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# Predatory Lending, Passive Judicial Activism, and the Duty to Decide

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# PREDATORY LENDING, PASSIVE JUDICIAL ACTIVISM, AND THE DUTY TO DECIDE\*

SUSAN E. HAUSER\*\*

*Since 1999, the North Carolina General Assembly has enacted a series of statutes designed to curb abusive practices in consumer mortgage lending, including the nation's first predatory lending law. These laws implicitly recognize that the practice of securitization has created incentives for predatory lending practices to develop in the home mortgage market. Against this financial and legislative background, the North Carolina appellate courts issued five decisions between 2003 and 2008 dealing with predatory lending issues.*

*This Article analyzes these five North Carolina decisions from two perspectives: first, as demonstrating the courts' evolving response to the widespread use of securitization, and second, as representing fundamentally different approaches to the courts' basic adjudicative duty. As explained in the Article, this adjudicative duty requires judges to reach decisions that respond to the parties' arguments with candor, respect guidance from the legislature, and are narrowly structured so that they do not unnecessarily preclude future legislative or judicial action on similar issues.*

*Based on an examination of the judicial duty to decide, the Article concludes that two of these five decisions, Shepard and Skinner, illustrate a form of passive judicial activism by using procedural doctrines to unnecessarily preclude future litigation and supplant the ability of the legislature to act in an area where it has expressed strong concern. Conversely, the remaining three decisions, Melton, Richardson, and Tillman, are narrowly decided and comply with the courts' adjudicative duty.*

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## INTRODUCTION

In July of 1999, North Carolina became the first state to adopt a predatory lending law<sup>1</sup> limiting abusive practices in home mortgage lending.<sup>2</sup> The law passed both houses of the General Assembly with strong support<sup>3</sup> and prompted Attorney General Mike Easley to

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1. Senate Bill 1149 was enacted as North Carolina session law 1999-332 and codified at various locations in chapter 24 of the North Carolina General Statutes in 1999. Act of July 22, 1999, ch. 332, sec. 1-8, 1999 N.C. Sess. Laws 1202.

2. There is no generally accepted definition of predatory mortgage lending, although the term is generally used to refer to lending practices that are illegal or provide no net benefit to the borrower. See *infra* notes 33-38 and accompanying text. Most predatory loans are also subprime loans, meaning that they are high-cost loans typically offered to borrowers with poor credit histories. Not all subprime loans are predatory, however. See *infra* note 21 and accompanying text; see also Kathleen C. Engel & Patricia A. McCoy, *A Tale of Three Markets: The Law and Economics of Predatory Lending*, 80 TEX. L. REV. 1255, 1261 (2002) (distinguishing between predatory loans and legitimate subprime loans).

3. The vote was 47:2 in the Senate and 109:9 in the House. THE COALITION FOR RESPONSIBLE LENDING, SUMMARY OF NC PREDATORY LENDING LAW, <http://www.responsiblelending.org/pdfs/shortsumm.pdf> (last visited Aug. 23, 2008).

announce that North Carolina had adopted “the strongest law against predatory lending in the country.”<sup>4</sup> North Carolina’s groundbreaking law generated national attention<sup>5</sup> and was the model for predatory lending laws adopted in other states.<sup>6</sup>

Eight years later, a national wave of foreclosures<sup>7</sup> led to the collapse of the subprime mortgage market,<sup>8</sup> rocked the foundations of leading financial institutions,<sup>9</sup> and sent aftershocks rippling through

4. *Id.*

5. North Carolina’s law has been the subject of empirical study, as well as much academic discussion. See *infra* note 133 and accompanying text; see also Baher Azmy, *Squaring the Predatory Lending Circle: A Case for States as Laboratories of Experimentation*, 57 FLA. L. REV. 295, 361–81 (2005) (discussing the impact of North Carolina’s predatory lending law).

6. See Philip Bond, David K. Musto & Bilge Yilmaz, *Predatory Lending in a Rational World* 24 (Fed. Reserve Bank of Philadelphia, Working Paper No. 06-2, 2006) available at <http://ssrn.com/abstract=875621> (reporting that North Carolina’s Predatory Lending Law is “widely regarded as the model for other states’ laws”); see also Donald C. Lampe, *Wrong From the Start? North Carolina’s “Predatory Lending” Law and the Practice vs. Product Debate*, 7 CHAP. L. REV. 135, 135 (2004) (noting that North Carolina’s law “has become the *de facto* model for state and municipal ‘predatory lending’ legislation, regulation, and ordinances throughout the country.”)

7. In early 2008, approximately 24% of subprime loans were delinquent or in foreclosure, and the delinquency and foreclosure rate for all mortgages was 7.3%—the highest level since the Mortgage Bankers Association starting tracking this data in 1979. See Vikas Bajaj & Louise Story, *Mortgage Crisis Spreads Past Subprime Loans*, N.Y. TIMES, Feb. 12, 2008, at A19. By the end of March 2008, “[one] in [eleven] American mortgages were [sic] past due or in foreclosure.” Vikas Bajaj & Michael M. Grynbaum, *A Rising Tide of Mortgage Defaults, Not All on Risky Loans*, N.Y. TIMES, June 6, 2008, at C1.

8. A number of subprime lenders were forced to seek bankruptcy protection in 2007, led by New Century Financial Corporation, which filed a chapter 11 petition in Delaware on Apr. 2, 2007. See, e.g., Julie Creswell & Vikas Bajaj, *Home Lender is Seeking Bankruptcy*, N.Y. TIMES, Apr. 3, 2007, at C1 (describing the bankruptcy of New Century Financial Corporation); *American Home Mortgage Seeks Chapter 11 Bankruptcy Protection*, N.Y. TIMES, Aug. 7, 2007, at C3; *Subprime Lender Seeks Protection from Creditors*, N.Y. TIMES, Aug. 14, 2007, at C10 (describing the bankruptcy of Aegis Mortgage Corporation).

9. The steep rise in foreclosures led to large losses at mainline financial institutions in 2007. See, e.g., Gretchen Morgenson, *Bear Stearns Says Battered Hedge Funds are Worth Little*, N.Y. TIMES, July 18, 2007, at C2; Robin Sidel & Jeffrey McCracken, *Citigroup Model is Left Shaken by Credit Crunch*, WALL ST. J., Oct. 16, 2007, at A1; Randall Smith, Ann Davis & Anita Raghavan, *Loss Pressures Morgan Stanley CEO*, WALL ST. J., Dec. 20, 2007, at A1 (reporting a \$3.59 billion quarterly loss by Morgan Stanley caused by the write-down of mortgage assets and summarizing similar losses ranging from \$8 to \$14 billion suffered by Citigroup, Merrill Lynch, and UBS AG). Losses continued to threaten financial markets in 2008. On Sunday, March 16, 2008, the Federal Reserve took a series of unprecedented steps designed “to rescue the nation’s financial markets from what officials feared could be a chain reaction of defaults.” Edmund L. Andres, *Bear Stearns Sold: A Bank Rate Cut and Open-Ended Credit for Big Firms*, N.Y. TIMES, Mar. 17, 2008, at A1. The Fed’s moves included the approval of a \$30 billion credit line to help JPMorgan Chase avert the collapse of Bear Stearns by acquiring it. *Id.* In July

financial markets.<sup>10</sup> Media coverage of these events highlighted the problem of predatory mortgage lending in the public consciousness, and led Congress to consider a variety of new federal remedies for a quintessentially state-level problem.<sup>11</sup>

Between these two mileposts, the North Carolina appellate courts decided five significant cases in which consumers challenged predatory practices in mortgage lending.<sup>12</sup> The first of these decisions, *Melton v. Family First Mortgage Corp.*,<sup>13</sup> found against the consumer borrowers on grounds that are consistent with North Carolina's Predatory Lending Law.<sup>14</sup> The second and third decisions, *Shepard v. Ocwen Federal Bank*<sup>15</sup> and *Skinner v. Preferred Credit*,<sup>16</sup> conflict with the policies underlying the Predatory Lending Act by establishing new hurdles for injured consumer borrowers.<sup>17</sup> The two

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of 2008, federal regulators seized IndyMac Bancorp and threatened the takeover of Fannie Mae and Freddie Mac, "the nation's two largest mortgage finance companies." Stephen Labaton & Steven R. Weisman, *U.S. Considers Takeover of Two Mortgage Giants: Conservatorship Is Option If Troubles Grow at Fannie Mae and Freddie Mac*, N.Y. TIMES, July 11, 2008, at A1; Louise Story, *Regulators Seize IndyMac After a Run on the Bank*, N.Y. TIMES, July 12, 2008, at C5.

10. See, e.g., Peter A. McKay, *Credit Worries Send Down Dow by 172.65 Points*, WALL ST. J., Dec. 18, 2007, at C1; Floyd Norris, *With Markets Moving Wildly, Insight Suffers: A Few Late Mortgages Create a Credit Crisis*, N.Y. TIMES, Aug. 17, 2007, at A1; Floyd Norris & Vikas Bajaj, *Global Stock Markets Tumble Amid Deepening Credit Fears*, N.Y. TIMES, July 27, 2007, at A1.

11. Bills introduced in 2007 included the Mortgage Reform and Anti-Predatory Lending Act of 2007, H.R. 3915, 110<sup>th</sup> Cong. (sponsored by Rep. Brad Miller, Rep. Melvin Watt, and Rep. Barney Frank), the Home Ownership Preservation and Protection Act of 2007, S. 2452, 110<sup>th</sup> Cong. (sponsored by Sen. Christopher Dodd), and three separate proposals by the 110<sup>th</sup> Congress to amend the Bankruptcy Code to allow modification of home mortgages: S. 2136 (Sen. Richard Durbin), S. 2133 (Sen. Arlen Specter), H.R. 3609 (Rep. Miller). The only federal remedy actually enacted in 2007 was the Mortgage Forgiveness Debt Relief Act, H.R. 3648, 110<sup>th</sup> Cong. (2007) (enacted Dec. 20, 2007 as Pub. L. No. 110-142, 121 Stat. 1803), which amends the Internal Revenue Code to exclude the discharge of indebtedness on a principal residence from the debtor's gross income.

12. See *infra* Part II.

13. 156 N.C. App. 129, 133, 576 S.E.2d 365, 368-69 (2003) (holding that only the originator of a fraudulent mortgage, and not a successor assignee, is liable for an unfair or deceptive trade practice under North Carolina law).

14. See *infra* Part II.A.

15. 361 N.C. 137, 141-42, 638 S.E.2d 197, 200 (2006) (holding that a cause of action arising from the making of an unlawful loan accrues on the date of the loan closing, rejecting the argument that financing a usurious fee creates a continuing violation).

16. 361 N.C. 114, 119-20, 638 S.E.2d 203, 209-10 (2006) (stating that North Carolina courts lacked personal jurisdiction over a New York trust holding the beneficial interest in 114 mortgages made with North Carolina citizens and secured by real property in North Carolina).

17. See *infra* Parts II.B. and C.

most recent decisions, *Richardson v. Bank of America*<sup>18</sup> and *Tillman v. Commercial Credit Loans*,<sup>19</sup> reversed this trend: both found in favor of the consumer plaintiffs and followed the legislature's lead in crafting effective responses to the problem of predatory mortgage lending.<sup>20</sup>

Predatory lending practices result, in part, from an altered mortgage lending environment. After origination, lenders almost universally assign subprime mortgages<sup>21</sup> to facilitate the process of securitization.<sup>22</sup> Securitization fundamentally distorts the cost-benefit analysis traditionally used in the mortgage lending industry because it associates value with the volume of mortgages written,<sup>23</sup> as opposed to the ability of debtors to repay borrowed funds. This, in turn, creates incentives for lenders to colonize new mortgage markets by developing exotic mortgage products and offering these and other mortgages to less creditworthy classes of borrowers.<sup>24</sup>

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18. 182 N.C. App. 531, 555, 643 S.E.2d 410, 425 (2007) (holding that lender's unauthorized sale of single-premium credit insurance for mortgage loans greater than fifteen years was an unfair and deceptive trade practice and breached the lender's duty of good faith and fair dealing), *review allowed in part, denied in part* by 361 N.C. 569, 650 S.E.2d 439 (2007), *review improvidently allowed* by 362 N.C. 227, 657 S.E.2d 353 (2008).

19. 362 N.C. 93, 108, 655 S.E.2d 362, 373 (2008) (finding arbitration clause contained in plaintiffs' loan agreements unconscionable and unenforceable), *rev'd* 177 N.C. App. 568, 629 S.E.2d 865 (2006).

20. See *infra* Parts II.D and E.

21. There is no standard definition of subprime loans, and it is possible to define them either objectively or subjectively. Objectively, subprime mortgage loans are "high-rate, high-cost home-secured loans." See Cathy Lesser Mansfield, *The Road to Subprime "HEL" Was Paved with Good Congressional Intentions: Usury Deregulation and the Subprime Home Equity Market*, 51 S.C. L. REV. 473, 475 (2000). Subjectively, they are defined by referring to the type of borrower to whom they are targeted; for example, as "high[er]-cost home loans intended for people with weak or blemished credit histories." CTR. FOR RESPONSIBLE LENDING, A SNAPSHOT OF THE SUBPRIME MARKET (Nov. 28, 2007), <http://www.responsiblelending.org/pdfs/snapshot-of-the-subprime-market.pdf> (last visited Aug. 23, 2008). Not all subprime loans are predatory, although most predatory loans are also subprime loans.

22. Securitization is a financial strategy in which the originator of receivables transfers them to another entity organized as a special purpose investment vehicle (typically a trust). The investment vehicle then issues securities backed by the receivables that are sold to investors in a secondary investment market. See *infra* notes 60–70 and accompanying text.

23. Because a constant flow of new mortgages has been necessary to feed the demand of institutional investors for additional mortgage-backed securities, securitization creates incentives for mortgage originators to write as many mortgages as possible. See Mark L. Korell, *The Workings of Private Mortgage Bankers and Securitization Conduits*, in A PRIMER ON SECURITIZATION 91, 96–97 (Leon T. Kendall & Michael J. Fishman, eds., 2000).

24. See, e.g., *EMC Mortgage Corp. v. Batista*, No. 34145/06, 2007 WL 1599986, at \*2 (N.Y. Sup. Ct. 2007) (describing a \$532,000 "2-28" adjustable rate mortgage with a balloon payment due after 15 years).

The willingness of some subprime lenders to disregard the default risk<sup>25</sup> of borrowers has been enabled, in part, by the lenders' ability to isolate and externalize the liability associated with individual loans by assigning these loans to other business entities.<sup>26</sup> If neither the originator nor the ultimate holder of the mortgage stands to incur liability from the making of these mortgages,<sup>27</sup> unscrupulous and short-sighted lenders are free to see more benefit than risk in ignoring both traditional underwriting standards that protect creditors and the consumer protection laws that protect borrowers.<sup>28</sup>

State legislatures have led the way in recognizing that the economic interests of mortgage originators no longer balance with the economic interests of consumers, and North Carolina's General Assembly has been in the vanguard of this movement. Since the passage of North Carolina's Predatory Lending Law in 1999, the General Assembly has continued to express a strong legislative intent to protect consumer mortgage borrowers against the impact of securitization by passing laws to regulate mortgage professionals in 2001<sup>29</sup> and by adopting a comprehensive package of new laws in the

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25. Default risk is simply the risk that the borrower will default on the loan. See *infra* notes 55–57 and accompanying text.

26. See *infra* Part I.B; see also Lynn M. Lopucki, *The Death of Liability*, 106 YALE L.J. 1, 24 (1996) (describing asset securitization as “both a substitute for borrowing and a powerful new strategy for judgment proofing” because assets are placed “in an entity separate from the one that is at risk for liability.”)

27. See Azmy, *supra* note 5, at 319.

The separation [of originator and noteholder] creates dangerous incentives. Lenders can feel free to originate loans with abusive terms or without regard to whether the borrower can afford the loan because the lender can quickly sell it off and shift costs of foreclosure to the secondary market; brokers, who understand that a loan will eventually be sold by the originating lender, can similarly deceive borrowers in order to get up-front fees or make loans that carry an unreasonable risk of default. At the same time, the secondary market's isolation from liability eliminates incentives that might otherwise exist to police abusive terms and practices engaged in by originating lenders; instead, lenders can collect all of the profits from predatory loans with little risk of legal or financial consequence.

*Id.*

28. This phenomenon has drawn much academic attention. See, e.g., Kurt Eggert, *Held Up in Due Course: Predatory Lending, Securitization, and the Holder in Due Course Doctrine*, 35 CREIGHTON L. REV. 503 (2002); Kathleen C. Engel & Patricia A. McCoy, *Turning a Blind Eye: Wall Street Finance of Predatory Lending*, 75 FORDHAM L. REV. 2039 (2007); Christopher L. Peterson, *Predatory Structured Finance*, 28 CARDOZO L. REV. 2185 (2007).

29. North Carolina Mortgage Lending Act, N.C. GEN. STAT. §§ 53-243.01 to .18 (2007), amended by Act of Aug. 17, 2008, ch. 228, sec. 1–14, 2008 N.C. Sess. Laws \_\_\_\_.

summer of 2007 designed, in part, to overrule the decisions in *Shepard* and *Skinner*.<sup>30</sup>

As indicated by the decisions in *Shepard* and *Skinner*, North Carolina's courts have not always been as forward-looking as the state's legislature. This Article analyzes this series of decisions from two perspectives: first, as demonstrating the courts' evolving response to the widespread use of the new financial technology of securitization, and second, as exemplifying fundamentally different approaches to the courts' adjudicative duty. *Shepard* and *Skinner*, in particular, have effects so contrary to the legislature's demonstrated intent to protect consumers that they can be viewed as embodying a form of passive judicial activism.<sup>31</sup> *Richardson* and *Tillman*, on the other hand, adopt a more sophisticated approach that accurately reflects the reality of the modern mortgage market.

Part I of this Article sets the context for a discussion of these decisions. It defines the problem of predatory lending, traces its roots in securitization, and examines the state and federal remedies available to injured North Carolina consumers. Part II reviews the decisions in *Melton*, *Shepard*, *Skinner*, *Richardson*, and *Tillman* and explains how these decisions either undermine or promote the statutory protections that the North Carolina legislature provides. Part III examines doctrines of justiciability and judicial restraint and argues that judges may sometimes have an affirmative duty to decide justiciable issues that fall within their jurisdiction. Part III then posits that the decisions in *Shepard* and *Skinner* illustrate a form of passive judicial activism in which courts use procedural doctrines to unnecessarily preclude future litigation and supplant the ability of the legislature to regulate business behavior and protect consumers. *Melton*, *Richardson* and *Tillman*, on the other hand, are not activist decisions. Instead, they exemplify decisional minimalism<sup>32</sup> because they are narrowly decided and are respectful of the General Assembly's leadership in the area of predatory lending.

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30. Act of July 4, 2007, ch. 163, sec. 1-2, 2007 N.C. Sess. Laws 269; Act of July 5, 2007, ch. 176, sec. 1-3, 2007 N.C. Sess. Laws 291; Act of Aug. 16, 2007, ch. 351, sec. 1-6, 2007 N.C. Sess. Laws 1065; Act of Aug. 16, 2007, ch. 352, sec. 1-10, 2007 N.C. Sess. Laws 1072; Act of Aug. 16, 2007, ch. 353, sec. 1-6, 2007 N.C. Sess. Laws 1080.

