LOYOLA CONSUMER LAW REVIEW

Volume 26 Number 1

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A RANDOMIZED EXPERIMENT ASSESSING THE ACCURACY OF MICROSOFT’S “BING IT ON” CHALLENGE

Ian Ayres*
Emad Atiq**
Sheng Li**
Michelle Lu**
Tom Maher**
& Christine Tsang***

Abstract: In advertisements associated with its “Bing It On” campaign, Microsoft claimed that “people preferred Bing web search results nearly 2:1 over Google in blind comparison tests.” We tested Microsoft’s claims by way of a randomized experiment involving U.S.-based Amazon’s Mechanical Turk (“MTurk”) subjects and conducted on Microsoft’s own www.bingiton.com website. We found that (i) a statistically-significant majority of participants preferred Google search results to Bing search results (53% to 41%); and (ii) participants were significantly less likely to prefer Bing results when randomly assigned to use popular search terms or self-selected search terms instead of the search terms Microsoft recommends test-takers employ on its website. Our findings suggest that some of the claims implicit in Microsoft’s advertisements warrant legal scrutiny. The Bing It On Ad Campaign may be viewed as (falsely) implying that: (i) Microsoft’s claims about consumer preferences for search engines were based on a generalizable study; (ii) the preferences of five million individuals who have taken the Bing It On Challenge online are either consistent with or the basis for Microsoft’s claim that consumers prefer Bing

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** Yale Law School, J.D. 2014.
*** Yale Law School, J.D. 2013.
nearly 2:1”; and (iii) the search terms Microsoft recommends people use when taking the online challenge are not biased in favor of Bing. Our findings suggest that each of these implicit claims is likely false and might provide the basis for a viable Lanham Act claim by Google.

I. INTRODUCTION

One year ago, Microsoft launched its “Bing It On” Challenge campaign. Advertisements associated with the campaign initially claimed that users prefer Microsoft’s search engine Bing over Google at a nearly 2:1 ratio. Microsoft based this initial claim on a single, undisclosed comparison study with fewer than 1,000 participants. The advertisements continue to invite Internet users to take a blind comparison test for themselves at bingiton.com.

We assess Microsoft’s claims by conducting a randomized, blind comparison study through the Bing It On webpage. We find Microsoft’s 2:1 claim to be implausible and misleading. In light of our findings, we analyze Microsoft’s potential liability to competitors under the Lanham Act for deceptive advertising. Our study offers an example of how large-scale, on-line experiments can prove to be an effective tool for detecting and deterring deceptive advertising.

History of Bing It On

Announced in May of 2009, and released to the public in June of the same year, Microsoft’s Bing search engine is the second-most widely used online search tool in the United States (with a 2013 market share of 16.7 percent, behind market leader Google at 67 percent). Since the search engine’s debut, Microsoft

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2 Wallaert, supra note 1; People Chose Bing, supra note 1.

Microsoft’s “Bing It On” Challenge Claims

has initiated major marketing campaigns to promote Bing, ranging from the Bing Rewards campaign in 2010 to the more recent “Bing It On” challenge.4 Modeled after the classic “Pepsi Challenge” of the 1970s, “Bing It On” challenges users to compare Bing directly against Google Search in a variety of blind searches.5 Microsoft simultaneously launched the campaign through television and Internet advertising. The campaign encourages Internet users “to break the Google habit.”6 A few months after launching, Microsoft’s television advertising urged viewers to “join the 5 million people who’ve visited the challenge.”7

According to Dr. Harry Shum, Corporate Vice President of Bing Research and Development, the Bing It On challenge grew out of internal testing of Bing search algorithms, and a sense within the Bing research team that Bing was ready to take on Google head-to-head.8 Microsoft commissioned Answers Research to conduct a study of nearly 1,000 participants directly comparing the two search engines.9 The study asked participants to enter a series of ten search terms of their choosing into a single search bar and then presented the participants with two unidentifiable browser windows set next to each other, one side displaying Google search results and the other Bing search results.10 Participants recorded their preferred search results. While Microsoft has not released the full methodology and analysis of the study, it reports that participants preferred Bing search results.11

_February_2013_U.S._Search_Engine_Rankings.


9 Id.

10 Id.
over Google “nearly 2:1 in the blind comparison tests.”

Microsoft released a simplified online version of this test at www.bingiton.com, which invites users to conduct a similar blind comparison using only five queries. Launched primarily as an advertising vehicle, bingiton.com prominently featured the 2:1 claim derived from the Answers Research study when it was launched. Microsoft representatives noted in October, 2012 that no specific comparison data from the website was being recorded. Bing General Manager Adam Sohn reported to WebProNews:

> We aren’t keeping track of the results from the Bing It On tool, because it’s non-scientific and was intended to be a fun way for customers to experiment with both search engines, seeing web search results side-by-side from both Bing and Google, hopefully noticing the progress Bing has made over the past few years.

As of April, 2013, however, Microsoft has altered the language on the official Bing It On website by replacing references to the near 2:1 ratio with the language, “in blind tests, people preferred Bing over Google for the web’s top searches.”

Several online blogs and news magazines have sampled the bingiton.com website and shared their experiences. The International Business Times, for example, ran two informal trials, with Google “coming out ahead in both cases, winning 3:2 in the first test and 4:1 in the second.” Paul Shapiro’s blog

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11 Id.
13 Id.
Microsoft’s “Bing It On” Challenge Claims reported an analysis of users posting their Bing It On results on Twitter—posts Microsoft itself solicited—that yielded a nearly 72% preference for Google, with a sample size of 286. These informal trials have cast some doubt on Microsoft’s original claim that consumers prefer Bing to Google 2:1.

The press and bloggers have also criticized the methodology of the Bing It On campaign. For example, PunditPress.com has noted that the search results pages generated by the Bing It On site differ slightly from the same searches run on the main bing.com and google.com websites. Joe Wilcox of betanews.com notes that the Bing It On site strips away location and social information, key functional components of both stand-alone search engines. Some savvy users even claim to be able to distinguish the two search results solely on the basis of page formatting. A study by the Catalyst Group found that users preferred Bing’s visual design over Google’s, but also found that most thought the two search engines produced equally relevant results, and overall, indicated a desire to continue to use Google as their primary search engine.

The concerns raised about Microsoft’s campaign warrant a systematic investigation into the reliability of its claims regarding the Bing It On challenge, and the campaign’s likely effect on consumers. This paper attempts to do just this.

II. METHODOLOGY

Our study employs MTurk to test user preferences for

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18 Paul N. Shapiro, Bing It On! Data Says Google Wins the Bing Search Challenge, PAUL SHAPIRO’S SOC. MEDIA & TECH. BLOG (Sept. 12, 2012), http://blog.paulnshapiro.com/bingiton-google-wins/.
Bing and Google in the Bing It On challenge. MTurk is an online crowdsourcing forum developed and operated by Amazon in which “requesters” pay human “workers” for human intelligence tasks (HITs). These tasks vary in content and have included proofreading, sorting photographs, and completing questionnaires. MTurk payments generally range from $0.05 to $5 per task and vary in accordance with the duration and complexity of the task completed. We restricted participants to MTurk participants who were aged 18 and above, had U.S. IP addresses, and an MTurk reliability rating of at least 80%. We tracked the unique MTurk IDs of survey respondents to eliminate the possibility of duplicate sampling. We initially offered 40 cents per survey and were able to obtain about 400 responses before the response rate slowed. Thereafter, we increased the payment to $1 and rapidly reached our target sample size of 1,000. We conducted the study between January 23 and March 1, 2013.

The study employed a 3x1 design. The study randomly assigned MTurk participants to one of three experimental groups, asked them to take the “Bing It On challenge” on www.bingiton.com, and asked them to fill out a questionnaire reporting their results. Members of the first group were asked to input search terms that were randomly generated from the top 25 Google keywords from 2012. Members of the second group were asked to input the search terms suggested by bingiton.com, while members of the third group were asked to use self-selected terms. All groups entered five search terms into the bingiton.com site. The website generates panels of Bing and Google search results, juxtaposed and stripped of identifying features. The panels for

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24 Id.
Microsoft’s “Bing It On” Challenge Claims

Each search randomly placed the Bing and Google results on the right or left side of the screen, as shown in Figure 1 below. Participants reported to the Bing It On site whether they preferred one panel over the other or preferred the two panels equally (a “tie”).

Figure 1: Bing It On Website Search Results Panels

At the end of five searches, the Bing It On site revealed the preferred search engine for each of the five searches. The study asked participants to report their final results and to submit a screenshot of the results page for confirmation. At the end of the survey, participants were asked to report demographic information, including gender, age, race, education, political ideology, and religious identity.

Reliability & Representativeness

The use of MTurk for social and behavioral science research has led to several investigations into the reliability of responses, with encouraging conclusions. These efforts found that demographic responses were largely truthful, that differences in compensation do not affect the quality of data, and that MTurk

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26 The web appendix includes an example of the search screen, the individual search results screen and the screen showing the identity of the search that produced the preferred result. See Web Appendix, Section II, available at http://islandia.law.yale.edu/ayres/Bing-It-On-Web-Appendix.pdf.


28 M. Buhrmester et al., Amazon’s Mechanic Turk: A New Source of
workers are as attentive as non-Internet participants of studies involving short tasks (defined as tasks that take no more than five minutes).29 One recent study cautioned that MTurk workers perform more poorly than college students on tasks that take longer than fifteen minutes and require attentive reading and English comprehension.30 The study found that MTurk workers perform equally well on such tasks in comparison to community members from a middle class urban neighborhood.31 Additionally, the failure rates of MTurk workers have been found to be correlated with IP addresses from outside of the United States.32 By limiting our sample to U.S. residents and requesting a comparatively simple task, our analysis should not suffer from a deficit of attention or comprehension.

To assess the degree to which our sample represents the population from which Bing could have plausibly collected data, we compared the demographic make-up of our MTurk sample with (1) the general U.S. population, and (2) a large Internet sample gathered by Gosling et. al. in 2004.33 The comparison with a large Internet sample is useful because a large Internet sample might better represent search engine users who are the target of Bing’s advertisements. The results of this comparison are summarized in Table 1 below:

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Cheap, Yet High-Quality Data?, 6 PERSP. ON PSYCHOL. SCI. 3 (2011).
31 Id.
32 Id.
We find that our sample over-represents younger people, whites, and males relative to the general U.S. population. Except for an overrepresentation of men, the sample is consistent with a large Internet sample along relevant demographic dimensions.

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34 Id.
36 Id.
37 Asians are also over represented at 12% compared to 5% in the U.S. population
38 Howden & Meyer, supra note 35.
40 U.S. Religious Landscape Survey: Religious Affiliation: Diverse and Dynamic, PEW F. ON RELIGION & PUB. LIFE 5 (Feb. 2008), http://religions.pewforum.org/pdf/report-religious-landscape-study-full.pdf. (includes respondents who are categorized as atheist (1.6%), agnostic (2.4%), or secular unaffiliated (6.3%). The other categories included Christian (78.4%), other religion (4.7%), religiously unaffiliated, (5.8%) and “don’t know/refused” (0.8%).
We also find that our MTurk sample is more educated than the U.S. population. While the Gosling Internet survey did not measure education attainment, it did use socioeconomic class as a proxy for education and concluded that higher socioeconomic groups are “somewhat overrepresented.”\textsuperscript{42}

Finally, we find large political and religious affiliation gaps between our sample and the U.S. population. This gap is likely a byproduct of our sample’s youth bias, and therefore would show up in Internet samples generally because they also exhibit a youth bias.\textsuperscript{43} Overall, we conclude that while our data is not fully representative of the United States population, its demographic characteristics are generally consistent with online samples of the type that Microsoft relied upon in its Bing It On studies.\textsuperscript{44} Our later regressions investigate whether demographics subgroups exhibit different search preferences.

III. FINDINGS

We obtained 1,008 Bing It On challenge responses from the MTurk platform and narrowed our analysis to 985 respondents who submitted screen shots for 4925 searches. The preference results analyzed at both the respondent level and the search level for each of the three experimental groups are summarized below:

\textsuperscript{42} Gosling, supra note 33, at 98 (finding that 32% identified as upper or upper-middle class, while only 15% identified as working-class and only 1% identified as being poor). Sociologists Thompson and Hickey estimate 16% of America falls in the upper or upper-middle classes and 40-50% fall into the working or lower class. WILLIAM THOMPSON & JOSEPH HICKEY, SOCIETY IN FOCUS (2005).


\textsuperscript{44} Wallaert, supra note 1; People Chose Bing, supra note 1.
2013  Microsoft’s “Bing It On” Challenge Claims

Table 2: Search Engine Preference for 3 Different Types of Search Terms

<table>
<thead>
<tr>
<th>Preference</th>
<th>All Searches</th>
<th>Popular Searches</th>
<th>Self-Selected Searches</th>
<th>Bing-Suggested Searches</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bing Wins</td>
<td>400 (41%)</td>
<td>129 (39%)</td>
<td>112 (35%)</td>
<td>159 (48%)</td>
</tr>
<tr>
<td>Tie</td>
<td>61 (6%)</td>
<td>19 (6%)</td>
<td>24 (8%)</td>
<td>18 (5%)</td>
</tr>
<tr>
<td>Google Wins</td>
<td>524 (53%)</td>
<td>184 (55%)</td>
<td>183 (57%)</td>
<td>157 (47%)</td>
</tr>
<tr>
<td>Total</td>
<td>985</td>
<td>332</td>
<td>319</td>
<td>334</td>
</tr>
</tbody>
</table>

Unit of observation = search:

<table>
<thead>
<tr>
<th>Preference</th>
<th>All Searches</th>
<th>Popular Searches</th>
<th>Self-Selected Searches</th>
<th>Bing-Suggested Searches</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bing Wins</td>
<td>2072 (42%)</td>
<td>673 (41%)</td>
<td>632 (40%)</td>
<td>767 (46%)</td>
</tr>
<tr>
<td>Tie</td>
<td>399 (8%)</td>
<td>129 (7.8%)</td>
<td>138 (9%)</td>
<td>132 (8%)</td>
</tr>
<tr>
<td>Google Wins</td>
<td>2454 (49%)</td>
<td>858 (52%)</td>
<td>825 (52%)</td>
<td>771 (46%)</td>
</tr>
<tr>
<td>Total</td>
<td>4925</td>
<td>1660</td>
<td>1595</td>
<td>1670</td>
</tr>
</tbody>
</table>

Our sample group generally preferred Google to Bing analyzed at both the respondent level (53% to 41%) and the individual search level (49% to 42%). The preference for Google was most pronounced when respondents used popular search terms or selected their own search terms. Respondents who used Bing-suggested search terms preferred Bing and Google in nearly equal numbers.

