
The Evolving Juridical Space of Harm/Value:

Remedial Powers in the
Subprime Mortgage
Crisis

**Philip Ashton, Associate Professor
of Urban Planning & Policy |
University of Illinois at Chicago**

Contact:

412 S. Peoria, 231 CUPPA Hall
Chicago, IL 60607

Email: pashton@uic.edu

Tel: (312) 413-7599

Introduction

In the 1920s, the American institutional economist John R. Commons traced the evolution of the notions of property, liberty and value through the tremendous changes in the US economy in the late 19th and early 20th centuries. This paper engages Commons' arguments regarding the relationship between law and capitalism with the legal framing of the subprime mortgage crisis. Like many fringe financial sectors over the past twenty years, the subprime market developed successful business models by extending new credit products to borrowers with tenuous risk profiles or a history of disconnection from credit. The profitability of this lending made it a critical growth sector for the US economy, and by the peak of the housing market in the mid-2000s, many of the largest financial conglomerates in the country were competing to fund, originate, service or resell subprime mortgages.

As going concerns, however, subprime lenders have opened up "grey areas" in the law regarding the application of earlier legal frameworks to new profit-making activities, including the legitimacy of many subprime loan terms (such as prepayment penalties or single-premium insurance), the status of mortgage deeds within complex securitization transactions, and the general bargaining position of borrowers relative to creditors. As with Commons' analysis of the 19th century legal reframing of property and value, these grey areas have promoted a range of legal projects that have attempted to work through problematic creditor practices; these have ranged from new state and local anti-predatory lending laws to a wide set of legal proceedings on behalf of borrowers and investors that have tested the limits of legal concepts like fraud, transparency and suitability. In the lead-up to and fallout of the subprime mortgage crisis, this has involved a significant expansion of legal experimentation – most evident in the 2012 National Mortgage Settlement over servicing fraud – that adapts the techniques of civil procedure (including private rights of action and settlement) with public enforcement powers to resolve borrower claims of harm.

Commons' analysis of the articulation of law and value in the late 19th century expressed a high degree of optimism that new authoritative sources – notably the US Supreme Court – would expand public powers to balance the growing economic power of financial and industrial going concerns. In this regard, the surge in legal proceedings against subprime lenders would seem to suggest a parallel process of legal enlargement on behalf of borrowers. In this paper, I suggest this optimism is premature.

Through a detailed engagement with Commons' arguments – in particular, his notion of state intervention as the normative hinge in transactions – I argue that changes in the legal landscape has altered how claims over financial status and vulnerability are taken up and resolved, as well as the legal remedies available to borrowers harmed through their exposure to the subprime market. I develop this argument through close analysis of recent legal actions and settlements against subprime mortgage lenders. In addition to situating the orientation of regulators to settlement (rather than prosecution), I argue that the legal techniques employed in structuring borrower claims embody certain selectivities that, when applied to concrete experiences of dispossession, transfer legal uncertainty back to borrowers and structure harm as legally unproblematic. They also ignore critical questions regarding the financial commodity chain, granting release from prosecution without clarifying the appropriate lines between fraud, harm, and legitimate business practices at

play in fringe finance. The settlement therefore works through grey areas by erasing certain categories of vulnerability from the law.

John R. Commons on Law, Value and the State

Commons' work on the relationship between law, the state and new forms of economic value that emerged from the late 19th century onwards help us to lay out a problematic for analysis of financial capitalism and the legal issues at stake in the mortgage crisis. This involves three elements: the changing nature of economic value, especially its orientation to the future; the role of law as a normative framework necessary for transactions to produce value; and a legal realist analysis of state intervention as critical to the realization of value.

From the *Distribution of Wealth* in 1893 to *The Legal Foundations of Capitalism* in 1924 and later work like *Institutional Economics* and the *Economics of Collective Action*, Commons developed a framework for analyzing modern industrial economies wherein simplistic notions of property (as title to physical or "corporeal" assets) had been superseded by the complexities of value creation through multifaceted inter- and intrafirm transactional arrangements characteristic of oligarchy or monopoly. Large industrial and financial entities increasingly shifted from buying and selling titles to physical goods and instead found profit in trading intangible and incorporeal goods such as "goodwill, patent rights, the right to continue in business or to continue business connections, the right to a labor market, the right to liberty of contract, and the kinds of public franchises, corporation charters, and public utility franchises" (Commons 1924: 24).

In Commons' framework, the transaction was a critical unit of analysis. Unlike the abstracted exchange portrayed by neoclassical economics – instantaneous in both time and space – Commons' transactions are forms of collective action that involve multiple actors choosing competitive options with one another within a dynamic market setting. Each transaction entangles its parties (to use Riles' (2010) terminology) through working rules that offer each varying degrees of room for maneuver. The "firm" in this framework ceases to be a unitary entity but is instead a "going concern" defined as an assembly of transactions that unfold over time.

The introduction of time is critical to understanding modern forms of economic value that are both produced and entangled in these transactions. All economic value, in Commons' terminology, is "expectancy" (Commons 1924: 25), and lies not simply in the immediate exchange of tangible goods but in the "invisible expectations of beneficial behavior" in the future. For Commons,

Capital is the present value of expected beneficial behavior of other people. Property has become intangible and incorporeal; liberty has become intangible property; duties are incorporeal property; each is the expected beneficial behavior of others in dealings with self, and *the present value to self of that expected behavior is capital or assets* (Commons 1924: 28, emphasis added).