31. The term "judicial activism" refers to the judicial usurpation of legislative functions and to the failure of judges to candidly and narrowly address legal issues placed before them. I use the term "passive judicial activism" to refer to a court's uncompelled use of procedural doctrines to preclude future litigation or legislative action. See *infra* Part III.C.

32. See *infra* notes 280-90 and accompanying text.



## I. THE PROBLEM OF PREDATORY MORTGAGE LENDING

### A. *Predatory Lending*

The term predatory lending describes a spectrum of abusive practices that lenders use to gain an unfair advantage over borrowers.<sup>33</sup> Characteristics of predatory mortgage loans include excessive, hidden, or illegal fees, unfairly high interest rates, charges for unnecessary products like single-premium credit life insurance, high loan-to-value ratios, mandatory arbitration clauses, and the use of repeated unnecessary refinancing to deplete the owner's equity while charging additional points and fees—a practice known as “loan flipping.”<sup>34</sup> Predatory lending practices also include making loans without fair consideration of the borrower's ability to repay, concealment of the true nature or cost of the loan from the borrower,<sup>35</sup> negative amortization,<sup>36</sup> and yield-spread premiums.<sup>37</sup> As

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33. From the borrower's subjective point of view, mortgage loans become predatory when they include terms that are either illegal or that produce no net benefit to the borrower. See, e.g., Kathleen C. Engel & Patricia A. McCoy, *A Tale of Three Markets: The Law and Economics of Predatory Lending*, 80 TEX. L. REV. 1255, 1257 (2002) (defining predatory lending as the practice of making “exploitative high-cost loans to naïve borrowers”). Because statutes like North Carolina's Predatory Lending Law are aimed at regulating lender behavior, they typically take the more objective approach of defining benchmark categories of covered loans and imposing specific requirements on these loans.

34. For a detailed discussion of the practice and purposes of loan flipping, see Mansfield, *supra* note 21, at 548.

35. Claims of fraud and unsavory practices are pervasive in predatory lending cases. See, e.g., *Indymac Bank F.S.B. v. Vicuna*, 83 Pa. D. & C.4th 129, 130 (Pa. Ct. Com. Pl. 2007) (fraud raised as a defense to foreclosure based on allegation that lender sold defendant an above-market mortgage after taking advantage of defendant's limited command of the English language); *Citifinancial Mortgage Co. v. Freeman*, NO. F-3151-04, 2006 WL 1029321, at \*1 (N.J. Super. Ct. Ch. Div. 2006) (defendant raised a meritorious defense of fraud).

36. Negative amortization describes “a situation in which monthly loan payments fall short of the actual monthly interest due on the loan. The unpaid interest, or ‘deferred interest,’ is then added to the principal and begins to accrue interest itself, causing the principal owed to increase despite the borrower's regular payments.” *Salois v. Dime Sav. Bank of N.Y., FSB*, 128 F.3d 20, 23 (1st Cir. 1997).

37. A yield-spread premium is a financial incentive given to a mortgage broker who finds the lowest wholesale rate available and then offers a higher interest rate to the borrower. See Les Christie, *Yield Spread Premiums Can Bite You*, CNNMONEY.COM, July 5, 2007, [http://money.cnn.com/2007/07/02/real\\_estate/yield\\_spread\\_premium\\_demystified/index.htm](http://money.cnn.com/2007/07/02/real_estate/yield_spread_premium_demystified/index.htm).

a whole, these lending practices are considered abusive because they benefit the lender while providing no net benefit to the borrower.<sup>38</sup>

Compounding the abuse, predatory lending practices have been heavily marketed to groups perceived by lenders as financially unsophisticated,<sup>39</sup> including low-income,<sup>40</sup> elderly,<sup>41</sup> and minority borrowers.<sup>42</sup> Numerous empirical studies have documented that predatory lenders disproportionately target consumers on the basis of their race<sup>43</sup> or age.<sup>44</sup> As one loan officer candidly explained, "If someone appeared uneducated, inarticulate, was a minority, or was particularly old or young, I would try to include all the [insurance] coverages . . . ."<sup>45</sup>

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38. Cf. Engel & McCoy, *supra* note 28, at 2043 (describing predatory lending as "a syndrome of loan abuses that benefit mortgage brokers, lenders, and securitizers to the serious detriment of borrowers.")

39. A number of predatory lending cases allege "reverse redlining" by lenders. Reverse redlining is the practice of extending credit on unfair terms to specific geographic areas based on the income, race, or ethnicity of residents. See, e.g., Assoc. Home Equity Servs., Inc. v. Troup, 778 A.2d 529, 537 (N.J. Super. Ct. App. Div. 2001).

40. Cf. Steven M. Graves & Christopher L. Peterson, *Predatory Lending and the Military: The Law and Geography of "Payday" Loans in Military Towns*, 66 OHIO ST. L.J. 653, 679 (2005) (documenting the marketing of predatory loans to junior enlisted military personnel described as "low-wage entry-level workers").

41. U.S. GEN. ACCOUNTING OFFICE, CONSUMER PROTECTION: FEDERAL AND STATE AGENCIES FACE CHALLENGES IN COMBATING PREDATORY LENDING 25 (2004).

42. See Elizabeth Warren, *The Economics of Race: When Making It to the Middle Is Not Enough*, 61 WASH. & LEE L. REV. 1777, 1794 (2004) (concluding that "[t]he connection between predatory mortgage lending and race is unmistakable: Predatory lenders target black and Hispanic homeowners")

43. See, e.g., ACORN HOUS. CORP., FORECLOSURE EXPOSURE: A STUDY OF RACIAL AND INCOME DISPARITIES IN HOME MORTGAGE LENDING IN 172 AMERICAN CITIES (2007) (describing a nationwide pattern of racial disparities in loans issued to homeowners with similar incomes); DEBBIE GRUENSTEIN BOCIAN, KEITH S. ERNST & WEI LI, CENTER FOR RESPONSIBLE LENDING, UNFAIR LENDING: THE EFFECT OF RACE AND ETHNICITY ON THE PRICE OF SUBPRIME MORTGAGES (2006) (analyzing subprime mortgage pricing, controlling for legitimate risks, and concluding that African-American and Latino borrowers are more likely to receive higher-rate subprime loans than white borrowers); U.S. DEP'T OF HOUS. & URBAN DEV., UNEQUAL BURDEN IN BALTIMORE: INCOME AND RACIAL DISPARITIES IN SUBPRIME LENDING (2000) (analyzing discriminatory patterns of subprime mortgage originations in the Baltimore metropolitan area in 1998).

44. See, e.g., Kellie Kim-Sung & Sharon Hermanson, *Experiences of Older Refinance Mortgage Loan Borrowers: Broker- and Lender-Originated Loans*, DATA DIG. 83 (AARP Pub. Policy Inst., Washington, D.C.), Jan. 2003, at 2-3, available at [http://www.aarp.org/research/credit-debt/mortgages/experiences\\_of\\_older\\_refinance\\_mortgage\\_loan\\_borro.html](http://www.aarp.org/research/credit-debt/mortgages/experiences_of_older_refinance_mortgage_loan_borro.html); Neal Walters & Sharon Hermanson, *Older Subprime Refinance Mortgage Borrowers*, DATA DIG. 74 (AARP Pub. Policy Inst., Washington, D.C.), July 2002, at 1, available at <http://www.aarp.org/research/credit-debt/mortgages/aresearch-import-184-DD74.html>.

45. Declaration of Gail Kubiniec, *FTC v. Citigroup, Inc.*, No. 1:01-CV-00606, ¶ 10 (N.D. Ga. 2001), available at <http://www.ftc.gov/foia/citigroup.pdf>. This statement by Ms.

The largest empirical study of predatory lending in North Carolina<sup>46</sup> assumes that most predatory loans are also subprime loans,<sup>47</sup> and then traces patterns within a database of 3.3 million loans from 1998 to 2002.<sup>48</sup> This study finds that “subprime mortgage originations are three times more common in low-income neighborhoods than in high-income neighborhoods and five times more common in black neighborhoods than in white ones. Furthermore, homeowners in high-income black neighborhoods are twice as likely as homeowners in low-income white neighborhoods to have subprime loans.”<sup>49</sup> Other studies have confirmed pronounced racial disparities in the issuance of subprime loans, even among homebuyers with similar incomes.<sup>50</sup>

A separate set of studies found older borrowers are disproportionately represented in the subprime lending market, particularly the subprime refinance market.<sup>51</sup> “[P]oor, elderly persons are often illiterate and/or unsophisticated and/or too ill, either physically or mentally, to carefully read and comprehend a complicated sheaf of mortgage loan documents.”<sup>52</sup> Elderly persons are particularly vulnerable to harm from predatory mortgage lending

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Kubinieć, a CitiFinancial loan officer, has been widely reported. See, e.g., Nikitra S. Bailey, *Attack of the Loan Sharks*, MSMAGAZINE, Jan. 1, 2008, at 12; Anita F. Hill, *Women and the Subprime Crunch*, BOSTON GLOBE, Oct. 22, 2007, at 11A.

46. Roberto G. Quercia, Michael A. Stegman & Walter R. Davis, *Assessing the Impact of North Carolina's Predatory Lending Law*, 15 HOUSING POL'Y DEBATE 573, 573 (Fannie Mae Foundation 2004).

47. Because of the difficulty of obtaining data on predatory loans, some empirical studies use subprime loans as a proxy for the smaller subset of predatory loans. This has drawn criticism, since not all subprime loans are abusive. See, e.g., STAFF OF S. COMM. ON BANKING, HOUS., AND URBAN AFFAIRS, 106TH CONG., REPORT OF THE STAFF TO CHAIRMAN GRAMM ON PREDATORY LENDING PRACTICES (2000).

48. Quercia, Stegman & Davis, *supra* note 46, at 573.

49. *Id.* at 575–76.

50. See FORECLOSURE EXPOSURE, *supra* note 43, at 1.

Nationally, African-American home purchasers were 2.7 times more likely to be issued a high-cost loan than white borrowers. Latinos were 2.3 times more likely to be issued a high cost home purchase loan than white borrowers. . . . These racial disparities persist even among homeowners of the same income level. In comparative terms, upper-income African-Americans were 3.3 times more likely than upper-income whites to be issued a high-cost loan when purchasing a home. Upper-income Latinos were 3 times more likely than upper-income whites to be issued a high-cost loan when purchasing a home.

*Id.*

51. See Kim-Sung & Hermanson, *supra* note 44, at 3; Walters & Hermanson, *supra* note 44, at 1.

52. Donna S. Harkness, *Predatory Lending Prevention Project: Prescribing a Cure for the Home Equity Loss Ailing the Elderly*, 10 B.U. PUB. INT. L.J. 1, 43 (2000).

because home equity generally comprises a substantial portion of their net worth and their decreased earning capacity makes recovery from financial harm difficult.<sup>53</sup>

By definition, subprime loans carry a greater risk of default than prime loans.<sup>54</sup> Default risk is a normal part of the lending process, and it is accounted for through an informed assessment of the borrower, as well as by application of the basic economic principle that the assumption of a higher risk by a lender demands a correspondingly higher return.<sup>55</sup> By definition, subprime mortgage loans carry higher interest rates than prime loans;<sup>56</sup> however, other ways of accounting for the default risk of subprime borrowers have sometimes been disregarded. For example, many subprime lenders issued “no-doc” loans,<sup>57</sup> even though such loans, at first blush, would seem to run counter to the lender’s own self-interest.

Empirical and anecdotal evidence supports the existence of a category of subprime mortgage loans that can fairly be characterized as predatory.<sup>58</sup> In connection with these loans, lenders have been willing to ignore the default risk of the borrower and have also been willing to incur the risk of legal liability associated with the

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53. See Deanne Loonin & Elizabeth Renuart, *The Life and Debt Cycle: The Growing Debt Burdens of Older Consumers and Related Policy Considerations*, 44 HARV. J. ON LEGIS. 167, 171–81 (2007).

54. See, e.g., Azmy, *supra* note 5, at 305 (noting that “[l]egitimate subprime loans carry interest rates or origination charges higher than conventional prime loans in order to compensate for generally higher risks”).

55. See, e.g., WILLIAM A. KLEIN & JOHN C. COFFEE, JR., *BUSINESS ORGANIZATION AND FINANCE: LEGAL AND ECONOMIC PRINCIPLES* 45 (10th ed. 2004) (stating that “as risk rises, expected rate of return or required payment will rise”).

56. See *supra* note 21 and accompanying text.

57. A “no-doc” loan is one in which the borrower is not required to provide documentary evidence of income. The issuance of no-doc loans, also known as “exceptions,” by subprime lenders has been extensively documented. See, e.g., Vikas Bajaj & Jenny Anderson, *Inquiry Focuses on Withholding of Data on Loans*, N.Y. TIMES, Jan. 12, 2008, at A1.

58. See *supra* notes 43–46 for studies providing empirical evidence of predatory lending. Other evidence is provided by reported cases dealing with loans that are arguably predatory. See, e.g., *Mitchell v. Church*, No. 04L-10-042, 2006 WL 2194738, at \*1 (Del. Super. Ct. 2006) (borrower alleged forged mortgage for home repairs that were never provided); *Assoc. Home Equity Servs., Inc. v. Troup*, 778 A.2d 529, 534 (N.J. Super. Ct. App. Div. 2001) (describing a predatory “home repair” loan extended to a 74-year old borrower who had lived in her home for 40 years); *Deutsche Bank Nat’l Trust Co. v. Castellanos*, No. 22375/06, 2007 WL 1378059, at \*3 (N.Y. Sup. Ct. 2007) (defining predatory loans as those “made on the basis of the value of the property, not the ability of the borrower to repay”); *Deutsche Bank Nat’l Trust Co. v. Clouden*, 2007 WL 2709996, at \*2 (N.Y. Sup. Ct. 2007) (same).

origination of unfair, fraudulent, or discriminatory loans.<sup>59</sup> These practices raise a fundamental question: What economic incentives motivate a lender to incur such heightened risks? To answer this question, we must examine the process of securitization and refine the definition of “lender” in light of this process.

### B. Securitization

Securitization, also known as structured finance,<sup>60</sup> “refers to the pooling of financial assets, such as mortgage loans, and the issuance of securities representing interests in the pool of assets.”<sup>61</sup> Any group of similar financial assets that generate cash flows can be securitized and thereby made liquid, even if the underlying assets themselves are not marketable standing alone.<sup>62</sup> Thus, from the standpoint of the entity that originates the asset, securitization provides a method to transform illiquid income-producing assets into cash and is attractive as an easily accessible source of capital.<sup>63</sup>

“In a typical [securitization], a company that seeks to raise cash [sells selected] assets to a special purpose vehicle or trust . . . that is organized in such a way that the likelihood of its bankruptcy is remote.”<sup>64</sup> After the sale, the special purpose vehicle (“SPV”) owns

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59. Interestingly, the agencies responsible for rating mortgage-backed securities were quite aware of the risk of liability posed by state predatory lending laws and accounted for this risk by refusing to rate securities backed by mortgage pools that included mortgages from states with particularly aggressive laws. See generally David Reiss, *Subprime Standardization: How Ratings Agencies Allow Predatory Lending to Flourish in the Secondary Mortgage Market*, 33 FLA. ST. U.L. REV. 985 (2006) (describing the impact of rating agency action on predatory lending laws in Georgia and New Jersey). No similar alarm was raised in response to structural incentives that might lead the originators of securitized loans to disregard underwriting standards.

60. The terms “securitization” and “structured finance” are frequently used interchangeably. See Peterson, *supra* note 28, at 2186 n.1 (discussing the usage of the two terms).

61. Lisa Keyfetz, *The Home Ownership and Equity Protection Act of 1994: Extending Liability for Predatory Subprime Loans to Secondary Mortgage Market Participants*, 18 LOY. CONSUMER L. REV. 151, 160–61 (2005).

62. See Thomas E. Plank, *The Security of Securitization and the Future of Security*, 25 CARDOZO L. REV. 1655, 1668 (2004) (“Securitization transforms somewhat liquid unrated receivables into highly liquid rated securities that can be sold in the capital markets”). For a detailed explanation of securitization in the home mortgage industry, see Peterson, *supra* note 28.

63. Steven L. Schwarcz, *The Alchemy of Asset Securitization*, 1 STAN. J.L. BUS. & FIN. 133, 136 (1994).

64. STEVEN L. SCHWARCZ, *STRUCTURED FINANCE: A GUIDE TO THE PRINCIPLES OF ASSET SECURITIZATION* 1 (1st ed. 1990). The concept of “bankruptcy remoteness” refers to the insulation of the assigned assets from the risk that the originator of those assets might file bankruptcy. The assignment of the assets to a separate entity removes

the assets,<sup>65</sup> and the SPV—not the originator—issues securities to investors. The SPV backs the issued securities with cash flows from the underlying assets. These securities are generically called asset-backed securities<sup>66</sup> because they are “intended to be payable ultimately and over time from collections on the receivables”<sup>67</sup> that the SPV purchases. The asset-backed securities are made more attractive to investors through credit enhancements and grading of risk by professional ratings agencies.<sup>68</sup> “This series of transactions leaves the investors with claims against the SPV, the SPV with the assets transferred by the originator, and the originator with the proceeds of the sale transaction.”<sup>69</sup>

Circular financial conduits between the mortgage brokers who originate the underlying loans and the institutions that form the secondary market of investors in mortgage-backed securities facilitate the securitization of the subprime mortgage market. When the initial broker sells mortgage-backed securities to investors in the secondary market, it generates capital to fund further mortgage originations.<sup>70</sup> Effectively, the secondary market enables the demand for subprime mortgages by providing a ready supply of capital to the mortgage brokers who originate them.

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them from the originator’s potential estate in bankruptcy, thereby making them appear safer to potential investors. See, e.g., Lopucki, *supra* note 26, at 24–26.

65. The SPV is typically an investment trust, but it may also be organized as another business form. The trust is a preferred structure “because under law it is exempt from taxes, permits the originator to treat the transaction as a loan sale, and reduces liability for the originator and issuer.” Leon T. Kendall, *Securitization: A New Era in American Finance*, in *A PRIMER ON SECURITIZATION* 1, 3–4 (Leon T. Kendall & Michael J. Fishman eds., 2000). By its nature, a trust is inherently more passive than operating business forms like corporations.

66. As a class, these types of securities are also called synthetic securities or derivatives. Individual issues will have more specific names that reference the underlying assets or characteristics of payment. For example, mortgage-backed securities may be called just that, or may be called collateralized mortgage obligations or residential mortgage-backed securities. Other securities may be sold to investors as interest-only strips or principal-only strips.

67. STEVEN L. SCHWARCZ, BRUCE A. MARKELL & LISSA LAMKIN BROOME, *SECURITIZATION, STRUCTURED FINANCE AND CAPITAL MARKETS* 7 (LexisNexis 2004).

68. See Reiss, *supra* note 59.

69. Christopher W. Frost, *Asset Securitization and Corporate Risk Allocation*, 72 TUL. L. REV. 101, 103 (1997).

70. Securitization is often described as a “form of capital formation because it gives originators of . . . receivables an additional way to raise capital to finance their operations or to extend credit to consumers.” Plank, *supra* note 62 at 1656–57; see also Engel & McCoy, *supra* note 28, at 2065 (noting that the advantages of securitization “are particularly strong for small or poorly capitalized lenders” because “aggregation enables marginal lenders to obtain financing despite obscure or questionable reputations”).

