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ASSIGNEE LIABILITY IN RESIDENTIAL MORTGAGE TRANSACTIONS

The Holder in Due Course Rule that Protects Assignees of Mortgage Loans from Borrowers' Claims Against Lenders Has Been Restricted by Federal and State Legislation Aimed at Protecting Consumers. Further Erosion of the Rule May Arise from the Judicial Doctrines of Imputed Knowledge and Sham Arrangements.

By Jeffrey P. Naimon, Jacob Thiessen and Jennifer Beall*

As long as lenders have been assigning the loans they make to investors, borrowers have been trying to hold investors to account for lenders' alleged misdeeds. And for almost as long, investors have maintained that they are not, and should not be, responsible for those misdeeds. This struggle has left traces in American law that include the common law holder in due course rule, Article 3 of the Uniform Commercial Code, the Federal Trade Commission's holder rule, the assignee liability and rescission provisions of the Truth In Lending Act, and the expansion of assignee liability in the Home Ownership and Equity Protection Act. No legal doctrine, however, whether rooted in ancient case law or arising out of a recently enacted statute, has established once and for all the relative legal positions of lender, borrower and assignee. Rather, the law has slowly relinquished the hard-headed position that the continued availability of credit depends on the absolute protection of assignees, without ever giving full support to the desire to make whole every deserving borrower from whatever source of assets is available.

The holder in due course rule remains an important aspect of the law relating to residential mortgage transactions,[1] but the protections it provides to assignees of mortgage loans have recently been under severe legal pressure. This article provides an overview of the development and current state of the law of assignee liability and discusses two legal trends that are contributing to that pressure. One trend imputes to the assignee enough knowledge of the activities of the lender from which the assignee

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1. We note that most commercial paper still consists of negotiable instruments to which the holder in due course rule applies. The focus of this article, however, is on the holder in due course rule as it applies to transactions involving consumers.

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buys the lender's loan production that the assignee cannot be considered a purchaser "without notice" — an assertion which, if true, calls into question the assignee's ability to claim the protection of the holder in due course rule. The second trend is to assert that the secondary market arrangement in which the assignee buys loans from the lender is really a sham, that there is no legally cognizable distinction between the lender and the assignee, and thus that the assignee should not be entitled to special legal protections. Although these trends still have limited legal support, their intuitive appeal both to advocates for consumers' rights — particularly against subprime mortgage lenders — and to populist demagogues interested in humbling high-profile financiers means that the financial services industry is likely to hear a great deal in coming years about imputed assignee knowledge and sham secondary market arrangements. Because the latter argument in particular deviates markedly from the principles underlying the law of assignee liability, it represents an unprecedented challenge to ordinary American lending practices and calls for assignees of loans to think strategically about their legal position in entirely new ways.

COMMON LAW AND UCC ARTICLE 3

In 1781, an opinion was handed down from the Court of King's Bench in *Peacock v. Rhodes* concerning an action on a bill of exchange. The bill had been drawn to order, endorsed in blank, stolen, and negotiated to an innocent purchaser who had attempted to collect on it. Lord Mansfield, holding for the purchaser, stated unequivocally that:

> The holder of a bill of exchange, or promissory note, is not to be considered in the light of an assignee of the payee. An assignee must take the thing assigned, subject to all the equity to which the original party was subject. If this rule applied to bills and promissory notes, it would stop their currency.... [A] holder, coming fairly by a bill or note, has nothing to do with the transaction between the original parties; unless, perhaps, in the single case ... of a note for money won at play.[2]

Mansfield's holding in *Peacock v. Rhodes* capped more than a century of legal attacks on the old common law maxim "one cannot give what one does not have." At first, the assignee of a promissory note, like the assignee of a deed to real property or title to a chattel, could obtain no more right to the thing assigned (whether note, realty or chattel) than the assignor had before the assignment. But beginning in the late seventeenth century and

2. *Peacock v. Rhodes*, 2 Doug. 633 (1781) (Mansfield, C.J.), *quoted* in James Oldham, *The Mansfield Manuscripts and the Growth of English Law in the Eighteenth Century* (2 vols, Chapel Hill and London: University of North Carolina Press, 1992), 1:607-8.

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increasingly through the eighteenth century, the law came to favor a subgroup of assignees called "holders," at first solely assignees of foreign bills of exchange, ultimately assignees of all bills and notes, who, if the proper formalities of assignment were observed, would obtain more rights with respect to the bill or note than the assignor had to give.[3] Mansfield's holding was only the logical conclusion of this trend: a holder should have the rights associated with that legal status even if the person from whom the holder obtained the note had no rights in the note at all — had stolen it, in fact.

Mansfield's rationale for this holding was the same as had underpinned the development of the holder doctrine from the beginning: certainty in commercial transactions, Mansfield's "currency," required it. Merchants could not know about the underlying transaction that gave rise to a particular bill or note taken in payment for goods, and in the paper economy that was already developing in England at the time they could not realistically demand coin rather than bills or notes as payment. Under the rule of *Peacock v. Rhodes*, if a merchant was a "holder" who "came fairly by" a bill or note, he could collect on that bill or note without having to know anything about the transaction that gave rise to it, other than its underlying legality.

More than two centuries later, this remains a basic principle of the American law of bills and notes, now lumped together as "negotiable instruments." Passing over from English common law into the common law of the individual states, the rule was ultimately codified in the Uniform Negotiable Instruments Act (1896), developed by the National Conference of Commissioners on Uniform State Laws and intended for use in every state.[4] It is an indication of the perceived indispensability, even a century ago, of this rule and of the uniform national payment system made possible by its general adoption that the Uniform Negotiable Instruments Act was one of the first uniform state laws developed by NCCUSL.