Value thus "has a dimension of futurity: it expresses the past with the principle of anticipation, because the repetition of acts is a basis for anticipating gains and losses expected in the future" (Commons 1934: 740). Key among these forms of value was credit, which in new kinds of financial instruments represented a shift in value to encompass "the invisibility of future behavior of creditors

and debtors” and their “expected beneficial performance of duty” – invisible by virtue of “[existing] only in the unseen future” (Commons 1924: 24).

The articulation between law and economics is critical for Commons’ understanding of value. Law does not simply reflect underlying economic fundamentals, but rather provides a normative framework for authorizing transactions, as well as the general process of collective action, to produce value along its various intangible and temporal dimensions. Norms such as trust are critical for this collective action to take place, to be sure, but law further enables the production of value in the present by staking out how an uncertain future might be governed. This includes laying out both the “substantive” powers for parties to a transaction – contracts which stake out value within each party’s liberties, liabilities, powers and exposures throughout the life of the transaction – as well as remedial powers (tort) wherein a party can pursue counterparties for lost value in order to remake a transaction as originally intended. As these substantive and remedial powers help parties navigate an uncertain future, private law works to authorize transactions and becomes the “ultimate means by which the members of a going concern are able to work together for a common purpose and to exert their united power against other concerns” (Commons 1924: 68).

However, Commons was emphatic that the liberties, liabilities, powers and exposures mobilized in a transaction all hinge on the state (Commons 1924: 117). In an embrace of legal realism, he argued that the law is not an immutable framework but depends on the exercise of police power by courts and state regulatory agencies “to compel you to behave as you promised if you do not do so willingly” (Commons 1924: 22, emphasis added). Rights and duties are meaningless unless officials can be compelled to act to secure those legal positions according to prevailing interpretations.

We have seen that unauthorized transactions are likely to fail in the two respects of lack of correlation and insecurity of expectations. For this reason a government or judiciary, with its rules regarding transactions, is needed to intervene with the double purpose of correlating rights, exposures, liberties, duties, and of maintaining the correlation even if the parties prove false or change their minds. Hence, even these authorized transactions must prove to be empty and ineffective if the superior authority is not at hand with power and willingness to make good on its promises and commands. In order to do so it must bring to the assistance or compulsion of the individual the collective power of the concern (Commons 1924: 100).

The potential availability of state enforcement creates the distinction between those transactions which are *authorized* through consent of the various parties and those which are *authoritative* by virtue of their recourse to state enforcement (Commons 1924: 106-7). Thus, for an economy to expand the state must be omnipresent in transactions even where it is seemingly invisible, as the promise of state action – the futurity of its intervention – is what makes possible the regulation of uncertainty in pursuit of investment and growth. The futurity of value and the futurity of state action are always intertwined.

These shifts in value challenged the legal foundations of capitalism and became a sphere of contestation, as new forms of value tried to gain legitimacy within inherited legal vocabularies of authority. For Commons, as firms adopted new and different contractual arrangements to regulate their transactions, and as they were exposed to new and different forms of state regulatory action, the courts were increasingly called upon to evaluate contested rules and practices and to transform

them into “working rules” that could regulate uncertainty. Commons thereby argued the US Supreme Court “occupies the unique position of the first authoritative faculty of political economy in the world’s history” (Commons 1924: 7) as the notion of value produced legal problems that occupied scholars, jurists, and legislators and that culminated in a series of cases that reached the Court in the 1890s. These cases resulted in an upward scaling in the legal geography of interpretation and authority, as questions of property and regulation were wrested away from the state legislatures (which are constitutionally charged with dealing with claims over title) and vested in the federal courts by virtue of the increasing association of property with exchange value (“the expected behavior of people in buying and selling, lending, hiring, borrowing and paying debts” (Commons 1924: 25)), access to markets, and relative bargaining power (Commons 1924: 16). Commons’ saw in these 19th century legal changes a natural enlargement of state police powers, from the prevention of excessive nuisance to the promotion of social control necessary to produce beneficial forms of economic development (Commons 1924: 34-35).

This underlying theory of legal change reflected a high degree of optimism that greater state intervention would balance the growing economic power of large industrial and financial going concerns relative to workers and debtors, particularly (in the sphere of labor relations) through the enforcement of the legal status of unions and the right to collective bargaining. However, Commons’ work also highlights a number of pitfalls for the development of remedial and substantive powers that could balance growing inequalities in economic power. There are two such pitfalls worth addressing here for their application to the current moment.

First, the articulation of legal discourse and economic change is not seamless. Legal concepts admit a significant degree of ambiguity, and Commons’ analysis of the application of the concepts *property* and *liberty* demonstrates how judicial interpretations of the presumptive equality between parties to a transaction – reflected in their equal freedom to formally make the transaction, rather than their relative stakes in the outcome of the transaction – increasingly secured unequal bargaining power between owners and workers or creditors and debtors. “liberty to choose between opportunities is passive and ineffective,” he argued, “but power to withhold opportunities is economic power, and associated power is government” (Commons 1924: 320). This is reminiscent of Marx’s analysis of bargaining rights and liberties between labor and capital, wherein exchange between formally equal money-owners and possessors of labor-power becomes imbued with the power relations between capital and labor.¹ Where one party’s livelihood depends on rights of access to labor or credit markets, then the other party’s exercise of its liberty to deny that access – to withhold employment or credit – represents *formal* equality between the parties but *substantive* inequality.