Institutional investors have been eager to drive this demand because the resulting mortgage-backed securities have offered perceived advantages over other comparable investments like government or corporate bonds.<sup>71</sup> In fact, the desirability of these investments has created institutional demand for larger numbers of residential mortgage originations<sup>72</sup> because mortgage-backed securities have offered investors higher yields than bonds, along with the assurance that the correspondingly higher investment risks can be known and controlled.<sup>73</sup> Securitization relies on a number of structural and legal devices to provide investors with these assurances of risk control.

First, the aggregation of large numbers of mortgages into income-producing pools theoretically mitigates the risk of borrower default for the investor. Credit enhancements required by agencies that rate securities before they are sold to investors further reduce the risk of default.<sup>74</sup> Finally, credit ratings themselves comfort investors, because they appear to objectively assess the risk associated with particular investments.<sup>75</sup>

Second, securitization allows the investor to avoid the operational risks associated with the potential bankruptcy of the originator or SPV. The sale of the underlying assets removes them from the potential bankruptcy estate of the originator, thereby shielding the investor from the risk of the originator's bankruptcy.<sup>76</sup> To preserve the advantage of "bankruptcy-remoteness," the SPV's organizational structure typically limits its business activities to

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71. SECURITIZATION: ASSET-BACKED AND MORTGAGE-BACKED SECURITIES 1-10 to 1-13 (Ronald S. Borod ed., 2004) (listing the benefits of securitization to investors as including: yield, relative liquidity, prepayment predictability, and entrance into the consumer credit market).

72. See Korell, *supra* note 23, at 97. ("To meet this need and profit from it, you must have a wide range of home loan product coming into your inventory or warehouse. The loan flow must be sufficient to fill up a fifteen-year bucket or pool, a thirty-year pool, a one-year adjustable loan pool, and a LIBOR-based pool on a timely basis. Only with a large flow of multiple product originations can you create the efficient, large-size securitization issues that the market will find particularly attractive.")

73. SECURITIZATION: ASSET-BACKED AND MORTGAGE-BACKED SECURITIES, *supra* note 71 at 1-10, 1-11 ("The principal attraction for investors of mortgage-backed securities (MBS), commercial mortgage-backed securities (CMBS), and asset-backed securities (ABS) is yield. Both types of securities have large enough spreads over comparable Treasuries to compensate for any credit risk or prepayment risk associated with the pooled assets.")

74. See Kendall, *supra* note 65, at 4.

75. *Id.*

76. Plank, *supra* note 62, at 1661-62 (discussing the "disaggregation of risk" associated with the originator's operations).

prevent non-investor creditors from incurring claims that could trigger a bankruptcy petition by or against the SPV.<sup>77</sup> For this reason, the servicing of the mortgage will be performed by a separate operating entity, the “servicer.”<sup>78</sup>

Third, securitization is attractive to investors because it allows the SPV to divide the risks associated with the underlying assets and sell “the risks off to the investors most able (or willing) to bear that particular type of risk.”<sup>79</sup> The designer of the SPV is able to carve the cash flows from the underlying mortgages into discrete payment streams, called tranches, each with different characteristics.<sup>80</sup> This is done by structuring the cash flows from a large group of mortgages into synthetic payment streams grouped by common characteristics like time of payment or credit risk.<sup>81</sup> This allows the creation of classes of derivative asset-backed investments tailored to the needs of institutional investors interested in investments with very specific risk profiles.<sup>82</sup>

Finally, because mortgage notes are negotiable instruments,<sup>83</sup> securitization triggers the “holder in due course” doctrine and shelters the holder of the note from much of the liability associated

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77. See SCHWARCZ, MARKELL & BROOME, *supra* note 67, at 6–8, 85–88.

78. See Katherine M. Porter, *Misbehavior and Mistake in Bankruptcy Mortgage Claims*, 87 TEX. L. REV. (forthcoming Nov. 2008) (describing the nature and purposes of mortgage servicing).

79. STEPHEN M. BAINBRIDGE, *CORPORATION LAW AND ECONOMICS* 71 (Foundation Press 2002).

80. See John H. Langbein, *The Secret Life of the Trust: The Trust as an Instrument of Commerce*, 107 YALE L.J. 165, 172–73 (1997) (discussing the use of commercial investment trusts for this purpose).

81. For example, an investor may purchase an interest in a tranche structured out of mortgage cash flows received in the first two years of the life of the underlying mortgages. Because the risk of prepayment is lower during this life stage of the mortgages, the risk associated with the investment will also be correspondingly lower. See Kendall, *supra* note 65, at 8–11.

82. Neil Kochen, *Securitization from the Investor View: Meeting Investor Needs with Products and Price*, in A PRIMER ON SECURITIZATION 103, 111 (Leon T. Kendall & Michael J. Fishman eds., 2000).

83. “[N]egotiable instrument” means an unconditional promise or order to pay a fixed amount of money, with or without interest . . . , if it: (1) is payable to bearer or to order . . . ; (2) is payable on demand or at a definite time; and (3) does not state any other undertaking or instruction by the person promising or ordering payment to do any act in addition to the payment of money, but the promise or order may contain (i) an undertaking or power to give, maintain, or protect collateral to secure payment.

U.C.C. § 3-104(a) (2002). This definition encompasses standard promissory notes secured by real property.



with the making of the mortgage.<sup>84</sup> Securitization results in a horizontally segmented lending process in which the tasks of funding, originating, servicing, and holding mortgage loans are performed by legally unrelated business entities.<sup>85</sup> This organizational structure separates the holder<sup>86</sup> of the mortgage from all other aspects of the lending process.<sup>87</sup>

To the extent that the holder qualifies as a holder in due course for purposes of the Uniform Commercial Code, the holder is shielded from most claims and defenses that the borrower<sup>88</sup> could assert against the original lender. As a holder in due course, the assignee/holder is subject only to a restricted list of "real" defenses, including infancy, extreme duress, lack of capacity, illegality, fraud in the factum, and discharge in bankruptcy.<sup>89</sup> The borrower may not raise a long list of "personal" defenses, including fraud in the inducement and mistake, against a holder in due course.<sup>90</sup> The holder in due course doctrine thus reduces the risk of nonpayment to the investor who is the ultimate beneficiary of the mortgage payments due to the holder.<sup>91</sup>

Originally, the holder in due course doctrine was intended to promote access to capital by making negotiable instruments freely transferable.<sup>92</sup> Today, the easy availability of consumer credit has

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84. A holder in due course is "(1) a holder (2) of a negotiable instrument who took it (3) for value (4) in good faith [and] (5) without notice of certain problems with the instrument." JAMES J. WHITE & ROBERT S. SUMMERS, UNIFORM COMMERCIAL CODE 509 (5<sup>th</sup> ed. 2000); *see also* U.C.C. § 3-302(a) (2002).

85. Although these entities are legally distinct, the consumer borrower may perceive any of these entities as his or her "lender."

86. The "holder" of a negotiable instrument payable to bearer is the person in possession of the instrument. *See* U.C.C. § 1-201(20) (2003). If the instrument is payable to the order of an identified person, only that person may be the holder and then only if he or she has possession of the instrument. *See id.* In the world of securitized mortgages, the holder is the SPV.

87. Predatory lending cases typically focus on the origination of the loan; however, the segmentation of the lending process creates the potential for abuse by the servicer as well. *See* Porter, *supra* note 78.

88. The borrower is the "maker"—the person "who signs or is identified in a note as a person undertaking to pay" the negotiable instrument. U.C.C. § 3-103(a)(7) (2003).

89. § 3-305(a)(1). Real defenses are supported by policies that override the policy involved in the marketability of the paper.

90. § 3-305(b). *See* WHITE & SUMMERS, *supra* note 84, at 542–46.

91. Investors may also be protected by contract provisions giving the holder recourse against the originator in the event of the borrower's default. *See* Eggert, *supra* note 28, at 548. These provisions, however, do not impact the borrower's remedies against the holder.

92. *See, e.g.,* Kurt Eggert, *Held Up in Due Course: Codification and the Victory of Form Over Intent in Negotiable Instrument Law*, 35 CREIGHTON L. REV. 363, 376 (2002); *see also* WHITE & SUMMERS, *supra* note 84, at 507 (holder in due course doctrine

rendered this rationale obsolete in the consumer context. Modern consumers have no difficulty obtaining credit, and accordingly there is little reason for the holder in due course doctrine to apply to instruments executed by consumers.<sup>93</sup> In recognition of this, the Federal Trade Commission's "Holder Rule"<sup>94</sup> has negated the holder in due course rule in most sales of consumer goods or services since the 1970's.<sup>95</sup> However, the Holder Rule does not apply to contracts for the sale of real property,<sup>96</sup> and the holder in due course doctrine is alive and well in consumer mortgage transactions.<sup>97</sup>

Historically, the borrower's ability to repay the loan was the most important variable in the lender's decision to write a mortgage. Securitization changes this equation. Today, there is no longer one "lender" who faces the full panoply of risks associated with the making of a mortgage loan. Instead, to facilitate securitization, the mortgage lending process is segmented among multiple actors with different financial interests. Securitization partitions the risks of the deal among these different actors and removes any market-based incentives to protect consumer borrowers against predatory lending.<sup>98</sup>

When mortgages are securitized, the originator of the mortgage can profit whether or not the borrower ultimately repays the loan.

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described as facilitating "the flow of capital from large lenders to the seller to an individual consumer.")

93. Professors White and Summers agree. "[W]e believe that on balance the world is better off with abolition of the holder in due course doctrine in consumer transactions." WHITE & SUMMERS, *supra* note 84, at 534-35.

94. FTC Holder In Due Course Regulations, 16 C.F.R. § 433.2 (2008). The regulation does not directly affect the U.C.C. or state law provisions adopting the holder in due course doctrine. Instead, it provides that it is an unfair or deceptive act or practice within § 5 of the FTC Act for a covered seller to omit a notice that any holder of the contract is subject to all claims and defenses that the borrower could assert against the seller. *Id.* The notice causes any assignee of the instrument to take the instrument subject to all of the borrower's claims and defenses. See U.C.C. § 3-106(d) (2002).

95. See Eggert, *supra* note 92, at 426-30; Peterson, *supra* note 28, at 2237-39; Michael F. Sturley, *The Legal Impact of the Federal Trade Commission's Holder in Due Course Notice on a Negotiable Instrument: How Clever are the Rascals at the FTC?*, 68 N.C. L. REV. 953, 953-60 (1990).

96. The Holder Rule may, however, apply to home repair contracts secured by real property. See *Assoc. Home Equity Servs., Inc. v. Troup*, 778 A.2d 529, 534 (N.J. Super. Ct. App. Div. 2001); *Mitchell v. Church*, NO. 04L-10-042, 2006 WL 2194738, at \*1 (Del. Super. Ct. 2006).

97. Professor Kurt Eggert persuasively argues that securitization has taken the place of the holder in due course doctrine in facilitating the flow of capital to the consumer mortgage market. See Eggert, *supra* note 28, at 607-38. With respect to consumer credit, this renders the holder in due course doctrine a dangerous relic that promotes predatory lending practices. *Id.*

98. See, e.g., Engel & McCoy, *supra* note 28, at 2041 (outlining the ways in which securitization results in negative externalities for borrowers).

This relaxes the need for the originator to be overly concerned about default risk or its lending practices. Investors who purchase mortgage-backed securities retain the risk of borrower default, but their concerns have been assuaged with assurances including credit-enhancements, risk grades, and the investor's ability to purchase investments with specific risk profiles. The holder in due course doctrine completes the picture by removing any remaining incentive that investors might have to police abuses in loan origination. As a result, securitization creates an ideal environment for unscrupulous or short-sighted mortgage originators to enhance their own profits and meet the demand for greater numbers of mortgage products by originating mortgage loans with predatory features.<sup>99</sup>

### C. *Legal Protections Against Predatory Lending*

The negative effects of securitization on mortgage loan consumers have not been uniformly addressed at the federal level, although a relatively small group of federal statutes offers some protection to consumers. Many states, including North Carolina, have found federal efforts inadequate and have implemented their own statutory solutions to the problem of predatory lending.<sup>100</sup> The North Carolina General Assembly has been in the vanguard of this trend and has supplemented existing common law remedies by adopting a progressive package of statutes that offer a clear statement of the legislature's intent to protect consumer borrowers against mortgage lending abuses.<sup>101</sup>

#### 1. Protections Provided by Federal Law

In contrast to North Carolina's efforts on the state level, there is no comprehensive federal response to the problem of predatory lending.<sup>102</sup> Instead, a disparate group of federal statutes and regulations address specific aspects of lender behavior, but offer only limited protection to consumer mortgage borrowers. Federal laws

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99. See Eggert, *supra* note 28; Engel & McCoy, *supra* note 28, at 2049; Peterson, *supra* note 28, at 2237–39.

100. As of August 23, 2008, 36 states—including North Carolina—had passed laws to address predatory mortgage lending practices. See Nat'l Conference of State Legislatures, Subprime and Predatory Mortgage Lending: Current State Laws, [http://www.ncsl.org/programs/banking/predlend\\_intro.htm](http://www.ncsl.org/programs/banking/predlend_intro.htm) (last visited August 23, 2008).

101. See *infra* notes 318, 332–34 and accompanying text.

102. See Azmy, *supra* note 5, at 345 (characterizing federal remedies as “an ineffective patchwork”); see also Peterson, *supra* note 28, at 2236–46.

that directly or indirectly impact predatory lending<sup>103</sup> include the Home Ownership and Equity Protection Act of 1994 (“HOEPA”),<sup>104</sup> the Truth in Lending Act (“TILA”),<sup>105</sup> and the Real Estate Settlement Procedures Act (“RESPA”).<sup>106</sup>

HOEPA exists as a series of amendments to the Truth in Lending Act and is implemented by TILA’s Regulation Z.<sup>107</sup> Although HOEPA is specifically targeted at predatory lending practices,<sup>108</sup> the narrow scope of its coverage limits its usefulness. HOEPA does not apply to many of the most common types of mortgages, including purchase money mortgages,<sup>109</sup> reverse mortgages,<sup>110</sup> and open-end credit lines. These exclusions make it easy for lenders to avoid HOEPA by structuring loan transactions to fall outside its coverage.<sup>111</sup> Beyond this, HOEPA applies only to “high cost” mortgage loans that meet one of two triggers based on the interest rate associated with the loan or points and fees charged to the borrower.<sup>112</sup> For mortgages that fall within its coverage, HOEPA

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103. Numerous other federal laws also impact lending practices. *See, e.g.*, the Equal Credit Opportunity Act (“ECOA”), 15 U.S.C. § 1691 (2000), and the Fair Housing Act (“FHA”), 42 U.S.C. §§ 3601-19 (2000) (both prohibiting discriminatory behavior by mortgage lenders); *see also* the Federal Trade Commission Act, 15 U.S.C. § 41 (2000) (prohibiting unfair or deceptive trade practices). ECOA and the FHA can be used to seek relief for predatory lending practices arising from discriminatory marketing of subprime loans. For example, in early 2008, the City of Baltimore sued subprime lender Wells Fargo under the FHA, alleging that Wells Fargo’s practice of “reverse redlining” minority neighborhoods discriminated against African-American borrowers and led to an upsurge of foreclosures that reduced city tax revenues and increased city expenses. *See* Ian Urbina, *Foreclosures Prompt Cities to Make Plea for U.S. Aid*, N.Y. TIMES, Jan. 24, 2008, at A15.

104. 15 U.S.C. § 1639 (2000).

105. §§ 1601-67(f).

106. 12 U.S.C. §§ 2601-17 (2000).

107. 12 C.F.R. § 226 (2008).

108. Margot Saunders, *The Increase in Predatory Lending and Appropriate Remedial Actions*, 6 N.C. BANKING INST. 111, 112-13 (2002).

109. *See* 15 U.S.C. §§ 1602(w) & (aa)(1).

110. A reverse mortgage allows a homeowner to borrow against the existing equity in her home. The lender makes payments to the borrower over the life of the reverse mortgage, then recovers the principal and interest from the future sale of the home. *See, e.g.*, U.S. Dep’t of Hous. & Urban Dev., *How HUD’s Reverse Mortgage Program Works*, <http://www.hud.gov/buying/reverse.cfm> (last visited Aug. 23, 2008).

111. *See, e.g.*, Engel & McCoy, *supra* note 33, at 1307-08 (discussing the ease with which lenders can evade HOEPA).

112. *See* 15 U.S.C. §§ 1602(aa)(1)-(4); 12 C.F.R. §§ 226.32(a)(1), (b)(1). The annual percentage rate on the loan must exceed the yield on comparable Treasury securities by 8% for first-lien loans or 10% for subordinate-lien loans. Alternatively, the total points and fees must exceed 8% of the amount borrowed or \$400.

requires a set of disclosures three days before the loan closing<sup>113</sup> and prohibits certain abusive loan practices.<sup>114</sup>

RESPA and TILA are disclosure statutes that require lenders to provide consumer borrowers with basic financial information about the terms and costs of the loan. RESPA requires the lender and mortgage broker to provide the borrower with a good faith estimate of closing costs within three business days after the borrower applies for the loan.<sup>115</sup> RESPA also requires the lender to provide the borrower with a HUD-1 settlement statement detailing the borrower's actual closing costs.<sup>116</sup> TILA requires the lender to provide a disclosure statement providing price information on the loan including the annual percentage rate, total finance charges, and the total of payments.<sup>117</sup> Although these statutes do not directly deter predatory lending, they may have the secondary effect of protecting knowledgeable borrowers against predatory loan terms.<sup>118</sup>

## 2. Protections Provided by North Carolina Law

### a. North Carolina's Predatory Lending Law

In 1999, a coalition of diverse interest groups in North Carolina, including the North Carolina Bankers Association, the North Carolina Attorney General's Office, and the Coalition for

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113. See 15 U.S.C. §§ 1601, 1639(a)-(b). The creditor must provide the following disclosures in conspicuous type size: "You are not required to complete this agreement merely because you have received these disclosures or have signed a loan application" and "If you obtain this loan, the lender will have a mortgage on your home. You could lose your home, and any money you have put into it, if you do not meet your obligations under the loan." The creditor must also disclose,

in the case of a credit transaction with a fixed rate of interest, the annual percentage rate and the amount of the regular monthly payment; or in the case of any other credit transaction, the annual percentage rate of the loan, the amount of the regular monthly payment, a statement that the interest rate and monthly payment may increase, and the amount of the maximum monthly payment, based on the maximum interest rate allowed.

*Id.* §§ 1639(a)(1)(A)-(B), (2)(A)-(B).

114. See 15 U.S.C. § 1639(h); 12 C.F.R. §§ 226.32(d), 226.34(a)(1). The substantive protections provided by HOEPA include a requirement that loans must amortize, a prohibition on certain penalty interest rate increases, and a prohibition on balloon payments on loans with terms in excess of five years. For a discussion of the protections provided by HOEPA, see Peterson, *supra* note 28, at 2227-28.

115. 12 U.S.C. §§ 2603-04; 24 C.F.R. § 3500.7.