Table 3 reports, at both the respondent and individual search level, t-tests of the following null hypotheses:

The frequency of Bing wins is equal to the frequency of Google wins. The hypothesis tests Microsoft’s current claim that “in blind tests, people prefer Bing to Google for the web’s top searches.”45

The frequency of Bing wins outnumbers the frequency of Google wins by a 2-to-1 margin. The hypothesis tests Microsoft’s initial claim that “people choose Bing web search results over

45 Wallaert, supra note 1.
Google nearly 2-to-1 in blind comparison tests.”46

Table 3: Statistical Tests of Equal or 2:1 Preference Hypotheses
Unit of observation = respondent:

<table>
<thead>
<tr>
<th>TYPE OF SEARCH TERMS</th>
<th>ALL TERMS</th>
<th>POPULAR</th>
<th>SELF-SELECTED</th>
<th>BING-SUGGESTED</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>TEST OF NULL HYPOTHESIS 1: FREQUENCY OF BING WINS = FREQUENCY OF GOOGLE WINS</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>t-stat</td>
<td>-4.11***</td>
<td>-3.15***</td>
<td>-4.25***</td>
<td>0.1123</td>
</tr>
<tr>
<td>P(Bing =&gt; Google)</td>
<td>0.0000</td>
<td>0.0009</td>
<td>0.0000</td>
<td>0.5447</td>
</tr>
<tr>
<td><strong>TEST OF NULL HYPOTHESIS 2: FREQUENCY OF BING WINS = TWICE THE FREQUENCY OF GOOGLE WINS</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>t-stat</td>
<td>-14.29***</td>
<td>-9.11***</td>
<td>-10.11***</td>
<td>-5.78***</td>
</tr>
<tr>
<td>P(Bing=&gt;2x Google)</td>
<td>0.0000</td>
<td>0.0000</td>
<td>0.0000</td>
<td>0.0000</td>
</tr>
</tbody>
</table>

Unit of observation = search:

<table>
<thead>
<tr>
<th>TYPE OF SEARCH TERMS</th>
<th>ALL TERMS</th>
<th>POPULAR</th>
<th>SELF-SELECTED</th>
<th>BING-SUGGESTED</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>TEST OF NULL HYPOTHESIS 1: FREQUENCY OF BING WINS = FREQUENCY OF GOOGLE WINS</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>t-stat</td>
<td>-5.70***</td>
<td>-4.76***</td>
<td>-6.00***</td>
<td>-.10</td>
</tr>
<tr>
<td>P(Bing=&gt;Google)</td>
<td>0.0000</td>
<td>0.0000</td>
<td>0.0000</td>
<td>0.4594</td>
</tr>
<tr>
<td><strong>TEST OF NULL HYPOTHESIS 2: FREQUENCY OF BING WINS = TWICE THE FREQUENCY OF GOOGLE WINS</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>t-stat</td>
<td>-28.11***</td>
<td>-17.84***</td>
<td>-17.88***</td>
<td>-13.11***</td>
</tr>
<tr>
<td>P(Bing=&gt;2x Google)</td>
<td>0.0000</td>
<td>0.0000</td>
<td>0.0000</td>
<td>0.0000</td>
</tr>
</tbody>
</table>

*Note:* *, **, and *** denote statistical significance to the 0.10, 0.05 and 0.01 levels, respectively.

Our analysis strongly rejects the possibility that web-users prefer Bing search results to those of Google by a 2-to-1 margin in

46 People Chose Bing, supra note 1.
general, and for subjects in each of the three test groups. Subjects who used popular search terms or self-selected search terms had a statistically significant preference for Google over Bing. Subjects who employed search terms suggested by Bing did not exhibit a statistically significant preference for either of the two search engines.

Table 4 reports the results of probit regressions at the individual-search level (dropping “ties”) testing whether the type of search term used, demographic factors, and payment made to respondent ($0.40 through the initial phase versus $1.00 through the second) had statistically significant effects on the likelihood of preferring Bing over Google. The omitted variable for the treatment group is the popular search term group. The omitted variables for demographic characteristics are: Gender: Male, Age: 18-25, Race: White, Politics: Liberal, Religion: None, and Ed: 4yr College.

Table 4: Probit Regression of Bing Preferred Indicator (“tie” observations excluded)

<table>
<thead>
<tr>
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<th>(2)</th>
<th>(3)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bing_Sug</td>
<td>0.06</td>
<td>0.066</td>
<td>0.065</td>
</tr>
<tr>
<td></td>
<td>(2.64)***</td>
<td>(2.94)***</td>
<td>(2.91)***</td>
</tr>
<tr>
<td>Self_Sug</td>
<td>-0.006</td>
<td>-0.001</td>
<td>-0.002</td>
</tr>
<tr>
<td></td>
<td>(0.26)</td>
<td>(0.04)</td>
<td>(0.11)</td>
</tr>
<tr>
<td>Female</td>
<td>0.058</td>
<td>0.058</td>
<td></td>
</tr>
<tr>
<td></td>
<td>(3.05)***</td>
<td>(3.07)***</td>
<td></td>
</tr>
<tr>
<td>Age_26to34</td>
<td>0.037</td>
<td>0.025</td>
<td></td>
</tr>
<tr>
<td></td>
<td>(1.73)*</td>
<td>(1.16)</td>
<td></td>
</tr>
<tr>
<td>Age_35to54</td>
<td>0.046</td>
<td>0.035</td>
<td></td>
</tr>
<tr>
<td></td>
<td>(1.68)*</td>
<td>(1.28)</td>
<td></td>
</tr>
<tr>
<td>Age_55to64</td>
<td>0.089</td>
<td>0.058</td>
<td></td>
</tr>
<tr>
<td></td>
<td>(1.35)</td>
<td>(0.91)</td>
<td></td>
</tr>
<tr>
<td>Age_Over65</td>
<td>0.122</td>
<td>0.104</td>
<td></td>
</tr>
<tr>
<td></td>
<td>(1.05)</td>
<td>(0.84)</td>
<td></td>
</tr>
<tr>
<td>Race_AfAm</td>
<td>0.079</td>
<td>0.069</td>
<td></td>
</tr>
<tr>
<td></td>
<td>(1.99)**</td>
<td>(1.75)*</td>
<td></td>
</tr>
</tbody>
</table>

47 A probit regression estimates the effect that various variables have on the likelihood that an observation would take one of only two possible outcomes. In this case, the two possible outcomes were whether or not a person would prefer Bing-generated search results.
<table>
<thead>
<tr>
<th>Variable</th>
<th>Coefficient_1</th>
<th>Coefficient_2</th>
<th>t-Statistic_1</th>
<th>t-Statistic_2</th>
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<tr>
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<td>0.323</td>
<td>(1.54)</td>
<td>(1.68)*</td>
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<tr>
<td>Race_Other</td>
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<td>0.049</td>
<td>(1.15)</td>
<td>(0.78)</td>
</tr>
<tr>
<td>Pol_Moderate</td>
<td>0.001</td>
<td>0.004</td>
<td>(0.05)</td>
<td>(0.18)</td>
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<tr>
<td>Pol_Conservative</td>
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<td>(1.48)</td>
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<td>Pol_Unaff_Indiff</td>
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<tr>
<td>Rel_Christian</td>
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<td>Rel_nonChristian</td>
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<td>0.041</td>
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<td>(1.17)</td>
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<td>-0.023</td>
<td>(0.68)</td>
<td>(0.38)</td>
</tr>
<tr>
<td>Ed_HSorGED</td>
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<td>-0.004</td>
<td>(0.17)</td>
<td>(0.12)</td>
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<td>-0.011</td>
<td>(0.74)</td>
<td>(0.48)</td>
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<tr>
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<td>0.003</td>
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<td>Ed_DocProf</td>
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<td>(0.39)</td>
<td>(0.37)</td>
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<td>Wave</td>
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<td>(4.49)***</td>
</tr>
<tr>
<td>N</td>
<td>4,526</td>
<td>4,449</td>
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<tr>
<td>Pseudo R²</td>
<td>.0025</td>
<td>.0134</td>
<td>.0182</td>
<td></td>
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</table>

*Note:* z-statistics in parentheses; *, **, and *** denote statistical
Microsoft’s “Bing It On” Challenge Claims

significance to the 0.10, 0.05 and 0.01 levels, respectively. Standard errors are clustered by respondent. The table reports the marginal effects derived from probit coefficients (using STATA’s dprobit procedure) and thus represent the predicted percentage-point effect on Bing preference of changing a right-hand indicator from 0 to 1 (while evaluating all other independent variables at their mean).

We find across our three nested specifications that using Bing-suggested terms (relative to popular terms) results in a statistically significant, 6 percentage point increase in the predicted likelihood of preferring Bing over Google. Females are estimated to be about 6 percentage points more likely than males to prefer Bing, although they still favored Google over Bing on average across all experimental groups. African-Americans, Asians, Native Americans and Pacific Islanders were statistically more likely to prefer Bing than Whites. Overall, the regressions suggest a broad consensus among demographic groups in their general preference for the Google panel over the Bing panel, and in the raw data, there were no substantial race, age, gender or level-of-payment subgroups that displayed an average preference for Bing.

In summary, our findings strongly reject the possibility that internet users would prefer Bing search results to Google search results at anywhere near a 2-to-1 ratio. We also statistically reject the weaker claim of people preferring Bing over Google, except when using search terms suggested by the Bing website, which appear to be biased in favor of Bing when compared to both popular and self-selected search terms. Even when subjects used Microsoft-selected terms, our analysis did not find statistically significant evidence of a preference for Bing. In light of these results, the next section analyzes whether Bing’s initial claim of a 2-to-1 preference as well as other explicit and implicit claims represent proscribed deceptive advertisements under Section 43(a) of the Lanham Act.

IV. LEGAL IMPLICATIONS

The Lanham Act and the Federal Trade Commission Act

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48 Overall, non-tying female respondents still preferred Google. Of our 393 non-tying female respondents, 52.7% preferred Google.

49 Two small racial respondent subgroups (Pacific Islanders and Native Americans) show a slight, non-statistical preference for Bing.

50 However, in the individual search results, African-Americans displayed a slight overall preference for Bing over Google (121 vs. 107 searches).
(FTC Act) govern false advertising at the federal level. Section 43(a) of the Lanham Act proscribes “false or misleading description . . . [or] representation of fact” in commercial advertisements and creates a right of action for competitors.\(^{51}\) The FTC Act authorizes the Federal Trade Commission (FTC) to regulate advertisements in order to protect consumers from false advertisements.\(^{52}\) In addition, numerous state legislatures have passed so called “baby FTC” acts prohibiting unfair and deceptive trade practices, which include provisions against false or misleading advertisements.\(^{53}\) This Section focuses on Microsoft’s potential liability as a result of the Bing It On campaign under the Lanham Act.\(^{54}\)

### The Lanham Act

Section 43(a) of the Lanham Act creates a private cause of action against false or misleading advertising.\(^{55}\) Though the statutory text reads that “any person who believes that he or she is or is likely to be damaged” by false or misleading advertisements can bring suit, federal courts have held that consumers lack standing to sue because the act was enacted “to protect persons engaged in . . . commerce against unfair

\(^{51}\) Lanham Act (Trademark Act of 1946) § 43(a), 15 U.S.C. § 1125(a) (2006) (providing that “(a)(1) Any person who, on or in connection with any goods or services . . . uses in commerce any word, term, name, symbol, or device or any combination thereof, or any . . . false or misleading description of fact, or false or misleading representation of fact, which . . . (B) in commercial advertising or promotion, misrepresents the nature, characteristics, qualities or geographic origin of his or her or another person’s goods, service or commercial activities, shall be liable in a civil action by any person who believes that he or she is or is likely to be damaged by such act.”). The Supreme Court in the coming term’s *Lexmark v. Static Control*, 387 F.3d 522 (6th Cir. 2004), *cert. granted*, 133 S. Ct. 2766 (2013), may determine whether other economic actors have standing to bring Lanham Act deceptive advertising claims.


\(^{53}\) See, e.g., Colorado Consumer Protection Act, COLO. REV. STAT. ANN. §§ 6-1-101 to 6-1-115 (West 2013); CONN. GEN. STAT. § 42-110a to -110g; Uniform Deceptive Trade Practices Act, GA. CODE ANN. §§ 10-1-370 to 10-1-375 (West 2013); OHIO REV. CODE ANN. §§ 41.4165.01-4165.04 (West 2013); Oklahoma Deceptive Trade Practices Act, OKLA. STAT. ANN. tit. 78, §§ 51–55 (West 2013); OR. REV. STAT. ANN. §§ 646.605-656 (West 2013).

\(^{54}\) Microsoft’s liability under the FTC Act and baby FTC acts are considered separately in a web appendix, available at [http://islandia.law.yale.edu/ayres/Bing-It-On-Web-Appendix.pdf](http://islandia.law.yale.edu/ayres/Bing-It-On-Web-Appendix.pdf).

The most obvious plaintiff to bring a Section 43 case against Microsoft for its Bing It On campaign is Google, the target of the disfavoring comparison. Other search engine providers, such as Yahoo or Baidu, might also have standing as competitors of Microsoft. In order to prevail in a Section 43(a) action, the plaintiff must show that defendant’s advertisement falls under interstate commerce and communicates a false or misleading message that materially deceives consumers.

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56 Lanham Act § 45, 15 U.S.C. § 1127 (2006). For cases denying consumers the right to sue, see, for example, Seven-Up Co. v. Coca-Cola Co., 86 F.3d 1379, 1383 n.5 (5th Cir. 1996) ("[W]e have found no case which suggests that ‘consumers’ as such have standing under § 43(a).")); Stanfield v. Osborne Indus., Inc., 52 F.3d 867, 873 (10th Cir. 1995) ("[T]hus, to have standing for a false advertising claim, the plaintiff must be a competitor of the defendant and allege competitive injury."); Serbin v. Ziebart Int’l Corp., 11 F.3d 1163, 1177 (3d Cir. 1993) (holding that the consumers, as noncommercial plaintiffs, do not have standing under the Lanham Act); Colligan v. Activities Club of New York, Ltd., 442 F.2d 686 (2d Cir. 1971) (analyzing the legislative history and purpose behind § 43(a) and concluding that consumers lacked standing to bring action under the Lanham Act); Bacon v. Southwest Airlines Co., 997 F. Supp. 775, 780 (N.D. Tex. 1998) (holding that there is no private cause of action for consumers under the false advertising prong of the Lanham Act).

57 Some Circuits have held that direct competition is not necessary for standing. See Joint Stock Soc’y v. UDV N. Am., Inc., 266 F.3d 164 (3d Cir. 2001) ("Section 43(a) is intended to provide a private remedy to a commercial plaintiff who meets the burden of proving that its commercial interests have been harmed by a competitor’s false advertising. This is not to say that a non-competitor never has standing to sue under this provision; rather the focus is on protecting commercial interests [that] have been harmed by a competitor’s false advertising and securing to the business community the advantages of reputation and good will by preventing their diversion from those who have created them to those who have not.") (citations and internal quotation marks omitted); Havana Club Holding, S.A. v. Galleon S.A., 203 F.3d 116, 130 (2d Cir. 2000). Other Circuits have held that plaintiffs have standing only against “competitive injuries.” See Barrus v. Sylvania, 55 F.3d 468, 470 (9th Cir. 1995); Stanfield, 52 F.3d at 873; L.S. Heath & Son, Inc. v. AT&T Info. Sys. Inc., 9 F.3d 561 (7th Cir. 1993) (denying standing to a non-competitor).

58 Federal courts repeatedly numerated the elements of a Section 43(a) claim as “(1) a false statement of fact by the defendant in a commercial advertisement about its own or another’s product; (2) the statement actually deceived or has the tendency of deceive a substantial segment of its audience; (3) the deception is material, in that it is likely to influence the purchasing decision; (4) the defendant caused its false statement to enter interstate commerce; and (5) the plaintiff has been or is likely to be injured as a result of the false statement, either by direct diversion of sales from itself to defendant or by a lessening of the goodwill associated with its products.” See, e.g., Clorox Co. P.R. v. Proctor & Gamble Commercial Co., 228 F. 3d 24, 33 n.6 (1st Cir.
Under section 43(a), plaintiffs must show that the allegedly false advertisement actually deceives, or has the potential to deceive, consumers regarding a relevant quality of the product. In assessing the degree of deception, courts first identify the express and implied “claims” of an advertisement, and then determine whether these claims are false or misleading. A claim is (1) false if it contains representations that are literally false; and (2) misleading if it contains representations that, while not literally false, nonetheless generate implications that have a tendency to mislead consumers. The actual deception requirement is obviated upon a finding of literal falsity. In other words, literally false advertisements are treated as per se deceptive, and courts do not require evidence of actual consumer deception to prove liability under the Lanham Act. Where the advertised claim is merely misleading, a plaintiff must meet the materiality requirement by showing that the advertisement actually or likely causes consumers to hold a misconception.

