

Power-Balancing: State Attorneys General and Unfair Mortgage Lending

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ABSTRACT

This paper is a case study in the enforcement of state unfair trade practice laws targeted at predatory mortgage lending and securitization abuses during the Global Financial Crisis of 2008. It considers how the Massachusetts Attorney General's Office (MA-AG) leveraged its dual mission as People's Lawyer and State General Counsel to achieve robust public safeguards and more equitable buyer-seller market relationships. It explains how the MA-AG spliced its consumer protection authority over improvident risk and unfair loan originations with its investor protection authority over faulty securitization practices to multiply their combined impact. Although some pre-2008 credit practices have disappeared, others persist in altered forms and still others are sure to emerge in the future. For that reason, the consumer protection power-balancing strategy has considerable importance for the future safety and equity of consumer practices and demonstrates the role state attorneys general offices can play to protect the marketplace.

Keywords: state attorneys general, consumer financial protection, enforcement, UDAP, unfairness, Global Financial Crisis

I. Introduction

In today's world, borrowing successfully for a house, car, school tuition, or small personal loan is still too risky a proposition for many households, most acutely for those closest to the financial edge. Despite increased efforts by federal and state regulators to make credit markets transparent, fair, and safe, the household financial environment remains densely clotted with arcane business practices, many of which provide cover for providers to take unfair advantage of borrowers.¹

In the period leading to the Global Financial Crisis of 2008 (GFC) and before the creation of the Consumer Financial Protection Bureau (CFPB) and other Dodd-Frank protections in 2010, state attorneys general (SAGs) provided the bulk of consumer credit safeguards notwithstanding efforts by federal regulators to retain their primacy in the field. Reliance on the states was necessitated, in large measure, by the fragmentation and tenuous performance of the federal regulatory framework and the deliberate policy of regulatory forbearance espoused by the Federal Reserve, the Comptroller of the Currency, and other prudential regulators.

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¹ Recent examples of problematic credit sector practices are documented in CFPB Supervisory Highlights https://s3.amazonaws.com/files.consumerfinance.gov/f/documents/cfpb_supervisory-highlights_issue-30_2023-07.pdf as well as Samuel Levine and Hannah Garden-Moneheit, Letter to Andrea

Stewart-Cousins and others, February 26, 2024 https://www.ftc.gov/system/files/ftc_gov/pdf/2024.02.26-NYUnfairnessLetter-Senate_0.pdf. For an historical analysis of fair dealing, a social norm rooted in Progressive Era jurisprudence and institutional thought, see Herrine (2020, 2021) and Nolette (2012).

In practice, even though SAGs were inundated with a wide-range of household borrowing complaints ranging from prices and product risks to discrimination, their focus was often narrowly limited to questions of truthfulness and the adequacy of information-sharing and credit disclosure. One result of this constricted approach was that lenders often felt they had license to perpetuate substantively injurious credit practices as long as they satisfied minimum disclosure requirements.

Although state Unfair and Deceptive Practices Acts (UDAP)—the leading source of state consumer protection oversight—gave Attorneys General (AGs) in many states the authority to ban “unfair” lending practices, most were reluctant to enforce this arm of the law. In large part they eschewed the unfairness approach in favor of the more familiar “deceptive” practices arm of UDAP because they considered unfairness overly aggressive and unacceptable to lenders, excessively subjective, and too indeterminate as a basis for compiling consistently successful litigation results. As a result, when the GFC erupted, very few cases of unfair lending had been resolved in state courts.

The Massachusetts AGO stood out as an important exception to prevailing practice. This paper describes an innovative use of countervailing enforcement power exercised by the Massachusetts Attorney General’s office (MA-AG). It reports pioneering efforts by the MA-AG to prohibit unfair mortgage foreclosures through a preliminary injunction filed against Fremont Investment and Loan, a major subprime mortgage lender in the Massachusetts marketplace, under the state’s UDAP statute. Enforcement of UDAP Unfairness was a novel strategy for constraining abusive mortgage lending practices and obtaining redress on behalf of borrowers.² The case study also documents

MA-AG’s equally innovative strategy for holding securitizers—in this instance the Wall Street giant, Morgan Stanley—accountable for their contribution to marketplace injury.³

Although this historical case study is grounded in the experience of a single state, it offers a point of reference for assessing the applicability of unfair practice laws to consumer financial protection in others. It provides detailed examples that support the proposition that numerous state SAGs have the capacity and authority to enjoin unfair lending practices in their respective jurisdictions and are well-positioned to do so if they choose.

While differences in AGO legal authority, historical precedents, professional bandwidth, leadership interests, and other factors help explain variations in state enforcement activity, this case study explores some often overlooked but significant commonalities. The combination of a state AGs’ constitutional and public interest responsibilities, its authority to aggregate and serve as effective guardians of consumer interests, its repeat player advantages in state courts, and the multiple sources of leverage AGO’s control put AGOs in a unique position to bring about a more equitable balance of buyer-seller power in financial markets.

The remainder of the paper will proceed in six additional sections: (II) the Massachusetts case study, (III) growth as a precipitant of the Global Financial Crisis, (IV) UDAP unfairness as a power-balancing enforcement strategy, (V) MA-AG as an enforcer, (VI) unfairness and securitization, and (VII) implications for more equitable power sharing.

II. The Massachusetts Case Study

The GFC as experienced in Massachusetts and elsewhere was marked by a vast increase in

² Although MA-AG had previously engaged actively with major predatory lenders such as Household Finance, Ameriquist, FAMCO, and Countrywide using its statutory authority to prohibit *deceptive* business conduct, this paper considers its counterpart authority to sanction *unfair* commercial conduct. Because SAGs play pivotal roles as frontline consumer protection responders, case studies that consider their historical traditions, policy goals, and the rationale for their strategic choices can help inform broader issues of policymaking and can enrich governance scholarship. This comports with Adam Yarmolinsky’s (1986) view that “general propositions do not determine specific cases”; what brings

policymaking into sharpest focus is forensic-style analysis of specific cases” (p 231)

³ The Massachusetts case study can be contrasted with the post-2008 federal enforcement story recounted by Bratton & Levitin (2020). In the Massachusetts case, a single enforcement agency, MA-AG, was able to link separate approaches to the “excessive risk and shabby practices” (Bratton and Levitin’s term) found in the subprime origination market with the “toxic products” found in the securitization market to generate important combined synergistic enforcement benefits.

mortgage defaults and foreclosures leading to a deep and long-lasting recession. It arose, fundamentally, from the implementation of a hyper-aggressive business strategy designed to grow the financial services sector despite the adverse effect on borrowers, investors, and global economic stability. It resulted in sub-optimal economic performance and social injustice (Vandenbosch & Sapp 2010); Engel & Fitzpatrick 2012; Cheffins 2018).⁴ It was facilitated by the failure of regulators to check the personal and systemic consequences of the business model.⁵

In 2007, as the foreclosure crisis reached a shrill crescendo in the Commonwealth, the MA-AG reacted by shifting its consumer protection approach from one that had focused on UDAP deception and the symptoms of predatory lending to a UDAP unfairness strategy that targeted the underlying business models and root causes of market failure.