3. For an excellent short synopsis and lucid analysis of the development of the law of negotiable instruments in seventeenth- and eighteenth-century England, *see* Oldham, *Mansfield Manuscripts*, 1:596-609.
4. Uniform Negotiable Instruments Act, § 57 (1896) in H. Noyes Greene (ed.), *Uniform Laws, Annotated, Book 5: Uniform Negotiable Instruments Act* (Northport, New York: Edward Thompson Company, 1923), 257.

The rule was fleshed out in the original version of Article 3 of the Uniform Commercial Code (1955). With the 1990 changes to Article 3, the rule can be found at 3-305(b), where it now reads:

> **Defenses and Claims in Recoupment.** ... The right of a holder in due course to enforce the obligation of a party to pay the instrument is subject to defenses of the obligor stated in subsection (a)(1) [that is "(i) infancy of the obligor to the extent it is a defense to a simple contract, (ii) duress, lack of legal capacity, or illegality of the transaction which, under other law, nullifies the obligation of the obligor, (iii) fraud that induced the obligor to sign the instrument with neither knowledge nor reasonable opportunity to learn of its character or its essential terms, or (iv) discharge of the obligor in insolvency proceedings"], but is not subject to defenses of the obligor stated in subsection (a)(2) [that is, defenses of the obligor stated in another section of Article 3 or "that would be available if the person entitled to enforce the instrument were enforcing a right to payment under a simple contract"] or claims in recoupment stated in subsection (a)(3) [that is claims "of the obligor against the original payee of the instrument if the claim arose from the transaction that gave rise to the instrument"] against a person other than the holder.[5]

Though more elaborate with each new enunciation, this remains in outline recognizably the same rule: with reference to a certain class of financial instruments, certain persons can enforce those instruments, and the persons obligated on those instruments have a very limited range of defenses that allow them to avoid paying.

The definition of the favored persons, though also grown more elaborate with the passage of time, has also not changed in substance. Mansfield called them "holder[s] coming fairly by a bill or note." The Uniform Negotiable Instruments Act labeled them "holders in due course." The original version of UCC Article 3 defined a holder in due course as "a holder who takes the instru-

5. Uniform Commercial Code, Article 3, § 3-305(b) (1990).

ment (a) for value; and (b) in good faith; and (c) without notice that it is overdue or has been dishonored or of any defense against or claim to it on the part of any person."[6] Revised Article 3 expands the core definition:

> ... "holder in due course" means the holder of an instrument if: (1) the instrument when issued or negotiated to the holder does not bear such apparent evidence of forgery or alteration or is not otherwise so irregular or incomplete as to call into question its authenticity; and (2) the holder took the instrument (i) for value, (ii) in good faith, (iii) without notice that the instrument is overdue or has been dishonored or that there is an uncured default with respect to payment of another instrument issued as part of the same series, (iv) without notice that the instrument contained an unauthorized signature or has been altered, (v) without notice of any claim to the instrument ... and (vi) without notice that any party has a defense or claim in recoupment[.][7]

But again, the fundamental point is recognizably the same as it was in Mansfield's day: in order to be favored at law, the person must obtain the instrument in a bona fide transaction (read "purchase it for value") that is in some sense fair (read "in good faith and without notice of irregularities, claims or defenses"). Note that the transaction that must be fair is the transaction between the seller of the instrument and the holder — not the transaction in which the obligor generated the negotiable instrument in the first place.

It would be hard to exaggerate the importance of this rule to the development of modern commercial law. The holder in due course rule underpins the use of banknotes (the ancestor of modern paper money), the law governing checks, and the discounting of bills (the ancestor of modern commercial banking). Secondary markets in negotiable instruments, important for capital formation and the maintenance of lender liquidity, function because the rule permits the sale and resale of large numbers of negotiable instruments without the need to scrutinize the underlying transactions that give rise to them. Institutions and practices that we take for granted would be far different without the holder in due course rule, if they could exist at all.

In part, of course, this simply reflects the rule's longevity and long-term consistency. The rule, however, is not merely venerable but also highly effective at creating the one thing merchants need most out of the law — certainty. Whatever else may be in dispute, the holder in due course rule makes it very hard for a merchant to repudiate the negotiable instruments that it issues, regardless of who ends up having to pay.

MODIFICATIONS OF THE RULE IN CONSUMER TRANSACTIONS

The common law tradition summed up in UCC Article 3 arose out of commercial disputes. It reflected those origins in its assumption that all parties to transactions were "merchants," sophisticated and knowledgeable about business matters. Though well adapted to the needs of commerce, however, the rule preserving in almost all cases the holder's ability to collect on the negotiable instrument led to inequities when applied to notes signed by unsophisticated consumers. A consumer, for example, who purchased a new car with her personal note would find that, even though the car dealer to whom she gave the note was insolvent and unable to deliver, she was still obligated on the note because the car dealer had negotiated it to a finance company before going bankrupt. In one such case, *Mutual Finance Co. v. Martin*,[8] the Florida Supreme Court reasoned that the consumer's relative lack of sophistication meant that "the finance company is better able to bear the risk of the dealer's insolvency than the buyer and in a far better position to protect his interests against unscrupulous and insolvent dealers." Based upon the policy considerations arising out of the consumer context of the transaction, the Florida Supreme Court declined to follow the rule.