Second, even as working rules aim to produce certainty by laying out each party’s liberties, liabilities, powers and exposures throughout the life of the transaction, the unknowability of the future introduces certain grey areas into the law that are unanticipated in the contract. Not only are authorized transactions incomplete by virtue of this uncertainty, the futurity of state intervention to secure remedial and substantive powers is itself contingent, depending as it is on changes in legislation, jurisprudence, and regulatory enforcement capacities. Commons acknowledges that

¹ “The one with an air of importance, smirking, intent on business; the other, timid and holding back, like one who is bringing his own hide to market and has nothing to expect but — a hiding” (Marx, Capital Vol.1, Chap 6).

authoritative transactions must therefore include state discretion in legal and regulatory spheres, and that this “state-in-action” (Commons 1924: 122) constructs legal exposures/immunities on the fly or in an *ad hoc* manner. Ultimately, Commons had confidence that discretion would be organized in a systematic manner, as it was organized under a durable regime of “stabilized prerogative” (Commons 1924: 316) characteristic of constitutionalism. Nevertheless, the futurity of state intervention admits its own instabilities and uncertainties.

Remedial & Substantive Powers in the Prosecution of the Mortgage Crisis

Commons’ framework for assessing the relationship between law and value resonates with recent analyses of financial capitalism and the transformation of value through financialization. Consider the example of the disintermediation of the mortgage lending process, wherein the value generated through a mortgage transaction has been split among brokers, retail lenders and wholesale conduits, servicers, insurers and credit enhancement providers, credit rating agencies, and investors. Each of these firms stakes out a specific position relative to the futurity of value, embedded not only in the expected beneficial performance of a single borrower but in a series of rights, duties, liabilities and exposures relative to the behavior of entire classes of parties to a transaction at specific moments as it unfolds over time. What I am calling the *juridical space of the subprime mortgage crisis*, then, necessarily involves consideration of a wide range of mortgage practices, numerous regulatory agencies and legal frameworks, and a diversity of legal venues and techniques.

Further, the consolidation and expansion of the subprime market has produced new market structures, and employed contractual terms that were not possible under earlier regulatory frameworks, to which litigation and regulatory enforcement has had to respond. As the pace of financial transactions and innovation has increased, finance has opened up “grey areas” in the law regarding the application of earlier legal frameworks to new profit-making activities and the relative positions of creditors, debtors and counterparties. These include:

- Mass securitization and the role of pooling and servicing agreements in making lenders responsible for any third-party liabilities;
- Complex risk-based pricing models that challenge identification of a common illegitimate pricing disparity (i.e., one that can’t be explained based on the risk profile of the borrower);
- Growing reliance on brokers and discretionary pricing models that, since the Supreme Court’s decision in *Wal-Mart v. Dukes* (2010), have become problematic from an evidentiary standpoint;
- Intrafirm segmentation – steering borrowers to subsidiaries or affiliates offering higher-cost loan products;
- Reverse redlining – targeting high-cost loan products to selected market segments.

In the wake of the mortgage crisis, courts and regulatory agencies have been called upon to interpret specific remedial and substantive powers as they take up and resolve these grey areas. This has been especially evident since 2008 with a proliferation of legal proceedings involving lenders, mortgage servicers and other firms that had compromised the subprime mortgage market. These have been produced within a broad range of administrative venues and used a variety of legal techniques, including: enforcement actions by the SEC, the OCC and other federal banking regulators

that have ended in settlements, consent decrees and deferred prosecution agreements; investigations by states' Attorneys General (also often ending in large-scale settlements); and private cases brought by borrowers and investors, often pursued on a class action basis.

Commons' framework points us to the character of state intervention – including its orientation to the future – to assess how creditor and debtor liberties, liabilities, powers and exposures are being redistributed through this diverse prosecution of the crisis. At first blush, the sheer number of cases and enforcement actions suggests a concerted regulatory effort to rein in the excesses of the market, assign culpability, and establish forward-looking rules governing relationships between creditors and debtors. Moreover, the terms of settlement have often emphasized remedies or damages for borrowers, making them a key policy tool for recuperating at-risk homeowners and mediating broader patterns of housing distress. This interpretation has been promoted by the Obama administration, particularly in its pronouncements over the 2012 National Mortgage Settlement. Following Commons', this would appear to represent a further expansion of police powers to balance the economic power of creditors with remedial powers for borrowers.

However, a full engagement of Commons' analysis in light of the rise and collapse of the subprime mortgage market requires that we engage his theory of legal change to address underlying dimensions to the futurity of state action – in particular, new and critical aspects of the legal landscape brought about through the growing connection between law and financial governance. For instance, Farhang (2010: 14) located changes in enforcement regimes in Congressional politics and a fragmented Federal administrative structure, rejecting a "modernization" interpretation (strikingly similar to that of Commons) that he characterizes as follows:

Modern economic activity also entails the proliferation and wide dispersal of risks that result in increases in the kinds of harm for which legal redress is sought, while at the same time citizen expectations, fueled by the growing capacities of technology and the state, demand redress for all harms suffered.