116. 12 U.S.C. § 2603(a); 24 C.F.R. § 3500.8(a).

117. 15 U.S.C. § 1631-32.

118. For a discussion of the limits of RESPA and TILA, see Engel & McCoy, *supra* note 33, at 1268-70.

Responsible Lending<sup>119</sup> developed the first state law specifically designed to combat predatory lending practices. When North Carolina's law was adopted, there was broad agreement that the number of home loans with predatory features was rapidly increasing and that existing state and federal remedies would not deter these practices.<sup>120</sup> This consensus resulted in strong legislative support for the passage of the predatory lending bill in both houses of the North Carolina General Assembly.<sup>121</sup>

The resulting law was based on HOEPA, but added three important protections to *all* home loans made in North Carolina<sup>122</sup> by prohibiting prepayment penalties for any home loan of \$150,000 or less,<sup>123</sup> the practice of loan flipping,<sup>124</sup> and the financing of single-premium credit insurance.<sup>125</sup> The legislation also improved on the protection HOEPA offered; it defined a broader category of "high-cost home loans" and added tighter restrictions on the terms of such loans.<sup>126</sup> The statutory thresholds for a high-cost home loan include high points and fees, a high interest rate, or certain prepayment

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119. Other interest groups involved in this discussion included the North Carolina Mortgage Bankers Association, the North Carolina Credit Union Network, the North Carolina Association of Financial Institutions, and the North Carolina Association of Mortgage Professionals. See Ctr. for Responsible Lending, North Carolina Predatory Mortgage Lending Law: Frequently Asked Questions, <http://www.responsiblelending.org/policy/state/north-carolina/NCfaqs.html> (last visited Aug. 23, 2008); see also U.S. GEN. ACCOUNTING OFFICE, REP. TO THE CHAIRMAN AND RANKING MINORITY MEMBER, SPECIAL COMM. ON AGING, U.S. SENATE, CONSUMER PROTECTION: FEDERAL AND STATE AGENCIES FACE CHALLENGES IN COMBATING PREDATORY LENDING 63-66 (2004).

120. See Richard R. Daugherty, *Will North Carolina's Predatory Home Lending Act Protect Borrowers From the Vulnerability Caused by the Inadequacy of Federal Law?*, 4 N.C. BANKING INST. 569, 569-77 (2000).

121. See *supra* note 3 and accompanying text.

122. See N.C. GEN. STAT. §§ 24-1.1A(b)(1), 24-10.2(c) (2007). These provisions apply to any loan, regardless of cost, in which: (i) the borrower is a natural person, (ii) the debt is incurred by the borrower primarily for personal, family, or household purposes, and (iii) the loan is secured by a mortgage or deed of trust on real estate. *Id.*

123. § 24-1.1A(b)(1).

124. § 24-10.2(c).

125. § 24-10.2(b).

126. For purposes of North Carolina law, a high-cost home loan is defined as a loan other than a reverse mortgage in which: (i) the principal amount of the loan is the lesser of \$300,000 or the conforming loan size limit for a single-family dwelling as established by the Federal National Mortgage Association (also known as Fannie Mae), (ii) the borrower is a natural person, (iii) the debt is incurred primarily for personal, family, or household purposes, (iv) the debt is secured by a security interest, mortgage, or deed of trust on the borrower's principal dwelling, and (v) the terms of the loan meet one of three statutory thresholds. § 24-1.1E(a)(4).

penalties.<sup>127</sup> If a home loan qualifies as a high-cost home loan under North Carolina law, the statute imposes limitations on the terms of the loan and prohibits certain “acts and practices” by the lender. Limitations on loan terms include prohibitions on discretionary call provisions,<sup>128</sup> balloon payments, negative amortization, increased interest rates on default, advance payments,<sup>129</sup> and modification or deferral fees.<sup>130</sup>

The restrictions on “acts and practices” bar any lender from making a high-cost home loan unless the borrower receives counseling on the advisability of the loan and its terms, and the lender reasonably believes that the borrower will be able to repay the loan.<sup>131</sup> This section also prohibits the lender from financing certain fees, points, and charges, prohibits charging points and fees to refinance an existing high-cost loan with a new high-cost loan, restricts the lender’s payment of loan proceeds under home improvement contracts, and prohibits the lender from shifting liability to the closing agent or closing attorney.<sup>132</sup>

Because North Carolina’s predatory lending law was the first in the nation, its impact on lending practices in North Carolina has been the subject of several empirical studies.<sup>133</sup> These studies consistently found that North Carolina experienced an overall decline in subprime

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127. The high-cost loan threshold based on points and fees is met if more than 5% of the loan amount is charged in upfront points, fees, or other charges, exclusive of allowable charges. § 24-1.1E(a)(6)b. The 5% threshold for fees and points applies to loans of \$20,000 or more. If the loan is less than \$20,000, the threshold is met if fees and points exceed the lesser of 8% of the loan amount or \$1000. *Id.* Alternatively, the threshold is met if the annual percentage rate of the loan is such that the loan is considered a mortgage under § 152 of HOEPA and regulations adopted pursuant to HOEPA. § 24-1.1E(a)(6)a. Finally, the high-cost loan threshold is met if the borrower is charged a prepayment penalty longer than thirty months or more than 2% of the amount repaid. § 24-1.1E(a)(6)c.

128. The lender may not, in its sole discretion, accelerate the loan. This provision does not apply when acceleration of the loan is triggered by borrower default, a due-on-sale provision, or pursuant to some other provision of the loan unrelated to the payment schedule. § 24-1.1E(b)(1).

129. The lender may not include terms under which more than two period payments are required to be consolidated and paid in advance from the proceeds of the loan. § 24-1.1E(b)(5).

130. § 24-1.1E(b).

131. §§ 24-1.1E(c)(1), (2).

132. §§ 24-1.1E(c)(3)-(6).

133. See, e.g., Gregory Elliehausen & Michael E. Staten, *Regulation of Subprime Mortgage Products: An Analysis of North Carolina’s Predatory Lending Law*, 29 J. REAL EST. FIN. & ECON. 411 (2004); Keith D. Harvey & Peter J. Nigro, *Do Predatory Lending Laws Influence Mortgage Lending? An Analysis of the North Carolina Predatory Lending Law*, 29 J. REAL EST. FIN. & ECON. 435 (2004); Quercia, Stegman & Davis, *supra* note 46.

lending activity relative to other southeastern states after the implementation of the new law.<sup>134</sup> These findings raised concern that the law was having a negative effect by obstructing the flow of legitimate subprime loans to potential borrowers with poor credit.<sup>135</sup> However, a leading study produced in 2004 found that the decline in subprime loans did not represent a decline in purchase money credit, but rather was attributable only to a dramatic decline in the number of subprime *refinancing* loans.<sup>136</sup> Because much predatory subprime lending occurs in the context of refinancing, the researchers concluded that North Carolina's predatory lending law was having the positive effect the legislature intended.<sup>137</sup>

This assessment is circumstantially supported by North Carolina's relatively low foreclosure rate during the national foreclosure crisis experienced in 2007 and 2008. Although North Carolina's rate of foreclosure was 9.4% higher in 2007 than in 2006,<sup>138</sup> this increase was much lower than the increase experienced in other areas of the United States during the same period.<sup>139</sup> In early 2008, the Office of the North Carolina Commissioner of Banks reported that North Carolina was well below the national averages for nontraditional mortgages, adjustable rate loans, subprime loans, and mortgage fraud.<sup>140</sup> These facts support the inference that North

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134. In one sample, North Carolina exhibited a 3% decline in subprime loan originations in the seven quarters immediately following July 1, 2000. See Quercia, Stegman & Davis, *supra* note 46, at 586. During the same period, the nation as a whole experienced a 17% increase in subprime lending, and the South experienced an 18% increase. *Id.*

135. See Elliehausen & Staten, *supra* note 133, at 429–30; Harvey & Nigro, *supra* note 133, at 453.

136. Quercia, Stegman & Davis, *supra* note 46, at 584. The study compared loans made for owner-occupied homes during the seven quarters preceding the effective date of the predatory lending law with comparable loans made during the seven quarters after this date. During the comparison period, the number of subprime purchase money originations actually grew from 4,429 to 7,612, an increase of 72.9%. This increase was offset by a 20.3% decline in the number of subprime refinancing loans, from 19,551 to 15,575. *Id.* at 584, 587.

137. *Id.* at 587–88.

138. DEPUTY COMM'R OF H. SELECT COMM., 110TH CONG., RISING FORECLOSURES IN NORTH CAROLINA 7 (Jan. 23, 2008), <http://www.nccob.org/NR/rdonlyres/63F9E8B2-3FB4-4693-80BE-EC2931F6E700/0/HouseForeclosureCommitteeJanuary2008.pdf>.

139. Nationally, 2.2 million foreclosures were filed in 2007, a 75% increase over 2006. Dudley Price & Paulette Stiles, *Townhouses' Financing Fiasco Saps Savings, Shreds Hopes*, NEWS & OBSERVER (Raleigh, N.C.), Apr. 13, 2008, at A1 (citing statistics compiled by RealtyTrac); see also Jesse McKinley, *From Housing Haven to Foreclosure Leader*, N.Y. TIMES, Aug. 13, 2007, at A13.

140. See H. SELECT COMM., *supra* note 138, at 5.



Carolina's strong predatory lending laws have protected the state's borrowers from the worst effects of the subprime lending crisis.

b. North Carolina's Mortgage Lending Act

In 2001, the North Carolina General Assembly passed the Mortgage Lending Act<sup>141</sup> intended to bolster the state's predatory lending law by regulating the conduct of mortgage professionals in the state.<sup>142</sup> The act imposes licensing requirements on mortgage bankers, mortgage brokers, and loan officers,<sup>143</sup> specifies qualifications for licensure,<sup>144</sup> and allows the imposition of continuing education requirements as a condition of license renewal.<sup>145</sup>

In an important innovation, the new law imposed a set of affirmative duties on mortgage brokers, including the duty to safeguard and account for money handled for the borrower, to "[a]ct with reasonable skill, care, and diligence," and to make efforts to provide a loan that is "reasonably advantageous to the borrower, . . . including the rates, charges, and prepayment terms of the loan."<sup>146</sup> These duties are in addition to existing duties other statutes or common law also impose on mortgage brokers.

Finally, the Mortgage Lending Act makes it unlawful for any person to make or broker a mortgage loan in violation of the Predatory Lending Act.<sup>147</sup> The North Carolina Commissioner of Banks is given disciplinary authority over individual mortgage professionals, such as authority to suspend or revoke licenses and impose civil penalties against any person, including a licensed mortgage professional, who violates the provisions of the act.<sup>148</sup>

c. Other Protections Provided by North Carolina Law

North Carolina's predatory lending statutes are specifically and exclusively aimed at curbing abusive mortgage lending practices. These laws supplement a range of common law and statutory

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141. N.C. GEN. STAT. §§ 53-243.01 to .18 (2007), *amended by* Act of Aug. 17, 2008, ch. 228, sec. 1-14, 2008 N.C. Sess. Laws \_\_\_\_.

142. See Caroline V. Barbee, Note, *North Carolina's Mortgage Lending Act: Licensing and Regulation of Mortgage Bankers and Brokers*, 7 N.C. BANKING INST. 263, 263 (2003); see also CONSUMER PROTECTION: FEDERAL AND STATE AGENCIES FACE CHALLENGES IN COMBATING PREDATORY LENDING, *supra* note 119, at 63.

143. § 53-243.02.

144. § 53-243.05.

145. § 53-243.07.

146. § 53-243.10.

147. § 53-243.11.

148. § 53-243.12.

remedies that are generically available to any consumer borrower injured by unfair lending practices, including North Carolina's powerful unfair and deceptive trade practices statute,<sup>149</sup> common law fraud,<sup>150</sup> civil conspiracy,<sup>151</sup> usury,<sup>152</sup> "unjust enrichment,"<sup>153</sup> "breach of the duty of good faith and fair dealing,"<sup>154</sup> and the argument that discrete loan terms are unconscionable.<sup>155</sup>

Finally, although predatory lending practices are associated with the origination of the loan, the consumer's involvement with the loan does not end at this point, and North Carolina borrowers have also sought relief for abusive actions by the servicer of the loan. For example, in *Williams v. HomEq Servicing Corp.*,<sup>156</sup> the borrowers sued the loan servicer for negligent infliction of emotional distress, as well as for violations of North Carolina's unfair debt collection practices statute<sup>157</sup> and violations of the state laws regulating collection agencies.<sup>158</sup> Another case, *In re Bigelow*,<sup>159</sup> illustrates that a

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149. § 75-1.1. Relief under this statute is sought in nearly every predatory lending case brought in North Carolina. See, e.g., *Shepard v. Ocwen Fed. Bank*, F.S.B., 361 N.C. 137, 138, 638 S.E.2d 197, 198 (2006); *Skinner v. Preferred Credit*, 361 N.C. 114, 116, 638 S.E.2d 203, 206 (2006); *Richardson v. Bank of Am., N.A.*, 182 N.C. App. 531, 535, 643 S.E.2d 410, 413 (2007); *Melton v. Family First Mortgage Corp.*, 156 N.C. App. 129, 132, 576 S.E. 2d 365, 368 (2003).

150. See *Melton*, 156 N.C. App. at 132, 576 S.E.2d at 368.

151. See *id.*

152. See *Shepard*, 361 N.C. at 138, 638 S.E.2d at 198; *Skinner*, 361 N.C. at 116, 638 S.E.2d at 206. But see *Citibank, S.D., N.A. v. Palma*, 184 N.C. App. 504, 506, 646 S.E.2d 635, 637 (2007) (holding that actions against national banks for usury are preempted by the National Bank Act). *Palma* follows in the footsteps of two recent decisions from the Supreme Court of the United States upholding the preemptive effect of regulations promulgated by the Office of the Comptroller of the Currency under the National Bank Act. See *Beneficial Nat'l Bank v. Anderson*, 539 U.S. 1, 11 (2003) (holding that National Bank Act provides the exclusive cause of action for usury actions against national banks); *Watters v. Wachovia Bank, N.A.*, 127 S. Ct. 1559, 1564-65 (2007) (holding that a mortgage lending subsidiary of a national bank is not subject to state regulation).

153. *Richardson*, 182 N.C. App. at 535, 643 S.E.2d at 413.

154. *Id.*

155. See *Tillman v. Commercial Credit Loans, Inc.*, 362 N.C. 93, 103, 655 S.E.2d 362, 370 (2008).

156. 184 N.C. App. 413, 646 S.E.2d 381 (2007).

157. N.C. GEN. STAT. §§ 75-50 to -56 (2007). In a case of first impression under North Carolina law, the Court of Appeals held that the plaintiffs stated a claim for relief under section 75-52(3) of the North Carolina General Statutes, which prohibits a debt collector from "[c]ausing a telephone to ring or engaging any person in telephone conversation with such frequency as to be unreasonable or to constitute a harassment." *Williams*, 184 N.C. App. at 422, 646 S.E.2d at 386. In *Williams*, the servicer's own records established that the plaintiffs were called on at least 2200 occasions. *Id.* The plaintiffs did not prevail on any other cause of action. *Id.*

158. §§ 58-70-1 to -130.

159. 185 N.C. App. 142, 649 S.E.2d 10 (2007).

sufficiently gross servicer error may effectively provide the borrower with a defense to foreclosure.<sup>160</sup> In *Bigelow*, the court of appeals barred a foreclosure when the borrower's "default" was caused by the servicer's wrongful refusal to accept tendered payments.<sup>161</sup>

## II. RECENT DECISIONS FROM NORTH CAROLINA'S APPELLATE COURTS

The widespread securitization of consumer mortgages has resulted in a horizontally-segmented lending process in which responsibility for funding, originating, servicing, and holding the underlying loans is divided among legally unrelated business entities. As outlined in Part I, this financing structure creates incentives for mortgage originators to engage in predatory lending practices while simultaneously making it more difficult for injured borrowers to locate responsible parties and hold them liable.

Against this background, the North Carolina courts have recently reached five decisions affecting the ability of borrowers to challenge predatory mortgage lending practices. In the first decision, *Melton*, the court found against the borrowers, but on grounds that were entirely consistent with North Carolina law. The following two decisions, *Shepard* and *Skinner*, reached problematic outcomes that exacerbated the difficulties that borrowers face when attempting to sue their lenders or the assignees holding their mortgages. Finally, the two most recent cases, *Richardson* and *Tillman*, reversed this trend and better reflected the changes in consumer mortgage lending that securitization created.

### A. *Melton: Assignee Liability*

As a general rule, the assignee of a contract stands in the place of the assignor under North Carolina law.<sup>162</sup> The holder in due course

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160. This is significant because North Carolina is not a judicial foreclosure state and permits few defenses to foreclosure. Instead, foreclosure typically proceeds under a power of sale clause in a deed of trust that inexorably allows foreclosure upon the servicer's showing of: (1) a valid debt, (2) default, (3) the right to foreclose under the instrument, and (4) notice. § 45-21.16(d). This statute was amended in August 2008 to add additional notice requirement for subprime loans made after December 31, 2004 and before December 31, 2007. Act of Aug. 17, 2008, ch. 226, sec. 3, 2008 N.C. Sess. Laws \_\_\_\_\_. If the elements of section 45-21.16(d) are satisfied, the mortgagor has no equitable defenses to foreclosure. See, e.g., *In re Foreclosure of Azalea Garden Bd. & Care, Inc.*, 140 N.C. App. 45, 50, 535 S.E.2d 388, 392 (2000).

161. *Bigelow*, 185 N.C. App. at 147, 649 S.E.2d at 14.

162. See, e.g., *Rose v. Vulcan Materials Co.*, 282 N.C. 643, 661, 194 S.E.2d 521, 534 (1973).

doctrine creates an exception to this general rule, shielding the assignee of a negotiable instrument from most claims and defenses to payment that a borrower could assert against the original lender, provided the assignee did not have knowledge of the claims and defenses at the time of the transfer of the instrument.<sup>163</sup> Because mortgage notes are negotiable instruments, the holder in due course doctrine shields the assignee of a mortgage from liability incurred by the originator of the note unless some other law negates this defense.<sup>164</sup>

North Carolina's predatory lending law imposes no liability on assignees of mortgage loans and, thus, does not change the holder in due course doctrine.<sup>165</sup> Absent such a provision in the predatory lending statutes, the most comprehensive and effective cause of action against assignees under North Carolina law would be the recognition of assignee liability under North Carolina's Unfair and Deceptive Trade Practices Act ("UDTPA").<sup>166</sup> However, this theory of relief was expressly rejected by the North Carolina Court of Appeals in *Melton v. Family First Mortgage Corporation*.<sup>167</sup>

In *Melton*, the plaintiff alleged that her adult granddaughter drugged her, took control of her finances, and then defrauded her.<sup>168</sup> The plaintiff claimed that, as part of the scheme, her granddaughter completed an application for a \$50,000 mortgage on her home without her knowledge, and that the lender, Family First, accepted the loan application with a forged signature and closed the loan without having previously met with the plaintiff.<sup>169</sup> Family First then immediately assigned the mortgage to a second entity, Flagstar.<sup>170</sup>

Among sundry other causes of action, the plaintiff included a claim against the assignee Flagstar seeking relief for unfair and

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163. See N.C. GEN. STAT. § 25-3-305(b) (2007); *supra* notes 89–92 and accompanying text.