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60  SC Johnson & Sons, Inc. v. Clorox Co., 241 F.3d 232, 238 (2d Cir. 2001); Johnson & Johnson v. GAC Int’l Inc., 862 F.2d 975, 977 (2d Cir. 1988) (outlining the two different theories of false advertising as either “(1) an advertisement must be false on its face; or (2) the advertisement may be literally true, but given the merchandising context, it nevertheless his likely to mislead and confuse consumers”).
61  Pizza Hut Inc. v. Papa Johns Int’l., Inc., 227 F.3d 489, 497 (5th Cir. 2000) (“With respect to materiality, when the statements of fact at issue are shown to be literally false, the plaintiff need not introduce evidence on the issue of the impact the statements had on consumers.”).
62  Cashmere & Camel Hair Mfr. Inst. v. Saks Fifth Ave., 284 F. 3d 302 (1st Cir. 2002) (finding a presumption of consumer deception when garments with less than 1% cashmere were labeled as 10% cashmere and where garments labeled “cashmere” were actually “recycled cashmere”); Coca-Cola Co. v. Tropicana Prods. Inc., 690 F.2d 312, 317 (2d. Cir. 1982) (holding that when a challenged representation is shown to be “literally or explicitly false, the court may grant relief without referencing to the advertisement’s impact on the buying public”).
63  Sandoz Pharms. Corps. v. Richardson-Vicks, Inc., 902 F.2d 222, 228-29 (3d. 1990); Am. Home Prods. Corp. v. Johnson & Johnson, 577 F.2d 160, 165-66 (2d Cir. 1978). Litigants typically employ surveys to demonstrate, or rebut, consumer deception. Courts have found material deception when 15% to 20% of respondents report being misled. See Novartis Consumer Health, Inc. v.
In recent years, several circuits have embraced a third category of false advertising, whereby an advertisement is offensive if it is “literally false by necessary implication.” Such advertisements contain statements that, while true, have unambiguous implications that are literally false. Courts define unambiguous implications as unstated claims that an audience nonetheless would unmistakably recognize, as if those claims had been explicitly made. Where this is the case, under the Lanham Act, plaintiffs need not produce explicit, extrinsic evidence of actual consumer deception.

Our study indicates that, while Microsoft makes no literally false claims, several of its implicit representations may be found to be either literally false by necessary implication or otherwise misleading. The following subsections analyze Microsoft’s express and implied claims under the Lanham Act.

A. Analysis of Microsoft’s Express Claims

Microsoft expressly claimed (1) “[i]n blind tests, people choose Bing search results over Google” results at a nearly 2-to-1 ratio, and (2) “[i]n blind tests, people preferred Bing over Google results at a nearly 2-to-1 ratio. See Johnson & Johnson-Merck Consumer Pharms. Co., 290 F.3d 578, 594-95 (3d Cir. 2002) (finding that a material deception rate of 15% was sufficient to demonstrate a likelihood of substantial consumer confusion); However, a misconception rate of less than 10% has been held to be insufficient evidence. See Johnson & Johnson-Merck Consumer Pharms., Co. v. Rohne Poulenc Rorer Pharms., Inc., 19 F.3d 125, 135-36 (3d Cir. 1994) (holding that a misconception rate of only 7.5% was insufficient evidence).

64  A total of six federal circuits have affirmed the doctrine, including the First, Second, Third, Fourth, Ninth and Tenth Circuits. See, e.g., Time Warner Cable, Inc. v. DirecTV, Inc., 497 F.3d 144 (2d Cir. 2007); Zoller Labs. LLC v. NBTY, Inc., 111 F. App’x 978 (10th Cir. 2004); Scotts Co. v. United Indus. Corp., 315 F.3d 264 (4th Cir. 2002); Novartis Consumer Health, Inc. v. Johnson & Johnson-Merck Consumer Pharms. Co., 290 F.3d 578 (3d Cir. 2002); Clorox Co. P.R. v. Procter & Gamble Commercial Co., 228 F.3d 24 (1st Cir. 2000); Southland Sod Farms v. Stover Seed Co., 108 F.3d 1134, 1139 (9th Cir. 1997).

65  Time Warner Cable, Inc., 497 F.3d at 158 (stating that, for a “necessary implication” to occur, an implied claim must be “unmistakable” and “susceptible to no more than one interpretation.”). See also Johnson & Johnson-Merck Consumer Pharms. Co. v. Proctor & Gamble Co., 285 F. Supp. 2d 389, 391 (S.D.N.Y. 2003). Clorox Co. P.R., 228 F.3d at 35 (ruling that an implication is unambiguous “when, considering the advertisement in its entirety, the audience would recognize the claims as readily as if it had been explicitly stated.”).

66  People Chose Bing, supra note 1.
for the web’s top searches.67 Both claims are based on actual tests that Microsoft commissioned. Presuming that Microsoft had indeed conducted blind comparison tests and did not falsify results, it is unlikely that plaintiffs can show that these claims are literally false.68

B. Analysis of Representations Implicit in Microsoft’s Express Claims Regarding Consumers’ General Preferences

Implicit in the reporting of test results is the representation that the results, rather than being specific to participants who took the test, are appropriately generalizable. In Southland Sod, a Ninth Circuit panel held that a chart depicting that “Bonsai” turf grass grew slower in “an independent comparison test” than other fescues necessarily implied (falsely) a general claim about the growth rates of different grasses.69 By the Ninth Circuit’s logic, implicit in Microsoft’s reporting of test results is the representation that Internet users generally prefer Bing over Google by a ratio of 2:1, and this preference holds true for the “web’s top searches.” The generalized implication is strengthened by Microsoft’s current representation, “Wherever we go, people prefer Bing over Google for the web’s top searches.”

Microsoft’s implied claim regarding the preferences of consumers generally can be judged false by demonstrating that the supporting tests were not sufficiently reliable to permit one to conclude with reasonable certainty that the general proposition holds true.70 A Ninth Circuit panel declared that, “[plaintiff[s] may meet this burden either by attacking the validity of the defendant’s tests directly or by showing that the defendant’s tests are contradicted or unsupported by other scientific tests.”71 Effective attacks against the validity of Microsoft’s commissioned study require more information about how it was conducted. Even if the original study was internally valid, the implied claims would still be vulnerable to contradicting scientific tests. Our research indicates that the likelihood of people in the general population preferring Bing over Google at a

67 Wallaert, supra note 1.
68 However, as discussed in the Web Appendix, the second statement’s express claim of applicability to “the web’s top searches” raises the possibility of a misleading finding.
69 Southland Sod Farms v. Stover Seed Co., 108 F.3d 1134 (9th Cir. 1997).
70 Id. at 1139.
71 Id.
2:1 ratio is virtually nil, and the likelihood of people preferring Bing over Google for the most popular web searches is less than 1%. Our results undermine the validity of Microsoft’s tests, and create a strong presumption that an implicit claim of generizability was false.

C. Analysis of Microsoft’s Implicit Representation that Its Express Claims were Based on a Sample Size of 5 Million

After making the “nearly 2:1” claim that the results of blind comparison tests favor Bing over Google, bingiton.com invites visitors to “[d]ecide for yourself which search engine you prefer”73 by taking the online Bing It On challenge. The proximity of the two phrases on the website, combined with Microsoft’s encouragement to “join the 5 million people who’ve visited the challenge,” may be viewed as implying (falsely) that Microsoft’s claims regarding people’s preference for Bing over Google are substantiated by data collected from five million Bing It On challenge takers, rather than data from a single, independent study commissioned by Bing with slightly less than one thousand participants.

A court might find that the advertisement necessarily implies that Microsoft’s claims were based on the larger sample or, alternatively, that the results from the five million blind challenge takers are consistent with the results from the (significantly smaller) commissioned study. Even if a court does not find the representation to be necessarily and unambiguously implied, it might still find that Microsoft’s failure to adequately distinguish the different blind tests has a tendency to mislead consumers. The confusion caused by this failure is likely substantial—the results of our independent study provide strong evidence that the preferences of the five million online challenge takers are not in fact consistent with the purported results of Microsoft’s commissioned study.

The Bing It On website includes a disclaimer in small text at the bottom of the webpage, as well as a hyperlink that takes the visitor to another webpage that provides limited details (“using a representative online sample of nearly 1,000 people, ages 18 and older, from across the US”) about the commissioned study.74 However, courts have often found corrective disclaimers

72 See supra Section III.
74 Id.
inadequate when they are not readily accessible to consumers.\textsuperscript{75} For example, in \textit{American Home Products v. Johnson & Johnson}, the Southern District of New York held, “If the advertisement contains a definition or disclaimer [that] is so inconspicuously located or in such a fine print that readers tend to overlook it, it will not remedy the misleading nature of the claim.”\textsuperscript{76} Furthermore, the Third and Fourth Circuits have voiced doubts over whether disclaimers can ever correct for a literally false claim, whether it is explicitly false or false by necessary implication.\textsuperscript{77}

The Bing It On disclaimer is particularly weak; it only clarifies that the reported test was “[b]ased upon a comparison of web search results panes only; excludes ads, Bing’s snapshots and Social Search panes and Google’s Knowledge graph.”\textsuperscript{78} The disclaimer merely describes the testing conditions employed by the commissioned study, which appear to be identical to the conditions employed by Microsoft to test the preferences of five million online users who took the Bing It On Challenge. The disclaimer does not indicate that the “blind test” that the 2:1 claim refers to was based on data collected independently of the online Bing It On Challenge, and on a sample size considerably smaller than five million.

The second sentence of the disclaimer references a “study,” but it is the only use of the word in the entire advertisement, leaving readers unclear as to what is being referenced. Only after clicking on the hyperlink and reading several paragraphs does the visitor learn that the study refers to a series of blind tests that were distinct from the Bing It On challenge.\textsuperscript{79} The necessary information is hidden away on a separate website. As a result, Microsoft’s disclaimer is likely to be judged inadequate.

\textsuperscript{75} \textit{See}, \textit{e.g.}, \textit{Giant v. FTC}, 322 F.2d 977 (D.C. Cir. 1963) (finding that the term “manufacturer’s list price” in an advertisement misled consumers to believe that the price was the competitive sales price and holding that a small print disclaimer explaining the meaning of “manufacturer’s list price” was insufficient to correct for consumer deception).


\textsuperscript{77} \textit{Scott v. United Indus. Corp.}, 315 F. 3d 264, 276 n.4 (4th Cir. 2002) (“If the graphic conveyed a literally or impliedly false claim, then the disclaimer might not be sufficient to eliminate the confusion.”).

\textsuperscript{78} \textit{BING IT ON}, http://www.bingiton.com (last visited October 17, 2013).

\textsuperscript{79} \textit{Wallaert}, \textit{supra} note 1.
D. Analysis of Microsoft’s Unstated Implication that the Bing It On Challenge is Free from Bias

The Bing It On Challenge is advertised as a “Bing vs. Google” comparison test available to visitors. An implicit claim imbedded in this invitation is that the comparison tests will not be biased—that the suggested search terms on bingiton.com were not chosen to favor Bing. This implication of lack of bias is clear from the description of the test as “blind” and the disclaimer emphasizing that search results strip away identifying characteristics. Yet our analysis of MTurk data indicates that the search terms suggested by Microsoft were likely biased in favor of Bing. As a result, Microsoft’s representation regarding the impartiality of its testing procedure is likely false.

We found that the preference for Google over Bing was significantly higher when subjects used popular search terms (55% to 39%) and self-selected search terms (57% to 35%) rather than Bing-suggested terms (47% to 48%). Regression analysis indicates (at the 95% confidence level) that using Bing-suggested terms significantly increased the likelihood of preferring Bing search results in the Bing It On Challenge. These findings create a strong presumption that Microsoft made strategic choices regarding the search terms that were recommended on the Bing It On website. Though the unbiased nature of suggested terms is only implied by the advertisement, courts are likely to find it to be a necessary implication, as the Bing It On Challenge’s advertised message of Bing being superior to Google would be undermined without it.

V. CONCLUSION

This article reports the results of a randomized experiment assessing the robustness of Internet-user preferences for Bing or Google search results on the www.bingiton.com challenge site. Although Microsoft has claimed that in an independent study nearly two out of three users preferred Bing, this article performed a similarly sized study and was not able to replicate the Microsoft result. On the contrary, we found a statistically significant preference for Google results over Bing results using

80 BING IT ON, supra note 79.
81 See Southland Sod Farms v. Stover Seed Co., 108 F.3d 1134, 1144 (9th Cir. 1997) (stating that a claim is a necessary implication where alternative meanings are “nonsensical”).
Microsoft’s own challenge site. Moreover, the results of our study suggest that Microsoft recommends that online users taking the Bing It On challenge employ search terms that are statistically more likely to produce user preferences for Bing than terms chosen by the users or those that appear on a list of popular search terms. Google likely has a viable Langham Act claim against Microsoft for making advertising claims with misleading “necessary implications.”
THE FORECLOSURE ECHO: HOW ABANDONED FORECLOSURES ARE RE-ENTERING THE MARKET THROUGH DEBT BUYERS

Judith Fox*

“Officer, that couple is just walking away from their mortgage!”

* Clinical Professor of Law, Notre Dame Law School.

I. INTRODUCTION

The financial crisis and resulting rise in home foreclosures has drawn a great deal of attention in recent years.\(^2\) As housing prices fell and mortgage defaults grew, the financial services industry began to complain about a perceived increase in “strategic defaults.”\(^3\) A strategic default is a voluntary mortgage default and the subsequent abandonment of the home by a homeowner who has the financial ability to pay the mortgage. There is considerable debate among contract scholars about the morality of this action and I leave that debate to them.\(^4\) A more practical question is whether strategic defaults actually occur. Numerous researchers have tried to determine the circumstances

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under which homeowners choose strategic default. However, strategic defaults are not easily quantifiable because, as one industry study explains, “while the total number of defaults can be measured with a high degree of precision, whether or not those defaults are due to an inability to pay or an unwillingness to pay is typically unobservable from market data.” Therefore, the evidence to support the contention that the foreclosure crisis was caused by widespread strategic default is mixed, at best.


See generally Bhutta, supra note 5, at 29 (estimating that one in five mortgage defaults in the sample were strategic); Ghent, supra note 5, at 3177 (finding that borrowers with property values over $200,000 at origination, in non-recourse state increases the possibility of strategic default); Deng, supra note 5, at 303 (concluding that the heterogeneity of mortgage borrowers cause variations in default behavior); Foote, supra note 5, at 245 (unable to verify
most we can say is there is some evidence to suggest strategic defaults are higher for well-to-do homeowners with expensive homes located in states where lenders cannot obtain deficiency judgments after default. Despite this, the financial industry has spent much time and effort creating models to predict strategic default instead of working to mitigate the losses in foreclosure. In response, and in light of widespread reports of lender abuse, some commentators have actually begun to advocate strategic default as a smart economic strategy. Thus, it is unlikely that

8 Ghent, supra note 5, at 3177. A deficiency judgment is an amount still owed to the lender at the end of the foreclosure process. For a more detailed discussion of deficiency judgments, see discussion infra Part III.


the rise in foreclosed and abandoned properties\textsuperscript{12} was caused by strategic defaults.\textsuperscript{13} Instead, the cause may be a systematic abandonment of low and moderate income neighborhoods by the housing industry.\textsuperscript{14}

Whether strategic or not, mortgage defaults increased steadily from 2006 through 2011.\textsuperscript{15} In some situations, lenders moved swiftly after default to foreclose the property; but for other homeowners the foreclosure process began and then stalled or was completely abandoned by the lender.\textsuperscript{16} The result of these

\begin{footnotesize}
\begin{enumerate}
\item Commission Report, supra note 2, at 214-21 (describing the increase in mortgage deficiency by type of loan and region of the county); Shane M. Sherlund, Mortgage Defaults (Mar. 8, 2010), available at http://www.chicagofed.org/digital_assets/others/region/foreclosure_resource_center/more_mortgage_defaults.pdf (showing an increase in mortgage defaults beginning in 2006, but real acceleration in 2009).
\item Linda Allen, Stavros Peristiani, & Yi Tang, Bank Delays in the Resolution of Delinquent Mortgages: the Problem of Limbo Loans (Fordham
abandoned foreclosures has been devastating to cities and consumers throughout the country.17 This article explores what is happening to homeowners caught up in the strange world of bank walkaways as the economy is beginning to improve. This second wave of collection activity, an echo of the original foreclosure crisis, could easily throw thousands of consumers back into financial hardship just as the economic recovery begins.