I propose that tracking the internal development and logic of state intervention within credit markets can retain Commons' modernization account of the articulation of law and value. One of the key parameters shaping the juridical space of the subprime crisis is shifts in the underlying structure of state intervention that have followed the tremendous pace of financial restructuring of the last 30 years. The organization of state discretion, following Commons, is critical to the concrete organization of remedial powers and the balance of economic power within a transaction. My proposition is that the futurity of state intervention has been patterned an overriding policy goal of maintaining a stable macro-environment in the face of the excesses of volatile financial markets. Such an approach, however, requires rejecting Commons' general interpretation of state intervention as a gradual and positive enlargement of powers. Instead, the contemporary forces shaping the development of remedial and substantive powers have, in my interpretation, superseded the legal standards of fairness or meaningful remedies for harmed borrowers with the pragmatic aims of stabilizing the circulation of financial capital.

There are three different aspects to this argument that we can see operating in the lead-up to and protracted working-out of the financial crisis: the reorganization of state discretion through deregulation and federal pre-emption; the narrow construal of responsibility and the expunging of broader claims in favor of identifiable classes of harm; and the embedding of remedial powers

within administrative venues and legal techniques where harm to borrowers is arbitrarily calculated and the economic power of creditors is normalized. I will treat these in turn before turning to a set of illustrative examples drawn from recent legal proceedings against subprime lenders.

Theories of Legal Change

First, we can appreciate how Commons' analysis of legal concepts opened the possibility that formal equality under the law could coexist with (or even promote) the securing or deepening of inequality in bargaining positions within transactions. This approach is evident in foundational fair lending legislation, which emphasized borrowers' rights of action against creditors in situation where the use of prohibited factors (such as the race or gender of the borrower) signaled the unequal exercise of power. The Fair Housing Act (FHA) of 1968 and the Equal Credit Opportunity Act (ECOA) of 1974 – to take two key examples – allowed private parties to pursue civil claims for judgment and damages against firms through the courts. Similar kinds of provisions are also evident in the Real Estate Settlement Procedures Act (RESPA), the Truth in Lending Act (TILA), the Fair Credit Reporting Act and the Home Ownership and Equity Protection Act (HOEPA) – legislation that collectively forms the essential parameters for fairness and transparency in U.S. mortgage market transactions. To this we can add a variety of state predatory lending and unfair and deceptive acts and practices (UDAP) legislation that has developed or been extended to mortgage lending over the past three decades. Together, these laws form a coherent private enforcement regime demanding fair treatment, full disclosure of loan terms, and even prohibitions on certain harmful loan terms and practices, but that rely in large measure on private initiative for their enforcement.

Despite the elevation of borrowers' rights within this legal framework, there are numerous longstanding critiques that underline how the formal equality offered by these laws makes invisible substantive inequalities in bargaining. Generally, contract law and the Uniform Commercial Code contest defects in formation of assent, rather than to disparities in bargaining power or fairness in contracts' substantive provisions (Engel and McCoy 2002). Even in situations of unconscionability – “an absence of meaningful choice on the part of one of the parties together with contract terms which are unreasonably favorable to the other party” - proof that a higher loan price charged to minority borrowers is “dictated by commercial reality may be sufficient to defeat the claim or defense and such proof may be easy to come by.” Contract remedies are further restricted in situations where loans are sold into secondary markets; the holder-in-due-course doctrine “protects a purchaser if she took the note for value, in good faith, and without notice of the defenses” (Engel and McCoy 2002). Looking more narrowly at civil rights legislation, Taibi (1994) has argued that the assumption that contracts are presumptively valid once cleansed of prohibited factors makes laws like the Equal Credit Opportunity Act silent on questions of structural discrimination, such as the ability of a subprime lender to charge higher prices and employ more onerous loan terms for loans to minority borrowers as compensation for their higher risk.

More importantly, legislative and judicial interpretations of key concepts such as *disparate impact* have relied on “legitimate business interests” in their construction of remedial and substantive powers. That is, claims against lenders are only actionable to the extent that they base the determination of value on factors that cannot be justified by business need, broadly construed. Recent Supreme Court jurisprudence has extended this even further by narrowing the notion of commonality on which class action discrimination cases in employment or lending can be certified;

Wal-Mart v. Dukes narrowed the scope for remedial powers in instances where pricing discretion is distributed among parties to a transaction (as in a lender-broker arrangement in a mortgage transaction). In these instances, the presumption of formal equality in bargaining rules out more expansive interpretations of how value-generating business practices generate harm.

Second, we need to appreciate how Commons' optimism regarding the expansion of state power to react to changing forms of value creation cannot hold where state discretion is being reorganized on a systematic basis. Farhang (2010) argued that a key design principle of the "litigation state" in the 1960s was the conscious decision to make state intervention in labor and credit market transactions discretionary rather than mandatory. That is, the construction of enforcement regimes for labor markets and consumer credit eschewed direct market regulation in favor of allowing private, civil suits against employers or lenders (by HUD, DOJ, or state Attorneys General) in situations of harmful patterns and practices.

From the 1980s onwards, this discretion was further restructured within credit markets by legislative initiatives and administrative rule-making which attempted to rationalize the banking system and/or respond to the decisional uncertainties produced by volatile finance. For instance, deregulation in 1980-1982 was specifically designed to bolster the banking system by giving banks the powers necessary to respond to increasingly volatile financial markets. This legislative fix of banking pre-empted state usury laws and permitted lenders to make adjustable-rate mortgages, mortgages with balloon payments, and non-amortizing mortgages. Further, Federal pre-emption in 2002 (through regulations issued by major banking regulatory agencies) over-ruled state legislative attempts to address the growing scale of harm through the subprime market, again ostensibly in the name of rationalizing banking markets. Some of these state laws had embraced direct product regulation or opened up new avenues for recourse to investors in situations where loans had been funded through securitization (Immergluck 2009).