The case study presented here makes use of semi-structured interviews and primary source documents to contextualize the thinking within MA-AG related to UDAP unfairness and securitization enforcement during the 2007-2008 GFC period.⁶ The UDAP unfairness action revolved around a preliminary injunction (PI) brought in the Massachusetts trial court against *Fremont Investment and Loan*, a California-based industrial bank. A related action centered around MA-AG's extensive investigation and settlement with the systemically significant Wall Street securitizer Morgan Stanley and the restitution and behavioral injunction obtained through administrative action.

III. Growth as a Precipitant of the Global Financial Crisis

Entering the 21st century, *accelerated growth* had risen to the top of the financial sector's business priorities. The overall objectives of financial services providers were to increase sales and earnings at an escalating rate in order to grow the sector's share of aggregate GDP and to solidify its dominant position in the macroeconomic structure. The unfair lending strategy the industry launched to achieve the sector's aggressive growth targets was at the root of the Global Financial Crisis.

By dint of size alone, it was logical for the mortgage segment to serve as the bell cow for the planned expansion. Since most existing homeowners already met traditional credit standards and held prime mortgage loans, the financial service sector's growth targets could only be realized if lenders relaxed their customary underwriting guidelines and originated mortgages for a new segment of subprime borrowers--households with low credit scores.⁷ The fundamental public policy problem was whether financial services providers could and would thread the needle to achieve exponential growth targets without destroying the safety and soundness of borrowers and credit markets.⁸

To facilitate the easing of credit standards, lenders adopted a new business model—*originate-to-distribute* (OTD)—that sought to leverage the capital needed to maximize growth. The OTD model called for lenders to originate mortgages and then to promptly sell them from their own asset portfolios into the capital markets (Santos J.A. 2012); Purnanandam 2011).

⁴ For an all but forgotten historical discussion of business exploitation, a phenomenon he referred to as "capitalistic sabotage", see Veblen (1919).

⁵ Congress adopted federal legal prohibitions against *unfair and deceptive acts and practices* (UDAP) in the 1938 Federal Trade Commission Act and the states followed suit with their own mini-FTC statutes starting in the late 1960's. For consideration of the problem of structural inequality and regulatory control, see, Rahman (2016); Raghavan (2022); Fung (2020); Barnhizer (2005); Fligstein & Roehrkasse (2013).

⁶ I conducted extensive interviews with state attorneys general and members of their consumer protection teams from five states in addition to Massachusetts. In addition, I interviewed legal scholars specializing in consumer law and members of the private bar with

experience on both sides of UDAP disputes involving state attorneys general.

⁷ The Federal Reserve has defined subprime as households with a credit score below 620 (Chomsisengphet & Pennington-Cross 2006). The Massachusetts trial court judge in the preliminary injunction brought by MA-AG against Fremont estimated that about 60% of the bank's residential mortgage loans fell into the subprime category.

⁸ Adam Levitin all but dismisses this as a source of internal conflict. "[T]he problem with the loans in *Fremont* was that they were all but doomed to foreclosure. Fremont was not looking to capture the borrowers' equity; it merely wanted to qualify more borrowers for mortgages than otherwise because that would increase the number of loans it would have to sell into securitizations." Levitin (2024) (pg. 465).

Mortgage *originators* like Fremont relied on Wall Street *securitizers*, made up of investment giants such as Goldman Sachs, Deutsche Bank, Merrill Lynch, and Morgan Stanley, to function as arrangers and funding sources for these transactions.⁹ Securitizers, in turn, profited handily from these business arrangements—generating substantial fees from bundling loans, managing investment trusts, earning interest on lines of credit and warehouse loans made to originators, creating special investment instruments (residential mortgage-backed securities or RMBS), marketing these asset-backed securities to institutional investors, and providing managerial oversight and compliance services.¹⁰

The sale of asset-backed securities to institutional investors in Massachusetts and around the globe was key to leveraging bank capital and maximizing growth. The sale of RMBS had the crucial structural effect of shifting the risk of loan defaults off the books of the originating bank and nonbank lenders and onto the balance sheets of institutional investors. Lenders effectively “went off the risk” for non-repayment of loans made to subprime borrowers. In so doing, they became far less sensitive to indicators of loan safety and soundness.¹¹

The sophisticated institutional investors who were the main purchasers of RMBS (and might have been expected to evaluate their safety beforehand) were generally slow to learn about these complex investment instruments and to ramp up their own due diligence. Adam Levitin and his co-authors (2009) have argued that other institutions integral to the RMBS market did not

help: “The issuer, the securitizer and the rater were only interested in the fees that they booked for each sale, which of course lent itself to a high volume of short-term profits instead of calibration of default risk and long-term loan performance.” (pg. 8)¹²

The end result was a sharp increase in the volume of high-risk loans that were financially unsuitable, and in many instances, virtually impossible for low-income, credit constrained subprime borrowers to repay on the terms negotiated. While the resulting credit cycle—from origination to securitization to re-lending—did succeed in generating the kind of growth members of the industry were seeking, it did so at the expense of borrowers who were doomed to default on their credit obligations.¹³ In sum, it represented an opportunistic misuse of informational power and a grossly uneven playing field with no real compensating advantages for borrowers.¹⁴

The result of the cycle—namely the Global Financial Crisis—represented a perfect storm. Brokers could earn commissions of up to \$10,000 for the sale of a single high-price, adjustable-rate mortgage to a borrower whose tenuous financial condition virtually guaranteed default. As Richard Bitner, a veteran subprime mortgage lender testified before the post-crash Financial Crisis Inquiry Commission: “At the time, I can recall thinking to myself that we were operating in a business environment that was unsustainable. Indeed, it was the desire to maintain this profitability that would be the industry’s ultimate undoing.”¹⁵ A reasonable conclusion could be (and was) drawn that the

⁹ As investigators subsequently came to understand, securitizers were also involved in establishing business goals for entities on the subprime lending platform, setting compliance policies, and applying them to mortgage origination and servicing operations. In other words, they were anything but passive conduits for reallocating risks and creating financial liquidity in financial markets. Engel & Fitzpatrick, op. cit. footnote 4.]

