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ARTICLE

A REGULATORY SCHEME THAT WORKS: THE CASE FOR A STATUTORY RIGHT TO REPRESENTATION BY COUNSEL IN MARYLAND RESIDENTIAL MORTGAGE TRANSACTIONS

By: Robert P. Pratz¹

I. INTRODUCTION

The residential real estate crisis underlying the present economic weakness in the United States has many causes. However, one of the particularly troubling aspects has been the substantial number of homeowners in foreclosure claiming ignorance of the terms and conditions of their mortgage financing agreements. Such claims suggest the likely inherent weakness of disclosure-based regulatory mechanisms.

Maryland has adopted a regulatory philosophy based on mandated disclosures throughout the process of obtaining mortgage financing secured by residential real property. This system is fatally flawed because the disclosures are required to be made by parties whose interests are inherently inimical to the interests of consumers, and no provision exists for assuring that consumers understand the information they are receiving. This fundamental problem makes reliance on mandated disclosure unworkable.

A better approach is to embrace the virtues of adversarial representation and introduce a statutory right to representation by counsel as the primary consumer protection in Maryland's residential mortgage marketplace. Our common law tradition of adversarial representation in both criminal and civil proceedings is predicated upon the inherent reliability of the outcomes, derived from the tug and pull of zealously advocated interests. This tradition is expanded and amplified by the ethical and professional duties owed to a client by an attorney under the Rules of Professional Conduct. The introduction of a professional advocate will enhance systemic reliability, which, in turn, will reduce the likelihood of a future catastrophic disintegration in the residential real

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estate market and increase consumer confidence in the security of their financial arrangements.

II. RECOMMENDATION

This paper proposes a strengthening of Maryland's consumer protections in residential mortgage transactions by providing a statutory right to counsel paid for by the mortgage industry. Such a right would provide consumers the opportunity to have an independent appraisal of a lender's offer, and to have a non-conflicted advisor/advocate explain the duties, responsibilities, and likely costs of a particular proposal. The present protections – essentially a system of complex disclosure rules – proved inadequate to protect the interests of mortgage consumers.

III. A CAUTIONARY TALE

Mr. and Mrs. Jones² first entered the office of their soon-to-be attorney in the early months of 2009. Mr. Jones was a truck driver for a national food service distribution company. Mrs. Jones was an assistant teacher at a government agency-sponsored daycare facility. The family had a combined annual income of approximately \$60,000.00, and lived in a five bedroom, three bath single-family home that they had purchased for approximately \$500,000.00 in 2006.

Unfortunately, the Joneses had been swept up in the worst excesses of the recent real estate asset bubble. For years, they had pursued a conservative lifestyle and approach to financial matters that had, ultimately and tragically, become the springboard from which they plunged to financial disaster.

Prior to the 2006 purchase, the Joneses had lived in a three bedroom, two bath townhome in Anne Arundel County, Maryland, that they purchased in the late 1990's for approximately \$150,000.00 with a thirty-year Federal Housing Administration (FHA) insured mortgage. The couple had a monthly mortgage payment of approximately \$1,400.00, which they paid without fail. As the years passed, and the real estate asset bubble formed, the value of the Jones' home soared to nearly \$250,000.00. The Joneses also had excellent credit ratings due to their prudent approach to the family's financial matters.

Sadly, the Joneses also proved susceptible to the lure of advertising and the hype surrounding the incredibly rapid growth in real estate asset values that occurred during the mid-decade. Believing that they needed to own a larger home, the Joneses began to peruse the multitude of

² The Joneses are a real couple whose story is summarized here. Their names and certain financial data have been changed to protect their identities. Otherwise, this is an accurate account of their experience.

mortgage financing offers they were receiving from the servicer of their loan, Countrywide Home Loans. Simultaneously, the Joneses put their townhome on the market. The couple eventually found a new-construction home that they decided was perfect for them; the five bedroom, three bath home every childless couple needs. However, even factoring in the substantial down payment the Joneses would have following the sale of their townhome, the couple was unable to qualify for a conventional mortgage of approximately \$450,000.00, due to insufficient income and excessive debt-to-income ratio.³

Still, there was another avenue open to the Joneses. A Countrywide loan consultant suggested the couple consider a pay-option arm.⁴ As the Joneses could not qualify under the fully amortizing or interest-only calculations, the minimum payment option seemed to be the answer to the couple's dilemma. In short order, the Joneses sold their townhome and moved into the new home and began making the pay-option minimum payments of approximately \$1,200.00 (net of taxes and insurance). The Joneses felt that they had reached their dream.

Not clearly understood by the couple, however, was the effect of making minimum payments on the principal balance of their mortgage loan. Each month their principal loan balance was increasing by approximately \$1,000.00 in a process called negative amortization. Also, the loan had a monthly adjusting interest rate that began resetting almost immediately after closing, making the minimum payment fluctuate. Finally, the Joneses bought their home near the peak of the housing market bubble, and paid the minimum down payment necessary to qualify for the loan. This combination became the witches' brew that eventually forced the Joneses into foreclosure and bankruptcy.

Pay-option arms have a negative amortization limit, which, when reached, triggers an event termed "recasting." The most common negative amortization limits are 110% and 125% of the original loan balance. When a pay-option arm recasts, the then outstanding principal balance and the fully indexed interest rate are used to calculate a fully amortizing payment over the remaining term of the loan. For the Joneses, the limit of 110% was reached in 2008. The recasting of the loan, then with a principal balance of nearly \$500,000.00, caused the required fully

³ Typically, mortgage underwriting is predicated on the five C's of credit; character, capital, collateral, conditions and capacity. Income sufficiency and debt-to-income ratio are measures of capacity.

⁴ The pay-option arm is a particularly complex instrument with substantial risks to borrowers. The terms of a pay-option arm allowed a borrower to pay a fully amortizing payment, an interest-only payment or a "minimum payment." The minimum payment was typically derived by applying an artificially low interest rate to calculate an interest-only payment. Borrowers' capacity to qualify for the loan would be based on the minimum payment.

amortizing minimum payment to jump to approximately \$3,450.00 (net of taxes and insurance). The Joneses were unable to pay this amount and, ultimately, ceased making mortgage payments altogether.