Third, Commons was confident that the legal transformation of value had elevated the Supreme Court to a pre-eminent role as arbiter of working rules; it was on this basis that he argued the Court "occupies the unique position of the first authoritative faculty of political economy in the world's history" (Commons 1924: 7). However, the current deluge of financial fraud and negligence cases – which range from anti-discrimination lawsuits to Securities and Exchange Commission enforcement actions and all the way to the recent state/federal campaign over mortgage servicer liability – suggests that Commons did not appreciate or could not anticipate how remedial and substantive powers would be swept up and reorganized into other administrative venues where alternate legal techniques and different policy rationalities hold sway. Following Scheuerman (2004), this is part of a general trend through the 20th century wherein the speed and excess of capitalism's relentless turnover challenges traditional deliberative decision-making and results in increasingly "motorized" forms of governance.

This process is particularly pronounced in the variety of state strategic projects oriented to governing financial risk over the four decades since the breakdown of Bretton Woods. Scheuerman (2004) argues that the shift from regulation to more ad hoc forms of governance and adjudication represented a pragmatic solution to the problem of "regulatory obsolescence" resulting from the increasing time lag between legislative deliberative processes and the pace of innovation and emanating from global financial circuits. Scheuerman highlights a "time lag" in liberal democracy,

one that increasingly produces a gap between the development of financial market practices and the deliberative design of policy or regulatory interventions that can discipline it and minimize its harmful impacts. In the hands of agencies such as the Securities and Exchange Commission (SEC), the US Department of Justice (DOJ), and states' Attorneys General, legal techniques such as arbitration, settlement, or deferred prosecution have emerged as expedient means to govern the "fast" world of volatile financial markets. Settlement and arbitration have multiple benefits as forms of "soft law." They are flexible in their application, can be deployed relatively quickly without extensive deliberations, and are not limited in their focus solely on pre-conceived standards of firm behavior. Moreover, they can customize sanctions to specific situations, including identifying the appropriate balance between punishments and (for the largest firms, those "too big to fail") safeguarding a firm's capacity to carry out critical market functions.

Precisely this situation-specific focus renders both arbitration and its competitors less past-oriented than traditional modes of legal regulation, thereby minimizing the impact of a legal past that increasingly seems irrelevant in the face of fast-moving economic trends... Litigation concerned first and foremost with assigning guilt to one party in reference to a past act may be less useful economically than a relatively quick compromise emphasizing positive lessons to be learned for both sides for the sake of maintaining cordial ties in the future (Scheuerman 2004: 174-5).

Both Scheuerman and Nagareda (2007) argue that, rather than simply representing the application of pre-existing legal norms along the lines envisioned by Commons, these administrative venues and legal techniques bring into play a wide range of tradeoffs rooted in state strategic projects. Examining government-led mass settlements (such as the tobacco Master Settlement Agreement (MSA)), for instance, Nagareda argued they expanded the scope for collusion between states and industry in ways that were quite far removed from the harms suffered by plaintiffs. For instance, Nagareda argues that the terms of mass settlements often amount to market reforms, but that careful scrutiny highlights how the terms of those reforms often work to normalize the very business practices at issue. He refers to the MSA as "a legal innovation in cartelization technology" (Nagareda 2007) in the way that it sanctioned price increases and established insurmountable barriers to entry for competitors. Further, the MSA reimburses states for the public health costs of smoking by closing off legal questions of industry's responsibility to individual smokers.

In sum, the overall effects of these regulatory projects have been an alteration of the legal terrain for challenging harm within the subprime market. This came through, on the one hand, a diminishment of the venues wherein private plaintiffs as well as activist state AGs and DOJ could apply remedial powers. On the other hand, it meant that those remedial powers themselves were more narrowly construed and needed to be assessed against "legitimate business necessity." Further, remedial and substantive powers are increasingly applied in administrative venues or through legal techniques where "classical legal virtues of generality, publicity, clarity, prospectiveness, and stability" (Scheuerman 2004: 172) are balanced against broader state strategic interests in the management of financial instability.

Constructing Remedial Powers: Countrywide Financial & Wells Fargo

One area where these broad shifts in the legal landscape (and their alteration of remedial and substantive powers) can be found within the prosecution of private, civil actions against lenders

underwriting loan products that caused disproportionate net harm to borrowers. The porousness of the law has opened up multiple avenues to pursue these legal complaints – ranging from class-action suits by customers to broader claims pursued by state Attorney Generals, and employing legal grounds ranging from disclosure to failure to adequately disclose loan terms to outright fraud. As such, the settlement is rooted in areas of the law that seem ripe for challenging a wide range of practices contributing to homeowner distress and governing the excessive impacts of hyper-competition and speculative excess on consumers and communities.

Nevertheless, close attention to recent cases involving two lenders – Countrywide and Wells Fargo – highlight how the tendency to settle these cases not only fails to remedy the precarious position of borrowers, but results in the further normalization of harmful business practices. Both lenders have been the target of numerous lawsuits and court proceedings brought by consumers and shareholders, and both built highly-profitable business models focused on mass distribution and servicing of subprime loans (cf Center for Responsible Lending 2004). In 2010, the Illinois Attorney General Lisa Madigan filed suit against Countrywide, alleging that its Countrywide Financial unit had systematically discriminated against Black and Hispanic borrowers during the peak years of the housing boom. The terms of the suit referenced the Illinois Fairness in Lending Act as well the federal Fair Housing Act of 1968 and the Equal Credit Opportunity Act of 1974; all three laws open a lender to private civil action if their lending practices have disparate impacts on minority borrowers.