¹⁰ See Commonwealth of Massachusetts In re Morgan Stanley & Co. Inc. *Assurance of Discontinuance*. Civil Action No. 10-258. (June 24, 2010). Eggert (2009) discusses profitability for rating agencies, pointing out that raters could earn four to five times as much rating a RMBS as a similar size municipal bond.

¹¹ For ideas about the role of consumer protection and the realignment of business incentives, see, Tennyson, S. (2010).

¹² This dynamic is commonly referred to as moral hazard (Keys 2010). A more colorful term used to characterize the effect of loosening underwriting standards and selling high-risk loans into the secondary market was “pass the trash” (McCoy 2009).

¹³ In 1997, the contribution of financial services to GDP exceeded the second most important economic sector (manufacturing) by 25%. By 2022, it had become 56% more significant than its next competitor, the professional and business services sector (Yuskavage and Pho 2004). For another contemporaneous recitation of MA-AG’s view of growth and unfairness, see the AG’s complaint in *Commonwealth v. H&R Block and Option One Mortgage Corporation*. Civil Action No. 08-2474-BLS (June 3, 2008).

¹⁴ Shennan Kavanagh articulated this calculus in an interview with the author (January 31, 2022). At the point she was interviewed, Kavanagh was serving as Chief of Consumer Protection at MA-AG. However, all during the MA-AG and Morgan Stanley period she was in private practice.

¹⁵ Testimony Before the Financial Crisis Inquiry Commission. <https://elischolar.library.yale.edu/yfcs-documents/5841>. FCIC Documents 2010. Decades before, Vern Countryman (1975) used the term “improvident lending” to describe this phenomenon. For an updated version, see Sanders & Raghavan (2018).

securitized subprime mortgage business model was unfair to its roots.¹⁶

IV. UDAP Unfairness as a Power-Balancing Enforcement Strategy

At the beginning of 2007, with the fallout from increasing subprime mortgage foreclosures and the crunch in housing prices sparking anguished calls for public action, Martha Coakley, then newly elected as Attorney General of Massachusetts and her leadership team took the innovative—yet precarious—decision to respond to the crisis by launching a UDAP unfairness enforcement action in court. They did so by filing a motion for preliminary injunctive relief in the architecturally distinguished but ever so gloomy looking Suffolk Superior Courthouse, visually suggestive of a bleak Dickensian law court.¹⁷

The underlying rationale for this approach had been previewed in an article published in the *Yale Journal of Regulation* several years before the GFC (Kaplan & Barry-Smith 2000). Exploring gaps in consumer safeguards associated with defective and dangerously designed consumer products—the prototype being handguns—Glenn Kaplan at MA-AG and his colleague Chris Barry-Smith (a MA-AG alumnus, then in private practice) made the novel argument that state UDAP unfairness statutes could provide more effective consumer

protections than more traditional tort and contract law remedies.¹⁸

Kaplan and Barry-Smith pointed out that the policy of fairness in buyer-seller relations was originally recognized by the Massachusetts courts in a 1974 Supreme Judicial Court decision, *Commonwealth v. DeCotis*. In *DeCotis*, Justice Herbert Wilkens analyzed the Massachusetts UDAP statute codified as Chapter 93A of the General Laws and found that the legislative purpose and basic policy of fairness was to “regulate business activities with the view to providing...a more equitable balance in commercial relations between buyers and sellers.”¹⁹

In outlining the criteria of unfairness, the Massachusetts legislature eschewed black letter definitions of specific acts and practices in favor of an indicative approach drawn directly from the U.S. Supreme Court’s decision in *FTC v. Sperry & Hutchinson* (1972).²⁰ In its S&H decision, the Court set out three highly conceptual criteria: (1) whether the practice was within at least the penumbra of some common-law, statutory, or other established concept of unfairness; (2) whether it was immoral, unethical, oppressive, or unscrupulous, and (3) whether it caused substantial injury to consumers.

Notwithstanding the broad scope of the policy laid out in Chapter 93A, the unfairness approach had rarely been used in Massachusetts courts—certainly not in the context of credit products.²¹ Thus, when Coakley and her team

¹⁶ See Martha Coakley’s “Comment of Massachusetts Attorney General Martha Coakley Concerning Amendments to Regulation Z, 12 C.F.R. Part 226”. As one account executive with Fremont told MA-AG attorneys, the whole process “was a race to the bottom.” The affidavits of account executives Tae Lee and Jeffrey McKay were excerpted in a consolidated securities class action lawsuit brought against Fremont and certain of its officers by the NY State Teachers Retirement System. The Massachusetts action was cited extensively in that case. See *Mohammed al-Beitawi et. al. v. Fremont General*. USDC Central District of California. (Case No. CV 07-5756 FMC (FFMx), available at: <https://static.blbgilaw.com/docs/FremontConsComplt.pdf>)

¹⁷ In a 2000 official Massachusetts inventory of courthouses in need of major repair or replacement, the Suffolk Superior Court was listed in the top tier.

¹⁸ Contrast the Kaplan and Barry-Smith analysis with Brescia (2009).