The Joneses brought their loan-closing package with them to their first consultation with their attorney. During that consultation, the Joneses repeatedly expressed their lack of understanding concerning the terms of their mortgage loan. They emphatically stated that they would not have taken such a loan if they knew the outcome could turn so devastatingly negative.

Yet, in reviewing the loan-closing package, it was clear that the Joneses had received and acknowledged all of the required loan disclosure statements. Their signatures were all in place, and Countrywide had adequately complied with all Federal and Maryland regulatory requirements. In short, the Joneses had, in fact, been told what the loan was, and what it could do. What those disclosures failed to do, however, was ensure that the Joneses understood, prior to consummating the transaction, how the characteristics of their mortgage loan could precipitate such dramatically negative consequences. Simply, regulation by disclosure proved inadequate to protect the Jones', and ultimately the public's, interests.⁵

IV. WHERE WE ARE AND HOW WE GOT HERE

In 2011, it was projected that over 1.2 million U.S. homes would be repossessed.⁶ This represents a 20% increase over the record-setting pace of 2010.⁷ While 2011 is expected to be the high-water mark of the foreclosure wave in America, foreclosure filings⁸ since 2006⁹ have manifested an increase in excess of 81% in filings, and an increase of more than 120% to nearly 2.9 million properties subject to such proceedings.¹⁰ These increases starkly illustrate the broad, and

⁵ The Jones' story ends much more happily than it began. Countrywide modified their mortgage to extend the term to forty years, reduced the principal balance to the original amount of approximately \$450,000.00, and lowered the interest rate to a fixed 2%. The Joneses are still in their home.

⁶ Janna Herron, *Firm predicts 1.2 million foreclosures*, ASSOCIATED PRESS (Jan. 13, 2011), http://cherokeetribune.com/view/full_story/11004198/article-Firm-predicts-1-2-3million-foreclosures.

⁷ *See id.*

⁸ For the purposes of this paper, "foreclosure filings" serves as a term representing default notices, auction sale notices and bank repossessions.

⁹ *Foreclosure Activity Increases 75 Percent in 2007*, REALTYTRAC (February/March 2008), available at <http://realtytrac.com/news/customer/2008.2/foreclosureTrends.asp>.

¹⁰ Elizabeth Kim, *Record 2.9M properties got foreclosure filings in 2010*, THE BUSINESS JOURNAL – MILWAUKEE (Jan. 13, 2011), available at <http://www.bizjournals.com/milwaukee/news/2011/01/13/record-29m-properties-got-foreclosure.html>.

implacable, reach of the foreclosure crisis presently confronting the United States.

The root causes of this crisis are many and varied. Among them is the widespread slowdown in U.S. economic activity that began in 2006, including substantial housing price declines.¹¹ Prior to 2006, other factors were crucial contributors. U.S. Federal Reserve monetary policy decisions following the dot-com era stock market bubble and the terrorist attacks of September 11, 2001 put unprecedented amounts of liquidity into U.S. capital markets.¹² This enhanced capital liquidity encouraged financial institutions to develop high-risk business strategies supported by low-cost capital.¹³

Also contributing to the crisis was the global capital surplus resulting from ongoing U.S. trade imbalances, which placed substantial dollar-denominated reserves in foreign hands.¹⁴ The nations and investor groups holding these reserves sought to repatriate the funds by purchasing high yielding, dollar-denominated investments, many of which were asset-backed securities (ABSs).¹⁵ U.S. mortgages, mortgage-backed securities (MBSs) and the more exotic variants of asset-based securities (i.e., collateralized debt obligations (CDOs) and credit default swaps (CDSs)) were exceptionally popular with foreign investors and hedge fund managers.¹⁶ These instruments were aggressively marketed to investors as vehicles imbued with exceptional safety, due to the fallacious assumption that the U.S. real estate market would not be subject to extended, widespread price declines, and that the innovative financial instruments themselves offered unprecedented amelioration and management of risk.¹⁷

Further, the relentless pursuit of subprime mortgages by Fannie Mae and Freddie Mac (the Government Sponsored Enterprises (GSEs))¹⁸ in

¹¹ U.S. DEP'T OF HOUSING AND URBAN DEV., REPORT TO CONGRESS ON THE ROOT CAUSES OF THE FORECLOSURE CRISIS, 19 – 21 (2010) [hereinafter REPORT TO CONGRESS], available at www.huduser.org/portal/publications/Foreclosure_09.pdf.

¹² John B. Taylor, *Housing and Monetary Policy*, Remarks Presented at the Policy Panel at the Symposium for Housing, Housing Finance and Monetary Policy, sponsored by the FEDERAL RESERVE BANK OF KANSAS CITY, in Jackson Hole, WY (Sept. 2007); see also Eric S. Belsky & Nela Richardson, *Understanding the Boom and Bust in Non-Prime Mortgage Lending* 34 (Sept. 2010) (unpublished manuscript on file with the Joint Center for Housing Studies of Harvard University) [hereinafter *Understanding the Boom*].

¹³ *Understanding the Boom*, *supra* note 12, at 39.

¹⁴ REPORT TO CONGRESS, *supra* note 11, at 37.