164. For example, federal law creates a partial solution to this problem by removing the holder in due course defense for high-cost mortgages subject to HOEPA. 15 U.S.C. § 1641(d)(1) (2000). However, this provision does not create an independent cause of action and applies only if a plaintiff can assert a claim under some other law. See *Dash v. FirstPlus Home Loan Trust 1996-2*, 248 F. Supp. 2d 489, 506 (M.D.N.C. 2003).

165. The Predatory Lending Law applies only to the "making" of the loan. See N.C. GEN. STAT. §§ 24-1.1E(d), 24-10.2(e).

166. § 75-1.1.

167. 156 N.C. App. 129, 576 S.E.2d 365 (2003), *aff'd per curiam*, 357 N.C. 573, 597 S.E.2d 672 (2003).

168. *Melton*, 156 N.C. App. at 131, 576 S.E.2d at 367–68.

169. *Id.* at 131–32, 576 S.E.2d at 369.

170. *Id.* at 131, 576 S.E.2d at 367.

deceptive trade practices under North Carolina law.<sup>171</sup> The court of appeals affirmed the dismissal of this claim, finding that “Flagstar had no dealings with the plaintiff in connection with the execution of the mortgage” and, in fact, no relationship with the plaintiff until after the plaintiff’s execution of the mortgage.<sup>172</sup> In addition, no evidence suggested that “Family First was acting as an agent for Flagstar” when it made the mortgage or that Flagstar itself had committed any improprieties in the execution of the mortgage.<sup>173</sup>

*Melton* states the rule that liability for an unfair or deceptive trade practice is limited to the party that commits the unfair act, and stands for the corollary proposition that the assignee of a fraudulent mortgage is not liable under North Carolina law for an unfair or deceptive trade practice committed by the originator of the mortgage.<sup>174</sup> Thus, *Melton* adheres to the holder in due course doctrine and refuses to create an exception for conduct that amounts to an unfair and deceptive trade practice under state law. Given the ephemeral nature of mortgage originators and the nearly universal assignment of consumer mortgages, this holding has a significant impact on the rights of consumer borrowers in North Carolina.

### B. Shepard: *Accrual of the Plaintiff’s Cause of Action*

Excessive and unnecessary fees, charges, and insurance premiums are ubiquitous features of predatory loans. Because the borrowers targeted for predatory loans rarely have cash to pay these charges when the loan is made, they commonly finance the unwarranted fees along with the principal of the loan.<sup>175</sup> When this occurs, a portion of any usurious fee is paid by the borrower with every monthly payment, raising an argument that the illegal fees are a continuing violation for purposes of the statute of limitations.

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171. The plaintiff’s other claims included common law fraud and civil conspiracy. *Id.* at 132, 576 S.E.2d at 368.

172. *Id.* at 133, 576 S.E.2d at 369.

173. *Id.*

174. This rule has been followed to relieve assignees from liability in at least four subsequent decisions from North Carolina’s state and federal courts. See *Dash v. FirstPlus Home Loan Trust 1996-2*, 248 F. Supp. 2d 489, 503 (M.D.N.C. 2003); *Lee v. Southstar Funding, LLC (In re Lee)*, Ch. 13 Case No. 06-31070, Adv. No. 06-03266 (Bankr. W.D.N.C. 2007) (PACER); *Tetterton v. Ocwen Fed. Bank (In re Tetterton)*, 379 B.R. 595, 600 (Bankr. E.D.N.C. 2007); *Skinner v. Preferred Credit*, 172 N.C. App. 407, 415–16, 616 S.E.2d 676, 681 (2005), *aff’d on other grounds*, 361 N.C. 14, 638 S.E.2d 203 (2006).

175. This, of course, increases the potential profit to the lender because interest is charged on the excessive fee.

A sharply divided Supreme Court of North Carolina rejected this argument in December of 2006 in *Shepard v. Ocwen Federal Bank, FSB*.<sup>176</sup> The plaintiffs in *Shepard* obtained a second mortgage in the amount of \$16,500 on July 25, 1997<sup>177</sup> from Chase Mortgage Brokers. The \$16,500 principal amount of the loan included Chase's loan origination fee of \$1,485, roughly 9% of the loan.<sup>178</sup> Chase deducted and retained its origination fee before disbursing net loan proceeds of \$15,015 to the plaintiffs.<sup>179</sup> Chase then assigned the \$16,500 loan to Ocwen Federal Bank, and Ocwen "assigned the loan to Wells Fargo Bank Minnesota."<sup>180</sup>

North Carolina law limits the origination fee that can be charged for most secondary real property loans to a maximum of 2% of the principal amount of the loan,<sup>181</sup> but also imposes a two-year statute of limitations on claims for usury.<sup>182</sup> The plaintiffs did not file suit until May 3, 2002, nearly five years after the closing of their loan, at which point they brought claims for usury and unfair and deceptive trade practices.<sup>183</sup> The defendants responded by filing a motion to dismiss,<sup>184</sup> asserting that the statute of limitations on usury claims, as well as North Carolina's four-year statute of limitations on claims for unfair and deceptive trade practices, barred the complaint.<sup>185</sup>

Because the usurious fee had been rolled into the loan and financed, the plaintiffs countered that they faced an ongoing violation of the law because they continued to pay part of the fee every time they made a payment on the loan.<sup>186</sup> Based on this argument, they sought recovery of the portion of the usurious fee paid within two years before the filing of their complaint, as well as any amounts paid after the complaint was filed.<sup>187</sup>

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176. 361 N.C. 137, 638 S.E.2d 197 (2006). The majority opinion in *Shepard* was written by Justice Brady.

177. *Id.* at 138, 638 S.E.2d at 198. Like the note and deed of trust in *Melton*, the transaction in *Shepard* predates North Carolina's predatory lending law.

178. *Id.*

179. Both the \$1,485 origination fee and the \$15,015 net proceeds were financed as part of the \$16,500 mortgage loan. *Id.* at 142, 638 S.E.2d at 200 (Timmons-Goodson, J., dissenting).

180. *Id.* at 138, 638 S.E.2d at 198. The plaintiffs in *Shepard* sued Ocwen and Wells Fargo, as well as the trustee of the original deed of trust. *Id.*

181. N.C. GEN. STAT. § 24-14(f) (2007).

182. §§ 1-53(2), (3).

183. *Shepard*, 361 N.C. at 138, 638 S.E.2d at 198.

184. *Id.* at 139, 638 S.E.2d at 198.

185. § 75-16.2.

186. *Shepard*, 361 N.C. at 140, 638 S.E.2d at 199.

187. *Id.*

Four of the seven justices on the Supreme Court of North Carolina rejected this argument, finding that the plaintiffs' claim accrued on the date of the loan closing. The majority opinion found that the origination fee, although usurious, was " 'fully earned' when the loan was made" and was "charged, paid and received at closing as a prerequisite for obtaining the loan."<sup>188</sup> The court found that the manner in which the origination fee was paid was simply irrelevant to the extension of the statute of limitations.<sup>189</sup> Because no usurious fees had been "charged or paid" since closing, the plaintiffs' claims were time barred by the two-year statute of limitations applicable to usury claims and the four-year statute applicable to unfair and deceptive trade practices claims.<sup>190</sup>

The majority opinion provoked a strong dissent from the remaining three justices on the court. The key to the disagreement between the majority and dissenting positions in *Shepard* is the majority's statement that the "origination fee was not added to the loan amount."<sup>191</sup> As the dissent notes, the origination fee was included in the \$16,500 amount financed by the plaintiffs.<sup>192</sup> As a result, the plaintiffs were contractually obligated to repay a portion of the origination fee every month and the inclusion of the usurious fee in the amount financed increased the amount of their monthly payments.<sup>193</sup> Thus, the majority's finding that the origination fee was not added to the loan amount is correct only if the term "loan amount" refers to the \$15,015 disbursed to the plaintiffs and not to the \$16,500 principal amount of the loan.<sup>194</sup>

The majority's inaccurate characterization of the loan allowed it to ignore the economic reality of the transaction. Although the origination fee was *paid to* the lender at closing, it was not *paid by* the borrower at that point.<sup>195</sup> In reality, the origination fee was being

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188. *Id.* The majority opinion relied on an unpublished decision from the Fourth Circuit Court of Appeals, *Faircloth v. Fin. Asset Sec. Corp. Mego Mortgage Homeowner Loan Trust*, 87 F. App'x. 314 (4th Cir. 2004) (unpublished).

189. *Shepard*, 361 N.C. at 140, 638 S.E.2d at 199.

190. *Id.* at 141, 638 S.E.2d at 200.

191. *Id.* at 140, 638 S.E.2d at 199.

192. *Id.* at 142, 638 S.E.2d at 200 (Timmons-Goodson, J., dissenting).

193. *Id.* at 143, 638 S.E.2d at 201 (Timmons-Goodson, J., dissenting). The dissent points out that if the plaintiffs had been charged a non-usurious origination fee of 2%, their monthly payment would have been \$203.86—not the monthly payment of \$219.63 that they were actually paying. *Id.*

194. The statute itself uses the term "principal amount of the loan," which would be \$16,500 in the *Shepards'* loan. See N.C. GEN. STAT. § 24-14(f) (2007).

195. Justice Timmons-Goodson notes that the Internal Revenue Service recognizes that home mortgage fees that are financed are not paid by the borrower at closing, with

repaid in the borrower's continuing monthly payments, and each of these payments was higher than the amount allowed by North Carolina law. Viewed in these purely financial terms, the court's holding that the ongoing payment of the illegal fee was not a continuing violation of the statute does not withstand analysis.<sup>196</sup>

C. *Skinner: Lack of Personal Jurisdiction over the Holder*

When different facets of mortgage transactions are fragmented during securitization, portions of the transaction may be isolated in entities whose contacts with North Carolina arise only through the mortgages themselves. In addition, the holder of the securitized mortgage itself will be an SPV, typically a trust that has been specifically designed to avoid operational liability. Although this holder is the beneficial owner of the mortgage, its inherently passive nature allows it to argue that it is not subject to personal jurisdiction outside its state of organization.

In *Skinner v. Preferred Credit*,<sup>197</sup> the Supreme Court of North Carolina concluded that the North Carolina courts lacked personal jurisdiction over a New York trust that was just such a defendant, even though the trust held the beneficial interest in 114 mortgages made with North Carolina citizens and secured by real property in North Carolina.<sup>198</sup> The passivity of the defendant trust was the crucial factor in this decision.<sup>199</sup>

The Skinners obtained a \$45,000 second mortgage from Preferred Credit on January 22, 1997.<sup>200</sup> The fees and costs charged to the plaintiffs at closing totaled \$5,225.70, which included an unlawfully high origination fee of \$3,600.<sup>201</sup> After closing, their loan was sold to Credit Suisse First Boston Mortgage Securities Corporation, which ultimately assigned all rights under the loan to

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the result that they cannot be deducted as mortgage interest in the year the loan is made. *Shepard*, 361 N.C. at 144, 638 S.E.2d at 201.

196. The Supreme Court of North Carolina's holding in *Shepard* was legislatively overruled by the North Carolina General Assembly in July of 2007. See *infra* note 333 and accompanying text.

197. 361 N.C. 114, 638 S.E.2d 203 (2006), *reh'g denied*, 361 N.C. 371, 638 S.E.2d 591 (2007).

198. *Skinner*, 631 N.C. at 119–20, 638 S.E.2d at 208–09.

199. *Id.* at 124, 638 S.E.2d at 211 (“Our cases analyzing minimum contacts rarely have dealt with so ‘passive’ a defendant.”).

200. *Id.* at 116, 638 S.E.2d at 207.

201. *Id.* The origination fee was 8% of the amount financed, and the total fees and charges amounted to 11.6% of the loan. *Id.* The annual percentage rate on the Skinners' loan was 16.902%. *Id.*



the "1997-1 Trust,"<sup>202</sup> a trust formed by Credit Suisse to facilitate securitization of the loan pool that included the Skinners' loan.<sup>203</sup> Pursuant to the Pooling and Servicing Agreement forming the 1997-1 Trust, its purpose was "to hold mortgage loans . . . , receive income from the mortgage loans . . . , distribute payments received from the Servicer . . . , and issue certificates [to investors]."<sup>204</sup> Outside these limited functions, the trust was inert. It had no employees, did not engage in any business, made no contracts, did not solicit mortgage loans, and did not directly collect payments from borrowers.<sup>205</sup> Instead, as is typical of securitized loans, all direct interaction with the borrowers was performed by a separate servicer.<sup>206</sup>

The plaintiffs initially sued twenty defendants alleging that Preferred Credit, the loan originator, had "charged excessive loan origination fees and usurious interest rates" and that the defendants had violated the UDTPA.<sup>207</sup> "Preferred Credit was never served," however, and most of the remaining defendants were dismissed during the course of the litigation, leaving only the 1997-1 Trust and its trustee as defendants.<sup>208</sup> On appeal to the Supreme Court of North Carolina, the only issue left for decision was whether the 1997-1 Trust was subject to personal jurisdiction in the state.

The *Skinner* decision was issued on the same day as *Shepard* and reveals the same 4-3 split among the seven justices.<sup>209</sup> The majority opinion in *Skinner* finds that jurisdiction over the out-of-state trust is not authorized by North Carolina's long-arm statute<sup>210</sup> and, in the alternative, holds that the exercise of jurisdiction over the trust would violate due process because the trust lacked sufficient contacts with North Carolina.<sup>211</sup>

Although the court analyzed three sections of North Carolina's long-arm statute,<sup>212</sup> its analysis could have ended with its holding that

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202. *Id.* The full name of the 1997-1 Trust was the Credit Suisse First Boston Mortgage Securities Corporation Preferred Credit Asset-Backed Certificates, Series 1997-1. *Id.*

203. *Id.*

204. *Id.* at 116-17, 638 S.E.2d at 207.

205. *Id.* at 117, 638 S.E.2d at 207.

206. *Id.* at 117-18, 638 S.E.2d at 207-08.

207. *Id.* at 118, 638 S.E.2d at 208.

208. *Id.*

209. The majority opinion in *Skinner* was written by Justice Newby. As in *Shepard*, Justice Timmons-Goodson wrote the dissent and was joined by Justices Martin and Edmunds.

210. N.C. GEN. STAT. § 1-75.4 (2007).

211. *Skinner*, 361 N.C. at 126, 638 S.E.2d at 213.

212. *Id.* at 119-22, 638 S.E.2d at 208-10. The court's analysis addressed sections 1-75.4(1)(d), (5)(d), and (6)(b) of the North Carolina General Statutes. *Id.*

§ 1-75.4(1)(d) did not support jurisdiction over the out-of-state trust. Section 1-75.4(1)(d) supplies personal jurisdiction over any party “engaged in substantial activity within this State, whether such activity is wholly interstate, intrastate, or otherwise.”<sup>213</sup> Because this section provides North Carolina courts with “the full jurisdictional powers permissible under federal due process,”<sup>214</sup> it effectively collapses the long-arm statute into the due process requirement. In tacit recognition of this, the court engaged in a *sub rosa* contacts analysis while discussing the long-arm statute, finding that this section does not authorize jurisdiction over the defendant trust because it has no “activity”<sup>215</sup> in North Carolina.

Although this part of the court’s holding was sufficient to dispose of the case, the court proceeded to engage in a separate, and entirely duplicative, due process analysis, noting and disposing of three separate North Carolina contacts, while improperly considering each in isolation.<sup>216</sup> First, the court considered the origination of the plaintiff’s loan in North Carolina by Preferred Credit.<sup>217</sup> Next, the court discussed the trust’s status as the holder of promissory notes secured by deeds of trust on North Carolina property.<sup>218</sup> Finally, the court addressed the trust’s receipt of loan payments made by North Carolina borrowers.<sup>219</sup>

The court quickly dispensed with the defendant’s first possible contact, finding the origination of the plaintiffs’ loan by another entity insufficient to support jurisdiction over the later-formed trust.<sup>220</sup> This holding is well-reasoned; however, the court’s analysis falters during its consideration of the remaining two sets of contacts.

Although the trust held 114 promissory notes secured by deeds of trust on North Carolina property, the court discounted these contacts because these notes comprised only 3% of the 3,537 loans

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213. § 1-75.4(1)(d).

214. *Skinner*, 361 N.C. at 119, 638 S.E.2d at 208 (citing *Dillon v. Numismatic Funding Corp.*, 291 N.C. 674, 676, 231 S.E.2d 629, 630 (1977)).

215. *Id.* The court noted that the 1997-1 Trust was created after the origination of the plaintiffs’ loan and that all of its activities (holding notes, receiving income, and issuing trust certificates) occurred outside of North Carolina. *Id.*

216. *Id.* at 123–24, 638 S.E.2d at 210–13; see also Recent Case, *Constitutional Law—Personal Jurisdiction—North Carolina Supreme Court Finds No Jurisdiction Over New York Trust—Skinner v. Preferred Credit*, 638 S.E.2d 203 (N.C. 2006), *reh’g denied*, 643 S.E.2d 591 (N.C. 2007), 121 HARV. L. REV. 636, 638 (2007) (noting that the court improperly considered each contact in isolation).

217. *Skinner*, 361 N.C. at 123, 638 S.E.2d at 211.

218. *Id.* at 123–24, 638 S.E.2d at 211.

219. *Id.* at 124, 638 S.E.2d at 211.

220. *Skinner*, 361 N.C. at 123, 638 S.E.2d at 211.

held in the trust's loan pool.<sup>221</sup> However, because the plaintiffs had invoked specific jurisdiction, the percentage of North Carolina loans held by the defendant was irrelevant.<sup>222</sup> Under a specific jurisdiction analysis, the dispositive question would be whether the defendant held the one promissory note that gave rise to the plaintiffs' claims. The court compounded the problem by dismissing the trust's interest in the plaintiffs' property as "simply a beneficial interest in North Carolina property."<sup>223</sup> With any deed of trust, legal title to the plaintiffs' property is held by the trustee under their deed of trust, but the holder of the beneficial interest is the party that has the right to receive payments. Thus, the mortgagee/trust possessed a significant property interest, despite the absence of legal title.

The majority was also unimpressed with the trust's receipt of the plaintiffs' mortgage payments. Although the court acknowledged the defendant as the ultimate "depository" of the plaintiffs' payments, it rejected this fact as unimportant because the payments were not made directly to the trust, but instead to the servicer.<sup>224</sup> Rather than recognizing the trust/servicer relationship as a standard financial conduit involuntarily imposed on the plaintiffs by the securitization of their mortgage, the court created a jurisdictional "privity" requirement that allowed the plaintiffs to sue only the entity that directly received their payments. This holding greatly strengthens the ability of lenders to use structured finance to shield themselves from suit.

The dissent in *Skinner* found that at least two sections of the North Carolina long-arm statute, including section 1-75.4(1)(d), would permit the exercise of personal jurisdiction over the trust.<sup>225</sup> The dissenting justices then found that the assertion of jurisdiction

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221. *Id.*

222. The percentage of contacts is relevant only to determine whether the defendant's contacts with the forum state are sufficiently systematic and continuous to support general jurisdiction. When, as here, personal jurisdiction is premised on specific jurisdiction, the plaintiffs need only show that their claim arises directly from the defendant's contact, however limited, with the forum state. See, e.g., KEVIN M. CLERMONT, CIVIL PROCEDURE: TERRITORIAL JURISDICTION AND VENUE 55 (1999).