¹⁹ *Commonwealth v. Michael DeCotis*, 366 Mass. 234 (1974). It was the first state consumer protection act to be adopted and had its origins in the Federal Trade Commission Act. On unfairness, Kathleen Keest, formerly an assistant attorney general in the Iowa

AG’s Office and Deputy Administrator of the Iowa Consumer Credit Code provided the Senate an excellent primer. U.S. Senate Subcommittee on Commerce, Trade, and Tourism. *Hearing on Improving Consumer Protections in Subprime Lending* 110th Congress 2nd Session (April 29, 2008). For concise statements relating to unfair practices in the Massachusetts ecosystem, see, Complaint, *Commonwealth of Massachusetts v. Venturcap Investment Group V, LLC D/B/A JD Byrider and Venturcap Financial Group, LLC D/B/A CNAC*. Civil Action No. 17-84CV03091 (Suffolk Superior Court, September 26, 2017) and Complaint, *Commonwealth of Massachusetts v. Credit Acceptance Corporation*. Civil Action No. 2084CV01954-BLS2 (Suffolk Superior Court, March 15, 2021).

²⁰ *FTC v. Sperry & Hutchinson*, 405 U.S. 233 (1972). Kaplan and Barry-Smith characterized the S&H criteria as “ephemeral” in their law review, *op. cit.*

²¹ A rare use was in the case of *United Companies Lending Corporation. v. Sargeant*, 20 F. Supp. 2d 192 (1998) in which a non-standard charge for closing costs was viewed as unfair from a disparate bargaining power perspective.

began to work through the enforcement options available to deal with the critical problem of subprime foreclosures, they had to cut through the fog of uncertainty to infer the trial court's likely reaction to unfairness as a framework.

There was a good chance that the courts would decline to intervene directly in the intricate details of mortgage financing, relying instead on the *laissez faire* argument made by many mainstream economists that market actors were better situated than courts or regulators to resolve marketplace frictions on their own.²² Beyond that, even if a court was willing to step in, it might have difficulty defining an objective and consistent standard of unfair practices that could be applied across-the-board.

By the time Martha Coakley had begun her term as AG in January 2007, Chris Barry-Smith had returned to the MA-AG and was serving as Chief of the Consumer Protection Bureau. His writing partner, Glenn Kaplan, was posted as head of the Bureau of Insurance and Financial Services. Together, the two became principal advisors to the AG on issues of consumer financial protection.

Facing intense public pressure to address the trauma of the subprime mortgage market, the MA-AG team moved its pre-trial investigation of Fremont into high gear. Their findings made it abundantly clear to them that they were dealing with marketplace practices that fit squarely with the description of unfairness as outlined in Chapter 93A: oppressive, and unscrupulous behavior, substantial injury, the penumbra of recognized concepts of unfairness, etc.

Pam Kogut, one of the most experienced consumer protection litigators in the Office at the time summarized their findings:

With lending cases involving a fair amount of technical legal background, I think it is fair to say that they were generated from the attorneys within the Consumer Protection Division rather than from management down. For the longest time, we were seeing these really crazy lending practices. It was beginning to look like every mortgage that crossed my desk had problems right on the face of the loans, ranging from unfairly large points being charged to adjustable rate mortgages that increased in unfair ways (we began referring to these as “exploding ARMs”) to fraud in the underwriting (“no doc” loans) and other such problems.²³

Jean Healey, another senior litigator in the consumer protection group confirmed Kogut's conclusion. “The more the team looked at Fremont and Option One, the more convinced we were that both banks had really bad facts. Indeed, Fremont may have had some of the worst loans in America.”²⁴ Her boss, Chris Barry-Smith weighed in.

We were determined to bring cases that did not require fact-intensive investigations and borrower-specific evidence. We set out to demonstrate that the features of the products themselves were definitive of their unfair character. That teaser loans sold to people who were at or over the edge in terms of loan-to-value or percent of income tied up in mortgage payments could not possibly succeed. These were things that could be shown through the documents, themselves.²⁵

Using its administrative subpoena power to study Fremont's loan files and conduct interviews with bank employees and borrowers, the MA-AG attorneys were fully convinced that the bank's subprime mortgages were structurally unfair. As Pam Kogut previously indicated, “the view from the team working these cases was unequivocal: they just needed to be brought.”²⁶

If successful, some of the anticipated benefits of the AG's motion for injunctive relief would

²² On the other hand, at least some regulators fully grasped the nettle and began to shift their sightlines from consumer information disclosure as a remedy for market failure to the direct evaluation of the content and fairness of the products and deals, themselves (Braucher 2012). An early institutionalist argument in favor of activist intervention can be found in Walton Hamilton's presidential address to the American Economic Association (Hamilton 1919). Hamilton and other institutionalists argued that economic transactions were driven by the deliberate “conventions, customs, habits of thinking, and modes of doing which make up the scheme of arrangements which we call “the economic order” and not by reflexive, equilibrium-seeking actions and reactions.

²³ Email from Pam Kogut to the author, February 11, 2018.

²⁴ Jean Healey interview (December 22, 2017).

²⁵ E-mail from Christopher Barry-Smith to the author (June 12, 2019).

²⁶ Kogut, *op. cit.* For an excellent discussion of the logic and tactics of pursuing predatory lenders through settlement using the Deception arm of UDAP, see the oral history interview with University of Minnesota Law Professor Prentiss Cox, formerly the Chief of Consumer Protection at the Minnesota AG's Office. <https://predatorylending.duke.edu/histories/prentiss-cox/> (June 1, 2020).

be: an immediate pause in the thrum of the ongoing crisis; recognition of UDAP unfairness as a way to characterize important predatory mortgage lending practices and to effect an across-the-board solution in lieu of litigating individual cases; a platform for attributing financial responsibility and legal accountability among the various players involved, and, in general, a new model for balancing the disproportionate power of sellers in the buyer-seller commercial relationship.

After considering all the risks, Coakley enthusiastically jumped on-board. As one member of the litigation team recalled:

Pam Kogan had been looking at predatory mortgage lending during the Reilly period [Coakley's immediate predecessor]; when Martha came in we pitched her, saying that we'd start getting complaints just as soon as the refinancing option dried up. She was supportive of the idea that we devote the substantial assets of the Consumer Bureau (18 attorneys) to bringing cases—not looking for settlements and she remained steadfast. Her major contributions were consistency; her willingness in the early days to make the argument before relatively hostile audiences of bankers and others like Chamber of Commerce; to take the risks involved in bringing novel cases without putting us through the drill of assuring her that the cases had an 80%, 90% chance of success; providing the resources needed to do cases.²⁷

Coakley's concurrence came with a price: a non-negotiable requirement that a mechanism be found to make substantial financial redress available to borrowers and to keep as many people in their homes as possible. It was presumed that these conditions would be an extremely heavy lift. In addition to subprime mortgage originators, Coakley's requirement would inevitably mean that securitizers like Morgan Stanley would have to step up. They had the deep pockets necessary to provide the kind of

redress contemplated. And they were an integral part of the predatory lending business model. Thus, according to MA-AG's legal theory, they should share liability for the outcome.²⁸ The job of leveraging this solution fell to Kaplan, an expert in the complex field of securitization and an advanced thinker in the area of UDAP unfairness.