¹⁵ *Id.*

¹⁶ *Id.*

¹⁷ *Id.*

¹⁸ Heath Aston, *Who are Fannie Mae and Freddie Mac?*, THE SUNDAY TIMES (July 18, 2008), available at http://business.timesonline.co.uk/tol/business/industry_sectors/banking_and_finance/article4345872.ece; CONGRESS OF THE UNITED STATES, CONGRESSIONAL BUDGET

response to Congressional and Executive branch housing initiatives¹⁹, and the simultaneous expansion by major U.S. and global investment houses of public and private label mortgage securitization, led to explosive growth in the origination of risky loans.²⁰ This growth, fueled by an increasingly fee-based lender compensation system (the so-called “originate to distribute system”)²¹, substantially increased the aggregate risk subsumed in the market.²² These factors led to an extraordinary boom in the housing industry, to the point where housing prices began to inflate to bubble-like proportions. This boom attracted a host of unsophisticated consumers, many of whom were first-time buyers. Additionally, there was a significant increase in the complexity of mortgage products whose affordability was not easily explained by lenders. This complexity was difficult for consumers to comprehend, much less adequately understand.²³

V. HOW MARYLAND WAS AFFECTED BY THE CRISIS

Maryland’s experience during the foreclosure crisis is comparable to that reflected by national averages, as the state saw a significant increase in foreclosure starts (defined as the percentage of existing mortgages subject to an actual foreclosure process filing) from .22% to .83% between 2005 and 2008.²⁴ While Maryland’s 2005 foreclosure start rate was somewhat lower than the national average, .39%, the state’s 2008 foreclosure start rate was essentially identical to the national average.²⁵ Further, the growth in foreclosure starts has continued through 2010, peaking at over 1.4%, and is predicted to remain at elevated levels for the foreseeable future.²⁶ Finally, the composition of Maryland’s aggregate

OFFICE: FANNIE MAE, FREDDIE MAC AND THE FEDERAL ROLE IN THE SECONDARY MORTGAGE MARKET 1 - 9 (Dec. 2010).

¹⁹ Understanding the Boom, *supra* note 12, at 109 (discussing the Congressional and Department of Housing and Urban Development mandates placed on the GSEs to foster mortgage lending in minority communities and the GSEs response to those mandates to encourage low down payment and relaxed underwriting origination in previously underserved communities). The discussion also includes an extensive analysis of the inherent tension created by permitting shareholder owned companies, acting with a United States government guarantee, to create exotic and risky securitizations, ultimately obligating the American taxpayer to trillions of dollars of mortgages. *Id.*

²⁰ REPORT TO CONGRESS, *supra* note 11, at 35.

²¹ Understanding the Boom, *supra* note 12, at 24. The “originate to distribute” model began in the 1980s and gathered strength as the markets for MBS grew in the 1990s and the first part of the 2000s. Eventually, this model would replace the “originate and hold” model as the dominant system of mortgage origination.

²² REPORT TO CONGRESS, *supra* note 11, at 38.

²³ *Id.* at 32.

²⁴ *Id.* at A-1.

²⁵ *Id.* at A-1 through A-2.

²⁶ Tim Dunne and Kyle Fee, *Economic Trends: Changes in Foreclosure and*

mortgage loan pool has the nation's fifth highest concentration of high-cost loans – exactly the type of loans most likely to end in foreclosure.²⁷

By September of 2009, Maryland's subprime owner-occupied mortgage loans ninety-day default rate was 23.4%.²⁸ The state's subprime foreclosure rate was 11.4%.²⁹ The comparable prime mortgage rates were 3.6% and 1.9%, respectively.³⁰ These numbers are especially alarming considering the relative economic stability Maryland experienced during national economic downturn. Unemployment rates in Maryland remained low, compared with national averages, 7.2% versus 9.0% in January 2011.³¹ The state's proximity to the national capital, its highly educated workforce, and substantial population of Federal workers and contractors has, in large measure, insulated the state from the extremes of the recession. Further buffering Maryland's economy is the location of several key Federal government installations within the state. Maryland is home to the National Security Agency, the Social Security Administration, Patuxent Naval Air Station, the National Institutes of Health, and Edwards Air Force Base, among others. These installations are economic engines providing economic-cycle resistant income generation to a large segment of Maryland's workforce. Federal employment provides over 200,000 jobs in Maryland, and accounts for approximately 7.4% of the state's overall employment.³² Four of the nation's wealthiest counties are Maryland counties (Howard, Montgomery, Charles and Calvert)³³, and the state as a whole is the nation's 4th wealthiest.³⁴ And yet, despite these advantages, Maryland has the nation's 10th highest foreclosure rate.³⁵

Unemployment Across States, FEDERAL RESERVE BANK OF CLEVELAND (July 6, 2010), <http://www.clevelandfed.org/research/trends/2010/0710/01regact.cfm>.

²⁷ REPORT TO CONGRESS, *supra* note 11, at 29, A-1 through A-2.

²⁸ Dep't of Legis. Servs., Fiscal Note, H.B. 1118, 2010 Leg., Reg. Sess. (Md. 2010), available at <http://mlis.state.md.us/2010rs/billfile/hb1118.htm>.

²⁹ *Id.*

³⁰ *Id.*

³¹ BUREAU OF LABOR STATISTICS, U.S. DEP'T OF LABOR, *News Release, Regional and State Employment and Unemployment Survey*, 5, Mar. 10, 2011, available at www.bls.gov/news.release/archives/laus_03102011.pdf.

³² Robert J. Rehrmann & Theresa M. Tuszynski, *Impact of the Federal Government on Maryland's Economy*, DEP'T OF LEG. SERVS., OFFICE OF POLICY ANALYSIS, 7-8 (Jan. 2011), available at mlis.state.md.us/2010rs/misc/ImpactFederalGov.pdf.

³³ Francesca Levy, *America's 25 Richest Counties*, FORBES (Mar. 4, 2010), available at <http://www.forbes.com/20-10/03/04/america-richest-counties-lifestyle-real-estate-wealthy-suburbs.html>.

³⁴ Les Christie, *America's wealthiest (and poorest) states*, CNNMONEY (Sept. 16, 2010), available at http://money.cnn.com/2010/09/16/news/economy/Americas_wealthiest_states/index.htm.

³⁵ Alan Zibel, *Foreclosure rate steadies in May; see state-by-state chart*, USA TODAY (June 11, 2010), available at http://www.usatoday.com/money/economy/housing/2010-06-10-foreclosures-may_N.htm.