Part I of this article explores the evidence of foreclosures started and then stalled or abandoned and their impact on consumers and communities. In Part II “the real zombie title” is introduced through evidence gathered in foreclosures in Indiana. This new form of “zombie loan” is a mortgage loan that has been foreclosed, but is suddenly and inexplicably “un-foreclosed.” The effect of zombie loans on homeowner, judicial system and communities is also explored. Finally, Part III discusses the increased presence of debt buyers in both the buying of loans and the collection of deficiency judgment in relation to the overall

University Schools of Business Research Paper No. 2018948), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2018948 (finding 21.79% of the loans in their sample of Florida foreclosures to be limbo loans); Linda E. Fisher, Shadowed by the Shadow Inventory: A Newark, New Jersey Case Study of Stalled Foreclosures and Their Consequences, 3 U.C. Irvine L. Rev. (forthcoming 2013) (finding that 37% of the cases in her study were in legal limbo); MICHAEL SCHRAMM, APRIL HIRSH, DIWAKAR VANAPALLI, DANIEL J. VAN GROL, KRISTA MOINE NELSON, & CLAUDIA COLTON, CENTER ON URBAN POVERTY AND CMTY. DEV., MANDEL SCH. OF APPLIED SOC. SCIENCES,STALLING THE FORECLOSURE PROCESS: THE COMPLEXITY BEHIND BANK WALKAWAYS (Feb. 2011), available at http://blog.case.edu/msass/2011/02/07/CUPCD_2011_02_07_Stalling%20the%20foreclosure%20process-%20complexity%20behind%20bank%20walkaway.pdf (examining bank walkaways in Cleveland and finding that in 17% of their sample the bank had affirmatively walked away and in another 39% there was an unexplained delay by the bank in the foreclosure); KATIE BUTRAGO, WOODSTOCK INSTITUTE, DECIPHERING BLIGHT: VACANT BUILDINGS DATA COLLECTION IN THE CHICAGO SIX COUNTY REGION 3 (June 2013) [hereinafter DECIPHERING BLIGHT], available at http://www.woodstockinst.org/sites/default/files/attachments/decipheringblight_buitrago_june2013.pdf (“the phenomenon of foreclosures that are initiated but not pursued to auction increased the likelihood that the properties become vacant”).

17 See generally Pinkston, supra note 10. These calls to default are often connected to reports of lender misbehavior, including the evidence that banks make similar decisions about walking away from properties that are too far underwater to be worth foreclosing. See supra note 11 and accompanying text.
concern currently being voiced regarding the debt buying industry. The clever ways banks are managing their foreclosure inventory make clear that the effects of zombie loans must be mitigated in order to avoid a second economic downturn, the “foreclosure echo.”

II. ABANDONED FORCLOSURES

Abandoned foreclosure, bank walkaway, “zombie title,” and “limbo loan” are all terms used to describe a situation where a homeowner is in default, but the foreclosure does not proceed in the normal fashion to the eventual sale of the. The phenomenon first surfaced in Midwestern rust belt states. Congress, at the urging of Ohio representatives, called for an investigation into the relationship between vacant properties and abandoned foreclosures. The General Accounting Office commenced a study that was released in November 2011. The study was limited in that it only examined loans owned by the large servicers and government sponsored entities. It concluded that most servicers do an equity analysis before determining whether to initiate a foreclosure. When it is not economically beneficial to foreclose, the lender charges-off the loan without initiating a foreclosure.

18 Different authors and commentators are using different terminology for the same actions. See GAO-11-93, supra note 10 (“abandoned foreclosure”); Allen et al., supra note 16 (limbo loans); SCHRAMM ET AL., supra note 16 (using the terminology “walkaway”); Michelle Conlin, Special Report: The latest foreclosure horror: the zombie title, REUTERS (Jan. 10, 2013, 1:58 PM), http://www.reuters.com/article/2013/01/10/us-usa-foreclosures-zombies-idUSBRE9090G920130110 (coined the term “zombie title”).


20 GAO-11-93, supra note 10.

21 Id. at 14.

22 Id. at 15.

23 The accounting term “charge-off” means the company writes off the loan as uncollectable. This allows the bank to take a tax deduction for the loss.
Some lenders reported initiating a foreclosure, but abandoning it before the property was brought to final foreclosure sale. As illustrated in the GAO chart reproduced below, properties evaluated in the study were significantly more likely to be abandoned by the homeowner if the loan was charged-off after the foreclosure was initiated than if the charge-off occurred before the foreclosure process began.

<table>
<thead>
<tr>
<th>Table 1: Numbers of Charge-offs in Lieu of Foreclosure by Foreclosure and Occupancy Status, January 2008 through March 2010</th>
</tr>
</thead>
<tbody>
<tr>
<td>Foreclosure not initiated</td>
</tr>
<tr>
<td>Total charge-offs in lieu of foreclosure</td>
</tr>
<tr>
<td>Occupancy status of properties from point of charge-off in lieu of foreclosure to June 2010:</td>
</tr>
<tr>
<td>Property occupied</td>
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<tr>
<td>Property vacant</td>
</tr>
<tr>
<td>Source: GAO analysis of data reported by six servicers.</td>
</tr>
</tbody>
</table>

While the number of abandoned homes related to abandoned foreclosures in this study was small as a percentage of all foreclosures, they were concentrated in certain areas, thus becoming a disproportionate problem for those communities. Of those identified communities, most were located in the Midwest. Since then, individual studies have documented the problem in Chicago, Illinois; Cleveland, Ohio; Newark, New Jersey; and the state of Florida.

The lender can continue with collection efforts or sell the loan.

24 GAO-11-93, supra note 10, at 15.
25 Id. at 16.
26 Id. at 17.
27 Id.
28 Id. at 16.
29 Detroit, Chicago, Cleveland and Indianapolis had the largest numbers of abandoned homes due to abandoned foreclosures. Of the top twenty, thirteen were in the Midwest. South Bend and Mishawaka, Indiana, though not listed in the top cities, were identified as communities where the overall number was too small to put them in the top twenty, but whose numbers of abandoned properties as a result of abandoned foreclosure were significant relative to the size of the community. Id. at 22.
30 See Allen et al., supra note 16; Fisher, supra note 16; Schramm et al.,
There can be significantly different legal consequences to homeowners depending on when in the default process the foreclosure is abandoned or what state the homeowner lives in. The case-specific information contained in this paper is from Indiana, a judicial foreclosure state.31 Some of the negative consequences to be discussed in this paper are only relevant to homeowners who live in a judicial foreclosure state. Others will only affect you if your state allows deficiency judgments. For some, your location does not matter. Thus far, all of the available studies have been conducted in judicial foreclosure states. This may be because the judicial process lends itself to inquiry. You can measure how many cases are filed and how many are followed through to completion. No such records exist in non-judicial foreclosure states. It may also be that the very definition of an abandoned foreclosure requires there to be some kind of “process” that was started and never finished. However, there are also homeowners in default, but for whom no foreclosure has occurred in non-judicial foreclosure states;32 however, it is harder to document those cases.

Because all the available studies of abandoned foreclosures are from judicial states, the focus of this discussion will be about the implications of these cases in judicial foreclosure settings. The specific procedures for judicial foreclosure vary from state-to-state, but as a general rule, once the homeowner defaults, the lender files a court action, obtains a foreclosure judgment, and then sells the property to satisfy that

supra note 16; DECIPHERING BLIGHT, supra note 16.


32 Realty Trac tracks foreclosure filings nationally. They report that the pre-foreclosure inventory rose 59% in the first quarter of 2013. The rise was not exclusive to judicial states, suggesting that the stalled foreclosure is not exclusively a judicial state phenomenon. REALTY TRAC, EXCLUSIVE REPORT: Q1 2013 FORECLOSURE INVENTORY UPDATE 1, 3 (2013), available at http://www.realtytrac.com/images/reportimages/RealtyTrac_Foreclosure_Inventory_Analysis_Q1_2013.pdf.
judgment. If there is no buyer at the sale, the bank will often re-purchase the asset. Evidence that a foreclosure can be abandoned at any stage of the process is provided by a review of Irwin Mortgage’s foreclosure filings in the doxpop electronic filing system from 2006 and 2007. Of the 157 foreclosures filed by Irwin Mortgage during this period, nearly one third could be categorized as abandoned foreclosures. Twenty-nine were filed and dismissed. Nine cases went to judgment, but the foreclosure sale never occurred. In another nineteen cases, judgment was entered and then vacated by the bank. The Governmental Accounting Office’s research concluded that most loans are charged-off before foreclosure is initiated. The situation that has created the most controversy, however, is when the foreclosure action is filed, but abandoned before a foreclosure judgment is entered.

A. Foreclosure Filed and Then Dismissed

It is difficult to calculate the number of borrowers whose loans have simply been charged-off by the bank prior to initiating foreclosure; evidence from the six largest servicers prior to 2010 documents the number at fewer than 20,000. Subsequent studies and anecdotal evidence suggest the phenomenon is far

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33 Id.
34 The failure of banks to maintain these properties is another serious, related problem. A growing body of evidence suggests that even if they do not walk away from the foreclosure, lenders are walking away from the property. See generally, NATIONAL FAIR HOUSING ALLIANCE, THE BANKS ARE BACK—OUR NEIGHBORHOODS ARE NOT: DISCRIMINATION IN THE MAINTENANCE AND MARKETING OF REO PROPERTIES (2012) [hereinafter BANKS ARE BACK], available at http://www.nationalfairhousing.org/Portals/33/the_banks_are_back_web.pdf (examining the condition of bank owned properties in seven different communities across the country and finding significant disparities in how the banks maintained properties in majority white as opposed to minority neighborhoods).
35 Doxpop is an electronic database of court filings available at www.doxpop.com. Docket sheets are available for 82 counties in Indiana. Copies of the case docket are available, though copies of individual filings are not.
36 GAO-11-93, supra note 10, at 16.
37 Conlin, supra note 18.
38 GAO-11-93, supra note 10, at 17.
39 Allen et al., supra note 16, at 16 (concluding that 1/5 of all Florida’s
more pervasive. A foreclosure that is never filed, or one that is filed and later dismissed, is a mixed bag for consumers, but it is a better situation for neighbors. The GAO study found that 70% of homeowners remain in their homes if the loan is charged off and foreclosure never initiated.41

If foreclosure is initiated, and then dismissed, the numbers drop to only 52%, though still more homeowners remain in their homes than abandon them.42 Take, for example, the story of Melissa Jones.43 Ms. Jones and her husband had a stable financial life until Mr. Jones became ill. As his situation deteriorated, Melissa found herself unable to work full time because of the need to be at home to care for her dying husband. When he finally passed away, the decline in her own income coupled with the loss of his disability income drove her into foreclosure. The bank filed a foreclosure action. This foreclosure was initiated early in the foreclosure crisis before any viable programs for loan modification were available for homeowners.44 When the

subprime mortgages originated between 2004 and 2008 are at some point “limbo loans.”); Fisher, supra note 16 (finding that 37% of the cases in her study in Newark, New Jersey were in legal limbo); SCHRÄM ET AL., supra note 16 (examining bank walkaways in Cleveland and finding that in 17% of their sample the bank had affirmatively walked away and in another 39% there was an unexplained delay by the bank in the foreclosure); DECRYPTING BLIGHT, supra note 16 (finding that abandoned foreclosure increased the likelihood of a property being vacant in Chicago).

40 For examples of homeowners caught up in abandoned foreclosures, see Conlin, supra note 18; Susan Saulny, When Living In Limbo Avoids Living On the Street, N.Y. TIMES, March 4, 2012, at A14.
41 GAO-11-93, supra note 10, at 17. The study found that in 70% of the cases they looked at where foreclosure had not been initiated, the homeowner was still in the home.
42 Id.
43 Not her real name. The circumstances of this story and other client stories contained in this article are factual. Unless previously released to the press, I have changed the client’s name and inconsequential details to preserve the homeowner’s privacy. All parties consented to their stories appearing in this article.
44 The Hope for Homeowners program was initiated in 2008. It was a voluntary program and widely considered a failure. In the first seven months of the program only one borrower in the entire country had obtained a refinance. McCoy, supra note 10, at 10. The Obama administration made changes that did allow more homeowners to be assisted, but many still feel not enough is being done to assist homeowners. See generally Alan M. White, Rewriting Contracts, Wholesale: Data on Voluntary Mortgage Modifications from 2007 and 2008 Remittance Reports, 36 FORDHAM URB. L.J. 509 (2009);
students at Notre Dame’s Economic Justice Project\textsuperscript{45} examined the paperwork for the loan foreclosure, they became suspicious. After some investigation and diligent searching, the students located the bank employee who had allegedly signed the documents. More accurately, they found the woman whose name appeared on the paperwork. She had not, in fact, signed them. Instead, someone else had signed her name and she signed an affidavit for the Economic Justice Project attesting to the forgery.\textsuperscript{46} When these errors were brought to the bank’s attention, they dismissed the foreclosure, with prejudice.\textsuperscript{47}

In a study of Florida foreclosures, Allen, Peristianui and Tang, tested whether lost or missing documentation could account for the abandoned foreclosures they discovered in their Florida study.\textsuperscript{48} They dubbed this the “operational risk hypothesis.”\textsuperscript{49} They found that the “greater incidence of foreclosure case dismissals (resulting from legal and operational

\textsuperscript{45} The Economic Justice Program is the consumer clinic the author supervises as part of the Notre Dame Law School’s Clinical Law Center. Students, usually in their final year of law school, represent low and moderate-income clients against foreclosure and related debt collection.

\textsuperscript{46} These documents are on file with the author. This occurred years before the robo-signing scandal became news. At the time, no one had heard of robo-signing. Now we know that such occurrences were common in the industry. See generally DAVID H. CARPENTER, CONG. RESEARCH SERV., RL 41491, “ROBO-SIGNING” AND OTHER ALLEGED DOCUMENTATION PROBLEMS IN JUDICIAL AND NONJUDICIAL FORECLOSURE PROCESSES 14 (2010) [hereinafter ROBO-SIGNING].

\textsuperscript{47} A dismissal with prejudice would mean the lender cannot re-initiate the foreclosure filing. However, the Indiana Court of Appeals, in Afolabi v. Atl. Mort. & Inv. Corp., had found there is neither res judicata or claim preclusion prevented the lender from initiating foreclosure after a previous foreclosure had been lost in summary judgment. Afolabi v. Atl. Mort. & Inv. Corp, 849 N.E.2d 1170, 1173 (Ind. Ct. App. 2006). Each missed payment triggers a new default and a new right to foreclose. \textit{Id.} While the facts in Ms. Jones’s case are distinguishable, it was not entirely clear that the bank could not re-file the foreclosure.

\textsuperscript{48} Allen et al., \textit{supra} note 16, at 5.

\textsuperscript{49} \textit{Id.} at 17.
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problems) is associated with a greater likelihood that a loan remains in limbo.”

Similarly, the Governmental Accounting Office found that “[t]he vast majority of abandoned foreclosures were loans that involved third-party investors including those that were securitized into private label [mortgaged-backed securities].”

Interestingly, the evidence from Florida also found that “the presence of MERS makes a delinquent loan more likely to end up in limbo.” Melissa’s loan was a MERS loan as well. The theory behind the MERS system is that MERS acts as the registered mortgage holder, allowing the mortgage to be sold while MERS maintains records of the equitable owner. Unfortunately, the theory failed to translate well into practice and research shows that MERS has not operated as intended.

In theory, one of two things should have occurred. Either the originating lender should have prepared “a blank mortgage assignment to be filled in later in the event that recording the assignment became necessary for foreclosure purposes” or MERS should have recorded the mortgage in its name as “nominee” and then kept track of the beneficial owner. However, Professor White presents a third option, which was to “take neither step, so that when foreclosure becomes necessary, the servicer is forced to obtain an assignment (or perhaps fabricate one) from the original lender to the current owner.”