The first hurdle the litigation team faced was to distill a stated cause of action that would have the heft necessary to attract the trial court's interest in unfairness and would help the court fashion a mechanism for cutting through the minutiae of subprime lending without getting bogged down in its complexities.

At the end of the day, there was little real doubt about the strategy MA-AG would ultimately select. The single characteristic that made the Fremont loans so offensive to the MA-AG attorneys was the composite of risk factors that made them inherently unsuitable for subprime borrowers and virtually impossible for them to repay. Although members of the MA-AG team may not have used the precise word "cynical" to describe Fremont's risk underwriting practices, that was what they saw and described as the hallmark of unfairness. It is not entirely clear who in the Office first came up with the term *structural unfairness* but it soon became the byword for describing the layering of underwriting risks—one on top of another—to a point where their composite weight made it all but impossible for borrowers to repay their loans (Sandler & Rogers 20).¹⁰²⁹ Another apt description was a loan product that was "doomed to fail".

Though *structurally unfair* may have been an addition to the lexicon of consumer protection, the concept itself was far from unprecedented.³⁰ As a matter of law, the furnishing of loans

²⁷ E-mail from a member of the litigation team to the author (June 13, 2019). In a parallel comparison between the incentives facing elected state AGs and career staff attorneys, Prentiss Cox makes the point: "I think in Household [a major UDAP Deception case] the elected officials were willing to settle much more quickly than some of the line staff like me who were more hawkish because we had different incentives. We had different incentives, but we were all on the same page ultimately. And having the elected officials there was huge." *Ibid.*

²⁸ Barry-Smith clearly acknowledged the challenge posed by the securitizers. "It is unlikely that we would have taken on

securitization—perhaps the biggest hurdle—had it not been for what we learned in Fremont." (email to the author, June 12, 2019).

²⁹ "Combined-risk" was also a synonym used to describe risk-layering. *Beverly Adkins, et. al. v. Morgan Stanley*. Class Action Complaint. USDC SDNY Civil Action No. 12 Civ 7667 (October 15, 2012).

³⁰ The term "presumptively unfair" has been used interchangeably to refer to structural unfairness. For clarity, the term "structurally unfair" will be preferred in this paper.

without adequate determination of the borrower's "ability to repay" violated various Massachusetts and federal statutes, regulations and applicable common law principles and thus satisfied the jurisprudential requirements of Chapter 93A.³¹

V. MA-AG as an Enforcer

January 15, 2008, was the opening day for the Fremont case in Massachusetts Superior Court. The matter at hand was MA-AG's emergency motion for preliminary injunctive (PI) relief. The intent of the PI was to preserve the *status quo ante* in order to forestall additional foreclosure activity while a lasting solution to the situation could be worked out. It is not hard to imagine how astonished the MA-AG and Fremont both must have been when Judge Ralph Gants, sitting without a jury in the Business Session of the Superior Court, virtually vaulted over the threshold claim advanced by MA-AG, namely that Fremont's misuse of risk underwriting factors was systematically associated with loan failure and should be deemed unfair as a matter of the state's UDAP law, Chapter 93A.

THE COURT: Here's what I understand to be the very gist of what they contend the bank did that not only was stupid, but also was an unfair practice, which is to grant loans to individuals based on an income-to-debt ratio, premised on the teaser, we all know what it means, with no equity cushion so when the value of that housing went down they were going to be stuck with a loan that could not be refinanced and that they could not afford. That I understand is to be one of the fundamental parts of their claim.

MR. CARROLL (For Fremont): That is the allegation.³²

As the PI hearing proceeded that day, MA-AG's worst fear, namely that the Court would be hostile or uninterested in a broad claim of UDAP unfairness, fully evanesced. As one member of MA-AG's litigation team put it: Judge Gants

"really got it. He crystallized the arguments better than I did and got to the heart of the unlawful conduct driving that crisis. In doing so, he did the public a great service."³³ He understood the stakes and why Fremont's risk underwriting practices were unfair and inimical to the public interest. He was not overwhelmed by the complexity and mind-numbing technical details thrown his way. He was attentive to but not intimidated by Fremont's proposition that as a matter of due process, the court would have to spend whatever time was necessary to hold mini-hearings on thousands of individual foreclosures.

In equal measure, the judge was not a pushover for the AG's claims, either. As set forth in the original complaint filed by MA-AG on October 4, 2007, the AG's basic assertion was that Fremont's subprime business model incorporated a long list of unfair risk factors and that any one of them was sufficient to cause foreclosures and injure borrowers. In making this claim, MA-AG followed the unfair risk inventory approach adopted by the Federal Deposit Insurance Corporation in a recently concluded Cease and Desist Order settled with Fremont.³⁴

The MA-AG attorneys pursued this so-called risk inventory approach to structural risk during the opening day of the PI hearing. As an illustrative example of an unfair risk factor, Jean Healey, one of the MA-AG attorneys, explained to Judge Gants why Fremont's adjustable, teaser rate product design would explode, why borrowers would suffer from "rate shock" at the expiration of the introductory period, and why adjustable rate mortgages (ARMs) were based on defective pricing and refinancing assumptions. Referring to the affidavit of Christine Murphy, MA-AG's financial analyst for its analysis of risk factors, Healey emphasized that teaser rates, standing alone, were sufficient to support the AG's claim of unfairness. In her presentation, she stopped well

³¹ The jurisprudential footing of "ability to repay" was summarized in *Commonwealth of Massachusetts v. Fremont Investment and Loan*. Suffolk Superior Court Civil Action. No. 07-4373-F. Commonwealth's Memorandum of Law in Support of Its Emergency Motion for a Preliminary Injunction (January 15, 2008).