VI. MARYLAND'S REGULATORY SCHEME

Maryland follows a regulatory scheme for mortgage lenders based on an initial licensing review, periodic file audit, and complaint response.³⁶ The primary regulatory authority for mortgage lending is the Commissioner of Financial Regulation in the Department of Labor, Licensing and Regulation.³⁷ Mortgage lenders must comply with both Maryland and Federal statutory requirements. The Federal requirements for mortgage lenders are governed by the Equal Credit Opportunity Act (ECOA)³⁸, the Real Estate Settlement Procedures Act (RESPA)³⁹, the Home Ownership and Equity Protection Act (HOEPA)⁴⁰, the Fair Credit Reporting Act (FCRA)⁴¹, and the Truth in Lending Act (TILA).⁴² These laws generally require disclosure of relevant information concerning the terms and conditions of consumer financial transactions, and mandate a forms-based disclosure process intended to alert consumers to the import of those terms and conditions.⁴³ The Commissioner of Financial Regulation's enforcement authority arises from Maryland's responsibilities under these Federal laws, combined with the Maryland Mortgage Lending Law⁴⁴, and other relevant sections of Maryland's Code.⁴⁵

Applicants for mortgage lender licensing are subject to an application review and licensing fee, a surety-bonding requirement, a minimum asset requirement, a pre-licensing education requirement, and a minimum experience requirement.⁴⁶ The Department of Financial Regulation relies primarily on an enforcement system predicated on lender file audits and complaint response. Audits are scheduled by the Commissioner, and every licensee must be examined at least once every 36 months, except newly licensed mortgage lenders, whose audit must be completed within the first 18 months of licensing.⁴⁷ The Commissioner may require any licensee to submit to an examination at any time, and is required to

³⁶ MD. CODE ANN., FIN. INST., § 11-501 *et seq.* (West 2011) (outlining Maryland's Mortgage Lender Law).

³⁷ *Id.*

³⁸ 15 U.S.C. § 1691 *et seq.* (2006).

³⁹ 12 U.S.C. § 2601 *et seq.* (2006).

⁴⁰ 15 U.S.C. § 1639 *et seq.* (2006).

⁴¹ 15 U.S.C. § 1681 *et seq.* (2006).

⁴² 15 U.S.C. § 1601 *et seq.* (2006).

⁴³ REPORT TO CONGRESS, *supra* note 11, at 32.

⁴⁴ MD. CODE ANN., FIN. INST., § 11-501 *et seq.* (West 2011).

⁴⁵ Maryland has a variety of statutory provisions respecting mortgage lending scattered throughout the Financial Institutions, Commercial Law Article, and the Real Property Articles. Suffice it to say that the provisions are adequately self-referential to carry out Maryland's regulatory scheme.

⁴⁶ MD. CODE REGS., 09.03.06.03, 23 (2011).

⁴⁷ MD. CODE ANN., FIN. INST., § 11-515(a)(2)(ii) (West 2011).

investigate any written complaint received.⁴⁸ The file audits are primarily *ex post facto* reviews of lender compliance with the statutory disclosure requirements.⁴⁹ The Commissioner can penalize a mortgage lender, or employee or agent of a mortgage lender, with anything from a cease and desist order, to administrative fines, to suspension or revocation of license, to felony penalties of up to 15 years imprisonment, and \$100,000.00 fines for fraudulent conversion in excess of \$300.00.⁵⁰

VII. THE EFFECTIVENESS OF MARYLAND'S REGULATORY SCHEME DURING THE CRISIS AND THE STATE'S RESPONSE

As indicated above, Maryland fortunately enjoyed a lower than average foreclosure start rate prior to the mortgage market meltdown of 2007.⁵¹ It is not entirely clear whether the efficacy of the state's mortgage lending regulatory system contributed to this favorable rate. Maryland's regulatory scheme is very similar in nature and operation to that of most states. In fact, the essential characteristics of the nation's mortgage market regulatory infrastructure are driven by compliance requirements in Federal legislation, such as the TILA, and the RESPA.⁵² The disclosure regime underlying these Federal laws is founded on the theory that the provision of sufficient information concerning the terms and conditions of a particular transaction will ensure appropriate and informed borrower decision-making.⁵³ Sadly, when tested in the crucible of reality, this regime utterly failed to prevent the current crisis, and the assumption that the provision of information equals understanding was exposed as illusory. The regime's fundamental nature leads to a mechanistic compliance that does little to achieve its purported objective of enabling informed consumer decision-making. In fact, commentators had begun to recognize that its efficacy was increasingly suspect long before the meltdown in the mortgage market began.⁵⁴ As financial products grew progressively more sophisticated, the disclosure-based regulatory regime became increasingly irrelevant as the choices facing consumers grew more complex, and the possible outcomes of any decision virtually impossible to assess as to risk and cost.⁵⁵ While it may be true that Maryland's regulatory mechanism was adequately funded, properly staffed, and professionally managed, ultimately, the state's

⁴⁸ *Id.* at (b)(1)-(2).

⁴⁹ *Id.* at (d)(1)-(3).

⁵⁰ MD. CODE ANN., FIN. INST., §§ 11-516, 11-517, 11-523 (West 2011).

⁵¹ REPORT TO CONGRESS, *supra* note 11, at A-1 through A-2.

⁵² *Id.* at 32.

⁵³ *Id.*

⁵⁴ *Id.*

⁵⁵ *Id.*

mortgage regulatory system proved inadequate to the challenge. In fact, the challenge the system faced was not one that had even been contemplated.⁵⁶

As the mortgage market dissolved through 2007, some manner of legislative and regulatory response was necessary given the severity and scope of the meltdown's reach. Maryland reacted in several different ways. Maryland's General Assembly, during the 2008 Session, passed the Maryland Mortgage Fraud Protection Act.⁵⁷ The Act was passed in response to 30 mortgage fraud complaints received by the Commissioner of Financial Regulation in 2007, and an additional 67 investigations initiated by the Commissioner that year.⁵⁸ The Act created the crime of mortgage fraud in Maryland and authorized criminal penalties. Also in 2008, the state strengthened the licensing requirements for mortgage lenders by increasing the surety bonding requirements, the net worth requirements, enhancing the Commissioner's enforcement powers, and imposing an "ability to repay" consideration requirement in mortgage underwriting.⁵⁹ In 2009, Maryland amended its mortgage lending and originator licensing legislation⁶⁰ by incorporating the provisions of the Federal Secure and Fair Enforcement for Mortgage Licensing Act of 2008.⁶¹ This legislation was intended to strengthen mortgage originator licensing requirements and adopt the Nationwide Multistate Licensing System and Registry (NMLSR) for Maryland mortgage originators.⁶² The state also outlawed foreclosure rescue transactions in 2008⁶³, and modified foreclosure notice requirements in 2008, 2009 and 2010.⁶⁴ Finally, in 2010, the state instituted a last chance loss mitigation mediation requirement in foreclosure proceedings.⁶⁵

⁵⁶ *Id.*

⁵⁷ MD. CODE ANN., REAL PROP., § 7-401 *et seq.* (West 2011).