223. *Skinner*, 361 N.C. at 123, 638 S.E.2d at 211.

224. *Id.*

225. *Id.* at 129, 638 S.E.2d at 214 (Timmons-Goodson, J., dissenting). The second section, section 1-75.4(6)(b) of the North Carolina General Statutes, provides for personal jurisdiction "[i]n any action which arises out of . . . [a] claim to recover for any benefit derived by the defendant through the use, ownership, control or possession by the defendant of tangible property situated within this State either at the time of the first use, ownership, control or possession or at the time the action is commenced." N.C. GEN. STAT. § 1-75.4(6)(b) (2007).

over the defendant trust would not violate due process because the trust's beneficial interest in mortgages made in North Carolina, specifically including the plaintiffs' mortgage, provide a sufficient contact to support the exercise of personal jurisdiction over the defendant trust.<sup>226</sup> The dissent's analysis concludes that the "defendant has purposefully availed itself of the privilege of doing business" with North Carolina residents, giving it every reason to expect that it might be subjected to litigation in North Carolina.<sup>227</sup>

*D. Richardson: Unauthorized Sale of Single Premium Credit Insurance*

Since July 1, 2000, North Carolina's Predatory Lending Law has prohibited the sale of single premium credit insurance on any mortgage loan originated in North Carolina.<sup>228</sup> Credit insurance is tied to a specific debt and typically pays any outstanding balance in the event of the borrower's death, disability, or job loss.<sup>229</sup> Single premium credit insurance is widely perceived as abusive because the premium is paid through one upfront payment at the loan closing and then financed over the life of the loan.<sup>230</sup>

*Richardson v. Bank of America*<sup>231</sup> was a class action brought by consumer borrowers who were sold single-premium credit insurance in conjunction with the closing of their mortgage loans.<sup>232</sup> When the plaintiffs' loans were made, North Carolina allowed the sale and financing of single-premium credit insurance in conjunction with loans having terms of fifteen years or less, but the Department of Insurance had not approved the sale of credit insurance on loans having a longer duration.<sup>233</sup> The plaintiff class in *Richardson* included

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226. *Id.* at 130–36, 638 S.E.2d at 217–19 (Timmons-Goodson, J., dissenting).

227. *Id.* at 136, 638 S.E.2d at 217 (Timmons-Goodson, J., dissenting) (citing *World-Wide Volkswagen Corp. v. Woodson*, 444 U.S. 286 (1980)).

228. § 24-10.2(b).

229. *See, e.g.*, U.S. DEP'T OF HOUS. & URBAN DEV. & U.S. DEP'T OF THE TREASURY, CURBING PREDATORY HOME MORTGAGE LENDING: JOINT REPORT 7 (2000), available at <http://www.huduser.org/Publications/pdf/treasrpt.pdf>.

230. *See Azmy, supra* note 5, at 342–43 (discussing single premium credit insurance and noting that it is a marker of predatory lending).

231. 182 N.C. App. 531, 643 S.E.2d 410 (2007), review granted in part by 361 N.C. 569, 650 S.E.2d 439 (2007), and discretionary review improvidently allowed by 362 N.C. 227, 657 S.E.2d 353 (2008).

232. *Richardson*, 182 N.C. App. at 535, 643 S.E.2d at 413. The borrowers financed the insurance premiums over the life of their loans, and the amount of the premium was based upon the amount financed, including any financed origination fees, points, and other closing costs. *Id.* at 534–35, 643 S.E.2d at 414.

233. *Id.*

a group of borrowers with loan terms greater than fifteen years who were sold unauthorized credit insurance by their lender.<sup>234</sup>

A three-judge panel of the North Carolina Court of Appeals<sup>235</sup> held that the lender's unlawful sale of single-premium credit insurance was an unlawful and deceptive trade practice under North Carolina law, breached the lender's duty of good faith and fair dealing, and constituted willful and wanton tortious activity sufficient to support the imposition of punitive damages. Adopting language from the trial court's opinion, the court found that single-premium credit insurance is "expensive insurance that meets the needs of very few if any customers,"<sup>236</sup> and that the large profit available to the lender was the "primary motivation" behind its sale of this product.<sup>237</sup>

Based on these findings, the court of appeals held that the lender had acted in "conscious and intentional disregard of and indifference to" <sup>238</sup> the plaintiffs' rights and that they were therefore entitled to submit their class claim for punitive damages to a jury.<sup>239</sup> Finally, the court agreed with the plaintiffs that the illegal insurance contracts were void as against public policy.<sup>240</sup> As a result, the credit insurance provided to the plaintiffs had no intrinsic value and could not be used to offset the plaintiffs' claims for damages.<sup>241</sup>

In *Richardson*, the court of appeals produced a strong, pro-consumer holding that stands in marked contrast to the opinions in *Melton*, *Shepard*, and *Skinner*. Several factors may explain the difference. First, the conduct in *Richardson* actively violated North Carolina insurance law. Insurance is a highly regulated product, and it is unlawful to sell insurance products in North Carolina that have not been approved by the state's Commissioner of Insurance.<sup>242</sup>

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234. *Id.* The class of plaintiffs in *Richardson* was limited to "North Carolina borrowers who obtained a loan before July 1, 2000." *Id.*

235. The opinion was written by Judge McGee and joined by Judges Bryant and Steelman. The Supreme Court of North Carolina originally granted discretionary review over the unanimous court of appeals decision pursuant to section 7A-31 of the North Carolina General Statutes; however, the court later issued a brief per curiam decision, holding that discretionary review had been improvidently allowed. See *Richardson*, 361 N.C. 569, 650 S.E.2d 439 (2007) (allowing review); 362 N.C. 227, 657 S.E.2d 353 (2008) (declining review).

236. *Richardson*, 182 N.C. App. at 560, 643 S.E.2d at 428.

237. *Id.*

238. *Id.* at 558, 643 S.E.2d at 427 (citing N.C. GEN. STAT. § 1D-5(7) (2007)).

239. *Id.* at 559, 643 S.E.2d at 428.

240. *Id.* at 563, 643 S.E.2d at 430.

241. *Id.* ("[T]he SPCI sold to Plaintiffs with loans greater than fifteen years in length did not have any value because the contract was void as against public policy.")

242. N.C. GEN. STAT. § 58-3-150(a) (2007).

North Carolina's insurance laws are express statements of legislative will and intent that should be enforced by the state's courts. To enable this enforcement, affected consumers must have the ability to sue lenders who violate the law.

Second, the sale of single-premium credit insurance was outlawed by North Carolina General Assembly with the passage of the 1999 Predatory Lending Law.<sup>243</sup> Although the transactions challenged in *Richardson* predate the effective date of this law, the legislature's prohibition of the sale of this product is a clear statement of public policy that adds additional force to the court's holding.

Finally, it is possible to see the opinion in *Richardson* as reflecting a more informed awareness of the changes that widespread securitization has brought to the consumer mortgage industry. Although the court did not articulate this factor, the *Richardson* court's approach to these issues is far more responsive to the interests of the consumer plaintiffs than the opinions in *Melton*, *Shepard*, and *Skinner*. *Richardson* signals a sea change that continues in *Tillman v. Commercial Credit Loans, Inc.*,<sup>244</sup> the last opinion in this series of decisions.

#### E. *Tillman*: Mandatory Arbitration Clauses

Like *Richardson*, *Tillman* was filed as a class action challenging the sale of single-premium credit insurance in conjunction with the origination of mortgage loans.<sup>245</sup> The plaintiffs alleged that the defendant "Commercial Credit sold them single premium credit insurance they did not need or want without disclosing such insurance was optional and that Commercial Credit was the beneficiary of the policies."<sup>246</sup> The two named plaintiffs had financed insurance premiums totaling \$2,064 and \$4,208, representing 11% and 20% of each plaintiff's respective amount financed.<sup>247</sup>

The real battle in *Tillman*, however, concerned the enforceability of an arbitration clause contained in the plaintiffs' loan agreements. The prominently-placed arbitration clause provided for mandatory arbitration of all claims arising out of the agreement with two lender-

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243. See *supra* note 125 and accompanying text.

244. 362 N.C. 93, 655 S.E.2d 362 (2008), *rev'g* 177 N.C. App. 568, 629 S.E.2d 865 (2006).

245. *Tillman*, 362 N.C. at 96–97, 655 S.E.2d at 366–67. Although *Tillman* was filed as a class action, there is no indication that the trial court certified the class. *Id.* at 96 n.1, 655 S.E.2d at 366 n.1.

246. *Tillman*, 177 N.C. App. at 569, 629 S.E.2d at 868.

247. *Tillman*, 362 N.C. at 94, 655 S.E.2d at 365.

friendly exceptions: (1) actions to foreclose the property, and (2) any matter where all parties in the aggregate seek \$15,000 or less, inclusive of damages, costs, and fees.<sup>248</sup> The arbitration clause also prohibited class actions, limited the joinder of parties, and included a provision shifting most arbitration costs to the borrowers.<sup>249</sup>

The plaintiffs ignored this arbitration clause and filed a civil suit in North Carolina superior court, prompting the defendants to respond by filing a motion to compel arbitration.<sup>250</sup> The trial court denied the motion and agreed with the plaintiffs that the arbitration provision was unconscionable and therefore unenforceable.<sup>251</sup> A divided panel of the court of appeals reversed the trial court, finding the provision enforceable.<sup>252</sup> The plaintiffs then appealed to the Supreme Court of North Carolina, which issued a deeply divided decision affirming the trial court's holding of unconscionability on January 25, 2008.

Five justices combined in two separate opinions to find the arbitration agreement unconscionable. Two justices joined a detailed opinion written by Justice Timmons-Goodson finding that the arbitration agreement was procedurally and substantively unconscionable.<sup>253</sup> Procedural unconscionability is “‘bargaining naughtiness’ in the form of unfair surprise, lack of meaningful choice, and an inequality of bargaining power.”<sup>254</sup> Substantive unconscionability, on the other hand, “refers to harsh, one-sided, and oppressive contract terms.”<sup>255</sup> Justices Edmunds and Martin

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248. *Id.* at 94–96, 655 S.E.2d at 365–66. The evidence showed that these exceptions had permitted Citifinancial to file more than 1700 foreclosure actions against North Carolina borrowers, as well as more than 2000 collections actions with an average amount in dispute of less than \$7,000. *Id.* at 97, 655 S.E.2d at 367.

249. Empirical evidence established that these procedures were effective in discouraging arbitration. Although Citifinancial had made more than 68,000 loans to North Carolinians since adding these provisions to its agreements, no North Carolina borrower had ever requested arbitration. *Id.* at 110, 655 S.E.2d at 374–75 (Edmunds, J., concurring).

250. *Id.* at 96–97, 655 S.E.2d at 366–67.

251. *Id.* at 100, 655 S.E.2d at 368.

252. *Tillman*, 177 N.C. App 568, 629 S.E.2d 865 (Judge Tyson wrote the majority opinion and was joined by Judge McCullough while Judge Hunter dissented).

253. *Tillman*, 362 N.C. at 102, 655 S.E.2d at 370.

254. *Id.* at 102–03, 655 S.E.2d at 370 (quoting *Rite Color Chem. Co. v. Velvet Textile Co.*, 105 N.C. App. 14, 20, 411 S.E.2d 645, 648 (1992)). These three justices agreed that the clause at issue was procedurally unconscionable because the borrowers were rushed through the loan closings, credit insurance and the arbitration clause were never mentioned to the borrowers, and because the bargaining power between the parties was “unquestionably unequal.” *Id.*

255. *Id.* at 104, 655 S.E.2d at 371. Justice Timmons-Goodson found the arbitration clause substantively unconscionable because it imposed “prohibitively high” costs on the

concurring in a separate opinion that unified the procedural and substantive components of unconscionability into an inquiry into the totality of the circumstances.<sup>256</sup> Finally, Justices Newby and Parker joined in a strong dissent objecting that the plurality was invalidating the arbitration clause merely “because it is an agreement to arbitrate.”<sup>257</sup>

The plurality and dissenting opinions in *Tillman* are premised on fundamentally different approaches to the problems posed by the case. Five justices were willing to find a consumer contract provision contained in a mortgage loan unconscionable and therefore unenforceable.<sup>258</sup> The two opinions that form the plurality focus on the harmful nature of the insurance sold to the plaintiffs, the plaintiffs’ limited financial means, and the fact that the arbitration clause effectively deprived them of any remedy.<sup>259</sup> These five justices were concerned with “the inequality of the bargain represented by the arbitration clause,” finding this “so manifest as to shock the judgment of a person of common sense,” and “so oppressive that no reasonable person would offer it on the one hand or accept it on the other.”<sup>260</sup> They were alert to the fact that the arbitration clause at

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borrowers, contained one-sided exceptions that allowed only the lender to sue, and prohibited joinder of claims and class actions. *Id.*

256. *Id.* at 110–11, 655 S.E.2d at 374–75 (Edmunds, J., concurring). The three opinions in *Tillman* differ in their interpretation of *Brenner v. Little Red School House, Ltd.*, 302 N.C. 207, 274 S.E.2d 206 (1981), the controlling North Carolina precedent on unconscionable consumer contracts. Justice Timmons-Goodson applies *Brenner* to conclude that the arbitration clause is procedurally and substantively unconscionable. Justice Edmunds’ concurrence views *Brenner* as requiring the court to apply a totality of the circumstances test. Justice Newby’s dissent appears to agree with Timmons-Goodson’s understanding of *Brenner*, but disagrees with her application of that decision to these facts. *Id.* at 118 n.6, 655 S.E.2d at 379 n.6 (Newby, J., dissenting).

257. *Id.* at 112, 655 S.E.2d at 375 (Newby, J., dissenting).

258. This worked a subtle change in North Carolina contract law. As Justice Newby notes in his dissent, *Brenner* equated “‘bargaining power’ with choices in the marketplace.” *Id.* at 120, 655 S.E.2d at 380 (Newby, J., dissenting). As a result, a contract of adhesion was not unconscionable in North Carolina, so long as the consumer was free to reject that contract and seek another option on the market. This aspect of *Brenner*, which made it virtually impossible for a consumer contract to be found unconscionable, was implicitly rejected by the majority in *Tillman*.

259. Justice Timmons-Goodson noted that the sale of single premium credit insurance on home mortgages has been outlawed in North Carolina since 2000 and highlighted the plaintiffs’ “limited financial resources.” *Id.* at 94, 655 S.E.2d at 365. She further noted the unequal bargaining power of the parties and the fact that the arbitration clause “severely limited plaintiffs’ access to the forum of their choice.” *Id.* at 108, 655 S.E.2d at 373. These themes are echoed by Justice Edmunds, who finds that the arbitration clause “effectively prevented plaintiffs from vindicating their rights under the contract in any forum.” *Id.* at 110, 655 S.E.2d at 374 (Edmunds, J., concurring).

260. *Id.* at 110–11, 655 S.E.2d at 375 (Edmunds, J., concurring).



issue was placed in the context of a consumer mortgage loan transaction involving a high-cost form of insurance that provided no value to the borrowers who paid for it.

The dissent was also aware of this context, as indicated by its initial statement that “[t]his case . . . is not about regulating subprime loans.”<sup>261</sup> Even though the arbitration clauses at issue were placed in subprime loan documents, in Justice Newby’s view, the case was about the bedrock contract principle that borrowers and lenders alike should have the freedom to make contracts—even foolish ones.<sup>262</sup> More fundamentally, however, the dissent viewed the case as implicating “the role courts should play in interpreting and enforcing contracts.”<sup>263</sup> The dissent’s paramount concern was with preventing judicial intrusion upon the bargain struck by the parties:

We must decide the case . . . not by what we may think would have been a wiser and more discreet contract on the part of the plaintiff, if he could have procured one, but by what is written in the contract actually made by them. Courts are not at liberty to rewrite contracts for the parties. We are not their guardians, but the interpreters of their words.<sup>264</sup>

The dissent in *Tillman*, like the plurality opinions in *Shepard* and *Skinner*, seems not to consider the drastic changes that securitization has produced in the mortgage market faced by consumer borrowers in North Carolina.

On the other hand, the plurality opinions in *Tillman* resemble the opinion in *Richardson*, in that they recognize the nature of the underlying loan transactions and do not hesitate to intervene within the bounds of the law. In effect, the *Tillman* majority is—as feared by the dissent—willing to regulate subprime loans.

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261. *Id.* at 111, 655 S.E.2d at 375 (Edmunds, J., concurring).

262. *Id.* at 111, 655 S.E.2d at 375 (Newby, J., dissenting) (“I recognize that . . . our General Assembly decided to outlaw the sale of single premium insurance some time after the execution of the contracts at issue . . . . [T]he Court’s decision today implicates bedrock principles of contract law which should not be disturbed in response to policy concerns over a disfavored industry.”)

263. *Id.* at 115, 655 S.E.2d at 377 (Newby, J., dissenting).

264. *Id.* at 116, 655 S.E.2d at 378 (Newby, J., dissenting) (quoting *Powers v. Travelers Ins. Co.*, 186 N.C. 336, 337, 119 S.E. 481, 482 (1923)).

## III. PASSIVE JUDICIAL ACTIVISM AND THE DUTY TO DECIDE

A. *Justiciability and Judicial Restraint*

Doctrines of justiciability are used to limit the judicial power and decisional reach of courts.<sup>265</sup> Justiciability concepts, including standing, ripeness, mootness, and the avoidance of advisory opinions, are used “to identify appropriate occasions for judicial action.”<sup>266</sup> Conversely, and more commonly, they are also used to identify situations in which a court may justifiably refuse to exercise its decisional power, even over cases that otherwise fall within its jurisdiction.<sup>267</sup> Controversies that are not justiciable are described as hypothetical, abstract, or moot.<sup>268</sup> Justiciable controversies, on the other hand, are “definite and concrete, touching the legal relations of parties having adverse legal interests.”<sup>269</sup>

Justiciability is most frequently an issue when courts are asked to determine the propriety of legislative or executive action.<sup>270</sup> This is because justiciability doctrines are used, in large part, to “define the role assigned to the judiciary in a tripartite allocation of power” and to ensure that courts do not “intrude into areas committed to the other branches of government.”<sup>271</sup> Justiciability doctrines provide legitimate limits on judicial power and complement other fundamental concepts that restrain the exercise of power by courts,

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265. Because federal courts are constrained by the “case and controversy” requirement of Article III of the Constitution, justiciability concerns are more pressing in federal courts than in state courts. However, state courts, including the North Carolina state courts, also defer to concepts of justiciability. See generally Helen Hershkoff, *State Courts and the “Passive Virtues”: Rethinking the Judicial Function*, 114 HARV. L. REV. 1833 (2001) (discussing the functions of justiciability doctrines in state courts).

266. *Malamud v. Sinclair Oil Corp.*, 521 F.2d 1142, 1146 (6th Cir. 1975). For North Carolina cases dealing with justiciability issues, see, e.g., *In re Peoples*, 269 N.C. 109, 250 S.E.2d 890 (1978) (“mootness”); *Neuse River Found. Inc., v. Smithfield Foods, Inc.*, 115 N.C. App. 110, 574 S.E.2d 48 (2002) (“standing”).