³² Suffolk County Superior Court Civil Business Litigation. Docket No. SUCV2007-04373 (January 15, 2008). Transcript of Hearing, *Commonwealth of Massachusetts v. Fremont Investment and Loan*.

³³ Jean Healey interview (December 22, 2017).

³⁴ The context of the FDIC action and this one were quite different: the FDIC was acting administratively and was not seeking judicial sanction. Nor was it seeking financial redress from *Fremont*.

short of quantifying the relative importance of each of the separate risk factors or measuring their additive contribution to risks as a whole.³⁵

In the second day of the PI hearings, the issue of layered risk underlying MA-AG's definition of *structural unfairness* came to a head. An obviously frustrated Fremont attorney, James Carroll, capsulized the problem Fremont was having trying to defend the lawfulness of its lending practices against MA-AG's oblique definition of structurally unfair practices. "[T]here is no such thing as structural unfairness without some sort of delineation of what it means."

The judge was inclined to agree that MA-AG's written presentation fell short of the standard of clarity required. Chris Barry-Smith initially repeated Jean Healey's prior example about the unfairness of quoting repayment obligations based on low teaser rate levels rather than higher fully-indexed levels.³⁶ At that point, however, he stood back and recognized that the open-ended risk inventory approach MA-AG was advocating may have been a bridge too far for Judge Gants to cross. Accordingly, Barry-Smith conceded that it was up to the court to determine the risk factors needed to satisfy the definition of structural unfairness.³⁷

Plainly unhappy with the suggestion that the Court was the proper one to parse structural unfairness and to decide not only how many angels fit on the head of a pin but precisely which ones, Judge Gants threw it back to MA-AG to come up with a working definition that would clarify its claim and help resolve this metaphysical dilemma. In all probability the term of art he used to describe the process he had in mind—"the Dayenu Theory"—must have sent all the attorneys scurrying to find a reference to this obscure legal theory in statute, case law or

even in a Webster's dictionary. At the end of the day, one would hope that Judge Gants got a good chuckle over the cosmic brilliance of his own algorithm and the tension it set up between the logic of "structural unfairness" and the deep mysteries of the "Dayenu Theory".³⁸

Discussion of the notional case of *Dayenu v. Structural Unfairness* was next taken up in a meeting convened in the judge's chambers. There, the tension was ultimately resolved in favor of a proposed redefinition of unfairness: modifying it from MA-AG's original proposal of a single risk factor to be extracted from an inventory of potential candidates to a well-defined "layering" of four specific risk factors, namely a combination of hybrid adjustable rate mortgage design, teaser rates, excessive debt-to-income, and loan-to-value ratios.

He asked us to come back to sharpen the relative importance of the 4 factors we had put forward as indicia of structural unfairness. He pushed on that. Of course, we would have been happier if the teaser rate, alone, was regarded as sufficient. [Approximately 75% of Fremont's outstanding Massachusetts loans would have qualified as unfair under that definition compared with fewer than 10% under the four factor redefinition]. He wanted us to specify the other factors and put them in some order. The first, and most encompassing was the teaser rate. Then, probably the loan-to-value determination. And third, the debt-to-income ratio. It was Judge Gants rather than Fremont that forced this issue.³⁹

MA-AG's initial position on the specific definition of structural unfairness may have been overly bold in view of the uncharted issues before the court. Nevertheless, the AG had to be encouraged by Judge Gants' recognition of its principled argument about the unlawfulness of unfair (doomed to foreclose) mortgage products. Together with the corresponding decision to

³⁵ Murphy, Christine F. "Affidavit" (Suffolk Superior Court, January 2, 2008).

³⁶ A fully indexed rate is established at the conclusion of the introductory period when the promotional interest rate discounts expire.

³⁷ Suffolk County Superior Court Civil Business Litigation. Docket No. SUCV2007-04373 (January 23, 2008). Transcript of Hearing, *Commonwealth of Massachusetts v. Fremont Investment and Loan*.

³⁸ As he presented it, the "Dayenu Theory" says: "you know it would be enough if... but if that is not enough then add this factor and yet another". Dayenu is a verse traditionally sung as part of the Jewish Passover Seder observance to express gratitude for God's

many gifts. The obvious reference to a cumulation of factors is what must have resonated with the judge.

³⁹ Christopher Barry-Smith interview (January 31, 2018). In addition, Barry-Smith agreed that Judge Gant's stricter standard had an additional compensating advantage. "It is true that, the more rigorous and multi-pronged the standard for structurally unfair loans, the better to guard against claims of AGO or judicial overreach. Of course, I don't know if judge Gants had that strategic consideration in mind, but it is true that the rigorous test made it hard to argue that our view of unfairness was arbitrary or too malleable." Ibid.

adopt an across-the-board enforcement approach applied exclusively on the basis of unfair product features—without convening a separate fact-finding hearing on each foreclosure—MA-AG understood it had a workable, if not perfect, corrective to an important scenario of consumer abuse.⁴⁰

Gants' ruling on the Fremont preliminary injunction received recognition for its unusually probing analysis of the nature, purpose, and effect of Fremont's business conduct and its impact on the equitable distribution of power in buyer-seller transactions (Costello 2010).⁴¹ Before taking a victory lap, however, the MA-AG team had to respond to AG Coakley's initial imperative that the liability and financial redress aspects of the matter be nailed down so that the Office could provide meaningful financial redress to homeowners, help restore state investor funds, and ultimately contribute to systemic reforms.

VI. Unfairness and Securitization

Ever since its 1998 predatory lending enforcement action brought against FAMCO, a California-based subprime lender, for charging grossly excessive closing fees, the Office knew that in cases involving securitizations it would have to confront the securitizers directly to ensure that a monetary judgment was available on behalf of injured borrowers (Kogut 2004).⁴² This was entirely consistent with MA-AG's view that "the subprime crisis was not caused by wrongdoers at the retail level [originators] alone. Rather, Wall Street's [securitizers'] appetite for mortgage loans vastly increased the volume of subprime loans and encouraged ever more lax lending standards at the retail level."⁴³

Accordingly, beginning in December 2007, the Office opened investigations of Morgan Stanley, Goldman Sachs, and other major securitizers. At the outset, MA-AG faced the challenge of identifying appropriate legal bases for claiming that securitizers had contributory responsibility for economic injuries suffered by subprime borrowers at the retail level. For their part, securitizers staked out the position that they had no liability for UDAP unfair mortgage practices. To the extent there was actionable bad conduct, securitizers argued that liability should fall exclusively on the originating mortgage lenders and servicers. In short, their argument was that the court's decision in Fremont did not go up the chain to reach the securitizers; the securitizers' behavior was not itself subject to the unfairness standards defined in Fremont, and securitizers had no liability for the behavior of originators.