⁵⁸ Dep't of Legis. Servs., Fiscal Note, H.B. 360, 2008 Leg., Reg. Sess. (Md. 2008), available at <http://mlis.state.md.us/2008rs/billfile/hb0360.htm>.

⁵⁹ Dep't of Legis. Servs., Fiscal Note, S.B. 270, 2008 Leg., Reg. Sess. (Md. 2008), available at <http://mlis.state.md.us/2008rs/billfile/sb0270.htm>.

⁶⁰ MD. CODE ANN., FIN. INST., §§ 11-501 *et seq.*, § 11-601 *et seq.* (West 2011).

⁶¹ Dep't of Legis. Servs., Fiscal Note, H.B. 292, 2009 Leg., Reg. Sess. (Md. 2009), available at <http://mlis.state.md.us/2009rs/billfile/hb0292.htm>.

⁶² *Id.*

⁶³ MD. CODE ANN., REAL PROP., § 7-301 *et seq.* (West 2011) (Protection of Homeowners in Foreclosure Act).

⁶⁴ MD. CODE ANN., REAL PROP., § 7-105 *et seq.* (West 2011).

⁶⁵ Md. R. 14-209.1.

VIII. REPRESENTATION BY COUNSEL AS A REGULATORY ALTERNATIVE

What is patently obvious with respect to Maryland's response to the mortgage crisis is that every legislative and regulatory initiative was reflexive and backward looking. While all of the actions described above may be salutary in the abstract, none of them corrects - or even addresses - the inherent problem, namely, that the purported advocates of the consumer's interests enter the transaction with substantial financial interests conflicting with those of their "clients." In the absence of a mechanism to independently and actively champion the borrower's interests throughout the process, the regulatory system will remain inadequate to the essential task of protecting individual consumers and reducing the risk that society will have to foot the bill for poor consumer decisions and unscrupulous lender business practices.

The mortgage financing agreement itself is essentially a hybrid contract where the parties dicker over some part of the transaction during the application process; typically, factors such as interest rate, pre-paid finance charges and term of years. However, this negotiation is not nearly as even-handed or binding as it may seem. Risk-based pricing, evaluation of a borrower's income and asset information, and collateral determination will all affect the final offer the lender makes as to rate, fees, and maturity. While the borrower is certainly not bound to accept the offer, the substantial investment of time and effort to reach the final offer stage virtually precludes the pursuit of alternatives.⁶⁶

Moreover, the parties' respective substantive legal rights and remedies are embodied in the language of a contract of adhesion drafted by the lender's lawyers, and are not subject to negotiation.⁶⁷ The borrower will not normally see these documents prior to reaching the settlement table. These agreements typically involve multiple components⁶⁸, are too lengthy to easily read at signing, and are written in the kind of dense legalese that frustrates understanding by lay consumers. The inherent disadvantages consumers suffer from this arrangement are compounded by the fact that the consumer usually is seeing these materials for the first time, and the setting is frequently a time-pressured circumstance with multiple parties at interest eagerly awaiting the consummation of the

⁶⁶ REPORT TO CONGRESS, *supra* note 11, at 32.

⁶⁷ Shelley Smith, *Reforming the Law of Adhesion Contracts: A Judicial Response to the Subprime Mortgage Crisis*, 14 LEWIS & CLARK L. REV. 1035, 1041 (2010).

⁶⁸ A typical mortgage financing transaction in Maryland may well require a note, a deed of trust or mortgage, addendums and riders to the note and, in many cases, assignments of right from the borrower to the lender.

deal.⁶⁹ It is at this moment when consumers are at their greatest disadvantage and, therefore, most vulnerable.

As the process is presently organized, there is simply no one at the table looking out for the interests of the persons ultimately bringing the money to the deal. Although no regulatory system can reasonably be expected to eliminate all transactional risk, thinking differently about the means employed to protect consumers' interests during mortgage financing transactions may provide Maryland a regulatory mechanism that portends superior short-term regulatory advantages, and advantageous long-term societal outcomes without increasing the aggregate cost of the transaction to the consumer. Rather than attempting to refine a system that is essentially incompatible with its alleged aims, and which has proven itself incapable of prospectively ensuring consumer well-being, I propose that Maryland adopt a regulatory scheme predicated on active representation by counsel of consumers' interests in transactions with mortgage lenders.⁷⁰

IX. AMERICA'S TRADITION OF ADVERSARIAL REPRESENTATION AND THE ATTORNEY IN THE ROLE OF COUNSELOR-ADVISOR

America has embraced adversarial representation since its founding⁷¹ as the elemental method in the search for truth in contested matters. Not only has the adversarial system been instrumental in the development of American criminal jurisprudence, it has been the lynchpin in the mitigation of grievances of the disenfranchised in civil litigation as well.⁷² While some modern commentators have expressed pointed criticism of the adversarial system of justice⁷³, such sentiment is not new. In fact, the adoption of the Federal Rules of Civil Procedure in 1938 was intended to

⁶⁹ Other than the buyer/borrower, a typical sales transaction can have a seller, multiple real-estate agents, one or more lenders and the settlement/title insurance company involved in the transaction. Compensation for all of these parties will only be realized if the transaction is executed.

⁷⁰ While I argue for representation by licensed counsel as the basis of this proposal, there may well be other professionals with the knowledge and skills necessary to protect consumer interests in mortgage transactions. Certified Public Accountants, financial advisors or planners, or even some real estate professionals may be qualified to act as a borrower's representative. The Maryland General Assembly may well determine that expanding the pool of available representatives would be in the best interests of consumers.