267. *Malamud*, 521 F.2d at 1146.

268. See, e.g., *Aetna Life Ins. Co. v. Haworth*, 300 U.S. 227, 240 (1937).

269. *Id.*

270. See, e.g., 13 CHARLES ALAN WRIGHT, ARTHUR R. MILLER & EDWARD H. COOPER, *FEDERAL PRACTICE AND PROCEDURE* § 3529 (2d ed. 1984) and cases cited therein; see also ERWIN CHERMERINSKY, *FEDERAL JURISDICTION* 45 (3rd ed. 1999) (“The justiciability doctrines define the judicial role; they determine when it is appropriate for the federal courts to review a matter and when it is necessary to defer to the other branches of government.”); Hershkoff, *supra* note 265, at 1840 (“In the federal system, justiciability doctrine defines the work of Article III courts and attempts to mark a boundary between the worlds of law and politics.”).

271. CHERMERINSKY, *supra* note 270 (quoting *Flast v. Cohen*, 392 U.S. 83, 95 (1968)).

like those embodied in the Eleventh Amendment<sup>272</sup> and the Due Process Clause.<sup>273</sup>

The subject matter jurisdiction of the federal courts,<sup>274</sup> as well as that of the North Carolina state courts,<sup>275</sup> is also constitutionally controlled. In addition, federal courts have developed abstention doctrines that allow them to refrain from deciding some cases that present justiciable controversies over which they have jurisdiction.<sup>276</sup> Even when not constitutionally mandated, these limits enforce important policy concerns and allow federal and state judges to police the application of their jurisdiction.

Outside these limits, a modern tendency exists to regard judicial power with suspicion, and the pejorative term "judicial activism" has been developed to describe judicial behavior that is not sufficiently restrained.<sup>277</sup> However, the most persuasive advocates of judicial restraint do not focus on judicial activism, but instead examine the productive and positive uses of prudent judicial inaction. For example, Alexander Bickel's classic analysis of the "passive virtues" of judging does not urge the creation of a corps of idle or unresponsive judges.<sup>278</sup> Instead, he counsels judges to use justiciability doctrines to avoid deciding issues prematurely or in advance of legislative action.<sup>279</sup>

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272. See, e.g., *Seminole Tribe of Fla. v. Florida*, 517 U.S. 44 (1996).

273. See, e.g., *Mullane v. Central Hanover Bank & Trust Co.*, 339 U.S. 306 (1950) (holding the notice statute unconstitutional); *International Shoe Co. v. Washington*, 326 U.S. 310 (1945) (finding sufficient minimum contacts in the state to subject appellant to a suit in the state).

274. See U.S. CONST. art. III.

275. See N.C. CONST. art. IV, § 12; see also JOHN V. ORTH, *THE NORTH CAROLINA STATE CONSTITUTION WITH HISTORY AND COMMENTARY* 111 (1995) (noting that the Supreme Court of North Carolina is a constitutional court because its existence derives from the North Carolina Constitution).

276. See, e.g., *Burford v. Sun Oil Co.*, 319 U.S. 315 (1943) (finding abstention appropriate where the state provided system of regulation, and federal intervention would cause undue delay).

277. See Frank H. Easterbrook, *Do Liberals and Conservatives Differ in Judicial Activism?*, 73 U. COLO. L. REV. 1401, 1401-04 (2002); Keenan D. Kmiec, *The Origin and Current Meanings of "Judicial Activism,"* 92 CAL. L. REV. 1441, 1442-44 (2004).

278. See ALEXANDER BICKEL, *THE LEAST DANGEROUS BRANCH* (1962) [hereinafter *THE LEAST DANGEROUS BRANCH*]; Alexander M. Bickel, *The Supreme Court 1960 Term: Foreword: The Passive Virtues*, 75 HARV. L. REV. 40 (1961). For the classic contemporaneous criticism of Bickel's work, see Gerald Gunther, *The Subtle Vices of the "Passive Virtues"—A Comment on Principle and Expediency in Judicial Review*, 64 COLUM. L. REV. 1 (1964).

279. *THE LEAST DANGEROUS BRANCH*, *supra* note 278, at 131. To illustrate the wisdom of this approach, Bickel cites Justice Jackson's dissent in *Korematsu v. United States*, 323 U.S. 214, 246 (1944) (Jackson, J., dissenting):

Thirty-five years after Bickel, Cass Sunstein provided a thoughtful analysis of the advantages of decisional minimalism, which he defines as “doing and saying as little as necessary to justify an outcome.”<sup>280</sup> In Sunstein’s view, the best judges “decide no more than they have to decide. They leave things open. They make deliberate decisions about what should be left unsaid.”<sup>281</sup> Sunstein’s minimalist judges are not passive. Instead, they use silence constructively and in a manner that he describes as “democracy-forcing,”<sup>282</sup> meaning not only that they leave issues open for decision by elected officials, but also that they reach decisions that require legislatures to “speak with clarity.”<sup>283</sup>

Minimalist judges issue narrow decisions that leave unsettled issues open for future legislative or judicial action, and use justiciability doctrines as a means to this end.<sup>284</sup> They decide only the case before them, and they avoid supporting their judgments with abstract pronouncements of principle.<sup>285</sup> They proceed “in a way that is catalytic rather than preclusive, and that is closely attuned to the fact that courts are participants in the system of democratic deliberation.”<sup>286</sup> Sunstein’s admiration for judicial minimalism is based, in part, on the principle that elected representatives are more democratically accountable than judges.<sup>287</sup> In his view, judicial decisions should not foreclose legislative solutions, but instead should

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A military order, however unconstitutional, is not apt to last longer than the military emergency . . . . But once a judicial opinion rationalizes such an order to show that it conforms to the Constitution, . . . the Court for all time has validated the principle of racial discrimination in criminal procedure and of transplanting American citizens. The principle then lies about like a loaded weapon ready for the hand of any authority that can bring forward a plausible claim of an urgent need . . . . There it has a generative power of its own, and all that it creates will be in its own image.

*Id.* Bickel views a bad rule made by the Court as far more dangerous than a bad rule made by military order. *Id.*

280. Cass R. Sunstein, *The Supreme Court 1995 Term: Foreword: Leaving Things Undecided*, 110 HARV. L. REV. 4, 6 (1995).

281. *Id.*

282. *Id.* at 7.

283. *Id.* at 25.

284. See Christopher J. Peters, *Assessing the New Judicial Minimalism*, 100 COLUM. L. REV. 1454, 1458 (2000).

285. *Id.*

286. Sunstein, *supra* note 280, at 101.

287. *Id.* at 19; see *infra* notes 312–13 and accompanying text for a discussion of the political accountability of elected judges.

encourage, enable, and reinforce lasting solutions that come through the democratic process.<sup>288</sup>

Minimalist opinions also reflect awareness that a court may decide complex, unsettled issues incorrectly or on the basis of incomplete information. To guard against these possibilities, minimalist judicial opinions leave flexibility for future decision-making. “Minimalists refuse to freeze existing ideals and conceptions; in this way they retain a good deal of room for future deliberation and choice.”<sup>289</sup> In Sunstein’s minimalist model, judges should be “cautious about imposing their own views on the rest of society” and respectful of democratically-expressed views embodied in legislation.<sup>290</sup>

### B. *The Duty to Decide*

Justiciability doctrines limit the adjudicative responsibilities of courts, while the ideal of judicial minimalism counsels judges to exercise restraint in their decisions. The development of these boundaries around the adjudicative function indicates that judges may sometimes have a positive duty to decide justiciable issues that fall within their jurisdiction.<sup>291</sup> Minimalism neither describes nor erodes this duty; it merely adds that judicial decisions should narrowly address the case before the court and not foreclose future development of the law through legislative or judicial action.

It is intuitively correct and natural that judges have an affirmative duty to decide justiciable issues placed before them. However, it is difficult to locate the exact parameters of any such duty.<sup>292</sup> The most famous expression of a duty to decide is found in Chief Justice Marshall’s opinion in *Cohens v. Virginia*: “With

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288. *Id.* Sunstein has been criticized for underestimating the important role of courts as “the deliberative crucible of principle” in a democratic system of government. See Peters, *supra* note 284, at 1466. This assessment oversimplifies Sunstein’s approach, which leaves wide latitude for courts to reach decisions that effect change. See, e.g., Sunstein, *supra* note 280, at 71 (seeing *Romer v. Evans*, 526 U.S. 620 (1996), as a narrowly-decided minimalist opinion whose value lies, partly, in the change effected by Justice Kennedy’s matter-of-fact treatment of homosexuals as “citizens like everyone else”).

289. CASS R. SUNSTEIN, ONE CASE AT A TIME: JUDICIAL MINIMALISM ON THE SUPREME COURT 259 (1999).

290. *Id.* at x.

291. See Chad M. Oldfather, *Defining Judicial Inactivism: Models of Adjudication and the Duty to Decide*, 94 GEO. L. J. 121, 127 (2005) (noting that “[t]he very existence of justiciability doctrines, which excuse courts from deciding cases in certain circumstances, implies that where those circumstances are not present, courts do not enjoy the freedom to abstain from adjudication.”).

292. *Id.* This problem is the focus of Oldfather’s article.

whatever doubts, with whatever difficulties, a case may be attended, we must decide it, if it be brought before us . . . . Questions may occur which we would gladly avoid; but we cannot avoid them.”<sup>293</sup> *Cohens* has not led to the development of a judicially-recognized duty to decide,<sup>294</sup> however, and the most thorough analyses of the adjudicatory responsibilities of judges come from legal scholars—not from the courts themselves.

Two classic accounts of the American adjudicative process were produced in the mid-1970s by Lon Fuller and Abram Chayes.<sup>295</sup> The traditional private law model of adjudication, as described by Fuller, views dispute resolution as the primary function of courts, and sees the prototypical case as a bipolar dispute between private parties.<sup>296</sup> The private law model sees the lawsuit as “a self-contained episode,”<sup>297</sup> whose impact is limited to the parties. On the other hand, Chayes’ “public law” model of adjudication focuses on the law-making function of the courts and views the most important characteristic of modern litigation as the “vindication of constitutional or statutory policies.”<sup>298</sup>

Today, both of these models are considered outdated because neither adequately captures the full range of roles played by judges in modern litigation.<sup>299</sup> Nevertheless, each continues to accurately describe certain aspects of the judicial role. As a practical matter, courts, particularly state trial courts, devote much of their time to resolving disputes between private parties.<sup>300</sup> However, private

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293. 19 U.S. (6 Wheat.) 264, 404 (1821) (affirming the Supreme Court’s jurisdiction over appeals from the highest court of a state).

294. Today, *Cohens* is used to support a duty to decide only within the context of the “doctrine of necessity,” which obligates an otherwise disqualified judge to decide a case if all available judges are disqualified. See Oldfather, *supra* note 291, at 128–29.

295. Abram Chayes, *The Role of the Judge in Public Law Litigation*, 89 HARV. L. REV. 1281 (1976); Lon L. Fuller, *The Forms and Limits of Adjudication*, 92 HARV. L. REV. 353 (1978).

296. See Fuller, *supra* note 295, at 357; see also Melvin Aron Eisenberg, *Participation, Responsiveness, and the Consultative Process: An Essay for Lon Fuller*, 92 HARV. L. REV. 410, 424 (1978); Chayes, *supra* note 295, at 1282 (“In our received tradition, the lawsuit is a vehicle for settling disputes between private parties about private rights.”).

297. Chayes, *supra* note 295, at 1283.

298. *Id.* at 1284. Chayes described “[s]chool desegregation, employment discrimination, and prisoners’ or inmates’ rights cases . . . as avatars of this new form of litigation.” *Id.*

299. See, e.g., Jonathan T. Molot, *An Old Judicial Role for a New Litigation Era*, 113 YALE L.J. 27, 29 (2003); Linda S. Mullenix, *Resolving Aggregate Mass Tort Litigation: The New Private Law Dispute Resolution Paradigm*, 33 VAL. U. L. REV. 413, 417 (1999); Judith Resnik, *Managerial Judges*, 96 HARV. L. REV. 374, 377 (1982).

300. In 1978, Owen Fiss wrote a narrative description of private law litigation that remains a true description of much state court litigation today. “[T]wo people in the state

dispute resolution does not exhaust the "social function of courts"<sup>301</sup>—even in cases between purely private parties. Within the confines of certain private disputes, courts may be called on to make law in a sense akin to the public law function described by Chayes.<sup>302</sup>

Thus, some lawsuits between private parties alleging private injuries also serve a public law purpose. One hallmark of these hybrid private/public cases is that remedies granted or denied will have "important consequences for many persons including absentees."<sup>303</sup> Law-making private disputes, like public disputes, "often have direct implications for people and entities who may not be parties to the lawsuit."<sup>304</sup> Another characteristic of this type of case is that the litigation, although private, may echo legislative action or have effects resembling legislative action.<sup>305</sup> And if the lawsuit impacts an area of the law where the legislature has already acted to express a clear public policy, private litigation may affect not only other potential litigants, but future legislative initiatives as well.

The public law and private law adjudicative models were developed to describe and analyze the role played by judges in each type of case. They do not address the scope of any adjudicative *duty* that inheres in the judicial office, although Professor Chad Oldfather has defined such a duty by extracting points of commonality from the dominant models of the adjudicative process.<sup>306</sup> Oldfather's analysis finds a "common, consistent conception of the minimal components

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of nature are squabbling over a piece of property, they come to an impasse, and, rather than resorting to force, turn to a third party, a stranger, for a decision. Courts are but an institutionalization of the stranger." Owen Fiss, *The Supreme Court 1978 Term: Forward: The Forms of Justice*, 93 HARV. L. REV. 1, 29 (1978).

301. *Id.*

302. Mass tort litigation, for example, evokes aspects of both the public law and private law models. Linda Mullenix has described modern mass tort litigation as "a new form of dispute resolution that represents nothing so much as aggregative private legislation often without the benefit of meaningful representation." Mullenix, *supra* note 299, at 424; *cf.* David Rosenberg, *The Causal Connection in Mass Exposure Cases: A 'Public Law' Vision of the Tort System*, 97 HARV. L. REV. 849, 905–24 (1984) (advocating the application of public law procedural mechanisms to mass tort litigation).

303. Chayes, *supra* note 295, at 1302. Class actions are the most obvious example of this effect; however, this principle is also at work in cases filed by discrete, non-representative plaintiffs who resemble other similarly situated individuals.

304. Chad M. Oldfather, *Remedying Judicial Inactivism: Opinions as Informational Regulation*, 58 FLA. L. REV. 743, 753 (2006).

305. *Cf.* Howard M. Erichson, *Coattail Class Actions: Reflections on Microsoft, Tobacco, and the Mixing of Public and Private Lawyering in Mass Litigation*, 34 U.C. DAVIS L. REV. 1, 16 (2000) (describing "the mixing of public and private lawyering roles" in mass litigation).

306. Oldfather, *supra* note 291, at 152.

of legitimate adjudication.”<sup>307</sup> These include: participation by the parties, judicial responsiveness and attention to the parties’ arguments, a decision based on appropriate criteria, and a candid explanation of the reasons for the court’s decision.<sup>308</sup>

The adjudicative duty identified by Oldfather complements the obligations imposed on judges by doctrines of justiciability and decisional minimalism. Together, they recognize a duty to decide that encompasses more than a duty to adjudicate cases responsively and with candor. In the most expansive sense, the judicial duty to decide also includes a responsibility to avoid nonjusticiable issues, an obligation to decide cases narrowly, a duty to structure decisions so that they are not unnecessarily preclusive of future legislative or judicial action, and a duty to respect the democratic process and the legislative enactments that it produces. This adjudicative duty stands in opposition to activist judging.

### C. *Passive Judicial Activism*

The term “judicial activism” carries two related negative connotations.<sup>309</sup> First, judicial activism is used to describe the phenomenon “of courts deciding issues they should not decide, issues that should be left to the ‘political process’—of courts stepping in where there has been no legislative failure . . . .”<sup>310</sup> The second negative connotation, closely related to the first, is “of courts implementing their own personal ideology or ‘values’ through their decisions rather than simply declaring what ‘the law’ is.”<sup>311</sup> In combination, these two senses of judicial activism refer to the politicization of the law through: (1) judicial usurpation of legislative functions, and (2) judicial failure to squarely and narrowly address the legal issues presented by the parties.

Accusations of judicial activism are most commonly leveled against federal courts, both because their power is limited by Article III of the Constitution<sup>312</sup> and because they frequently face constitutional questions. Since state courts have a role in the development of common law, it is expected that they will have

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307. Oldfather, *supra* note 304, at 758.

308. *Id.*; see also Oldfather, *supra* note 291, at 127.

309. Christopher J. Peters, *Adjudication as Representation*, 97 COLUM. L. REV. 312, 318 (1997).

310. *Id.*

311. *Id.*

312. See Hershkoff, *supra* note 265, at 1836–75 (discussing how state judicial practice differs from the model imposed on federal courts by Article III).



lawmaking authority in certain areas. In addition, many state judges—including those in North Carolina—are elected, making them more politically accountable than their federal counterparts. Despite this, to the extent that they stray beyond the boundaries of their power and usurp legislative functions, state courts can fairly be said to engage in judicial activism.<sup>313</sup>

Proscriptions against judicial activism at both the federal and state levels have much in common with Sunstein's decisional minimalism, as well as with doctrines of justiciability. The respect for democratic processes that underlies the minimalist approach to judging strengthens the obligation of judges to tread cautiously when deciding private legal issues that have drawn much legislative attention. A similar regard for the role of legislatures is embedded in the various doctrines of justiciability. When the legislature addresses an issue and adopts a statutory solution, as North Carolina has done with predatory lending, concern for that issue is incorporated into the public policy of the state. A court that ignores such an issue, or that fails to decide it squarely and narrowly, can rightly be said to have acted in an activist manner.

Even without attention from the legislature, predatory lending cases occupy a middle ground between the private law cases and public law cases described by Fuller and Chayes.<sup>314</sup> They involve private parties, private harms, and private rights. However, like mass tort cases and class actions, predatory lending cases have a potential regulatory aspect because successful litigation may constrain the behavior of businesses who are not parties to the case. Predatory lending cases also are quasi-public because the court's decision, particularly a preclusive decision,<sup>315</sup> may impact consumers who are strangers to the litigation. These "law-making" effects of predatory lending cases may trigger hostility from judges who see themselves as minimalist or who wish to avoid charges of activism.

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313. As a practical matter, state courts are often accused of judicial activism. See, e.g., CENTER FOR INDIVIDUAL FREEDOM, JUDICIAL ACTIVISM IN NEVADA: STATE SUPREME COURT TRUMPS WILL OF THE PEOPLE 1 (2003), [http://www.cfif.org/htdocs/legislative\\_issues/state\\_issues/nevada\\_judicial\\_activism.htm](http://www.cfif.org/htdocs/legislative_issues/state_issues/nevada_judicial_activism.htm) (last visited Aug. 23, 2008); Michael B. Brennan, *Are Courts Becoming Too Activist?*, MILWAUKEE JOURNAL SENTINEL, Oct. 1, 2005, available at <http://www.jsonline.com/story/index.aspx?id=359831>.