Such judicial refusal to protect assignees became increasingly common as inequities in consumer transactions arising out of the operation of the holder in due course rule became more apparent.[9] While some courts took the approach of the *Martin* court, abrogating the

6. Uniform Commercial Code, Article 3, § 3-302 (1955).
7. Uniform Commercial Code, Article 3, § 3-302(a) (1990).
8. Mutual Finance Co. v. Martin, 63 So. 2d 649, 653 (Fla. 1953).
9. *See generally* Dee Pridgen, Consumer Credit and the Law § 14:4 (West 2001).

rule on the grounds of public policy, others tried to modify the legal framework of the rule without discarding it completely. In 1940, the Arkansas Supreme Court developed the theory of "close connectedness" in *Commercial Credit Company v. Childs*,[10] under which a creditor taking the assignment of a note on the day of an automobile sale was held to be so closely connected to the consumer transaction as to be an "original" party to the transaction. In such a situation, the creditor could not be a holder in due course and was subject to the consumer's claims against the seller. Other courts began to apply a "should have known" standard to holders and, using that standard, held more frequently that assignees had enough knowledge of the seller's practices to defeat holder in due course status.[11]

Many attempts at a comprehensive legislative or regulatory solution to the equitable shortcomings of the holder in due course rule eventually arose out of this judicial discontent. At the state level, legislatures began enacting "anti-holder in due course" statutes — by 1975, almost forty states had implemented such legislation.[12] At about the same time, two important federal initiatives addressing the same problems were undertaken: the Federal Trade Commission's holder rule (the "FTC Holder Rule") and the Truth in Lending Act ("TILA"). These initiatives, together with the later amendment to TILA labeled the Home Ownership and Equity Protection Act ("HOEPA"), limited the scope of the holder in due course rule as a way to protect consumers, generally by giving the consumer another party from which to obtain redress in the event of a violation or default by the assignor.

The FTC Holder Rule

Like some of the judicial initiatives noted above, the FTC Holder Rule sought to enhance the rights of consumers while retaining the overall framework of the holder in due course rule. Its motivation arose out of the same recognition that it was unjust for a "seller to employ procedures in the course of arranging the financing of a consumer sale which separate the buyer's duty to pay for goods or services from the seller's reciprocal duty to perform as promised."[13] In order to close that gap, however, the FTC appealed neither to the equities of particular factual circumstances nor to overarching policy considerations. Instead, it ingeniously created a procedural mechanism that protected consumers while *reinforcing* the basic principle that only a person taking a negotiable instrument without notice qualified as a holder in due course.

The FTC Holder Rule did so by requiring the insertion of a special notice in every "consumer credit contract," defined to include every instrument evidencing a debt arising out of a purchase-money loan made either by a seller of goods or services, by the seller's affiliate, or on a referral from the seller.[14] Since 1975, every such instrument has had to contain a ten-point boldface statement that:

> ANY HOLDER OF THIS CONSUMER CREDIT CONTRACT IS SUBJECT TO ALL CLAIMS AND DEFENSES WHICH THE DEBTOR COULD ASSERT AGAINST THE SELLER OF GOODS OR SERVICES OBTAINED PURSUANT HERETO OR WITH THE PROCEEDS HEREOF. RECOVERY HEREUNDER BY THE DEBTOR SHALL NOT EXCEED AMOUNTS PAID BY THE DEBTOR HEREUNDER.[15]

Under UCC Article 3 as it stood at the time the FTC Holder Rule was enacted, taking an instrument having such a disclosure might not technically *defeat* holder in due course status, because the notice would not impart knowledge of the fact of a claim or defense against the seller. But because the notice would amount to a *waiver* of holder in due course status and would thereby subject the assignee to any claim or defense against the holder that actually arose against the seller, it would have the same effect as if it had defeated holder in due course status by imparting actual knowledge of the claim or defense. The passage of time, and changes to Article 3, have made it clear that the effect of the FTC Holder Rule is to eliminate holder in due course protections

10. 137 S.W.2d 260 (1940).
11. *See, e.g.*, Morgan v. Reasor Corp., 447 P.2d 638 (1968); Davis v. Commercial Credit Corp., 94 N.E.2d 710 (1950).
12. *See* Pridgen, *supra* note 9, at § 14:8.
13. *See* Federal Trade Commission, Trade Regulation Rule, Preservation of Consumers' Claims and Defenses, Statement of Basis and Purpose, 40 Fed. Reg. 53,506, 53,510 (Nov. 18, 1975).
14. 16 C.F.R. § 433.1(d), (e), (i); 12 C.F.R. 226.2(a)(16).
15. 16 C.F.R. § 433.2(a).

with respect to consumer credit contracts.[16] Without altering the general principles associated with the holder in due course rule, therefore, the FTC Holder Rule protected consumers buying goods and services with credit made available by or through the seller from the potentially harsh consequences of the rule. Consumer transactions that did not fall into the definition of a consumer credit contract, however, in particular residential mortgage transactions, remained subject to the holder in due course rule.

The Truth in Lending Act

At the same time that pressures for relief were building towards the enactment of the FTC Holder Rule, Congress was considering a comprehensive disclosure statute for *all* consumer credit transactions that would cover some of the same ground in a different way. The Truth In Lending Act, passed in 1968, included penalty provisions with some effects on assignee liability. Like the FTC Holder Rule, both of TILA's penalty provisions — its imposition of statutory penalties for failure to satisfy the disclosure requirements and its grant of a right to rescind certain residential mortgage transactions altogether — fit comfortably within the established framework of the holder in due course rule, while broadening its scope for assignee liability in slightly different ways than the FTC Rule.

TILA provides for national uniformity of disclosure requirements and regulation of certain creditor practices in consumer credit transactions. A creditor that fails to make required disclosures or commits certain other TILA violations is liable to the consumer for actual damages and twice the amount of the finance charge in the transaction (up to a maximum of $2000 for a closed-end credit transaction secured by real property).[17] The creditor's assignee is liable for such damages if, and only if, "the violation for which such action or proceeding is brought is apparent on the face of the disclosure statement [required by TILA to be provided to the consumer]."[18] While the FTC Holder Rule changed the fact of notice by requiring a disclosure in the note, TILA changed the fact of notice by requiring the generation of a disclosure *in addition* to the note but *integrated with it*, at least for liability purposes. The same basic principle applies. Like the FTC Holder Rule, the TILA rule for assignee civil liability is recognizably rooted in the basic holder in due course principle that a holder who takes with notice gains no special protection — but under TILA the circumstances constituting notice are changed.