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50 Id. at 28 (finding that “one-standard-deviation increase (14.2%) in dismissals is associated with a 9.4% increase in the probability that the loan remains in limbo.”)
51 GAO-11-93, supra note 10, at 28.
52 MERS is the Mortgage Electronic Registry System. It was created to allow for the easy buying and selling of loans by “eliminating the need to record each mortgage assignment in county property records.” Alan M. White, Losing the Paper - Mortgage Assignments, Note Transfers and Consumer Protection, 24 LOY. CONSUMER L. REV. 468, 486 (2012); See generally Commission Report, supra note 2, at 407 (explaining how standing problems with MERS exacerbated the foreclosure problems); Christopher L. Peterson, Two Faces: Demystifying the Mortgage Electronic Registration System’s Land Title Theory, 53 WM & MARY L. REV. 111 (2011) (describing MERS and its purpose, creation, and the problems it created in the land recording system).
53 Allen et al., supra note 16, at 28.
54 White, supra note 52, at 486.
55 Id. at 485-88.
56 Id. at 485.
57 Id.
58 Id.
This is exactly what happened in Melissa’s case. When the lender wanted to foreclose, the servicer did not have the paperwork. The original lender had been out of business for several years. An assignment was fabricated, ultimately resulting in the foreclosure being dismissed. Considering the many paperwork problems discovered in relation to securitized loans, it is not surprising that these loans would be disproportionately abandoned.

Dismissal in a mortgage foreclosure may seem like a good result for a homeowner, but in many ways it is not. After the dismissal, Melissa was in legal limbo. She made multiple attempts to contact the bank to negotiate ways to pay back the loan, but the bank had charged-off the loan so they would not discuss repayment with her. She did not have a clear title to facilitate a sale. The Economic Justice Project filed a quiet title action and was able to permanently remove the mortgage lien from her property. Removing the mortgage, however, does not solve the entire limbo loan problem. The original note, if it exists, can still be enforced against the homeowner. Indiana follows the common law rule that the mortgage follows the note. Granted, the mortgage was extinguished in the quiet title action, but this is such an unusual situation that it is hard to predict what a court might do with these facts. If the note ever re-appears, Melissa will owe a huge debt that she cannot possibly pay off.

A pro se petitioner will likely have trouble succeeding on, let alone filing, a quiet title action. Most consumers in foreclosure are unrepresented and, therefore, will be unable to remove the

59 See generally White, supra note 522 (describing many of the paperwork problems that appeared during the foreclosure crisis); ROBO-SIGNING, supra note 466, at 9 (describing how robo-signing and other issues manifest themselves in judicial foreclosure states).
61 This was codified in the IND. CODE ANN. § 26-1-9.1-203(g) (West 2013). See generally Whaley, supra note 60, at 320–23 (explaining the merger doctrine and the common law rule the “the mortgage follows the note”).
62 MELANCA CLARK & MAGGIE BARRON, BRENNAN CENTER FOR
mortgage lien from their home. If these homeowners need to move for business or personal reasons, their only option is to abandon the home.

**B. Foreclosure Filed, Then Stalled**

Another category of borrowers are those for whom home foreclosure was filed in court, but not prosecuted to completion. These might best be called “stalled,” as opposed to abandoned, foreclosures. Some of these foreclosures are stalled because the lender cannot locate the proper paperwork, while others are in the endless loop that has become loss mitigation, and an undetermined number are bundled into new securities and sold back into the secondary market, often along with performing mortgages. Some lenders may simply be waiting for the economy to improve before proceeding. This is what happened to Nick, another client of the Economic Justice Project.

Nick was sued for foreclosure in May 2010. At the time he was unemployed and did not qualify for a loan modification. He resigned himself to losing the house and put it up for sale. He was unable to find a buyer. He tried unsuccessfully to contact the bank. Nearly three years passed and then, unexpectedly, the bank asked the court to enter a foreclosure judgment. A new servicer was involved. Nick is now working and can afford to make payments. He is attempting to work with the bank to retain the home. This case is likely to have a happy ending; or is it?

A stalled foreclosure case raises a number of problems for
the homeowner. Three years of interest and fees can substantially increase the balance due on a mortgage. It exacerbates the problem many homeowners already experience: that they owe more on the home than the home is worth. Faced with this dilemma, some may choose to walk away from the property.

The buying and selling of these distressed mortgage assets has become big business, again suggesting the number of these nonperforming loans is not small. Some of these buyers are willing to work with homeowners; others are looking to foreclose and flip the property. It is hard to know which is more

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68 Some have argued that this is a deliberate attempt to increase fees for the servicers. See McCoy, supra note 10, at 41–44 (for an explanation of the fee structure associated with mortgage servicing).

69 And now we have come full circle. Those who may not have strategically defaulted, strategically choose to give up attempts to save the home when faced with the growing balance due. The industry has doggedly resisted any principal write downs to save homes from foreclosure, even when the “principal” is really capitalized interest and fees.


beneficial to the economy; occupied homes are usually better than vacant properties, but homeowners whose loans are sold to investors can be left in uncertain and often expensive situations.

C. Foreclosure Abandoned After Judgment, Pre-sale

Troubling stories have surfaced concerning homes that were foreclosed, but never sold to satisfy the judgment.72 Mercy is one such mortgage holder.73 In 2007, the Economic Justice Project represented almost exclusively mortgage defense clients. Mercy came in for assistance with a property issue that did not seem to fit the typical foreclosure profile. The Project’s student intern and I almost turned her away. Had we done so, I would not be writing this article. Mercy’s case first made me aware of the devastating effects of bank walkaways.

Mercy was a recent immigrant, unsophisticated in American real estate practice. A local real estate investor convinced her that the way to succeed in America was through land speculation. She and several other recent immigrants were persuaded to purchase several rental properties.74 In one day, through one closing, Mercy signed closing documents for ten loans, several with the same bank. All the properties were rental properties, allegedly occupied with tenants. As it turned out, none of the properties had tenants and most were not habitable. The loan documents she signed accurately reflected her poverty-level income and lack of knowledge in real estate management. However, she never saw the documents submitted to the banks.

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72 See Conlin, supra note 18 (describing what she dubs the “zombie title” as a situation where the homeowner thinks his or her home was lost in foreclosure, only to discover the bank never took title and there are thousands of dollars of fees owed to local governments); Podmolik, supra note 19 (discussing the problems loan walkaways are creating for municipalities); Saulny, supra note 19 (explaining the story of loans abandoned after judgment).

73 See Saulny, supra note 19 (featuring Mercy in one of the early stories of bank walkaways).

Unsurprising, all the properties fell into foreclosure almost immediately.\(^75\)

Interestingly, it was not one of these foreclosures that brought Mercy to my office, but a notice from the City of South Bend informing her that one of her properties was in violation of city building codes. Mercy was confused. Two years earlier, she had appeared in St. Joseph Superior Court and agreed to the foreclosure and sale of this property.\(^76\) When Mercy came to my office, she brought a copy of the notice for sheriff’s sale. She had abandoned the property prior to the June 2007 sale date, and had not visited the property since. We were sure there had been a mistake and contacted the city to explain that Mercy no longer owned the property. We were wrong. The bank had filed the foreclosure. Mercy had, in fact, appeared in court and agreed to the entry of a judgment. The judgment had been entered, just as she remembered. The bank had requested a sheriff sale and a date had been set. Notice of that sale was sent to Mercy, as required by Indiana law.\(^77\) What Mercy did not know was that the sale never occurred. The bank cancelled it, presumably because it determined that the home was not worth selling. Mercy did not receive notice that the sale had been cancelled because no such notice is required by Indiana law. The property remained in Mercy’s name; therefore, she remained legally responsible for the maintenance.\(^78\) Unfortunately for Mercy, the city and her former neighbors, she had no knowledge of this obligation. The property had been uninhabited for a year and in that time vandals had stolen nearly everything of value, including the copper pipes and appliances. Eventually, the property was demolished.

\(^{75}\) Cause No. 71-CO1-0605-MF-00430; 71-C01-0605-MF-00441; 71-C01-0605-MF-00440; 71-DO1-0606-MF-00611; 71-CO1-0606-MF-00497; 71-DO7-0606-MF-00557; 71CO1-0606-MF-00483; 71DO5-0807-MF-00723; 71DO6-0605-MF-00484. The mortgage on the tenth property has not been paid in many years, though no foreclosure has been filed. The property is not habitable.

\(^{76}\) Judgment was entered on 7/10/2006. The sale was set for 6/21/2007. 71-D07-0696-MF-00557.

\(^{77}\) IND. CODE ANN. § 32-29-7-3(c) (West 2013).

\(^{78}\) Under Indiana law, the home remains in the name of the homeowner until sheriff’s sale. The foreclosure judgment allows the bank to petition for the sale, but it does not divest the homeowner of ownership of the property. IND. CODE ANN. § 32-29-7-11 (West 2013). In normal times, this was a good thing. In the era of abandoned foreclosures, it has become a nightmare for many homeowners.
Mercy’s story is all too common.\(^{79}\) Through conversations with the City of South Bend’s code enforcement office, we discovered that this “happens all the time.”\(^{80}\) A special report by Reuters documented homeowners in Columbus, Ohio, Cleveland, Ohio and Buffalo, New York facing similar circumstances.\(^{81}\) The number of cases in front of Cleveland Housing Court Judge Raymond Pianka involving “derelict properties” has doubled in recent years, “due largely to homes vacated by people who fled before an imminent foreclosure sale, only to learn later that they remain legally responsible for their house.”\(^{82}\) A Woodstock Institute study of vacant properties in Chicago found that homes were more likely to become vacant when foreclosure was initiated, but not followed through to sale.\(^{83}\) This situation can create different problems, depending on the laws in your particular community. In Cleveland, the homeowner can find herself facing multiple fines and court costs. In Mercy’s hometown of South Bend, Indiana, the number of these cases has doubled since 2006.\(^{84}\)

### III. The Real “Zombie Title”

Michelle Conlin of Reuters coined the term “zombie title” to explain these uncompleted foreclosures.\(^{85}\) While the homeowners she described as having “zombie titles” faced significant problems, a truer form of “zombie title” has entered the market—a home that is foreclosed, never set for sale, and then “un-foreclosed” by the lender. The note and mortgage are inexplicably re-born.

It is hard to determine how many of these “zombie titles” are really lurking in the shadows of the mortgage industry. Foreclosure is a state court process and there is no efficient way

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\(^{79}\) Conlin, supra note 18.

\(^{80}\) Interviews with Ann Carol Nash and Cathy Toppel, City of South Bend, March 3, 2009.

\(^{81}\) Conlin, supra note 18.

\(^{82}\) Id.

\(^{83}\) DECIPHERING BLIGHT, supra note 16, at 3.

\(^{84}\) Id.

\(^{85}\) Conlin, supra note 18. “Zombie title” is an obvious reference to the term “zombie debt”, which has become widely recognized in the debt collection world as referring to debt that is very old, usually beyond the statute of limitation or already discharged in bankruptcy that is seemingly re-born by a debt collector who aggressively works to collect.
to search court filings to determine the number of cases where a foreclosure judgment was entered and subsequently set aside.\textsuperscript{86} Indiana does not have an online filing or records system, although approximately one half of Indiana’s counties record their docket sheets in an online docket system, doxpop.\textsuperscript{87} A search from January 1, 2009 to July 1, 2011 revealed hundreds of cases where the judgment was set aside, but did not reveal much about why the judgment was set aside. Judge Manier, a St. Joseph County Superior Judge, reports a recent increase in the number of requests to set aside foreclosure judgments.\textsuperscript{88} In a study of abandoned foreclosures in Cleveland, researchers categorized 17% of the loans in the sample as loans where the bank had either set aside a previously awarded judgment or notified the court it did not want to proceed.\textsuperscript{89} In the vast majority of cases, no reason was given for the motions to vacate or dismiss.\textsuperscript{90} In her study of Newark, New Jersey foreclosures, Linda Fisher also found evidence of judgments that were being set aside.\textsuperscript{91} These additional findings are consistent with mine. I am, therefore, confident in stating that banks are going back into foreclosure cases and setting aside previously entered foreclosure judgments.

I am less confident stating one definitive reason for the practice. A review of files in St. Joseph, LaPorte, Allen and Elkhart counties suggests some reasons, but it is impossible to state one definitive cause for this phenomenon. Lenders tend to give vague or nonexistent reasons for seeking to vacate a judgment.\textsuperscript{92} A closer examination of some of the files illustrates


\textsuperscript{88} Hearing Transcript at 12-13, JP Morgan Chase v. Pinckert, No. 71D05-1208-MF-00529 (St. Joseph Cnty., Ind. Super. Ct. Aug. 27, 2013) [hereinafter Hearing Transcript].

\textsuperscript{89} SCHRAMM ET AL., supra note 16, at 7.

\textsuperscript{90} Id.

\textsuperscript{91} Fisher, supra note 16, at 37-38.

\textsuperscript{92} SCHRAMM ET AL., supra note 16, at 7. (In one case the study cites the lender moved to set aside the judgment because “the parties had resolved the matter.” When the judge inquired further, the bank admitted that the parties had not resolved the matter. The low equity in the property was the real reason for setting aside the judgment.). In my review of files, language implying the parties had settled was common. In every case that the judge inquired, it turned out to be untrue. See infra Part II.C.
the difficulty in determining the real motivation behind these zombie loans.

A. The Doctrine of Merger and its Implication in the Selling of Distressed Mortgages

Donna had what I would characterize as an abandoned mortgage, not a “zombie title.”93 However, her story best explains how a mortgage loan might move from being simply abandoned to being re-born as “zombie title.” When Donna came to the Economic Justice Project for assistance, her home had already been foreclosed.94 In the ensuing two years, the house had fallen into disrepair. Donna had been surprised to receive a complaint for a second foreclosure proceeding on the same mortgage note. She did not have a second mortgage, nor did she recognize the name of the company that was foreclosing. We later determined it was an investor. The investor claimed it had purchased the note from the lender. The lender, likewise, appeared and claimed it had sold the note and mortgage to the investor after entry of the judgment.

The doctrine of merger makes the lender’s and the investor’s understanding of the situation legally impossible. According to this longstanding doctrine, when a judgment is entered the underlying claim merges into that judgment.95 In a foreclosure, the underlying claim would be the note and the

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93 Donna has agreed to let us discuss her situation, but requested to protect her anonymity. The specifics of this case are not as important as the legal implications. Therefore, I am not providing the file numbers and parties’ names in order to obscure her identity. The records are public and on file with the St. Joseph Superior Court.

94 Because of a prior foreclosure, the judgment was “in rem” and did not, as is customary in Indiana, include a personal judgment on the note.

95 RESTATEMENT (SECOND) OF JUDGMENTS § 18 cmt. a (1982). See In re Schlect, 36 B.R. 236, 240 (Bankr. D. Alaska 1983) (finding promissory note had merged into the foreclosure judgment previously entered in state court and, therefore, the provision in that note that allowed for the payment of attorney’s fees did not apply in the bankruptcy court); Caine & Weiner v. Barker, 713 P.2d 1133, 1134 (Wash. Ct. App. 1986) (judgment awarded against two signers of a promissory note; when one paid the debt and then tried to obtain attorney’s fees provided for in the note from the second debtor, the court found that the note had merged into the judgment); But see In re Gayle, 189 B.R. 919, 920 (Bankr. S.D. Tex. 1995) (bank foreclosed in a non-judicial proceeding and then obtained a separate court judgment on the note; the court held that the doctrine of merger did not preclude a bank from pursuing the foreclosure).
mortgage, both of which merge into the foreclosure judgment once it is entered. Simply put, when the lender allegedly sold this note to an investor, there was no promissory note to sell. There was only a judgment.

