Banks Ramp Up Foreclosure*, Wall St. J., Apr. 16, 2009, at A1 (acknowledging that these companies have lifted internal moratoriums which temporarily halted foreclosures).

124 Commonwealth v. Fremont Inv. & Loan, 897 N.E.2d 548, 550-51 (Mass. 2008).

mandated or court ordered loan work-outs. As evidenced by the program instituted in Texas,[125] individual borrowers who qualify could receive interest rate freezes, interest rate reductions, loan term extensions, conversions from variable to fixed rate loans, and principal reductions. The first issue that could arise with requiring individual loan work-outs is the substantial amount of time that it would take to work out these loans and the financial impact of these modified loans. A court cannot work through each subprime mortgage loan individually. Instead, court ordered initiatives similar to what has occurred in Texas and in the *Fremont* ruling in Massachusetts could be an effective conduit to working out troubled mortgage loans.

Legislatively mandated residential loan work-outs could be problematic outside of the bankruptcy context based on historic case law.[126] In *Louisville Joint Stock Land Bank v. Radford*, the Court ruled that "the Fifth Amendment commands that, however great the nation's need, private property shall not be thus taken even for a wholly public use without just compensation."[127] Legislatively mandated loan work-outs could be considered a "taking" of the lenders property. In *Radford*, the Court determined that if taking property of individual lenders in order to relieve the necessities of individual borrowers is in the public interest, action must be taken through a proceeding by eminent domain.[128]

Work-outs mandated as the result of a judicial proceeding where there has been a finding of lender wrongdoing may provide a remedy. Due to the finding of lender wrongdoing the constitutional issues are avoided. The *Fremont* settlement, if executed effectively, would allow the Massachusetts Attorney General to review the foreclosure before the homeowner is forced to leave his or her home. Provided the Attorney General determines that the loan was "presumptively unfair," the Attorney General could force the lender to negotiate new terms with the homeowner. In this scenario, the homeowner could keep his or her home. The loan would continue, as modified, allowing the lender to

125 *Texas Restitution, supra* note 119.

126 *See generally* Louisville Joint Stock Land Bank v. Radford, 295 U.S. 555 (1935); *cf.* Wright v. Vinton Branch of Mountain Trust Bank of Roanoke, VA., et. al., 300 U.S. 440 (1937).

127 *Id.* at 601-02.

128 *Id.* at 602 (explaining that through taxation, the burden of the relief being provided in the public interest would be borne on the public).

realize some sort of value for a loan that seemed destined for foreclosure. The lender would bear the financial impact in the form of writing down principal or lowering interest rates. However, in the wake of the Goldman settlement, it is apparent that money is being made available to finance these concessions. In effect, the payments from Fremont and Goldman, while arguably a minimal amount when measured against the current rise in foreclosures, will begin to correct the problems of the housing market that has been ravaged by the very mortgage products Fremont created.

It is important to note the negative aspects of this solution. First, it will take a substantial amount of time to implement many of these loan work-outs. In order to fairly determine which loans should be modified, the Massachusetts Attorney General will need to review each individual loan. Second, the money that the Attorney General has secured from Fremont and Goldman will not be enough to help all affected borrowers. Furthermore, the Attorney General's office will have to determine the parties who are entitled to the settlement amounts on a case-by-case basis. Finally, foreclosures are not going to stop. Every loan that is in default will not be worked out. Families will still lose their homes. The troubling aspect of many of these loans is the fact that the variety of terms allows courts wide latitude when determining whether the loan was "presumptively unfair." Courts will face situations in which the homeowner has a loan containing three of the four troublesome characteristics and must decide if this is sufficient for the loan to be deemed unfair. The *Fremont* ruling and subsequent settlement does not provide a perfect solution.

V. The End of the Beginning

As the dust settles and the economy begins to stabilize, governments – on the local, state, and federal level – and courts must take leading roles working through the fallout from the boom in subprime lending in the early part of the decade. Judicial proceedings, such as *Fremont*, provide the best solution for working through many of these loans because the court can determine the applicable "unfairness" standard to be applied. As evidenced by the Goldman settlement, the Massachusetts Attorney General is not finished investigating the practices of subprime lenders as well as banks that supported subprime lenders.

The *Fremont* decision supplies the Attorney General with a structure for reviewing home loans that are part of a foreclosure proceeding. Although reviewing each mortgage loan on a case-by-case basis may be costly and time intensive, this review may be the only fair method in determining which individuals should qualify for a loan work-out and which foreclosures should proceed as planned. Other methods, such as foreclosure freezes and loan refunds, while beneficial for borrowers, would not effectively pinpoint the individuals who were wronged by these unfair and deceptive lending practices.

The landscape of the mortgage lending market is ever changing. The fallout has affected many lives and businesses. The wave from the housing bubble has come to an end and it is now time to repair the damage. Ideally, the subprime lending crash will compel borrowers to refrain from over-leveraging and lenders to take more care when determining borrowers' financial stability. The *Fremont* decision will provide individuals working through these mortgage loans with a framework for determining which loans qualify for restructuring. Additionally, it may also prompt lenders and borrowers to begin restructuring negotiations before the foreclosure process is implemented, reducing stress on the court and the Massachusetts Attorney General's Office. While time will only tell the effect of the *Fremont* decision, the Commonwealth is arguably moving in the right direction.