314. See *supra* notes 295–98 and accompanying text.

315. The preclusive effects of a hybrid private/public law case may be broader than the familiar litigation doctrines of claim preclusion, issue preclusion, or *stare decisis*. As demonstrated in *Skinner*, the court's power of judicial review allows it to block future legislative action as well. See *infra* notes 322–23 and accompanying text.

However, the issue of predatory lending has not been met with “legislative failure” in North Carolina. To the contrary, the North Carolina General Assembly has proactively led the nation in recognizing the phenomenon of predatory lending and in protecting North Carolinians by devising effective legislative solutions.<sup>316</sup> The state legislature has addressed predatory lending in a series of statutes adopted over a period of eight years.<sup>317</sup> Most recently, in the summer of 2007, the General Assembly adopted five separate statutory packages dealing with mortgage lending in North Carolina.<sup>318</sup>

The consistency and duration of the state legislature’s concern with predatory mortgage lending defuses any charge of “judicial activism” that might be leveled at North Carolina courts in this area. Instead, predatory lending cases, even cases invoking non-statutory common law remedies, reverberate with legislative intent. This is not to say that borrowers will always win these cases, only that North Carolina courts faced with justiciable predatory lending issues have an affirmative duty to decide these issues squarely on their merits when possible.

In *Melton v. Family First Mortgage Corporation*,<sup>319</sup> for example, the court faced a compelling set of facts<sup>320</sup> and yet rejected the plaintiff’s argument that the assignee of her mortgage should be liable for the originator’s unfair and deceptive trade practice. *Melton* is not a consumer-friendly ruling, yet it is completely consistent with North Carolina law. In shielding assignees from liability for fraud committed by the originator of the mortgage, the court’s decision tracked the holder in due course doctrine and North Carolina’s Predatory Lending Law. By refusing to create an ancillary exception under the Unfair and Deceptive Trade Practices Act, the court in *Melton* reached an outcome that complements and respects the legislative decision embodied in the Predatory Lending Law. In doing so, the court made a clean, straightforward decision on the merits, following precedent and direction from the state legislature.

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316. See *supra* Part I.C.2.

317. *Id.*

318. Act of July 4, 2007, ch. 163, sec. 1–2, 2007 N.C. Sess. Laws 269; Act of July 5, 2007, ch. 176, sec. 1–3, 2007 N.C. Sess. Laws 291; Act of Aug. 16, 2007, ch. 351, sec. 1–6, 2007 N.C. Sess. Laws 1065; Act of Aug. 16, 2007, ch. 352, sec. 1–10, 2007 N.C. Sess. Laws 1072; Act of Aug. 16, 2007, ch. 353, sec. 1–6, 2007 N.C. Sess. Laws 1080.

319. 156 N.C. App. 129, 576 S.E.2d 365 (2003), *per curiam*, 357 N.C. 573, 597 S.E.2d 672 (2003).

320. The plaintiff alleged that she was drugged by a family member and swindled out of her home equity with the cooperation of the mortgage originator. *Melton*, 156 N.C. App. at 131, 576 S.E.2d at 367–68.

Predatory lending is an area in which the North Carolina legislature has perceived the need for consumer protection and responded with a carefully calibrated set of remedies.<sup>321</sup> Since the legislature expressly declined to provide for assignee liability in this area, the court might have earned the sobriquet “activist” if it had disregarded the legislature’s guidance and recognized assignee liability in *Melton*. Given the legislature’s clear statement of public policy, North Carolina’s courts should be similarly reluctant to enter predatory lending decisions that will preclude future legislative or judicial action. Unless required and cleanly supported, a predatory lending decision with preclusive effect, particularly a decision that goes beyond judicial issue preclusion and precludes future legislative action, may subvert the legislative will and thus fairly be called activist.

The majority opinions in *Shepard* and *Skinner* illustrate this sort of activism. The court’s interpretation of the statute of limitations in *Shepard* blocked judicial action in future predatory lending cases brought by other similarly situated consumers.<sup>322</sup> *Skinner*’s holding that the state long-arm statute did not authorize suit against the out-of-state trust had a comparably preclusive effect. The alternative holding in *Skinner*, that the out-of-state trust lacked minimum contacts to support personal jurisdiction in North Carolina, is even more broadly preclusive. Not only does the holding foreclose consideration of this issue by other courts, it cannot be modified or reversed by the legislature because it is based on the court’s interpretation of the Due Process Clause.<sup>323</sup>

*Shepard* and *Skinner* use procedural doctrines to create this preclusive effect and avoid reaching the merits of the case. This strategy superficially appears to evoke Bickel’s passive virtues and Sunstein’s decisional minimalism, echoing the familiar uses of justiciability doctrines and minimalism to constrain judicial power. However, several key distinctions show that the decisions in *Shepard* and *Skinner* do not model the forms of decisional modesty advocated by Bickel and Sunstein, but instead represent a form of passive judicial activism.

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321. See *supra* Part I.C.2.

322. The preclusive effect referenced here results from the doctrine of *stare decisis*, and not from issue or claim preclusion. See DAVID L. SHAPIRO, CIVIL PROCEDURE: PRECLUSION IN CIVIL ACTIONS 10–11 (2001).

323. Because virtually all subprime mortgages are securitized and held by an out-of-state trust like the defendant in *Skinner*, this decision impacts a large number of consumers across North Carolina.

First, *Shepard* and *Skinner* were decided against a backdrop of sustained and thoughtful legislative action. The North Carolina General Assembly was quick to realize that the wholesale securitization of consumer mortgages created a new financial “technology” and incentives for predatory lending that did not previously exist. Legal concepts are commonly adapted to reflect new technologies;<sup>324</sup> however, Bickel and Sunstein would caution judges to make these adaptations carefully, non-preclusively, and with deference to existing and future legislative solutions.<sup>325</sup> The majority opinions in *Shepard* and *Skinner* fail to acknowledge either the phenomenon of predatory lending or the solutions devised by the legislature. As a result, despite their apparent passivity, these decisions have the effect of actively precluding consumer litigation in an area of persistent legislative concern.

Second, both decisions drew strong dissents that evidenced a sharp 4–3 split between the justices.<sup>326</sup> This lack of accord indicates that the outcome reached by the majority was not inevitable, was not clearly controlled by existing precedent, and instead was the product of judicial discretion.<sup>327</sup> Given the high level of legislative interest in predatory lending and the formidable public policies at issue,<sup>328</sup> judicial restraint would caution against the use of procedural doctrines with a widely-preclusive effect unless these outcomes are clearly required. The uncompelled use of procedural doctrines to preclude future litigation of predatory lending cases does not square with Bickel’s passive virtues or Sunstein’s decisional minimalism; instead, it is a form of disguised judicial activism. This is particularly true of the holding in *Skinner*, which evades the presumption that long-arm statutes are liberally construed in favor of finding jurisdiction<sup>329</sup> only to add a duplicative and unnecessary due process

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324. For example, it has been necessary to adapt many legal concepts to the Internet. See, e.g., *Zippo Mfg. Co. v. Zippo Dot Com, Inc.*, 952 F. Supp. 1119, 1122–28 (W.D. Pa. 1997) (adapting principles of personal jurisdiction to internet sellers).

325. See *supra* Part III.A.

326. See *supra* notes 191–94 and 209–11 and accompanying text.

327. Cf. Recent Case, *supra* note 216, at 640 (describing the ways in which the majority’s due process analysis “does not accord with settled jurisdictional precedent”).

328. The dissents in *Shepard* and *Skinner* not only challenge the majority’s legal analysis, they emphasize “the paramount public policy” of protecting consumer borrowers expressed in the North Carolina General Statutes. *Shepard*, 361 N.C. at 142, 638 S.E.2d at 201 (Timmons-Goodson, J., dissenting) (quoting N.C. GEN. STAT. § 24-2.1 (2005)).

329. See, e.g., *Brown v. Ellis*, 184 N.C. App. 547, 549, 646 S.E.2d 408, 410–11 (2007); *Strother v. Strother*, 120 N.C. App. 393, 395–98, 462 S.E.2d 542, 543–45 (1995).

analysis that exponentially increases the impact of the court's holding.<sup>330</sup>

Finally, the North Carolina General Assembly's swift response to *Shepard* and *Skinner* offers additional evidence of the activist nature of these decisions. In August 2007, a mere six months after the decisions in *Shepard* and *Skinner*,<sup>331</sup> the General Assembly issued an unambiguous statement that these decisions had intruded into the legislature's domain when it ratified House Bill 1374.<sup>332</sup> The new law legislatively overruled *Shepard* by amending the statute of limitations to provide that the period for filing a usury action "accrue[s] with each payment made and accepted on the loan."<sup>333</sup> It also amends North Carolina's long-arm statute to provide for jurisdiction over out-of-state special purpose trusts like the defendant in *Skinner*.<sup>334</sup> However, because it is impossible for the legislature to overturn the due process component of the *Skinner* decision, *Skinner*'s holding will continue to frustrate the legislature and consumers into the future.

If *Shepard* and *Skinner* exemplify a form of passive judicial activism, the pro-consumer decisions in *Richardson* and *Tillman* employ a pattern of adjudication that is much closer to decisional minimalism. The claims underlying both *Richardson* and *Tillman* challenged the sale of single-premium credit insurance (SPCI), a worthless product that mortgage lenders have been unable to sell to consumer borrowers in North Carolina since July 1, 2000.<sup>335</sup> Although the insurance sold in *Richardson* and *Tillman* predated this law, the General Assembly's subsequent prohibition of its sale is a powerful statement about its lack of value to North Carolina consumers.

In *Richardson*, the defendant bank sold insurance that it was not authorized to sell, violating a statutory prohibition in the heavily regulated insurance industry to make a profit.<sup>336</sup> The placement of this conduct in the context of consumer mortgages tagged the bank's behavior as a form of predatory lending—triggering the application of

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330. See *supra* notes 212–16 and accompanying text.

331. *Shepard* and *Skinner* were decided on December 20, 2006. See *supra* notes 15–16.

332. Act of Aug. 16, 2007, ch. 351, sec. 1–6, 2007 N.C. Sess. Laws 1065. House Bill 1374 was titled "An Act to Overturn the Shepard Case [and] to Overturn the Skinner Case." *Id.*

333. *Id.*

334. *Id.*

335. The sale of SPCI is prohibited by section 24-10.2(b) of the North Carolina General Statutes, added in the 1999 Predatory Lending Law and in effect since July 1, 2000. See N.C. GEN. STAT. § 24-10.2 (2007).

336. See *supra* notes 233–34 and accompanying text.

a second set of policies under North Carolina law. Thus, although *Richardson* involves dispute resolution between private parties, it has public law overtones because the defendant's behavior flouted North Carolina's insurance laws and involved a form of credit insurance tied to predatory lending.

Because the legislature has spoken with such clarity in these two areas, there was no need for the court to exercise restraint and defer to the legislative process. Instead, the court had an affirmative duty to decide the case on its merits, and it complied with this duty in a minimalist manner. This is not to say that *Richardson* does not change North Carolina law. It does. However, *Richardson* is minimalist because it resolves the parties' dispute by interpreting existing law in an area where it had authority to do so. Equally as important, the court reached a decision that does not foreclose modification or adaptation of its rules in future decisions or legislative action. The court decided no more—and no less—than it was required to do on the facts of the case.

In *Tillman*, the five justices who joined the plurality were united by an overarching belief in the unconscionability of the one-sided arbitration clause at issue.<sup>337</sup> Despite their inability to agree on the appropriate test for unconscionability in North Carolina, these five justices were in accord that whatever test was used, the arbitration clause at issue in *Tillman* was unconscionable because it “prevented plaintiffs from vindicating their rights under the contract in any forum,”<sup>338</sup> while leaving the defendants free to pursue claims against borrowers in court. The key to this finding was the plurality's particularized focus on the plaintiffs and their financial circumstances.<sup>339</sup> The plurality viewed the case as an instance of

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337. *Tillman*, 362 N.C. at 102, 655 S.E.2d at 370. Three justices adopted the rule that a party asserting unconscionability must prove both procedural and substantive unconscionability. *Id.* Two justices concurred in the result, but wrote separately to state their belief that the court should apply the totality of the circumstances test set out in *Brenner*. *Id.* at 109, 655 S.E.2d at 374 (Edmunds, J., concurring); see *supra* notes 254–56 and accompanying text.

338. *Tillman*, 362 N.C. at 110, 655 S.E.2d at 374 (Edmunds, J., concurring). Justice Timmons-Goodson makes a nearly identical finding in her opinion, finding the arbitration clause unenforceable because it “simply does not allow for the meaningful redress of grievances.” *Id.* at 109, 655 S.E.2d at 373–74.

339. The plurality opinions focus on the plaintiffs' inability to pay the high costs of arbitration. For example, Justice Timmons-Goodson writes: “In terms of ability to pay, the evidence of plaintiffs' limited financial means is uncontested. Plaintiffs live paycheck to paycheck and usually have very little money left in their bank accounts after paying their monthly bills.” *Id.* at 104, 655 S.E.2d at 371.

dispute resolution involving specific plaintiffs, specific defendants, and a specific contract.

The dissent, in contrast, viewed *Tillman* as involving nothing less than "bedrock principles of contract law which should not be disturbed in response to policy concerns over a disfavored industry."<sup>340</sup> The case was not about specific plaintiffs, but rather about larger issues, including the freedom to contract and the illegitimacy of judicial interference with private bargains.<sup>341</sup> In the dissent's view, a contract is unconscionable only if "the contracting party is denied any opportunity for a meaningful choice."<sup>342</sup> In other words, so long as the plaintiffs could have obtained another mortgage without an arbitration clause, there was no inequality of bargaining power, and the clause at issue could not be found unconscionable.

The dissent's myopic focus on protecting contracts from judicial interference allowed it to ignore the nature of the specific contract at issue in *Tillman*. And it allowed the dissent to disregard the legislative concerns embodied in North Carolina's predatory lending laws. With respect to consumer mortgages, it is no longer the law in North Carolina that "even 'though [a] contract was a foolish one, it would hold in law.'"<sup>343</sup> In the more innocent time when that statement was written, there was a presumption that the parties to a bargain had equal information and equal incentives to act rationally. This is no longer true of some consumer mortgage loans, and the General Assembly has recognized this fact and acted to protect consumers from abusive and predatory mortgages.

Although the loans in *Tillman* predate the enactment of these laws,<sup>344</sup> North Carolina's strong legislative focus on predatory lending supports the plurality's decision in the case. Because the plurality is following the legislature's lead, the pro-consumer outcome they achieve is not vulnerable to charges of judicial activism. Instead, the plurality is following the legislature's lead by implicitly recognizing the changed nature of consumer mortgage lending in North Carolina

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340. *Id.* at 111, 655 S.E.2d at 375 (Newby, J., dissenting).

341. *Id.* at 114-15, 655 S.E.2d at 377. In support of this principle, the dissent quotes five North Carolina cases dating from 1874 to 1958: *Alford v. Textile Ins. Co.*, 248 N.C. 224, 103 S.E.2d 8 (1958); *Troitino v. Goodman*, 225 N.C. 406, 35 S.E.2d 277 (1945); *Peoples Bank & Tr. Co. v. Mackorell*, 195 N.C. 741, 143 S.E. 518 (1928); *Powers v. Travelers Ins. Co.*, 186 N.C. 336, 119 S.E. 481 (1923); *Norfleet v. Cromwell*, 70 N.C. 634, 1874 WL 2479 (1874). Each of these quotes focused on the court's hands-off role in contract interpretation.

342. *Tillman*, 362 N.C. at 116, 655 S.E.2d at 378.

343. *Id.* at 116, 655 S.E.2d at 377 (quoting *Norfleet*, 70 N.C. at 641).

344. See *supra* note 262 and accompanying text.

and adapting the law to these changes. Against this background of legislative activity, the plurality's decision is a model of decisional minimalism because it decides only the specific dispute before the court: whether the arbitration clause used by the defendant is unconscionable. Collectively, the justices in the plurality reach a result that decides no more and no less than needs to be decided.<sup>345</sup>

### CONCLUSION

In addition to House Bill 1374, the North Carolina General Assembly passed four other bills addressing consumer mortgage lending in the summer of 2007.<sup>346</sup> The legislature's focus is evidence that it sees predatory mortgage lending as a serious and continuing problem in North Carolina. In addition, however, the legislature was explicitly attempting to overturn the Supreme Court of North Carolina's 4-3 decisions in *Shepard* and *Skinner*, decisions it saw as frustrating important legislative initiatives in an area of deep concern.

Since 1999, the General Assembly has recognized the ways in which widespread securitization has changed the nature of consumer mortgage lending by allowing lenders to externalize transactional risks. As a result, North Carolina has led the nation in creating legislation to protect consumers from the harmful effects of this new financial technology. The North Carolina courts have adapted more slowly to the impact of securitization and issued decisions in *Shepard* and *Skinner* that run counter to the legislature's lead. Because these decisions undercut the legislature's initiatives and, in the case of *Skinner*, had a broadly preclusive effect that cannot be modified by the legislature, they express a form of judicial activism, albeit a passive form.

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345. The differences between the two plurality opinions can be explained in terms of decisional modesty, as the points of disagreement between the justices arise when explaining the common outcome on which all agree.

346. Act of July 4, 2007, ch. 163, sec. 1-2, 2007 N.C. Sess. Laws 269; Act of July 5, 2007, ch. 176, sec. 1-3, 2007 N.C. Sess. Laws 291; Act of Aug. 16, 2007, ch. 351, sec. 1-6, 2007 N.C. Sess. Laws 1065; Act of Aug. 16, 2007, ch. 352, sec. 1-10, 2007 N.C. Sess. Laws 1072; Act of Aug. 16, 2007, ch. 353, sec. 1-6, 2007 N.C. Sess. Laws 1080. In the summer of 2008, the General Assembly passed three additional bills impacting consumer mortgage lending in North Carolina. Act of Aug. 17, 2008, ch. 226, sec. 1-6, 2008 N.C. Sess. Laws \_\_\_\_ (creating an Emergency Foreclosure Reduction Program and adding additional foreclosure requirements for subprime loans made after December 31, 2004 and before December 31, 2007), Act of Aug. 17, 2008, ch. 227, sec. 1-4, 2008 N.C. Sess. Laws \_\_\_\_ (amending various statutes to regulate mortgage servicers), Act of Aug. 17, 2008, ch. 228, sec. 1-14, 2008 N.C. Sess. Laws \_\_\_\_ (amending the Mortgage Lending Law to give the North Carolina Commissioner of Banks regulatory authority over mortgage servicers).



The essence of judicial activism is usurpation of the legislative function. A judicial decision is not activist simply because it employs the power of judicial review or decides a case in a way that appears to be pro-consumer or pro-business. Rather, a judicial decision can properly be seen as activist only when it supplants or subverts the legislature's role—either by interfering with the legislative function outside the boundaries of judicial review, or by deciding cases in a way that prevents the legislature from acting. Under this definition, *Shepard* and particularly *Skinner* are activist decisions.

*Melton*, *Richardson*, and *Tillman*, on the other hand, take a minimalist approach to adjudication that better fulfills the courts' decisional duty. These decisions are not unnecessarily preclusive of future legislative or judicial action. Instead, they respect the democratic process and the legislative initiatives that it has produced to combat predatory lending. These decisions squarely address the issues presented by the parties, decide them narrowly, and follow the legislature's lead in adapting North Carolina law to the new technology of securitization.