This case eventually came to a satisfactory conclusion as the bank agreed to assign its judgment to the investor. Procedurally, this is what the bank should have done if it wanted to charge-off the loan after the judgment was entered. The assignment of judgment allowed the investor to proceed with the sheriff’s sale. The investor ultimately took possession by bidding the judgment amount at the sale.

This case illustrates several important issues for discussion. First, it suggests that at least some of the underlying loans connected to the abandoned foreclosures are being sold on the secondary market. It also appears these sales may occur despite the fact that there is no longer a promissory note to sell. Of course, the experience of one homeowner does not prove a pattern; though it does provide evidence for one. Additional evidence is found in the fact that throughout the process, the investor, the mortgage servicer, and their legal representatives failed to understand the doctrine of merger and the legal implications of the prior foreclosure judgment. As a result, judicial resources and attorney time were wasted. This experience left my students and me with few doubts that this has occurred to other, unrepresented homeowners and helps to explain why some lenders may be seeking to vacate judgments, thereby creating a “zombie title.”

1. Trial Rule 60

The doctrine of merger makes it favorable for the lender to set aside the mortgage judgment when it wants to sell a nonperforming mortgage loan. Because these loans were judicially foreclosed, a lender must return to court to set aside the judgment. How and when that can be accomplished is governed by the rules of civil procedure. Most courts follow either Rule 60 of the Federal Rules of Civil Procedure or a close variation of it.

Indiana’s trial rule, while not identical, is the same as the federal

96 See infra Part III for a discussion on how the industry seems to be working around this problem.

97 FED. R. CIV. P. 60.
rules in terms of the issues relevant to this discussion. It is unusual for the prevailing party to seek to set aside a judgment, therefore the decisions discussing this issue are almost exclusively concerned with not prejudicing the party for whom the judgment was entered. The courts seem to assume that setting aside a judgment will always be a good thing for the losing party. The concept of a “zombie title” challenges that assumption.

One of the most troubling aspects of the “zombie title” is the fact that lenders rarely supply reasons, let alone accurate ones, to support a motion to vacate a foreclosure judgment. Furthermore, lenders virtually never cite the relevant portion of the law to support such a motion. A judgment can be set aside for a number of reasons, including “mistake, surprise or excusable neglect.” The usual parties to a mortgage foreclosure action are the homeowner, who in this case was already informed his home was foreclosed, and the loan servicer, who now wants to un-foreclose the loan. None of the files I reviewed mention “mistake, surprise or excusable neglect” as a reason to support the motion to vacate judgment, nor do any of the reports of other studies mention this as a reason for setting aside a judgment.

A judgment may also be set aside for “fraud” or “newly discovered evidence”. Again, no lender cited these as reasons to set aside the judgment. The most common reason stated in motions to set aside judgment was language implying that a settlement had been reached. Examples include: “all matters in controversy have since been settled” and “the subject matter of

98 IND. TRIAL R. 60. Both rules allow for the correction of clerical errors and require the motion be filed within one year when claiming “mistake, surprise or excusable neglect, newly discovered evidence or fraud.” FED. R. CIV. P. 60(b)(1), (b)(2), (b)(3); IND. TRIAL R. 60(B)(1), (B)(2), (B)(3). Both rules also allow litigants to file a motion within a reasonable time for three additional reasons: “the judgment is void”, “the judgment has been satisfied, released or discharged,” and “any other reason” justifying relief. FED. R. CIV. P. 60(b)(4), (b)(5), (b)(6); IND. TRIAL R. 60, 60(B)(6), (B)(7), (B)(8). The Indiana rule includes additional reasons for setting aside a default judgment for lack of proper notice and judgments involving guardians or representatives. IND. TRIAL R. 60(B)(4), (B)(5).

99 FED. R. CIV. P. 60(b)(1); IND. TRIAL R. 60(B)(1).

100 FED. R. CIV. P. 60(b)(1); IND. TRIAL R. 60(B)(1).

101 FED. R. CIV. P. 60(b)(2), (b)(3); IND. TRIAL R. 60(B)(2), (B)(3).

102 FED. R. CIV. P. 60(b)(5); IND. TRIAL R. 60(B)(7).

103 See, e.g., Motion to Set Aside Judgment, HSBC Bank USA, N.A. v. Harvell, No. 20C01-1205-MF-00355 (Elkhart Cnty., Ind. Cir. Ct. DATE)
this present litigation is no longer at issue.104

One motion stated that because the loan had been charged-off, the lender wanted to set it aside.105 While not a valid reason under Trial Rule 60, it was at least an honest one. The judge denied the motion.106 Most of the files contain no information about how the homeowners reacted to these motions because servicers rarely notify homeowners of the decision to charge-off the loan.107 The lack of notice to other parties was consistent in all the motions to vacate judgment I examined. When notice is given, it is often to the already abandoned property address. Occasionally a court sets the matter for hearing on its own initiative.108 That is when things get interesting.109

Unfortunately, there is evidence that at least some of the stated reasons for setting aside the judgment are not truthful. In the Cleveland study, for example, the investigators discuss one lender who claimed that “the parties had resolved the matter” and, therefore, the foreclosure judgment should be set aside.110 When questioned by the Court, the lender admitted that the real reason it wanted to set aside the judgment was the lack of equity in the property.111 Settlement is a valid reason to set aside a judgment, so long as the motion is brought within a reasonable time.112 Claiming there is a settlement when there is not a settlement so that you can earn more money is never a permissible reason to vacate or set aside a judgment.

106 See infra Part II.A.2. for further discussion of this case.
107 Abandoned Foreclosures, supra note 17, at 38.
108 See, e.g., Hearing Transcript, supra note 88, at 3. Unfortunately, in most cases notice is sent to an already vacant property.
109 See discussion infra notes135-153 and accompanying text.
111 Id.
112 OHIO R. CIVIL P. 60. The motions to set aside default I discovered in Indiana were filed between a few days after the judgment was entered to six years after judgment.
2. Agreed Judgments, “In-rem” Judgments

A disturbing subset of these cases involves motions to vacate that seek to set aside an agreed, “in-rem” judgment of foreclosure. This came to my attention early in my research when I stumbled upon JPMorgan Chase Bank, N.A. v. Yusuph, a case filed in 2009. The pleadings indicate that at the time of this foreclosure the home was in serious disrepair. The City of South Bend entered the case because it had a pending repair order against the property for violations of the Unsafe Building Act. An agreed, “in rem” foreclosure judgment was entered in December 2009. In April 2010, Chase filed a motion to set aside the judgment because the bank had “charged off this mortgage loan account.” Neither the homeowner who had defaulted, nor the City which had agreed to the entry of the judgment, were notified of the motion. The judge did not request a hearing.

The judge originally signed an order vacating the judgment. However, the judge reconsidered and set the matter for hearing. After the hearing, the judge entered an order

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113 An “in rem” judgment can only be satisfied with the proceeds from the sale of the home. No personal liability attaches to the homeowner.

114 It should be noted that the affidavit filed in support of the judgment in this matter was clearly a stamped signature. Exhibit A, Motion for Default Judgment Entry and Decree of Foreclosure, Yusuph, No. 71-D05-0907-MF-00671 (filed Nov. 4, 2009). This case was decided before Chase halted its foreclosures for a period of time in September 2010 in response to robo-signing accusations. See generally, ROBO-SIGNING, supra note 46, at 1 (for a description of the robo-signing scandal).

115 Answer, Yusuph, No. 71-D05-0907-MF-00671, (filed July 16, 2009 by the City of South Bend, Indiana) [hereinafter Yusuph Answer].

116 IND. CODE ANN. §36-7-9-26 (West 2013).

117 Agreed Judgment and Decree of Foreclosure, Yusuph, No. 71-D05-0907-MF-00671 (Dec. 17, 2009). An “in rem” foreclosure judgment in Indiana is judgment that can only be executed against the secured property that was subject to the foreclosure. Lenders have the option to also ask the court a personal judgment that can be collected against any other assets of the defendant. In this case, the bank only requested an “in rem” judgment.

118 Yusuph Motion to Set Aside Judgment, supra note 105.

119 While it is hard to prove a negative, there was no proof of service attached to the motion, nor was there a notice of hearing in the court file.

120 Order Setting Aside the Judgment and Dismissing the Lawsuit, Without Prejudice or Consent, Yusuph, No. 71-D05-0907-MF-00671 (filed April 12, 2010).

121 Order, Yusuph, No. 71-D05-0907-MF-00671 (setting hearing for December 7, 2010). The court cites the “extent to which the Motion to Vacate
reinstating and confirming the judgment.\textsuperscript{122} It was the correct decision in this circumstance as setting aside a default judgment is much different than setting aside a judgment that had been agreed to by the parties. It is well recognized in Indiana that “after entering an agreed judgment the trial court has no authority to modify or change the judgment in any essential or material way.”\textsuperscript{123} In the JP Morgan case described above, the homeowner had been defaulted but the City of South Bend, also a defendant, had participated in the case and signed the agreement for an “in rem” only judgment against the homeowner.\textsuperscript{124}

While there is no conclusive evidence as to why the bank sought to set this judgment aside, there are a number of clues in the case files. First, the property was in serious disrepair. There were pending orders to repair this property that had apparently been ignored.\textsuperscript{125} The typical procedural step after a foreclosure would be to set the property for sheriff’s sale.\textsuperscript{126} However, the property had already been dubbed “unsafe” by an administrative proceeding of the city.\textsuperscript{127} As a result, it was highly unlikely that anyone would purchase the property because, if they did, they would become responsible for the repairs. Accordingly, if the bank purchased the property in the sale—the usual procedure when there are no other bidders—it would be left to make the

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\textsuperscript{122} Order, JP Morgan Chase Bank v. Yusuph, No. 71-D05-0907-MF-00671 (reinstating and confirming the judgment).

\textsuperscript{123} Wagler v. West Boggs Sewer District, Inc., 980 N.E.2d 363, 376 (Ind. Ct. App. 2012). This principal is not confined to Indiana. Most states follow this rule. See, e.g., Bryan v. Reynolds, 123 A.2d 192 (Conn. 1956) (stipulated judgments cannot be set aside unless it is shown they were obtained by fraud, duress, accident or mistake); Westfall v. Wilson, 467 P.2d 966 (Or. 1970) (consent judgments can only be changed by agreement of all parties); Laffin v. Laffin, 760 N.W.2d 738 (Mich. Ct. App. 2008 ) (consent judgments cannot be modified absent fraud, mistake or unconscionable advantage); Baran v. Baran, 72 A.2d 623 (Pa. Super. Ct. 1950) (consent decree can only be reviewed if obtained by fraud or based on mutual mistake).

\textsuperscript{124} Agreed Judgment and Decree of Foreclosure, Yusuph, No. 71-D05-0907-MF-00671 (filed Dec. 17, 2009). The city of South Bend was defendant because of fines and other actions to the property as a result of its being abandoned.

\textsuperscript{125} Yusuph Answer, \textit{supra} note 115.

\textsuperscript{126} IND. CODE ANN. §32-29-7-3 (West 2013).

\textsuperscript{127} Yusuph Answer, \textit{supra} note 115.
repairs. Therefore, it is not surprising that the bank decided this asset was not worth acquiring and never set the sale.  

As discussed previously, lenders appear unconcerned with simply walking away from foreclosures when it is not economical to proceed. Doing so requires no affirmative action and, at least currently, violates no laws.  What made this loan different? For one, it was an “in rem” judgment.  The lender’s recovery was limited to the amount it could receive from the sale of the property, and the difference between the sale amount and the amount of the loan would be lost. The lender would not be able to sell the property without making substantial repairs and, even then, it was not likely to recover the entire amount of the loan.  The reason the lender articulated for asking the court to set aside the judgment was that the bank had charged off the loan.  The fact that a debt has been charged off is usually a reason to seek judgment from the court, not a reason to set one aside. That is, of course, if the creditor intends to collect on that judgment. In this circumstance, Chase could not realistically collect on the debt. They had not obtained a personal judgment, so they could not attempt to collect against the homeowner’s wages or other assets. The home, as mentioned previously, was not likely to sell at sheriff’s sale.

However, there was one way that the bank could recover some of its loss. It could sell the note. This foreclosure occurred at about the same time that the buying and selling of distressed mortgages was heating up.  As Donna’s case illustrated, in order

128 Numerous allegations were being made at the time that banks were failing to maintain properties it owned in low income neighborhoods. This property was just such a neighborhood. See generally, BANKS ARE BACK, supra note 34.

129 GAO-11-93, supra note 10, at 16.

130 Without ordering an expensive transcript, it is impossible to determine why the judgment was in rem. A search of the bankruptcy records does not reveal a bankruptcy, the most common reason for the entry of an “in rem” judgment.

131 Various on-line websites list the value of this property between $27,600 (trulia.com, last visited September 4, 2013) and $28,327 (zillow.com, last visited September 4, 2013). The judgment entered in December, 2009 showed the homeowner owed $62,597.01, more than double the value of the home in its current, repaired condition.

132 Yusuph Motion to Set Aside Judgment, supra note 105, at ¶ 3.

133 Janet Morrissey, NEW RETI S POUNCE ON DISTRESSED MORTGAGE ASSETS, TIME (Aug. 18, 2009), available at http://www.time.com/time/printout/0,8816,1916998,00.html#; Carolyn Said,
to properly bundle this loan with other loans for sale, the note must be un-merged from the judgment.\textsuperscript{134} Therefore, the most likely reason the bank sought to set aside the judgment was a desire to sell the note on the secondary market.

A rare hearing that occurred in \textit{JP Morgan Chase v. Pinckert}\textsuperscript{135} provides a glimpse of the serious issues these cases raise. The court in \textit{Pinckert} set a hearing on two cases in which the same law firm had filed motions to set aside default judgments.\textsuperscript{136} The lender had filed a motion to vacate judgment and to reinstate the note, but apparently did not supply a reason that satisfied the court.\textsuperscript{137} The court asked the attorney to explain the reason for the motion.\textsuperscript{138} His response was:

\begin{quote}
Well, I do, but only in a general sense. Sometimes we get information that will say ‘short sale completed’ or ‘deed in lieu’ or something of that nature, or ‘loan modification completed.’ On both of these, the message that we got . . . And that message just says ‘loss mitigation.’\textsuperscript{139}
\end{quote}

The court stated, “I’m not quite sure how to understand a loss mitigation if we may not even have one party,” expressing concern that though there were two defendants, Merlin and Ginger Pinckert, Ginger had only been served by publication.\textsuperscript{140} After looking through the file, the court informed the attorney that Mrs. Pinckert was deceased.\textsuperscript{141} The Court then continued to explore what “loss mitigation” might mean.

\begin{quote}
Court: You don’t know if the term “loss mitigation” is
\end{quote}

\textsuperscript{134} See discussion of merger, supra note 95.
\textsuperscript{135} See Hearing Transcript, supra note 88.
\textsuperscript{136} \textit{Id.} at 3. There is no specific information about the second matter. It is simply referred to in the opening of the hearing.
\textsuperscript{137} \textit{Id.}
\textsuperscript{138} \textit{Id.}
\textsuperscript{139} \textit{Id.}
\textsuperscript{140} \textit{Id.} at 3-4.
\textsuperscript{141} \textit{Id.} at 4.
used for something other than resolving the matter personally with the borrower?

Attorney: It’s my experience it’s not for that. I mean, let’s put it this way: it’s some form of loss mitigation, so it may be—especially given the fact that Miss Pinckert is deceased—it may be a deed in lieu or it may be some type of short sale.

Court: I guess my concern is it doesn’t mean that one is mitigating the loss to the financial institution by changing its mind, and rather than foreclosing and having a deficiency judgment and a piece of property you may or may not want, it’s now decided to sell this debt to.

The attorney misunderstood the judge and interrupts her to explain that the bank does not set aside judgments when it is changing servicers. The court, however, was not concerned about a change in servicer. The court was concerned about a change in ownership. That was clearly not what the court was referencing. The court was clearly expressing a concern about debt buyers, not servicer transfers.