The right to rescind conferred by TILA harks back to an even older principle, but one that is also firmly within the scope of the rule. TILA permits a consumer to rescind a non-purchase-money loan secured by the consumer's principal residence at any time up to three business days after closing,[19] or until three business days after the receipt of complete and accurate material disclosures.[20] As a result, if inaccurate or incomplete material disclosures are received, the rescission right can last until up to three years after the consummation of the transaction or until three business days after the inaccuracy or incompleteness is resolved, whichever comes first.[21] If the consumer discovers the inaccuracy or omission and seeks to rescind the loan, it is immaterial that the loan may no longer be in the original creditor's hands — the loan is cancelled, and the entire finance charge up to the date of rescission must be refunded by the holder of the loan.[22]

While this appears superficially to mark a dramatic breach with the holder in due course rule by making the holder completely liable for the creditor's errors, in fact, a holder in due course always takes an instrument subject to the risk that the instrument itself is void as a matter of public policy. In *Peacock v. Rhodes*, Mansfield held that a holder in due course could not enforce a note for a gambling debt. In a later case, Mansfield held that a holder in due course of a bill of exchange drawn on a usurious note could not enforce the bill, reluctantly concluding that "[t]his is one of those instances in which private must give way to public convenience."[23] The UCC did not extend

16. The 1990 revisions specifically stated that for an instrument having such a notice "there cannot be a holder in due course." Uniform Commercial Code, Article 3, § 3-106(d) and comment 3 (1990).
17. 15 U.S.C. § 1640(a).
18. 15 U.S.C. § 1641(a).
19. 15 U.S.C. § 1635(a). Strictly speaking, the right extends to any loan secured by an obligor's principal residence that is neither (i) a purchase-money mortgage loan nor (ii) a refinance of a purchase-money loan by the same lender without an additional advance of credit. 15 U.S.C. § 1635(e)(1), (2).
20. 15 U.S.C. § 1635(f).
21. *Id. See* Ralph J. Rohner and Fred H. Miller (eds. Robert A. Cook, Alvin C. Harrell and Elizabeth Huber), *Truth In Lending* (Chicago, 2000: American Bar Association), § 8.03(2).
22. 15 U.S.C. § 1635(b).
23. Lowe v. Waller, 2 Doug. 736 (1781), quoted in Oldham, *Mansfield Manuscripts*, 645.

holder in due course protection to illegal instruments. TILA's rescission remedy was merely an extension of this principle to a new category of transactions, for which the "public convenience" (to use Mansfield's term) of timely, accurate disclosure was deemed to override private considerations of commercial certainty.

Like the FTC Holder Rule, therefore, TILA expanded the possible liability of assignees within the enduring framework of the holder in due course rule. It did not establish new theories of assignee liability but rather simply established a new mechanism for providing the information apparent to the holder that would defeat holder in due course status.[24]

The Home Ownership and Equity Protection Act

There is some debate as to whether HOEPA — the most recent federal alteration to the holder in due course rule — has continued or departed from this tradition of working within the holder in due course framework. The legislative history of this amendment to TILA and the language of the amendment itself lend support to both interpretations.

HOEPA was a reaction to increasing high-cost home equity lending in the 1980s and early 1990s. In an apparent departure from previous home equity booms, a significant secondary market for subprime home equity loans developed.[25] Consumer advocates raised the specter of mortgage companies defrauding borrowers, selling resulting mortgage loans on the secondary market, and then "closing shop" before borrowers could assert their claims.[26] In such a situation, without legislative relief, a secondary market assignee could protect itself from a borrower's claims and hold the borrower to repayment of the mortgage debt by embracing the holder in due course rule.[27] Based upon this argument, though apparently without any concrete proof that in fact such a scenario was more likely in high-cost home equity lending than other segments of the mortgage industry, Congress altered the rules on assignee liability for a particular class of high-cost, non-purchase money mortgage transactions that have come to be called "HOEPA loans."[28] Assignees can only avoid liability if they can demonstrate by a preponderance of evidence that "a reasonable person exercising ordinary due diligence could not determine, based on the documentation required by this title, the itemization of the amount financed, and other disclosure of disbursements" that a loan was a HOEPA loan.[29] If a reasonable person could make such a determination with respect to the loan, then the assignee of the loan is subject to "all claims and defenses with respect to that mortgage that the consumer could assert against the creditor of the mortgage[.]"[30]

The notice requirement, like the basic TILA notice requirement, is recognizably within the holder in due course tradition. Under the basic holder in due course rule, the appearance of any violation on the face of the note amounts to notice of the violation and defeats holder in due course status. Under the basic TILA rule, any violation apparent on the face of the truth-in-lending disclosure has the same effect. Under HOEPA, still more documents are subject to scrutiny and the threshold for notice is lower — notice of the fact that the loan is a HOEPA loan, not even notice of a violation, is all that is required to defeat holder in due course status. Thus, for a HOEPA loan, either of two types of "knowledge" defeats holder in due course status. Knowledge of the originator's violation of law — which would have defeated holder in due course status with respect to a non-HOEPA loan — has the same effect for a HOEPA loan.[31] In addition, however, the presence of a HOEPA notice in a loan file, or the existence of information in the loan file that shows a HOEPA notice should have been provided, defeats holder in due course status simply by putting the assignee on notice that