⁷¹ Monroe S. Freedman, *Our Constitutionalized Adversary System*, 1 CHAP. L. REV. 57 (1998).

⁷² *Id.* at 64.

⁷³ See, e.g., Amanda Frost, *The Limits of Advocacy*, 59 DUKE L. J. 447 (2009); see also Carrie Menkel-Meadow, *The Trouble with the Adversary System in a Post-Modern, Multicultural World*, 38 WM. & MARY L. REV. 5 (1996); Rosemary Nidiry, *Restraining Adversarial Excess in Closing Argument*, 96 COLUM. L. REV. 1299 (1996). These articles are but a sampling of the work devoted to this topic.

inject equity into the nation's civil litigation system.⁷⁴ The Rules were proposed and adopted in response to disquiet associated with the commonly perceived "all or nothing" character of adversarial advocacy.⁷⁵ Still, uncertainty remained in the courts as to the magnitude of the sea-change, the shift toward open-handed discovery (arguably the most equitable and non-adversarial provision of the Rules) portended.⁷⁶

The Supreme Court resolved any doubt as to the role adversarial values would play in American civil litigation when it asserted protections approaching privilege of lawyer work-product, fact gathering, and analysis in its decision in *Hickman v. Taylor*.⁷⁷ There, the Court stated that an attorney's primary duties are "to promote justice and to protect their clients' interests."⁷⁸ The Court admonished the bench and stated that forcing the turnover of attorney work-product would seriously undermine the adversarial system, specifically stating "[t]he effect on the legal profession would be demoralizing. And the interests of clients and the cause of justice would be poorly served."⁷⁹ Today, the adversarial system remains the nation's primary method for resolving disputes.⁸⁰

While adversarial representation is customarily identified with judicial proceedings, mortgage-financing transactions are not such proceedings. They can be more appropriately described as semi-active negotiations where the parties dicker over only a few of the terms of the deal. Despite this difference, the virtues of adversarial representation can be readily applied to this realm in the interests of consumers. Freedman describes this application of the adversarial system outside of the courtroom thusly, "[a]ny lawyer who counsels a client, negotiates on a client's behalf, or drafts a legal document for a client must do so with an actual or potential adversary in mind. When a contract is negotiated, there is a party on the other side."⁸¹ This sentiment captures the essential duty of counsel, and is perpetuated in Maryland's Rules of Professional Conduct, which state

⁷⁴ Arthur R. Miller, *From Conley to Twombly to Iqbal: A Double Play on the Federal Rules of Civil Procedure*, 60 DUKE L.J. 1, 3-4 (2010).

⁷⁵ *Id.* at 4-5.

⁷⁶ Adoption of the Rules suggested a weakening of the nation's commitment to the adversarial system.

⁷⁷ Norman W. Spaulding, *The Rule of Law in Action: A Defense of Adversary System Values*, 93 CORNELL L. REV. 1377, 1401 (2008) (explaining the impact of the Supreme Court's decision in *Hickman v. Taylor*, 329 U.S. 495, 511-14 (1947)).

⁷⁸ *Hickman*, 329 U.S. at 511.

⁷⁹ *Id.* Justice Jackson's concurring opinion is even more forthright in its emphasis on the cost that emasculating the adversarial system would entail. *Id.* at 515-16 (Jackson, J., concurring)

⁸⁰ David Barnhizer, *The Virtue of Ordered Conflict: A Defense of the Adversary System*, 79 NEB. L. REV. 657, 680 (2000).

⁸¹ Monroe H. Freedman, *Professionalism in the American Adversary System*, 41 EMORY L.J. 467, 469 (1992).

“[a]s advocate, a lawyer zealously asserts the client's position under the rules of the adversary system. As negotiator, a lawyer seeks a result advantageous to the client but consistent with requirements of honest dealing with others.”⁸²

Despite its virtues, the nature of the adversarial system is at odds to some degree with the character of the residential mortgage transaction. The consumer is not likely to seek conflict with the lender. Rather, the consumer is motivated to find a way to consummate a deal. It is this very motivation that often induces consumers to take offers they do not adequately understand, and that may well have been designed to take advantage of the consumer's desire to complete the transaction. It is here that the attorney, in her role of counselor-advisor, is in the forefront.

Maryland's Rules of Professional Conduct describe the advisor's role thusly, “[i]n representing a client, a lawyer shall exercise independent professional judgment and render candid advice. In rendering advice, a lawyer may refer not only to law but to other considerations such as moral, economic, social and political factors, that may be relevant to the client's situation.”⁸³ The wording of this duty, particularly the second sentence, establishes that an attorney's purview as advisor is larger than that of a mere legal consultant. Rather, the expansive nature of the language suggests the advisory responsibility borne by an attorney is one that requires the contemplation of the totality of a client's circumstances when rendering advice. This is exactly the viewpoint necessary to ensure the protection of a client's interest in a complex transaction of significant value.

X. HARNESSING THE VIRTUES OF REPRESENTATION TO REGULATORY REFORM

As presently constituted, the mortgage financing system provides no effective mechanism for ensuring that consumers have adequate understanding, rather than merely disclosure, of the terms, conditions and obligations of a particular transaction.⁸⁴ In fact, even where consumer education and counseling programs have been provided, borrower decision making was not appreciably superior, especially in the face of aggressive marketing campaigns by mortgage lenders.⁸⁵ Statutes requiring more disclosure, or which further outlaw anti-predatory lending practices, or which prohibit such lender compensation devices as yield-

⁸² Md. R. 16-812.

⁸³ Md. R. 16-812(2.1).

⁸⁴ REPORT TO CONGRESS, *supra* note 11, at 52.

⁸⁵ *Id.*

spread premium, or service-release premium⁸⁶, will not suffice to fill the void in consumer knowledge and understanding. The missing element is a knowledgeable and trusted advisor/advocate whose loyalties lie solely with the consumer.