Court: Yet we seem to be finding—I’ve had, within the last couple weeks, quite a number of motions to vacate and dismiss. And one attorney said he thought perhaps Fannie Mae had directed this, that they were directing it. But he didn’t have a lot more information. My big concern is that someone has walked away from this foreclosure, they may even have gotten an in rem judgment. They’ve walked away, and they don’t necessarily know that the judgment’s now been vacated. What, the debt reinstated to be transferred to someone else that’s going to seek some other remedy?

The court thus identified the crux of the problem with “zombie titles.” When a judgment is set aside and the loan reinstated, it can be transferred to someone else who is likely to pursue another remedy. An “in rem” judgment can easily become

142 Id. at 4-5.
143 Id. at 5.
144 Id. at 6.
an “in personam” judgment with no notice to the debtor.

At this point, the hearing took a rather bizarre twist. The court asked why the underlying judgment was “in rem.”\textsuperscript{145} The lawyer claimed the homeowner filed bankruptcy, but as they investigated the file, it turned out to be untrue.\textsuperscript{146} However, the lawyer ultimately discovered an agreed “in-rem” judgment in the file:

Attorney: We have—we have an agreed entry. We haven’t sent that your way. I apologize. It’s signed by XXX for Real Services,\textsuperscript{147} legal guardian for Merlin Pinckert.

Court: That’s not the judgment I signed and it’s not been—I don’t see that in the file.

Attorney: Merlin Pinckert, right?

Court: So this person is under a guardianship?

Attorney: That’s correct.

Court: Not according to anything on the docket sheet or in the file.\textsuperscript{148}

The attorney goes on to inform the court that the guardian

\textsuperscript{145} Id. at 8.
\textsuperscript{146} Id.
\textsuperscript{147} Real Services is a not-for-profit agency in South Bend that often acts as guardians for indigent senior citizens who are deemed incompetent to manage their affairs. The name of the guardian has been redacted.
\textsuperscript{148} Hearing Transcript, supra note 88, at 9. If a person is under a guardianship, Indiana Trial Rule 4.2(c) suggests there is a duty to inform the court if one of the litigants is incompetent, the situation if a guardian had been appointed. IND. TRIAL R. 4.2(c). The attorney complained that he did not know there was a guardianship because the dockets are not online in St. Joseph County. Hearing Transcript, supra note 83, at 13. The guardianship dockets are online through the Quest system in the St. Joseph Probate Court. In addition, he had already informed the court that the agreement, signed by the guardian, was in the file. Id. at 13. Had he looked at the free, online system, the attorney would have seen that the Probate Court had approved the sale of this property on July 23, a month before the hearing in Superior Court. In fact, according to the Probate Court records, 71J02-1111-GU-00220, this property was already sold. The question remains: what was the purpose of the motion to vacate?
had signed an in-rem agreement, but that a different in-rem judgment was submitted to the court. 149 This is the one and only case in my review where the lender’s reason for the motion to vacate and to set aside the judgment was clear:

Attorney: So once they vacate it [the property in foreclosure], if Mr. Pinckert is in an end-of-life situation, his wife is already deceased, apparently none of his family wants this home, it may fall into disrepair and ultimately become the obligation of the city, which is unfortunate, but –and I know there’s been discussions about that in the legislature, but nothing has come of it.

And I think legally my client is entitled; they don’t have an obligation in that regard. But that sounds, quite frankly, more likely than loss mitigation. 150

The attorney in this matter either did not understand or deliberately dodged the judge’s question regarding the selling of the note. Though the court clearly understood and questioned the propriety of setting aside an in rem judgment and exposing the debtor to further collection. 151 The lawyer honestly replied that “as a legal matter I don’t think that my client is prohibited from doing that.” 152 As a legal matter, he may be correct; but as a moral matter, there is likely a different answer. 153

It is clear that many of these “zombie titles” are being re-sold in the secondary market and it seems that many were sold to PennyMac, a “finance company run almost entirely by alumni of Countrywide Financial.” 154 This should be frightening to anyone who has followed the mortgage industry. Countrywide loans were a significant contributor to the mortgage foreclosure crisis. 155

149 Id. at 10.
150 Id. at 12.
151 Id. at 7.
152 Id.
153 A plaintiff or a defendant has the right to set aside a judgment pursuant to Indiana Trial Rule 60. Whether or not the rule is being fully complied with is a major concern.
Below is a very small sample of the loans I discovered illustrating the “zombie loan” pattern:

<table>
<thead>
<tr>
<th>LENDER</th>
<th>FORECLOSURE Judgment</th>
<th>JUDGMENT SET ASIDE</th>
<th>PENNYMAC files FORECLOSURE</th>
<th>JUDGMENT ENTERED</th>
</tr>
</thead>
<tbody>
<tr>
<td>Citimortgage</td>
<td>12/30/2008</td>
<td>1/6/2010</td>
<td>10/10/2012</td>
<td>2/25/2013 dismissed</td>
</tr>
<tr>
<td>Citimortgage</td>
<td>9/2/2010</td>
<td>2/14/2011</td>
<td>1/31/2012</td>
<td>8/14/2013 foreclosure</td>
</tr>
</tbody>
</table>

CHART A: SMALL SAMPLE OF PROPERTIES WITH MULTIPLE FORECLOSURES

In each case a foreclosure judgment was set aside and then the loan was sold to PennyMac, allowing PennyMac to file a new foreclosure action. Not all loans sold to PennyMac fell immediately back into foreclosure. It is not possible to track those loans through the court docket system. Chart A above is a very small sample of cases I discovered where one lender foreclosed, moved to set aside the judgment and then sold the loan. This is representative of the fact that at least some “zombie titles” are

158 CitiMortgage v. Westover, No. 89D01-0904-MF-052 (Wayne Cnty., Ind. Super. Ct. Sept. 02, 2010).
162 CitiMortgage v. Waller, No. 10C01-1101-MF-00036 (Clark Cnty., Ind. Cir. Ct. May 11, 2011).
being repackaged and resold, either alone or as part of new securities.

The re-securitization of nonperforming loans, especially when they are combined with new loans originated by individuals who contributed so heavily to the last mortgage crisis, should be cause for concern. The securitization of subprime loans was a major contributor to the 2008 economic downturn. Regulators should not allow those loans at the center of the crisis to be simply repackaged and reprocessed. They will re-explode.

B. The Dual Track

It would be both unfair and inaccurate to claim that all efforts to vacate foreclosure judgment are deceptive, inaccurate or done for the sole benefit of the lender. Sometimes the parties really do reach an agreement. Evidence of this was also found in court files. One example is HSBC Bank v. Harvell. A complaint for foreclosure was filed on May 7, 2012. The homeowners failed to respond and a default was entered on July 17. On August 9, the lender filed a praecipe asking the sheriff to set the home for sheriff’s sale. On August 16, the homeowners sent a letter to the court, explaining that they were seeking a loan modification and had just been asked for another set of documents for the loan servicer. On April 15, 2013, the bank filed to vacate the judgment because the parties had reached an agreement, presumably a loan modification.

The homeowner in this situation was able to stop the foreclosure and the judgment was set aside. It is troubling,

164 Gandel, supra note 154.
167 Id. at 1 (Minute Entry, May 9, 2012).
168 Id. (Minute Entry, July 19, 2012).
169 Id. (Minute Entry, Aug. 9, 2012); IND. CODE ANN. §32-29-7-3 (West 2013).
170 Harvell Case Summary, supra note 166, at 1 (Minute Entry, Aug. 23, 2012).
171 Id. at 2 (Minute Entry, Apr. 17, 2013).
however, how quickly this case proceeded from filing to judgment when the home owner was engaged in loss mitigation. This is symptomatic of the dual tracking problem that has been common in the industry.172

Dual tracking is the process by which lenders pursue both loss mitigation and foreclosure consecutively.173 The homeowner is often told not to worry about the foreclosure process and, as a result, fails to appear in the foreclosure case filed in court. The result is that many homeowners are faithfully working with the bank to save their home, only to learn that a default has been entered and the home foreclosed.174 Dual tracking has been very controversial.175

In April of 2011, Fannie Mae and Freddie Mac bowed to considerable pressure and modified their servicing guidelines.176 Servicers were instructed not to commence or conclude a foreclosure if loss mitigation was in process.177 On February 14, 2013, the Consumer Financial Protection Bureau issued rules meant to restrict the practice of “dual tracking.”178 The tragedy is that the restriction is too little too late. Many of the homeowners who faced dual tracking have already lost their homes. Vacating foreclosure judgments that occur in the context of “dual tracking” may actually benefit some homeowners; however, eliminating the practice would benefit many more homeowners.

174 Id.  
177 Id.  
The number of motions to vacate seems to be increasing.\textsuperscript{179} Several recent cases that have come before the St. Joseph Superior Courts raise additional concerns.\textsuperscript{180} These cases are significant both because of the reasons articulated for vacating the judgments and the underlying circumstances of each of the homeowners. The first case is \textit{Bank of America, N.A. v. Kimes}.\textsuperscript{181} The complaint to foreclose this mortgage was filed on September 17, 2012.\textsuperscript{182} Mr. Kimes died of cancer four months earlier on May 18, 2012.\textsuperscript{183} A default judgment was entered on May 10, 2013.\textsuperscript{184} In July, the bank requested that the judgment be vacated because “the subject matter of this present litigation is no longer at issue.”\textsuperscript{185} The court questioned how the matter could possibly be resolved in loss litigation when Mr. Kimes was deceased.\textsuperscript{186} The attorneys for the bank explained that they were required to set the judgment aside by the U.S Department of Housing and Urban Development’s (H.U.D.) Distressed Asset Stabilization Program.\textsuperscript{187}

Soon after, a second motion to set aside judgment was filed in \textit{Nationstar Mortgage, LLC v. Estrada}.\textsuperscript{188} This foreclosure was filed in 2012.\textsuperscript{189} The homeowner failed to respond and a

\begin{footnotesize}
\begin{enumerate}
\item See, e.g., Hearing Transcript, \textit{supra} note 88, at 12-13.
\item See \textit{Motion to Set Aside Judgment and Decree of Foreclosure and to Dismiss Complaint to Foreclose Mortgage, Bank of America, N.A. v. Kimes}, No. 71-D051D05-1209-MF-00617 (St. Joseph Cnty., Ind. Cir. Ct. July 10, 2012) [hereinafter Kimes Motion to Set Aside Judgment].
\item \textit{Id.}
\item \textit{See} Kimes Motion to Set Aside Judgment, \textit{supra} note 181.
\item \textit{Id.} at ¶ 1.
\item \textit{Id.}
\item Motion to Set Aside Judgment and Decree of Foreclosure and to Dismiss Complaint to Foreclose Mortgage, Nationstar Mortgage LLC v. Estrada, No. 71-D05-1212-MF-00787 (St. Joseph Cnty., Ind. Super. Ct. July 19, 2013) [hereinafter Estrada Motion to Set Aside Judgment].
\item Complaint on Note and to Foreclose Mortgage on Real Estate, \textit{Estrada}, No. 71-D05-1212-MF-00787 (filed Dec. 10, 2012).
\end{enumerate}
\end{footnotesize}
default judgment was entered on May 10, 2013.\footnote{Default Judgment Entry and Decree of Foreclosure, \textit{Estrada}, No. 71-D05-1212-MF-00787 (entered May 10, 2013).} The motion to set aside the judgment also claimed “the subject matter of this present litigation is no longer at issue.”\footnote{Estrada Motion to Set Aside Judgment, \textit{supra} note 188 at ¶ 1.} Again, the judge inquired as to the real reason for the motion and was again told it was required by HUD or perhaps directed by Fannie Mae.\footnote{Judge Manier Interview, \textit{supra} note 186.}

In July 2012, HUD announced the Distressed Asset Stabilization Program, a program to offer pools of defaulted loans to investors.\footnote{HUD No. 12-116, \textit{supra} note 71.} The stated intention of the program is to allow “pools of mortgages headed for foreclosure to be sold to qualified bidders and charges them with helping to bring the loan out of default.”\footnote{U.S. DEP’T OF HOUS. & URBAN DEV. HUD No. 12-187, \textit{HUD Announces Preliminary Results of Note Sales Under Expanded Distressed Asset Stabilization Program} (Dec. 3, 2012) [hereinafter HUD No. 12-187], http://portal.hud.gov/hudportal/HUD?src=/press/press_releases_media_advisories/2012/HUDNo.12-187.} In order to be part of the program the loan must be at least six months delinquent, the servicer must have exhausted loss mitigation options and the foreclosure must have been initiated.\footnote{Id.} It is too early to know if the sale of these notes will truly offer new hope for struggling homeowners and neighborhoods. The initial pools of loans were sold in September 2012.\footnote{Nathaniel Cushman, \textit{HUD Announces September 2012 Loan Sale}, NIXON PEABODY AFFORDABLE HOUS. RES. CTR. (July 25, 2012, 11:02 AM), http://web20.nixonpeabody.com/ahrc/Lists/Posts/Post.aspx?List=023e142d%2Dc9f%2D44c8%2D8bf3%2D5aaeeb635b8&ID=45.} They were divided into one national pool and one neighborhood stabilization pool of loans originating from Chicago, Illinois; Newark, New Jersey; Phoenix, Arizona; and Tampa, Florida—all areas previously identified as having high numbers of abandoned foreclosures and vacant homes.\footnote{Id.} Consumer advocates are dubious of the Distressed Asset Stabilization Program’s ability to provide relief to struggling homeowners and neighborhoods.\footnote{FHA REFORM, \textit{supra} note 71; HOME RETENTION GOALS, \textit{supra} note 71.}
responses and recommendations regarding this program. One of the concerns is that the program will reward those servicers who delay “loss mitigation reviews beyond the time frames allowed” by allowing them to sell the loan without really having done loss mitigation. The program may also be encouraging lenders to “un-foreclose” some long abandoned properties in an effort to remove these properties from their books instead of focusing on saving the homes in default that have not yet been foreclosed. The short amount of time between some of these judgments and motions to vacate suggests that better communication between the servicers and their counsel could prevent the delay in resolving the foreclosure caused by foreclosing and then vacating judgments. It may also prevent some people from abandoning their home because they thought the foreclosure judgment was the end of their opportunity to save the home. The theory behind the program is that the investor will be able to work with the homeowner to remain in the home, but in reality by the time the loans reach the program most of these homeowners will be long gone. One concern is that this kind of program may result in once stable neighborhoods becoming transient, rental neighborhoods. At the same time, rental homes are better than abandoned homes.

The cases coming before the St. Joseph Superior Court raise other, serious concerns. It is not credible that the reason for setting aside a judgment for a deceased borrower is to increase the opportunity for the borrower to engage in loss mitigation. Are these programs really designed to increase the opportunity for loss mitigation, as advertised, or are they instead encouraging, or even mandating, the setting aside of previously entered judgments so that HUD, Fannie Mae and Freddie Mac can unload assets? I submitted an inquiry to HUD asking whether or not loan servicers were being instructed to set aside judgments in

199 Id.
200 HOME RETENTION GOALS, supra note 71.
201 GAO-11-93, supra note 10, at 17-18 (finding that homeowners are much more likely to abandon a property if the loan is charged off after foreclosure than if it is charged off before foreclosure is initiated).
203 See HUD No. 12-187, supra note 194.
order for the underlying loans to be included in this program. I was told that their attorney would get back to me. No one has.

IV. DEFICIENCY JUDGMENTS AND DEBT BUYERS

It should now be clear that a motivating factor—if not the motivating factor—in the abandoned and zombie foreclosures is lenders ability to sell the notes into the secondary market. The secondary market is a market of investors and debt buyers. The debts differ depending on whether they are secured, as in the selling of a note to an investor, or unsecured, as in the selling of a note, without the mortgage, or the deficiency judgment. The relationship between the abandoned foreclosure problem and the debt collection problem was well articulated by St. Joseph Superior Court Judge Jenny Manier:

Well, if I’m a defendant against whom an in rem judgment has been entered, I’ve lost the property and I have no deficiency judgment. Judgment’s vacated, which what, gives rise or resuscitates the debt and the bank says, you know, we don’t want to be stuck with this piece of property and this debt that we’ll be collecting for the next 20 years, let’s sell the underlying debt to someone else for dimes on the dollar, pocket the money and count on it as loss mitigation. And then the purchases is now going after this person, this defendant who thought they had walked away by losing just their home but without any deficiency. And all of a sudden someone is suing them for the same judgment that they thought had been resolved.