24. In this connection, *see Taylor v. Quality Hyundai*, 150 F.3d 689 (7th Cir. 1998) (no assignee TILA liability for violation not apparent on the face of disclosure statement, despite assignee's actual knowledge of creditor business practices); *Walker v. Wallace Auto Sales, Inc.*, 155 F.3d 927 (7th Cir. 1998) (same).
25. *See Problems in Community Development Banking, Mortgage Lending Discrimination, Reverse Redlining, and Home Equity Lending: Hearings Before the Senate Comm. On Banking, Housing and Urban Affairs*, 103rd Cong. (1993).
26. *See* National Consumer Law Center, Truth in Lending 599 (1999).
27. *Id.* at 622-623.
28. In general, a loan is covered by HOEPA if it is a non-purchase money loan secured by the consumer's principal dwelling that has associated points and fees amounting to 8% or more of the total loan amount or that has an annual percentage rate more than 8% higher than the interest rate for similar-maturity federal securities (10% for second liens). 15 U.S.C. 1602(aa), 12 C.F.R. 226.32.
29. *Id.*
30. 15 U.S.C. § 1641(d)(1).
31. *See, e.g., Hays v. Bankers Trust Co. of California*, 46 F. Supp. 2d 490 (S.D.W.V. 1999).

the loan is a HOEPA loan. This creates the possibility that the assignee can take the loan subject to the claims and defenses of the consumer even if the lender's violation, or the claims and defenses arising out of the violation, are not only unknown to the assignee, but are unknowable to the assignee. In sum, then, HOEPA amounts to a legislative expansion of the scope of the notice that can defeat holder in due course status.

A close reading of the actual language of HOEPA's assignee liability provision, however, suggests that the statute may actually *create* new liability for assignees that would not otherwise have existed. It holds the assignee subject to "*all* claims and defenses" that could have been maintained against the creditor — arguably without regard to whether the statute that imposed the liability on the creditor in the first place contemplated the possibility of assignee liability.[32]

In rejecting this argument so far, courts have used the legislative history of HOEPA as justification for holding that, regardless of what Congress said, it only meant to eliminate holder in due course protections. Thus, in *Bank of New York v. Heath*,[33] the borrowers, following a foreclosure attempt by the assignee of a loan, tried to use the HOEPA assignee liability provision to assert TILA, Real Estate Settlement Procedures Act (RESPA), and Illinois Consumer Fraud Act claims against the assignee for alleged violations by the originator of the loan. The Illinois Consumer Fraud Act only allows claims against the actual perpetrator of the fraud. The court held that HOEPA's assignee liability provision did not entitle borrowers to new rights against an assignee. Basing its decision on the clear legislative history of section 1641(d), the court held that HOEPA only "eliminates the holder-in-due course defense and is not intended to bestow any new rights upon the borrower."[34] The state law cause of action that was preserved by section 1641(d) did not apply to an assignee because the Illinois Consumer Fraud Act only allowed claims against the person committing fraud.

32. *See* Barbara Mishkin & Kevin Toth, *Assignee Liability: How Far Does it Extend?*, Consumer Financial Services Committee, Section of Business Law, American Bar Association (April 4-6, 2002).
33. No. 98 CH 8721 (Cook County Cir. Ct. Ch. Div., October 21, 2001).
34. *Heath*, No. 98 CH 8721 at 4-5.

Similarly, in *Dowdy v. First Metropolitan Mortgage et al.*,[35] borrowers filed an Illinois Consumer Fraud Act claim against the assignees of their mortgage loan based on the fraudulent conduct of the originating lender. The court dismissed the borrowers' claims, holding that HOEPA merely eliminated the holder in due course defense and, because the Consumer Fraud Act did not apply to assignees, to allow a borrower to assert a Consumer Fraud Act claim against an assignee through the HOEPA assignee liability provision would create a state law right that did not exist.

The question remains open whether the district courts' interpretation of 1641(d) will withstand appellate scrutiny. It is clear, however, that such an interpretation is more consistent with the larger history of the holder in due course rule and the law of assignee liability than the alternative of a new federal cause of action. *Heath* and *Dowdy* place HOEPA firmly in the tradition of the FTC Holder Rule and TILA: all are adjustments to the holder in due course rule, withdrawing its protections from certain classes of transactions in a manner that is consistent with the basic principles of the rule itself.

NEW LEGAL THEORIES

As the steady march of legislative and regulatory limitations to the holder in due course rule should suggest, the dominant tradition in the law of negotiable instruments subordinates judicial inclinations to legislative ones. In *Lowe v. Waller*, Mansfield himself felt constrained by the usury statute then on the books to deny recovery to a plaintiff holding a bill of exchange arising out of a usurious transaction: "I own, with a great leaning and wish on my part, that the law should turn out to be in favour of the plaintiffs. But the words of the Act are too strong."[36] There is irony to such deference, given that the holder in due course rule is such supremely judge-made law. But if the underlying purpose of the rule itself is to produce and enforce clarity in commercial transactions, accepting legislative but not judicial modifications to that rule has the benefit of preserving that clarity — legislative modifications, in contrast to judicial ones, are prospective, provide notice to litigants and non-litigants alike, and (at least theoretically) are applied consistently.

35. No. 01-C-7211 (N.D. Ill., January 29, 2002).
36. Lowe v. Waller, 2 Doug. 736 (1781), quoted in Oldham, *Mansfield Manuscripts*, 645.

As the *Martin* and *Childs* cases discussed above suggest, however, judicial restraint may be the dominant strain in negotiable instrument jurisprudence, but it is not the only one. The holder in due course rule contains its own principles of applicability, and a court that holds the rule to be inapplicable in a particular instance based upon those principles actually upholds the rule. The danger comes if a court gives in to the urgings of a plaintiff to abrogate the holder in due course rule without reference to those principles. The farther plaintiff's argument diverges from the structure of the rule, the more violence plaintiff's theory does to it.