Although many legal scholars had written that extant theories of securitizer liability were murky and in need of extensive analytic and legal overhaul, the practical work of documenting the connections between securitizer behavior and the adverse impact on borrowers and securities investors fell to Kaplan and members of his team.⁴⁴ The corresponding job of framing theories of liability was also part of their brief.

As Glenn Kaplan has recounted the story, the Goldman Sachs investigation that settled in 2009, a year before the Morgan Stanley case, was by far the more difficult and nerve wracking of the two. For the most part, the team's work was done in the dark by piecing together complex and obscure documents and matching them with bits and pieces of confirmatory information gathered from other sources.

⁴⁰ Paradoxically, the combined risk definition, though less favorable to MA-AG's position in one way, may have saved it from a potentially successful claim that each individual risk factor on the inventory was entirely proper. What wasn't fair, as the Supreme Judicial Court went on to emphasize, was the sale of a loan that embodied all four of the risk factors that the trial court incorporated in its definition of structural unfairness. *Commonwealth v. Fremont Investment and Loan*, 452 Mass. 73 (2008).

⁴¹ Also note Justice Margot Botsford's recognition in her opinion affirming Judge Gants' ruling in the decision of the Supreme Judicial Court. *Ibid.*

⁴² Lehman Brothers securitized FAMCO subprime mortgage loans and was sued by a number of state attorneys general for its

complicity as funder of unlawful predatory loans. For technical reasons, MA-AG was barred from joining in these actions against Lehman.

⁴³ Letter from Glenn Kaplan to Elizabeth Murphy, Secretary, Securities and Exchange Commission. Re: Securities and Exchange Commission's Proposed Rule Concerning Asset Backed Securities, Release Nos. 33-9117; 34-61858; File Number S7-08-10 (August 2, 2010).

⁴⁴ Katherine Engel and colleagues have written extensively on this topic. See, Engel & McCoy (2004, 2007). For later analysis, see, Engel & Fitzpatrick, *op. cit.* footnote 4; Engel & McCoy (2016). See also, Wilmarth Jr (2002).

In Goldman, the MA-AG attorneys had to concentrate on learning and fact checking the minute details of the securitization business and understanding the myriad ways Goldman Sachs incentivized, capitalized, and otherwise participated in the lending and securities practices resulting in the systemic failure of subprime mortgage loans. There was an exhaustive investigatory project that documented the numerous facets of Goldman's role from bankrolling and facilitating the various aspects of the loan origination function to serving in a compliance role and ultimately to evaluating the safety of the loans that collateralized the RMBS and providing investors required quality assurances. The most daunting aspect of the project was the risk of missing something or overlooking some nuance.

By the end of the investigation MA-AG had constructed a comprehensive picture of the role of securitizers that documented what they knew, what they did, and what they shared with the investors who purchased their mortgage-backed securities. MA-AG's encyclopedic account was not only an invaluable resource for those directly involved in the Massachusetts credit ecosystem but for others with an interest including other SAGs, state banking regulators, the Securities and Exchange Commission, other federal agencies, and private sector stakeholders.

Although MA-AG interviewees were reticent to discuss the particular legal theories they most relied on to drive settlement negotiations with Goldman (and Morgan Stanley), suffice to say they included laws governing securities transactions as well as common law principles bearing on the facilitation and aiding and abetting of unfair practices on the part of mortgage lenders and others on their platform.⁴⁵ The culmination of the Goldman investigation included an impregnable demonstration that securitizers knew and were intimately involved in virtually all aspects of mortgage origination activity, that they had firsthand information about the risks of the loans that served as collateral for the RMBS, and that they

contributed, substantially to injuries suffered by borrowers and investors and ultimately to third parties such as communities and local governments.

In the all-important financial assistance domain underscored by Martha Coakley at the outset, the agreement produced a loan modification that incorporated \$50 million in principal write-downs ranging from 25-35% on first mortgages and 50% or more on second mortgages. Both of these were meant to provide "genuine financial relief" to households by offering them a cushion for the refinancing or resale of troubled properties. At the same time, MA-AG judiciously avoided over-compensating borrowers by demanding terms that were unreasonably generous. In all of this, the AG's Office was functioning as the People's Lawyer.

In addition to borrower redress, MA-AG focused on pursuing losses suffered by the state's own investment funds. As a consequence of misrepresentations made by Goldman, the state was misled about the risks of the pooled subprime mortgage loans that state retirement and municipal employee funds had purchased. Perhaps most galling to MA-AG was that the Commonwealth had been positioned as a pawn to finance and further the unfair practices of the originators and securitizers. As an outcome, the Goldman agreement produced \$10 million for losses suffered and expenses incurred by the state as an investor. Throughout this aspect of the case MA-AG was wearing its "State Agency General Counsel" hat. Understandably, this was a politically attractive role to play. It recouped state funds without any charge to the state budget. And it provided a signal that the state would take action to safeguard its funds against unfair and deceptive actions on the part of securitizers. Most important, Goldman provided a vehicle for demonstrating the powerful synergy between MA-AG as a People's Lawyer and MA-AG as the State's General Counsel.

The following year, MA-AG entered settlement discussions with Morgan Stanley,

⁴⁵ In her press announcement, AG Coakley categorized one aspect of Goldman's actions as "facilitation" of unfair and predatory lending practices. See, Massachusetts Attorney General's Office. "Attorney General Martha Coakley and Goldman Sachs Reach

Settlement Regarding Subprime Lending Issues." *Press Conference* (May 11, 2009). The settlement was embodied in an agreement filed in Superior Court on May 7, 2009, that was binding on both parties.

another active subprime mortgage securitizer in the Commonwealth. The completed Goldman investigation was tremendously useful because it precluded the necessity of a top to bottom reconstruction of the business model and transactional details behind securitization. And it also provided a working template for the financial settlement. This made it possible for MA-AG to devote the bulk of its attention to the systemic impact of securitization and to a substantive remedial plan for reform.