The Illinois suit was joined by the Justice Department, expanding its scope to nationwide.² Investigation of Countrywide’s lending practices identified higher fees and rates charged to more than 200,000 minority borrowers relative to white borrowers, even when controlling for credit risk. DOJ also determined that Countrywide had steered more than 10,000 minority borrowers into costly subprime mortgages when white borrowers with similar credit profiles received regular loans (Savage 2011).

Lending data showed that Countrywide ended up charging Hispanics and African-Americans more, on average, than white applicants with similar credit histories. In 2007, for example, Countrywide employees charged Hispanic applicants in Los Angeles an average of \$545 more in fees for a \$200,000 loan than they charged non-Hispanic white applicants with similar credit histories. Independent brokers processing applications for a Countrywide loan charged Hispanics \$1,195 more, the department said (Savage 2011).

In December 2011, DOJ announced a record \$335 million settlement with Bank of America, which had acquired Countrywide in mid-2008– the largest residential fair lending settlement in history. Attorney General Eric H. Holder Jr. said the settlement showed that the Justice Department would ‘vigorously pursue those who would take advantage of certain Americans because of their race, national origin, gender or disability,’ adding: “Such conduct undercuts the notion of a level playing field for all consumers. It betrays the promise of equal opportunity that is enshrined in our Constitution and our legal framework” (Savage 2011). In signing the consent order, Countrywide

² This was part of a broader emphasis on using civil and criminal proceedings to enforce anti-discrimination sanctions. “In early 2010, the division created a unit to focus exclusively on banks and mortgage brokers suspected of discriminating against minority mortgage applicants, a type of litigation that requires extensive and complex analysis of data. Working with bank regulatory agencies and the Department of Housing and Urban Development, the unit has reached settlements or filed complaints in 10 cases accusing a lender of engaging in a pattern or practice of discrimination” (Savage 2011).

denied allegations that it had done anything wrong, which allowed it to limit further claims against its discretionary pricing practices.

The 2011 settlement followed on an earlier 2008 suit against Countrywide by Madigan's office. This complaint had a much broader basis, alleging the lender had deliberately promoted a loan product known as a hybrid ARM that required only minimal payments during the first 2-3 years before recasting into much higher interest rates and payment. Based on a review of nearly 111,000 pages of Countrywide documents, Madigan's office determined that 60% of its hybrid ARM borrowers "would not have qualified at the full payment rate" and that "almost 25 percent of the borrowers would not have qualified for any other mortgage product that it sold" (Morgenson 2008). The suit called for the rescission of all contracts entered between Countrywide and Illinois consumers through the use of unlawful methods from 2004 through 2008 and asked that the lender pay damages to borrowers as well as civil penalties for the violations (Morgenson 2008). The suit was joined by Attorneys General in nine other states, including California (Illinois Attorney General 2008).

The 2008 suit was quickly settled by Bank of America, which had acquired the lender only a month after the Illinois complaint was filed (Illinois Attorney General 2008). The terms of the settlement appeared quite punitive: Bank of America agreed to up to 400,000 mandatory loan modifications nationwide at a projected cost of \$8.4 billion. In addition, the lender agreed to direct payments of \$8.5 million to borrowers who had lost their homes due to default on specific loan products, as well as \$1 million in relocation assistance for homeowners unable to qualify for a loan modification.

Several points emerge from closer examination of these deals. First, there is a struggle to find a legal basis to challenge contested forms of value within these transactions. Many of the legal grounds to directly challenge harmful rent-seeking within the subprime market power were swept away by deregulation and financial modernization legislation or rule making from the 1980s onwards. Correspondingly, activist state AGs (joined, since 2009, by DOJ) have ramped up enforcement but have had to employ narrower frameworks for prosecution drawn from the fair lending laws of the 1960s and 1970s (FHA, ECOA and TILA). In addition, states have used their own unfair and deceptive acts and practices (UDAP) laws to initiate legal action against subprime lenders, often constructing complaints melding federal and state law, as in the 2008 multistate settlement with BofA/Countrywide.

Still, the grounds for challenging contested practices are narrow. A prime example was a suit brought by the City of Baltimore against the large lender Wells Fargo under the Fair Housing Act. The City argued that the lender engaged in a pattern or practice of reverse redlining – "a pattern or practice of targeting African-American neighborhoods in Baltimore for deceptive, predatory or otherwise unfair mortgage lending practices" and "that has the effect and purpose of placing vulnerable and underserved borrowers in loans they cannot afford" (Relman, Dane and Colfax 2010: 2). This resulted in a disproportionately high rate of foreclosure on loans within Baltimore's majority African-American neighborhoods, at significant cost to the City.

Baltimore sought to obtain injunctive and declaratory relief and to recover damages for the injuries caused by the foreclosures in Baltimore's minority neighborhoods. However, the initial suit was dismissed based on Wells Fargo's defense that it had to charge high prices to minority borrowers because of a higher cost of capital on loans within its subprime Wells Fargo Financial unit. That is, "within a large financial institution such as Wells Fargo, mortgage prices for borrowers with similar

credit scores and qualifications vary widely according to channels and products” (White 2009). Investors in subprime mortgage-backed securities expected high yields that could only be validated by higher interest rates and fees, making intrafirm segmentation into a legitimate business practice. This “transforms internal marketing decisions into legal defenses of product classifications as if they were independently based on credit qualifications” (White 2009). In 2011, the suit was allowed to proceed only after its terms were significantly narrowed to focus on minority borrowers who qualified for prime mortgages but instead were issued subprime loans (Martin 2011).