Imputing Knowledge to the Assignee

One theory currently in vogue, which imputes knowledge of the originator's activities to the assignee, has recognizable roots in holder in due course jurisprudence but goes far beyond its origins. The main premise behind the "imputed knowledge" argument is that an assignee cannot assert that it was "without notice" of the creditor's violations if the assignee has direct, first-hand knowledge of the creditor's activities due to a steady working relationship between the creditor and the assignee. This argument, which echoes the "close connectedness" standard of *Childs*, has been given new life by recent developments in the lending industry.

The most important of these is the litigation against Lehman Brothers arising out of its business relationship with the mortgage lender First Alliance Mortgage Corporation. First Alliance offered home loans targeted to subprime borrowers. Lehman Brothers extended First Alliance a warehouse line of credit, purchased its loan production, and securitized portfolios of its loans as mortgage-backed securities. In addition, Lehman Brothers took an equity stake in First Alliance as partial payment for its provision of credit facilities. By 2000, First Alliance faced several putative class action lawsuits and state regulatory enforcement actions based on its lending practices.[37] The lawsuits included claims against Lehman Brothers, which was named as an integral and necessary participant in the alleged "predatory lending" scheme.

In March 2002, the FTC, numerous state attorneys general (including those of Arizona, California, Florida, Illinois, Massachusetts and New York), and class action plaintiffs settled allegations that First Alliance had violated federal and state laws in making home mortgage loans to customers. The claims against Lehman Brothers, however, which had been named a defendant in at least two putative class action lawsuits, were unaffected by the settlement.

Bowser v. First Alliance Mortgage Co.,[38] one of the first class action lawsuits including fraud claims against Lehman Brothers, is typical in the claims that it makes, based on the integral role that Lehman Brothers allegedly played in the activities of First Alliance. In *Bowser*, the plaintiff alleged that:

> Lehman Brothers, as owner of First Alliance and *more particularly in its role as financier* had knowledge of the fraudulent practices ... and tacitly or expressly approved those practices in its financing of the lending operations. Absent this approval, First Alliance's fraudulent loan scheme would not have been possible.[39]

From the complaint, it appears that the *Bowser* plaintiffs believe that Lehman Brothers actually had knowledge of the allegedly illegal practices of First Alliance. It is equally clear, however, that the *Bowser* plaintiffs think Lehman Brothers should be held responsible for the practices of First Alliance because of its structural role as "financier" of the loans made through those practices. The first of these grounds of liability consists of a straightforward failure to purchase without knowledge under well-established holder in due course law. The second, however, is potentially revolutionary. If taking on the role

37. The complaints against First Alliance alleged that First Alliance marketed its loans through a sophisticated campaign of telemarketing and direct mail solicitations. First Alliance's solicitations allegedly misled consumers about the existence and amount of loan origination fees and other fees, which typically amounted to ten to twenty-five percent of the loan. Further, consumers were allegedly misled about the increases in the interest rate and the amount of monthly payments on adjustable rate mortgage ("ARM") loans. Additionally, the complaints alleged that First Alliance violated TILA by failing to provide consumers who obtained ARM loans with required disclosures about how such loans worked.

(footnote continued on next column...)

(footnote continued...)

38. No. SA00-12370LR (Bankr. C.D. Cal. filed May 1, 2000).
39. *Bowser v. First Alliance Mortgage Co.*, No. SA00-12370LR (Bankr. C.D. Cal. filed May 1, 2000).

of "financier" means that a purchaser *per se* has knowledge of the circumstances in which the loans it "finances" are made, then the financier cannot take the loans without knowledge. As a result, this imputation of knowledge takes the old theory of "close connectedness" a long step down the road towards abolition of the holder in due course rule.

It may be, of course, that the record developed in Bowser will ultimately show that Lehman Brothers in fact did have actual knowledge of First Alliance's alleged illegal practices. If so, there will be no reason to create new theories of liability that establish a precedent harmful to the holder in due course rule. It may also be that any final decision in *Bowser* will take the form of a holding that a reasonable loan purchaser in the special position of Lehman Brothers — a part-owner of the originator as well as the funder and purchaser of the originator's loans — either must have known or should have known of the activities of First Alliance. Such a standard would cause some harm to the certainty of the rule, and would impute knowledge to stockholders that in fact stockholders almost never have unless they are also members of a company's Board of Directors or senior management. But at least such a holding would have the merit of being limited in its applicability to owner/purchasers — a small class of loan purchasers and one that, after such a holding, would probably grow still smaller. Even if the *Bowser* plaintiffs are successful in their theory of *per se* liability for "financiers," any limitation on the definition of a "financier" will effectively preserve the holder in due course rule for non-financiers. But once the theoretical argument has been made that some class of assignees should be denied holder in due course status *per se* because they have a particular economic relationship with the originator, pressures will grow to expand the definition of the disfavored economic relationship. *Bowser* and the other cases against Lehman Brothers thus bear watching as bellwethers for the future of the rule.