As I anticipate the application of adversarial representation in the mortgage-financing arena, there would be no independent third-party arbiter, nor would the system alter the current method of utilizing standardized contracts in most transactions. Further, I am not suggesting that this system provide a forum for dispute over every point. The realities of modern commerce are considerations that cannot be disregarded in designing regulatory mechanisms. The system needs to support the consummation of these transactions, not thwart them. The imposition of structures or processes that unreasonably constrict transaction flow would fatally wound the nation's mortgage financing system. Instead, what I envision is a regulatory system that harnesses the energy of representation, the client-centric objectivity of the attorney as counselor-advisor, and that invokes the duties of loyalty and confidentiality in the meaningful protection of the interests of consumers during loan negotiation.

Legislation mandating that residential mortgage borrowers be presented the opportunity, without cost, to consult with counsel can provide the means to ensure that consumers have adequate opportunity and resources to understand the import of a proposed transaction. By affirmatively embracing the virtues of a representative system as a regulatory tool, Maryland can provide consumers with an effective and easy-to-understand mechanism that both the legal system and the mortgage distribution system can readily integrate. This proposed system will fill the empty seat at the table that plagues the current system; the empty seat that concedes the potential for a future meltdown.⁸⁷

The attorney as counselor-advisor will provide consumers with an objective and loyal voice to describe the benefits, costs, and implications of a proposed transaction. Moreover, the counselor-advisor will be in a position to discern the consumer's immediate needs, and long-term interests, and carefully weigh those against the offer presented. This is a critical component as residential mortgage transactions are complex and high value, and other parties to the transaction – often with their own

⁸⁶ Yield-spread premium is commission payable to mortgage brokers for originating a loan. Service-release premium is commission payable to mortgage lenders for originating a loan. The difference in the two forms of compensation is that lenders lend their own money, and are subsequently paid for transferring the loan to another lender, while broker loan transactions are conducted with funds from the initial lender. Both forms of compensation are interest and fee sensitive.

⁸⁷ REPORT TO CONGRESS, *supra* note 11, at 32.

counselor-advisors in tow – may well seek to shift risk away from themselves and onto the consumer in ways not obvious nor easily understood by lay people.

Further, by placing a knowledgeable advocate at the consumer's elbow, lenders will find their loan offers and the terms and conditions of closing documents scrutinized by an officer of the court. The very fact that such scrutiny will be required in each loan transaction will make the overall mortgage marketplace more fair, efficient, and lower-cost by eliminating the distortions that occur when consumers unknowingly accept high-cost, high-risk loans to their detriment. Further, such advocacy on the consumer's behalf is also likely to create competition among lenders to provide the most favorable terms, transparency, and processing service; all of these developments will redound to the consumer's benefit.

Finally, the proposed system will likely provide significant impetus for the adoption of more easily understood and fairer transaction documents. Critics of this proposal, most likely concerned about the impact on lenders, may suggest mandatory consumer representation will result in intractable negotiation between consumer and lender. Such concerns are ill-founded. The form contract has arisen as an indispensable means for businesses to conduct commercial-scale transactions⁸⁸, and its role in this proposed system of regulation need not be any different than it is today. There is no need to undertake extensive negotiation of each and every term of a consumer transaction. Rather, informed consumers, aided by an impartial and loyal counselor, can choose between offers (including the terms and conditions of the note and deed of trust, as well as the rate and fees) that have been reviewed and explained as to cost, conditions, and contingencies.

XI. CONSIDERATIONS FOR IMPLEMENTING THE SYSTEM

It is especially noteworthy that the adoption of this proposed system should not cause an increase in Maryland state administrative expenditures. While the Commissioner of Financial Regulation will still perform the same pre-licensing reviews, periodic lender examinations and complaint response duties as presently required, the proposed system will add no new responsibilities to the Commissioner's staff. In fact, the actual number of mortgage lenders and originators⁸⁹ subject to the

⁸⁸ Shelley Smith, *Reforming the Law of Adhesion Contracts: A Judicial Response to the Sub-Prime Mortgage Crisis*, 14 LEWIS & CLARK L. REV. 1035, 1084 (2010).

⁸⁹ Dep't of Legis. Servs., Fiscal Note, H.B. 944, 2011 Leg., Reg. Sess. (Md. 2011), available at <http://mlis.state.md.us/2011rs/billfile/hb0944.htm>. In 2010, the Commissioner had authority over 1,478 mortgage lenders and 5,007 mortgage originators in Maryland, down from more than 3,700 lenders and 11,000 originators in 2008.

Commissioner's oversight should continue to decline over time as the proposed system begins to force, through improved transactional scrutiny and market pressures, marginal, inflexible and dishonest lenders and originators from the market. Also, lender disclosure and regulatory compliance should improve as lenders seek to streamline the lending process by better ensuring file compliance in the knowledge that an experienced set of eyes will be critically reviewing the file, on behalf of the consumer, for discrepancies, errors, and deceptive practices. As these benefits materialize, the state may well be able to reduce the staff and budget of the Commissioner's office and re-direct those resources elsewhere.

The necessary legal resources for the proposed regulatory system also seem to be largely in place. In 2008, Maryland was home to more than 32,000 lawyers.⁹⁰ As of the 2010 United States Census, Maryland had a population of approximately 5.7 million, up slightly from nearly 5.3 million in 2000.⁹¹ Maryland also has just fewer than 2.4 million housing units (not all of which are owner-occupied units)⁹² and 54,605 of those units were sold in 2010.⁹³ Although it is difficult to calculate precisely the number of instances of mortgage refinancing transactions in the state in 2010, the Mortgage Bankers Association has estimated that the total percentage typically hovers near 70% of the total market.⁹⁴ A simple extrapolation provides a reasonably accurate estimate of the extent of residential refinance activity in Maryland throughout 2010.⁹⁵ Approximately 127,500 consumers applied for mortgage refinancing during the year.⁹⁶ Combined, these numbers suggest that the state's total mortgage activity was in the range of 182,000 transactions. Even assuming that merely 5% (1,600) of Maryland's lawyers would be interested in acting as borrower's counsel, these numbers suggest that each would have only two to three transactions per week. As it is reasonable to anticipate that a much higher participation rate is likely,

⁹⁰ Erin Delmore & Marisa M. Kashino, *How Many Lawyers Are There?*, WASHINGTONIAN, (Dec. 1, 2009), available at <http://www.washingtonian.com/articles/people/14534.html>.