Second, even where prosecution does find traction within one or more areas of the law, the damages leveraged through settlement pale when compared to the scale of housing distress they are meant to remedy, and are often rooted in problematic means of calculating damages. The significant size of the 2008 settlement³ pales when compared to the scale of housing distress it is meant to remedy: \$8.4 billion spread among 400,000 borrowers amounts to an average of \$21,000 per loan in principal write-downs or reduced interest payments. Given that a typical \$150,000 hybrid ARM loan could generate over \$200,000 in cumulative interest income over its lifespan, this represents only a marginal tax on profitability. For the 2011 settlement, \$335 million must be spread among nearly 200,000 minority borrowers nationwide, resulting in an average payment of \$1,675.

The relatively small damage amounts are rooted in means of calculating damages that often end up construing lenders’ business practices as unproblematic; this is evident in the 2011 Countrywide settlement. Even though the complaint focused on the disproportionate harm caused by the crowding of minority borrowers into the subprime market, damages were calculated based only on the *differences* in rates paid by minority and white borrowers. That is, the harm to minority borrowers is only construed as the marginal increase (\$1,675) over rates and fees charged to white borrowers – which were already high by virtue of Countrywide Financial’s focus on the high cost loan market. The settlement thus sanctions the firm for charging higher prices to minorities when it should have charged equally high prices to all borrowers. This normalization of business practices has been a persistent problem in the application of the *private attorney general* concept, and it is one reason why many cases are dismissed before they reach the settlement stage (cf. Taibi 1994).

In the 2011 settlement, the limited legal basis for challenging harmful lending practices meant that the calculation of damages construed key parts of the lending practices at issue as unproblematic. Even though the complaint focused on the disproportionate harm caused by the crowding of minority borrowers into the subprime market, the average damage figure of \$1,675 was calculated based only on the *differences* in rates paid by minority and whites borrowers. That is, the harm to minority borrowers is only construed as the marginal increase over rates and fees charged to white borrowers – which were already high by virtue of Countrywide Financial’s focus on the high cost loan market. Thus, the settlement sanctions the firm for charging higher prices to minorities when it should have charged equally high prices to all borrowers.

Third, this problematic framing of remedy can be seen just as clearly in the settlements’ orientation to the underlying contracts. Rather than rescind the contracts, as Madigan originally demanded, the 2008 settlement required that Bank of America modify home mortgages to increase the likelihood

³ Indeed, the DOJ did not join this case and the Bush administration put tremendous pressure on the lead AGs to avoid loading the Bank with liabilities right at the moment when its safety and soundness, along with that of the US banking system as a whole, was in question.

that owners could afford to stay in their homes. This represents a curious intermixing of borrower remedies with business efficiency – the hybrid ARMs had been defaulting at an extraordinarily high rate, and modification is a pragmatic strategy to retain the long-term value of those loans on lenders' balance sheet. It is also a highly selective form of remedy – it only works for borrowers who are still solvent, and it works by displacing arrears and penalties to the end of the loan and re-amortizing the whole thing. Under the terms of the 2008 settlement, BofA was also under no obligation to address second lien loans – piggyback mortgages that were key parts of the subprime industry from 2004 to 2007. Thus Alan White at CUNY has described the BofA settlement as more as loss mitigation for the bank and investors in mortgage-backed securities than recompense for victims of predatory lending (SOURCE).

In addition, the modification practices employed followed standards that were subsequently laid out in the federal Home Affordable Modification Program (HAMP): producing an affordable payment by temporarily reducing interest rates to as low as 2%⁴, re-amortizing the outstanding principal balance to as long as 40 years, and forbearing any extra principle as necessary to reduce the overall cost to 31% of the borrowers' income. As others have noted, this produces owner stability in the short-run only by stabilizing lenders' claims for as much of the value of the loan as possible (Ashton 2011; Langley 2009). Modifications also involve the lender applying a Net Present Value calculation, which gives license to the lender to expedite foreclosures where the risk-weighted benefits to the lender of a modification do not exceed the risk-weighted costs of foreclosure. Together, constructing remedial powers in this way only serves to transfer legal uncertainty back to borrowers by securing the status of the original mortgage contract.

There are numerous other criticisms that could be leveled against the private prosecution of firm behavior – its *ex post facto* nature, the high cost and significant evidentiary burden should a case proceed to trial, its narrow focus on the single firm and its erasure of investor liability, and the difficulties in making complex financial problems legible for judges and juries (Dorn 2011; Taibi 1994). However, the critical point for this analysis is that, whereas the spate of cases seems to indicate a new phase in the regulatory enforcement, closer examination yield a diminishment of the remedial powers of borrowers in favor of normalization of harmful business practices and the securing of substantive powers for lenders.