Sham Secondary Market Transactions

Of comparable, perhaps even greater significance to the long-term survival of the rule is the argument that secondary market sales are mere "sham" transactions intended to hide the fact that the secondary market purchaser is the "real" maker of the loans that it nominally only purchases. The sham transaction argument has been in play at least since the 1998 decision in *Chandler v. Norwest Bank Minnesota*.[40] The mortgage loan that gave rise to the *Chandler* litigation was originated by Custom Mortgage, Inc., drawing on a line of credit it had arranged with CoreStates Bank. Pursuant to a prior agreement, the loan was then sold to Norwest Bank Minnesota as trustee of a securitization trust for an amount that included the cost of the draw on the line of credit.[41] In Chandler, mortgage loan borrowers brought an action under RESPA against Norwest, alleging that Norwest, not Custom, was the "real source of funding" for the borrowers' mortgage loan, and thus that it was liable for the allegedly excessive and unearned closing fees that they paid. In a 2-1 decision, the Eighth Circuit held that the mortgage company, not Norwest, had originated the mortgage loan. In dissent, however, Judge Gibson asserted that the sale from Custom to Norwest was not "bona fide":

> A bona fide secondary market transaction is one where a mortgage lender makes loans for its own portfolio and finances these loans from its own or borrowed funds and holds the loans for varying periods of time, or until maturity, with the option of selling its loans, usually in batches on the open market, and not in a preordained procedure where a party makes a loan knowing it will be transferred in due course in a matter of days to the ultimate lender.[42]

Because Custom knew that Norwest would be purchasing the loan, Gibson asserted, the "real source of funding" for the loan was Norwest, and the sale from Custom to Norwest thus was merely a "sham transaction" designed to evade RESPA liability.[43]

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40. 137 F.3d 1053 (8th Cir. 1998). The sham transaction argument has a long history in connection with the law of usury, in which courts have routinely seen through the form of a transaction to its usurious substance. *See, e.g., Cohen v. Eisenberg*, 697 N.Y.S.2d 625, 626 (N.Y.App. 1999); *Approved Finance Co. v. Schaub*, 349 A.2d 81, 85 (N.J.App. 1975); *Sondeno v. Union Commerce Bank*, 71 Cal.App.3d 391, 395-396 (Cal.App. 1977); *Daniel v. First National Bank of Birmingham*, 227 F.2d 353, 355 (5th Cir. 1956) (interpreting Alabama law); *Real Estate Trust Co. of Philadelphia v. Wilmington & N.C. Electric Ry. Co.*, 77 A. 756 (Del.Ch. 1910) (dicta). We note, however, that a usurious loan is a transaction that is almost uniquely disfavored at law. *See above*, text accompanying notes 23, 36.
41. *Chandler*, 137 F.3d at 1058 (Gibson, J., dissenting).
42. *Id.*
43. *Id.*

Judicial ratification of the sham transaction theory could have a devastating effect on the holder in due course rule. Given the fungibility of money, determining the "real source of funding" of a loan is inevitably a difficult, debatable proposition. Judge Gibson's proposed test — did the putative originator "know" that the putative purchaser was going to purchase the loan — only clouds the issue. If the putative originator has the funds and has obligated itself to make the loan, does the fact that it has prearranged a sale to a putative purchaser mean that the putative originator is not the "real" lender, or that it "knows" the loan will be purchased? After all, the purchaser could renege on the purchase obligation, or reject it as not complying with the terms of purchase. Furthermore, does the sale of loans in a freshly negotiated bulk purchase mean that the loans were more the lender's loans than if they were sold under a pre-existing flow agreement? But if Judge Gibson's test of the "real source of funding" is rejected, what standard of "reality" is to be enacted?

If the availability of holder in due course protections were subject to the outcome of such an inquiry, the most salient characteristic of the holder in due course rule — its ability to generate certainty as to the assignee's legal liability-would effectively be lost. While the rule might still apply from time to time, it would have ceased to function as intended, and from a pillar of commercial law it would have descended to a mere historical curiosity — fully on a par with the Rule Against Perpetuities.[44] Financial markets would then have to price for the additional risk created by the possibility of successful litigation against assignees based on originator violations — a risk premium that would eventually be passed on to consumers in the form of generally higher credit costs. Moreover, any replacement rule for determining the real source of funding for particular loans would at best be some facsimile of the contentious, imprecise RESPA test for distinguishing mortgage brokers from mortgage lenders (*Chandler* concerned RESPA violations). At worst, the holder in due course rule would have been replaced by a standardless I-know-a-real-lender-when-I-see-one approach productive of nothing so much as further litigation. There are thus sound reasons of policy and jurisprudence why in the end the *Chandler* court ultimately rejected the sham transaction theory by a 2-to-1 margin and preserved the effectiveness of the rule.

These reasons have not, however, prevented the reargument of the sham transaction theory in different contexts. Since *Chandler*, the most active litigation based on the theory has involved the "payday lending" activities of ACE Cash Express, Inc. and Goleta National Bank. Payday loans are small cash advances that a lender provides in exchange for a personal check to be held for future deposit. These small advances, generally less than $500, must be repaid on the borrower's next payday; thus, even when they involve relatively small finance charges, these often translate into very high annual percentage rates, sometimes more than 400%. ACE is currently the nation's largest check-cashing chain and a significant provider of related retail financial services — including payday loans in states where it is legal for ACE to provide such loans at such rates. In states where usury laws make it illegal for ACE to make such loans, Goleta has made payday loans through ACE facilities, taking advantage of federal preemption of most state usury limits. Recent litigation against ACE and Goleta has advanced the argument that Goleta was a "sham lender" and that these loans were "really" made by ACE.

This litigation has had mixed results. In *Goleta National Bank v. Lingerfelt*,[45] the court denied Goleta's motion to dismiss because of factual issues concerning the identity of the "real lender" and whether ACE was a "de facto lender." On the other hand, in *Hudson v. ACE Cash Express*,[46] the court granted ACE's motion to dismiss. While Hudson argued that ACE should be treated as the "true" lender, the court held that loans nominally originated by Goleta were as a matter of law made by Goleta and subject to the National Bank Act. As a result, the loans could be made at the interest rates permitted by California law (Goleta's state of location), regardless of another state's more restrictive usury laws.