The Morgan Stanley agreement, titled an Assurance of Discontinuance (AOD), was settled without acknowledgment of alleged wrongdoing or liability on the part of Morgan but with the acceptance of the terms and conditions set forth in the settlement. It was characterized as a means of avoiding the time and expense of litigation and was offered for settlement purposes alone.

It began by describing in great detail the interactions, on the ground (2004-2007), between Morgan and the New Century Mortgage Corporation, a major subprime originator writing loans in Massachusetts. The thrust of the MA-AG presentation was that Morgan made a major financial contribution to the capitalization of New Century loans through an ongoing series of working capital loans; further, that it knew about, encouraged, and approved the origination of loans that failed to meet New Century's own underwriting standards. Also, that Morgan performed or contracted for due diligence of various types (including valuation and credit and compliance due diligence) and when New Century failed to meet standards, Morgan intentionally closed its eyes in the interest of preserving profitable relations with the lender and those on its business platform. Finally, it concluded that Morgan deliberately misrepresented the quality of the collateral backing many of its pooled loans and provided misinformation about its due diligence actions. MA-AG alleged that these securitizer business practices directly affected borrowers by encouraging and incentivizing New Century to make unfair loans. And it directly resulted in losses suffered by investors including the state's own funds as a result of Morgan Stanley's material misrepresentations.

At the conclusion of the AOD, a list of seven best practice and information disclosure actions was enumerated as a step in the direction of reforming current abuses and establishing a prospective framework of fair securitization practices. These seven practices covered matters ranging from underwriting practices to investor disclosures.

The financial settlement provisions were generally in line with Goldman's apart from the specific numbers which included \$58 million for one thousand homeowners, \$23 million for state investment funds, and \$20 million for the state general fund.

Finally, by way of perspective, in 2016 the U.S. Department of Justice settled a case against Morgan Stanley initiated on behalf of the state-federal RMBS Working Group. The settlement covered Morgan's 2005-2007 New Century securitizations (as did the Massachusetts AOD). After developing a comprehensive set of allegations, generally consistent with the lines set out in the MA-AG AOD, Morgan acknowledged responsibility, accepted liability, and provided payments totaling \$2.6 billion.

VII. Implications for More Equitable Power Sharing

Consumers often find themselves on the losing side of commercial transactions in which producers deal unfairly and offer products and services that are ineffective or unsuitable for normal use. The historical case study presented addresses a landmark instance of unfair and severely injurious practices in the subprime mortgage market during the Global Financial Crisis. And it describes an innovative response one state attorney general took to correct the imbalance in buyer-seller power that was at its root.

A. Unfairness and Power Sharing

Fremont's foreclosure of subprime mortgage loans that were deemed to be structurally unfair was subject to legal restriction following the filing of an unfair trade practices complaint in state court by the Massachusetts Attorney

General. Structural unfairness arose when Fremont originated loans that incorporated a combination of risk factors that doomed the loans to failure from their very outset.

The unfairness initiative adopted by MA-AG provided an effective framework for countering the power of lenders to sell loan products that took unfair advantage of borrowers in the credit marketplace.

B. The Unique Enforcement Role of MA-AG

The Massachusetts AGO had exclusive authority to apply for injunctive relief in state court and to bring an action in “the public interest” in the name of the Commonwealth. The court was entitled to consider the AGO’s public interest justification in making its decision.

The case study also reflected important AGO strengths in the conduct of the enforcement process itself. First, the trial court invited the MA-AG to provide the working definition of “structural unfairness” in the Fremont case. That definition was then used as a template for perfecting the criteria the court ultimately adopted in its ruling.⁴⁶

Second, in resolving the securitization matter, the AGO relied on its unique and extensive pre-trial discovery authority to assemble a comprehensive guide to the role played by securitizers in the loan origination process. It then used the detailed information to defeat representations made by Morgan Stanley and Goldman Sachs that they had no knowledge and bore no responsibility for the misdeeds of the loan originators and did not mislead investors about the risks underlying the RMBS collateral.

Third, wearing its hat as State General Counsel, the AGO was able to leverage negotiations with the securitizers on behalf of state investment funds and to recoup losses suffered as a result fraudulent investment disclosure practices. Undoubtedly, the potential power of the AGO to draw negative attention to an investment bank’s business practices and

ethical standards had to be an influential ingredient.

The leverage applied by the AGO acting as the People’s Lawyer in the Fremont unfairness matter and as the Commonwealth’s General counsel in the Morgan Stanley and Goldman Sachs securitizations was combined synergistically to correct the imbalance of buyer-seller power, to indemnify borrowers, and to address fair dealing and economic justice in the marketplace.

C. The Countervailing Power of a Single State

The decision taken by the MA-AG to go it alone was based on an amalgam of unique historical factors and cultural preferences. It was heavily influenced by the Office’s assessment of its own strengths and weaknesses, those of its counterparties, and its general sense of the attitude of state courts at the time. To be sure, this distinctive constellation of factors could help explain why other SAGs chose not to launch counterpart unfairness actions of their own. Nevertheless, the case study also underscores the many sources of countervailing strength common to state attorneys general that puts them in position to equalize the bargaining power of buyers and sellers in the marketplace.

D. Going Forward

It is safe to assume that issues of commercial fairness in the household finance sector are not a thing of the past. Clearly, each AGO will have to make its own strategic decision about the feasibility and desirability of taking on issues of unfairness and assaying alternative approaches under contemporary conditions. At a minimum, however, the MA-AG case study will provide useful background about a significant success.

In closing, for those who wonder about the value of historical case studies for contemporary public policymaking, the noted American historian, Heather Cox Richardson finds wisdom in William Faulkner’s observation that “the past is never dead. It’s not even past” (Richardson 2022). History is not immutable; while it is a

⁴⁶ This represented an apt example of what Herbert Kritzer (2003) described as the government’s power to establish the rules that the courts ultimately enforced.

source for informing the future, it is also under constant editorial revision based on current understandings, changing events, and contextual factors that elucidate the past. This powerful insight into the dynamic quality of history suggests there is value in looking back to prior episodes such as those in which MA-AG took the lead enforcing social controls over abusive business practices and helping redress disparities in economic power.

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