⁹¹ *Census 2010 Redistricting (Public Law 94-171) Data For Maryland, MD. STATE DATA CENTER*, <http://planning.maryland.gov/msdc/census/Cen2010/PL94-171/PL-total.shtml> (last updated May 24, 2011) (displaying of the 2010 United States Census data, as it applies to Maryland).

⁹² *Id.*

⁹³ *Housing Statistics*, MD. ASS'N OF REALTORS, <http://mdrealtor.org/HousingStatistics/HousingStatistics> (last visited Feb. 27, 2012).

⁹⁴ *Refinance Activity Falls, Purchase Applications Steady in Latest MBA Weekly Survey*, MORTGAGE BANKERS ASSOCIATION (May 27, 2009), available at <http://www.mortgagebankers.org/NewsandMedia/PressCenter/69022.htm>.

⁹⁵ Calculated as follows: $(54,605/.30) - 54,605 = 127,411.667$.

⁹⁶ *Id.*

there are more than adequate legal resources available to support the transition to the proposed system. Further, as the mortgage finance market is substantially depressed from its peak in 2006 and 2007 (as seen by the precipitous decline in licensed lenders and originators)⁹⁷, transitioning in the immediate future is likely to be easier and less disruptive than it might otherwise be if the mortgage marketplace was operating near capacity. Further, the addition of an insured professional subject to malpractice litigation into the regulatory process provides a social benefit in the form of additional financial resources available to defray the cost to Maryland's taxpayers in the event of an unfavorable outcome in any particular transaction. And, as I am not proposing an increase in the number of licensed attorneys in Maryland, the present professional oversight staff at the Attorney Grievance Commission is adequate to the task envisioned. Finally, the proposed system's enacting legislation should ensure that any attorney acting as a borrower's counsel may not simultaneously act as a settlement agent, to prevent the appearance of conflict. As the system is intended to capture the virtues of the adversarial system and the duties of loyalty and confidentiality, permitting an unnecessary compromise at the outset is contrary to the system's fundamental aims.

It is exceptionally likely that this proposal will be manfully resisted by the mortgage lending industry. The proposed system will subject a powerful industry (with an exceptionally active and effective lobby) to a level of immediate scrutiny it is unaccustomed to, and to which it will not willingly submit. To further heighten the likelihood of resistance by the industry, I also propose that lenders be responsible for a flat fee payment toward the borrower's counsel fees. Consumers would be permitted to spend more than the flat fee, if desired and at their own expense, but lenders will be required to contribute a statutorily described fee for any application that progresses beyond initial data collection to the formal offer of financing stage (the issuance of a loan commitment and loan disclosure package). This requirement will fundamentally alter the current industry practice of providing estimates or offers to loan prospects prior to actually underwriting the transaction. These provisions are in no way punitive; instead, all they do is continue to place the regulatory costs of operating a regulated industry upon members of the industry who are involved in transactions governed by its rules. The provisions are intended to encourage lenders to more carefully evaluate the risks of extending credit by closely evaluating both loan applicants and the collateral securing the transaction. Finally, it is at this point that a lender

⁹⁷ Dep't of Legis. Servs., Fiscal Note, H.B. 292, 2009 Leg., Reg. Sess. (Md. 2009), available at <http://mlis.state.md.us/2009rs/billfile/hb0292.htm>.

would be required to provide borrowers, along with the other disclosures required by statute, an admonition to contact a professional to review the offer. In order to ensure the independence of the consumer's advocate, I envision a state registry of certified counselors maintained by the Commissioner of Financial Regulation.⁹⁸ Any authorized advocate could be employed by a consumer, and the lender will be prohibited from referring any particular counselor.

As described above, this proposal will likely improve the overall performance of the mortgage marketplace by forcing lenders to compete on transparency, efficiency, and, ultimately, price. While these performance improvements will surely inure to the benefit of consumers, the mortgage lending industry also will realize substantial benefits; not the least of these is a marked decrease in the risk of default in any particular transaction (due to the factors discussed above) and the concomitant increase in the confidence of investors in the secondary market.⁹⁹

CONCLUSION

The proposal to co-opt the energy of the United States' tradition of adversarial advocacy, and the duties owed to clients by counsel to protect the interests of consumers, should not be viewed as a radical departure. We trust these systems with matters of life and death. The very character of the United States' legal system is imbued with its ethic and its Constitutional overtones.¹⁰⁰

However, what is clearly evident is that the current regulatory system proved inadequate to its task, and much of the blame for the real-estate market meltdown can be attributed to a backward-looking system of regulation by disclosure. The regime should be supplemented by active adversarial interactions that would serve as a prophylactic against systemic disaster, and protect individual consumers from error before they get into financial trouble. Disclosure is an extremely weak mechanism for protecting either the entire market or individual consumers, as was demonstrated by the recent meltdown. The bar is adequate to the task of providing the necessary help to consumers to

⁹⁸ As discussed in note 61 *supra*, the General Assembly may well decide to allow other professions that can demonstrate the requisite credentials to act as borrower's representatives. Should the Legislature decide to do so, some licensing would be necessary and could reasonably be administered by the Commissioner of Financial Regulation. The cost of any such system could be defrayed by licensing fees. However, it would serve one of this proposal's underlying considerations to require that any borrower representative must be able to maintain professional liability insurance.

⁹⁹ REPORT TO CONGRESS, *supra* note 11, at 55.

¹⁰⁰ Freedman, *supra* note 81, at 467-68.

alleviate the problem, the means are available to finance the administration of a regime funding legal services in the area, and savings accrued by avoiding default would likely outstrip any cost increases the new regime would cause. A mandatory right to counsel in the purchase of a home – likely the most important financial transaction the average citizen is likely to make over a lifetime – would be effective and is needed. All that is required now is the collective will to extend this right to homebuyers and fund it. It is time for the Legislature to take up the task.