Recently, ACE entered into a settlement agreement with the Office of the Colorado Attorney General, stemming from a complaint in which ACE was accused of making improper loans under a "rent-a-charter" arrangement

44. We note that at least one important function of the holder in due course rule — its protection of the ultimate purchaser of a note from claims and defenses of *intermediate owners* — would have been undisturbed by the *Chandler* dissent. In a securitization context, such claims and defenses are significant.

45. 211 F. Supp. 2d 711 (E.D.N.C. 2002).
46. 2002 WL 31255461 (S.D. Ind., Sept. 27, 2002).

with Goleta.[47] As part of the settlement, ACE agreed to discontinue its relationship with Goleta. Nevertheless, it is worth pointing out that the ACE litigation has not yet resulted in a clear ratification of the sham lender theory; we have yet to see a court clearly revive the substance-over-form argument last seen in the *Chandler* dissent. But potential vehicles for such a holding clearly already exist.

THE TWENTY-FIRST CENTURY ASSIGNEE

Unlike its counterpart at the beginning of the twentieth or the nineteenth, a purchaser of consumer loans at the beginning of the twenty-first century thus cannot blithely assume that it is insulated by the holder in due course rule from the consequences of the actions of the originator of those loans. Statutes and regulations have circumscribed the rule. More troubling, recent litigation has suggested a renewed effort to attack the rule's fundamental principle: its formal test for assignee liability. The arguments for the continued existence of the rule remain what they have been for centuries: it produces commercial certainty; enhances lender liquidity; and makes access to capital easier by lowering barriers to entry into the lending market, allowing quantification of risk, and generating competition. All of this ultimately lowers the cost of credit to consumers. But the fundamental argument for abrogation of the rule also remains what it has always been: its continued existence forces consumers to bear the risk that originators will abscond, default or otherwise be unavailable to compensate consumers for their misdeeds, a risk that consumers are ill-equipped to bear or even to evaluate. In a consumer lending litigation environment heavily influenced by routine allegations of "predatory lending," it is inevitable that assignees who would in a previous generation have rested easy in their status as holders in due course will face arguments that they "should have known" about the activities of originators, that as financiers they will have such knowledge imputed to them, or even that the difference of identity between the loan originators and themselves is a sham.

The prudent assignee will therefore have to consider a question that would have been nonsense not long ago: should I even try to rely on the holder in due course rule? If the answer is "yes," then the assignee will have to be scrupulous about adhering to the formalities of the rule and ensuring that it does not in fact acquire knowledge of the originator's actions. The latter is crucial: if the cases against Lehman Brothers tell us anything, it is that an institution will be challenged on the sum total of information it received, from whatever outside source, to whatever recipient inside the institution. It should be expected that plaintiffs' attorneys will argue that any information the assignee or any of its affiliates, subsidiaries or divisions received — whether or not that information was communicated to the person or office actually responsible for the loan-purchase decision — constitutes "knowledge" that could defeat holder in due course status. A purchaser of loans will thus need to remain aware at all times of just how many ties to a particular originator it actually has, and of the information flows that those ties generate. In particular, the purchaser will always want to keep in mind whether it is receiving any information from which knowledge about the lender's actual lending practices can be deduced.

Even if it is not receiving specific information, of course, the purchaser of loans will need to consider the risk that excessive ties between it and the lender may suggest that it is the "real" lender. The assignee thus must consider whether it wants to, for example, be the sole purchaser of the loan production of a particular originator, or to be both the provider of warehouse credit and the purchaser of loan production, or establish some other unusually close relationship. Such facts lend greater persuasiveness to assertions that the lender is merely an alter ego of the purchaser, and thus that the rule has no role to play.

Because of the difficulties involved in maintaining its freedom from knowledge about the lender's activities, and because there is no guarantee that the holder in due course rule will be upheld in a particular case, the loan purchaser may wish to take precisely the opposite course and abandon reliance on the holder in due course rule. In such a case, the purchaser must assume that it will be held liable for the lender's activities — either because actual knowledge will be uncovered, or because knowledge will be imputed to it, or because the rule will be deemed inapplicable in this instance or generally. Given that the purchaser may be assumed to have such knowledge, whether it actually does or not, no additional harm will come to

47. *See* Press Release, Colorado Attorney General, ACE Cash Express to Pay $1.3 Million in Restitution to Consumers (May 6, 2002), *available at* www.ago.state.co.us/PRESREL/presrl2002/prsrl40.stm.

the purchaser from finding out how lenders from which it purchases loans actually make those loans, while obtaining that knowledge will allow the purchaser to take the actions that may limit its liability.

The purchaser's range of possible actions depends to some degree on the nature and extent of the diligence it conducts on lenders. If the purchaser conducts regular and surprise on-site reviews of lender operations, it can obtain a very good — albeit still not perfect — understanding of the lender's ordinary business practices without a review of every loan file. On that basis it should be able to price what could be called the originator's "compliance risk," and simply refuse to deal with the lender if the compliance and reputation risks are too high. If by contrast the purchaser conducts little on-site review but examines all loan files, it can both price the compliance risk based on written records of the lending process — which are inevitably incomplete — and refuse to purchase any loan with apparent errors. If the purchaser conducts cursory diligence, its ability to price the compliance risk accurately is limited, and it may be forced to rely on broader risk evaluations based on the lender's range of products, general business reputation, and so forth.

Thus, a loan purchaser operating on the assumption that it cannot rely on the holder in due course rule must either take on additional due diligence costs, or it must rely on broad evaluation criteria, in order to achieve anything like the legal and business certainty that it once could have derived from the rule. The former increases the cost of credit overall, while the latter tends to produce uneven access to credit as persons, products and businesses perceived to be trustworthy find themselves economically favored because they are perceived to represent lower legal risk. Whether the game of eliminating the inequities of the rule as applied to consumers is worth this particular candle will doubtless be the policy question underlying the next phase in the history of the holder in due course rule. ■