Conclusion

As I noted earlier, this analysis of the reshaping of remedial and substantive powers requires skepticism regarding Commons' optimism that new authoritative sources would balance the growing economic power of financial going concerns. Closer examination of the surge in legal proceedings against subprime lenders does not support the contention that a parallel process of legal enlargement on behalf of borrowers is at work. I argued this is partially due to changes in the legal landscape that have altered how claims regarding the harms of the subprime market are interpreted and remedied. Here, legal concepts of fairness – such as disparate impact, reverse redlining, or suitability – have had a difficult time gaining traction against a broad range of lender and servicer practices used to generate value within subprime mortgage transactions. Instead, borrowers are presumed to have formal equality with lenders through disclosure provisions and the ostensible

⁴ After five years, interest rates would begin to rise again.

availability of other options. Further, deregulation and federal pre-emption have reorganized state discretion, diminishing rather than enlarging the scope for remedial powers on behalf of borrowers. As a result, recent cases highlight how a narrow construal of harm and calculation of damages have the capacity to erase certain business practices (such as geographic or borrower segmentation within high cost lending channels) from the legal landscape.

Further, Commons expressed faith that a durable regime of “stabilized prerogative” – manifest in a powerful independent judiciary, constitutional protections of due process, and a commitment to positive law – would establish working rules that could balance inequalities between creditors and debtors. This faith seems misplaced as the prosecution of the crisis has been taken up, not by institutions of positive law such as the Supreme Court, but within administrative venues such as the SEC, DOJ, or consortia of state AGs. The legal techniques employed in these venues, as evidenced in the 2008 and 2011 BofA/Countrywide settlements, embody certain selectivities that, when applied to concrete experiences of dispossession, transfer legal uncertainty back to borrowers and structure harm as legally unproblematic. They also ignore critical questions regarding the financial commodity chain, granting release from prosecution without clarifying the appropriate lines between fraud, harm, and legitimate business practices at play in the working rules of the subprime market.

References

- Ashton, Philip. 2011. The financial exception and the reconfiguration of credit risk in US mortgage markets. *Environment & Planning A* 43 (8): 1796-1812.
- Commons, John R. 1924. *The Legal Foundations of Capitalism*. New York: The Macmillan Co.
- Commons, John R. 1934. *Institutional Economics: It's Place in Political Economy*. New Brunswick, NJ: Transactions Books.
- Dorn, Nicholas. 2011. Regulatory sloth and activism in the effervescence of financial crisis. *Law & Policy* 33 (3): 428-448.
- Engel, Kathleen, and Patricia McCoy. 2002. A tale of three markets: The law and economics of predatory lending. *Texas Law Review* 80 (6): 1255-1382.
- Farhang, Sean. 2010. *The Litigation State: Public Regulation and Private Lawsuits in the United States*. Princeton: Princeton University Press.
- Illinois Attorney General. 2010. Madigan Sues Countrywide for Discrimination against African American and Latino Borrowers. Available online at http://illinoisattorneygeneral.gov/pressroom/2010_06/20100629b.html [downloaded December 12, 2011].
- Illinois Attorney General. 2008. Illinois Attorney General Madigan Leads \$8.7 Billion Groundbreaking Settlement of Lawsuit against Mortgage Giant Countrywide. Available online at http://www.illinoisattorneygeneral.gov/pressroom/2008_10/20081006.html [downloaded December 12, 2011].
- Immergluck, Dan. 2009. *Foreclosed: High-Risk Lending, Deregulation, and the Undermining of America's Mortgage Market*. Ithaca, NY: Cornell University Press.
- Langley Paul. 2009. Debt, discipline, and government: Foreclosure and forbearance in the subprime mortgage crisis. *Environment and Planning A* 41(6): 1404-1419.
- Martin, Andrew S. 2011. Judge allows redlining suits to proceed. *The New York Times*, May 5. Available online at <http://www.nytimes.com/2011/05/06/business/06redlining.html> [downloaded November 11, 2011].
- Marx, Karl. 1963. *Capital: A Critical Analysis of Capitalist Production. Volume 1*. Moscow: Progress Publishers.
- Morgenson, Gretchen. 2008. Illinois to sue Countrywide. *The New York Times*, June 25. Available online at <http://www.nytimes.com/2008/06/25/business/25mortgage.html> [downloaded December 12, 2011].
- Nagareda, Richard A. 2007. *Mass Torts in a World of Settlement*. Chicago: University of Chicago Press.

Relman, Dane and Colfax PLLC. 2010. Third Amended Complaint for Declaratory and Injunctive Relief and Damages, Mayor and City Council of Baltimore v. Wells Fargo Bank/Wells Fargo Financial Leasing. Case no. 1:08-cv-00062-JFM, US District Court for the District of Maryland, Baltimore Division. Filed October 21.

Riles, Annelise. 2011. *Collateral Knowledge: Legal Reasoning in the Global Financial Markets*. Chicago, IL: University of Chicago Press.

Savage, Charles. 2011. Countrywide will settle a bias suit. *The New York Times*, December 21. Available online at <http://www.nytimes.com/2011/12/22/business/us-settlement-reported-on-countrywide-lending.html>? [downloaded February 5, 2012].

Scheuerman, William. 2004. *Liberal Democracy and the Social Acceleration of Time*. Baltimore, MD: The Johns Hopkins University Press.

Taibi, Anthony. 1994. Banking, finance, and community economic empowerment: Structural economic theory, procedural civil rights and substantive racial justice. *Harvard Law Review* 107 (7): 1463-1545.

White, Alan M. 2009. Borrowing while Black: Applying fair lending laws to risk-based mortgage pricing. *South Carolina Law Review* 60 (3).