A. The Deficiency Judgment

As mentioned previously, it is clear that some foreclosure

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204 E-mail from author to John Hall, Indianapolis Field Officer, HUD, (Aug. 14, 2013) (on file with author).
205 Email from John Hall, supra note 204, to author. (Aug. 14, 2013) (on file with author).
206 There has been no response as of September 10, 2013.
207 Hearing Transcript, supra note 88, at 7 (explaining to lender’s counsel why she is concerned with setting aside an in rem judgment of foreclosure).
judgments are being vacated solely to facilitate the sale of the loan. Others are vacated because the homeowner obtained a loan modification or reinstated the loan. It is also clear that some homeowners, in the end, cannot climb out from under the debt and the property is foreclosed, leaving them with a deficiency judgment. Below is one extreme example of this, taken from Howard County, Indiana. These are all foreclosures on the same property, against the same property owner, filed from 2003 through 2008:

<table>
<thead>
<tr>
<th>Plaintiff</th>
<th>Date Foreclosure Filed</th>
<th>Date of Judgment</th>
<th>Amount of Judgment</th>
<th>Vacated and Note Reinstated</th>
</tr>
</thead>
<tbody>
<tr>
<td>Citimortgage</td>
<td>11/21/2008</td>
<td>1/20/2009</td>
<td>$140,075.96</td>
<td>8/19/2009 judgment assigned</td>
</tr>
</tbody>
</table>

CHART B: THE HISTORY OF ONE LOAN IN INDIANA

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208 It is also possible that some of these are simply servicer changes. It is virtually impossible to determine who owns a loan when looking at the pleadings.


211 Civil Case Detail, Irwin Mortg. Corp. v. Newburn, et. al., No. 34D02-0608-MF-00776 (Howard Cnty., Ind. Super. Ct.) (Doxpop).

212 Civil Case Detail, ABN AMRO Mortg. Grp., Inc. v. Newburn, No. 34 D040705-MF-00476 (Howard Cnty., Ind. Super. Ct.) (Doxpop).

213 Civil Case Detail, Citimortgage, Inc. v. Newburn, No. 34C01-0803-MF-00240 (Howard Cnty., Ind. Cir. Ct.) (Doxpop).

214 Civil Case Detail, Citimortgage, Inc. v. Newburn, No. 34C01-0811-MF-01164 (Howard Cnty., Ind. Cir. Ct.) (Doxpop).
The property in question is located in Kokomo, Indiana. On October 3, 2003 Mortgage Electronic Registration Systems (MERS) filed a foreclosure action, obtaining a default judgment two months later. On February 9, 2004 that judgment was vacated and, according to the court, the “note and mortgage canceled by merger in the judgment are hereby reinstated.” Eleven months later, MERS filed another foreclosure. Again, a default judgment was entered. The amount of the judgment has now increased from $141,544.39 to $146,944.51, a difference of $5,400.12. It appears from the figures that few, if any, payments were made in the intervening year. Five months after entry of the default judgment, the court again vacated the judgment and reinstated the loan.

The next foreclosure on this property was filed by Irwin Mortgage in August of 2006, a year after the previous judgment was vacated. It too obtained a default judgment. Interestingly, this judgment was only slightly larger than the previous judgment, suggesting some payments had been made. One month later, Irwin set the judgment aside and reinstated the note. The speed at which this judgment was set aside, coupled with the significant decrease in the next judgment amount (see Chart B, above), suggests the homeowners may have reinstated the loan by bringing it current at this point. Apparently, though, it did not last.

On May 1, 2007, ABN AMRO filed to foreclose on the same mortgage, now for the fourth time in as many years. Again, it obtained a default foreclosure judgment and quickly moved to vacate the judgment and re-instate the note.

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216 Id. at 3, (Minute Entry, Feb. 9, 2004).
217 Id. at 1, (Minute Entry, Jan. 21, 2004).
218 Id. at 2 (Minute Entry, March 6, 2005).
219 Id. at 3 (Minute Entry, Aug. 25, 2005).
221 Id. at 2-3 (Minute Entry, Oct. 24, 2006).
222 Id. at 3 (Minute Entry, Nov. 2, 2006).
223 Civil Case Detail at 1-2, ABN AMRO Mortg. Grp., Inc. v. Newburn, No. 34D04-0705-MF-00476 (Minute Entry, May 1, 2007).
224 Id. at 2 (minute entries of default judgment on July 31, 2007 and vacating
Citimortgage entered the picture on March 11, 2008 when it filed the fifth attempt to foreclose on this property.\textsuperscript{225} It obtained a judgment and also vacated it, reinstating the note and mortgage on November 25, 2008.\textsuperscript{226}

The reason for vacating this judgment is clear: four days earlier, on November 21, 2008, Citimortgage had filed another foreclosure action on this same note and mortgage.\textsuperscript{227} Indiana, like most states, does not permit a plaintiff to bring a second action to foreclose when it is currently “prosecuting any other action for the same debt.”\textsuperscript{228} It is odd that Citimortgage would chose to set aside a judgment it had already obtained in the first filing, as opposed to dismissing the second, extraneous filing, but it did. The last and final foreclosure judgment was entered on January 20, 2009 against the owners for $140,075.96 plus interest and costs.\textsuperscript{229}

The county land records show that on November 10 the property was transferred from the homeowners to Fannie Mae, and then to a third party purchaser.\textsuperscript{230} The price paid by the purchaser was $22,000.\textsuperscript{231} The homeowners now owe a deficiency judgment of over $120,000.\textsuperscript{232} That judgment was promptly assigned to a debt buyer, Dyke O’Neal.\textsuperscript{233} Dyke O’Neal claims to be “a leading nationwide purchaser, collector and servicer of real
estate deficiencies.” They set to work immediately to collect the deficiency in this matter. Unsurprisingly, the homeowner filed bankruptcy, notifying the court on April 25, 2012.

A deficiency judgment is the amount of money a homeowner may still owe the lender if, after foreclosure, the home is not worth as much as the underlying mortgage debt. Deficiency judgments have always been an issue in hard economic times. In this crisis, policy makers focused on the loan modification as a solution. In the depression, the relief offered was restrictions on deficiency judgments. Challenges to this relief were decided in the borrowers’ favor when, in *Gelfert v. National City Bank of New York*, the United States Supreme Court held that a state may restrict the lender’s recourse in a mortgage foreclosure. Several states have restricted or eliminated deficiency judgments.

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235 It should also be noted that Dyke O’Neal does not, according to the Indiana Secretary of State, have the required license to act as a debt collector in Indiana.

236 Civil Case Detail, Citimortgage v. Newburn, No. 34C01-0811-MF-01164 (Minute Entry, Apr. 25, 2012).

237 Deficiency judgments are allowed in some form in the majority of the states. Twelve, including some of those hit hardest by this crisis such as California and Arizona, have passed statutes barring deficiency judgments in most circumstances. Twenty other states limit the impact of the deficiency by requiring the lender to calculate the deficiency based on market value and not the price obtained in sheriff sale. Unfortunately, Indiana falls in neither camp and allows deficiency judgments in every situation. *Foreclosure Defense, supra* note 31, app. E, at 547-49.

238 White, *supra* note 52, at 514.


the right to a deficiency judgment. Most states allow for at least some collection of deficiency judgments. Indiana has no real restrictions.

The Newburn cases illustrated above are extreme, or are they? Numerous loans have been coming in and out of foreclosure since the start of this crisis. This case shows us just how large a deficiency a homeowner can accumulate in a depressed housing market. It also raises serious questions about the servicing of this loan. A significant amount of legal time and energy went into the filing of six successive foreclosure actions, two even pending at the same time. The case is symptomatic of a chaotic industry. The homeowner incurred attorney’s fees in each of the filings.

The lack of meaningful communication between the servicer and its foreclosure attorney is another problem evident in this and many foreclosure cases. The foreclosing attorney is often communicating to its client through the same toll free numbers as the consumers. An example of this can be seen in the exchange between the court and JP Morgan Chase’s foreclosure counsel in the hearing to set aside a foreclosure judgment previously discussed. The only message the attorney received from his client was “loss mitigation.” He was not told that, a month earlier, this home had been sold in a short sale with the full knowledge and approval of his client. While it is desirable to encourage loss mitigation, real loss mitigation requires real communication between all the stakeholders in the process.

It does not appear from the court file that much loss mitigation occurred for this homeowner in Kokomo. However, because the homeowner could well have been working with the lender and the lender did not communicate this information to its counsel, it is equally possible that loss mitigation was occurring

242 Of the thirty-eight states that allow some form of deficiency, twenty have enacted at least some restrictions. Id.
243 See, generally White, supra note 52 (Allen M. White on the old model).
244 Since 2011, I have facilitated hundreds of settlement conferences between the homeowner and their counsel. This is a common complaint of lender’s counsel.
245 See supra text accompanying notes 135-53.
246 Hearing Transcript, supra note 88, at 3.
247 See supra note 149 and accompanying text.
throughout the process.\textsuperscript{248} At the same time, there were not many successful loss mitigation options available when the first four cases were filed.\textsuperscript{249} The homeowner failed to appear in all of the six cases filed and the foreclosure fees mounted. Yet, each time a judgment was entered it was set aside and the note sold. A home in foreclosure for over five years must increase the fees and the ultimate balance due. In the end, this home sold for less than 15\% of the judgment. The delay in foreclosing is at least partially responsible for this increase.

The growing balance is one of the problems with the collection of deficiency judgments. Once entered, the judgment continues to accrue interest in Indiana at the judgment interest rate, currently 8\%.\textsuperscript{250} Another is the complete lack of information provided to the homeowner. There is a record of the court judgment in the court file and, presumably, a copy of that order is sent to the borrower. However, there is no record of the amount, if any, of the deficiency. Only some courts make any note of it at all. Some states require confirmation of the judgment.\textsuperscript{251} The third, and most disturbing, is that by allowing lenders to set aside agreed “in rem” judgments courts have resurrected the possibility of a deficiency judgment that the homeowner believed he had avoided by agreeing to judgment in the first place.\textsuperscript{252} Once obtained, the deficiency debt enters the murky world of debt collection, already awash in bad information and controversial practices.\textsuperscript{253}

\textbf{B. The Debt Buyer}

It is not clear how many debt buyers are in the market for mortgage debt.\textsuperscript{254} The federal trade commission recently

\textsuperscript{248} See supra Part II.B. for a discussion of dual tracking.  
\textsuperscript{249} White, supra note 52 (documenting the lack of success of loss mitigation efforts in 2007 and 2008).  
\textsuperscript{250} IND. CODE § 24-4.6-1-101(1)(2013).  
\textsuperscript{251} Foreclosure Defense, supra note 31, app. E, at 550-52.  
\textsuperscript{252} Hearing Transcript, supra note 88, at 6.  
\textsuperscript{254} At the moment, at least, the market seems to be stronger for the nonperforming loans, hence the moves to set aside judgments. See Rudolf, supra note 70; Said, supra note 70; Yu & Kelly, supra note 133; Morrissey,
concluded an investigation of the debt buying industry that included specific data on the top nine debt buying firms. The report goes on, however, to clarify that these numbers are skewed by the fact that some portfolios were tied to performing loans. In fact, “a significant number of mortgage portfolios” were acquired for less than one cent per dollar. The mean price was ten cents per dollar.

Dyke O’Neal purchased the debt in the case illustrated in Chart B. This company claims it has been in the business of buying mortgage deficiencies since 1988. According to their webpage, Dyke O’Neal is “the leading nationwide purchaser, collector and servicer of real estate deficiencies.” The size and opportunities these markets now bring for both legitimate investors and bottom-feeding debt collectors has changed due to this crisis. As debt collectors, who traditionally shied away from mortgage deficiency collection, enter the market, they are likely to bring the problems associated with the collection of credit cards into the world of mortgage deficiencies. The problems supra note 133.

255 See FEDERAL TRADE COMMISSION, THE STRUCTURE AND PRACTICES OF THE DEBT BUYING INDUSTRY (January 2013) [hereinafter Debt Buying], available at www.ftc.gov/os/2013/01/debtbuyingreport.pdf. The nine firms that provided specific data to the study were Sherman Financial, Arrow Financial Services, LLC., Encore Capital, Portfolio Recovery Associates, LLC, Unifund Corp., eCast, B-Line LLC., Asta Funding, NCO Portfolio Mgmt. Id. at 7. Because the data is limited to these firms, it is not a complete picture of the debt buying marketplace.

256 Id. at T-4.

257 Id. at T-5.

258 Id.

259 See supra notes 233-36 and accompanying text.


261 Id. But see supra note 234 (describing Cease and Desist Order issued by the Georgia Department of Banking and Finance, and Consent Order issued by Massachusetts Office of Consumer Affairs and Business Regulation).

262 Recent crackdowns on the selling and collecting of credit card debt could easily cause debt buyers to search for other revenue streams. See generally, Maria Aspan & Jeff Horwitz, Chase Halts Card Debt Sales Ahead of Crackdown, AMERICAN BANKER (July 1, 2013, 3:29 PM), http://www.americanbanker.com/issues/178_126/chase-halts-card-debt-sales-ahead-of-crackdown-1060326-1.html (explaining that Chase has halted selling its credit card debt because of investigations into robo-signing). The
associated with the collection of mortgage debt are already surfacing in relation to the collection of second mortgage loan debt.263

The debt collection industry is structured to allow debts to be bought and sold with little underlying documentation and supporting paperwork.264 When you combine this with the recorded paperwork disaster that has become common in the world of mortgage foreclosure,265 the results can be nothing but bad.

V. CONCLUSION AND RECOMMENDATIONS

Abandoned foreclosures and zombie titles pose concerns for consumers and their communities. Policy makers need to act to mitigate the impact of these problems before they become a crisis themselves, the “foreclosure echo.” A review of foreclosure processes in Indiana and abandoned homes across the nation leads me to recommend the following:

A. The Foreclosure Process

The current judicial foreclosure process may have some issues, but the answer is not to speed up the process, as industry advocates claim. It is, instead, to determine whether the foreclosure can be avoided before you initiate the judicial foreclosure process. If loss mitigation were truly incentivized over foreclosure, the number of homes moving into foreclosure and then stalling could be reduced. When a home is truly abandoned,

investigation will likely spread, as they did in the foreclosure crisis, prompting other credit card lenders to also stop selling their debt, at least temporarily.

263 Carolyn Said, Homes Lost, but Some 2nd-Mortgage Debts Remain, S.F. CHRON. (April 19, 2010, 4:00 AM), http://www.sfgate.com/realestate/article/Homes-lost-but-some-2nd-mortgage-debts-remain-3266964.php (explaining the rise in mortgage debt collection on second mortgages); Jim Wasserman, Debt Collectors can Come Calling Years After a Mortgage Default, WASH. POST, March 27, 2010, at E06.

264 Debt Buying, supra note 255, at iii.

265 Commission Report, supra note 2, at 407-08 (discussing how the flawed paperwork exacerbated foreclosure issues); Allen et al., supra note 16, at 29 (finding “greater incidence of foreclosure case dismissals (resulting from legal and operational problems) is associated with a greater likelihood that a loan remains in limbo”); Streitfeld, supra note 63.
efforts should be made to quickly foreclosure in a way that allows the asset to be purchased and re-occupied before it falls into disrepair. The focus should be on the “home” asset and not the “loan” asset.

Lenders should not be rewarded for shoddy loss mitigation by allowing them to vacate the judgment and sell the loan.

Decisions about the economic viability of the foreclosure should be made before the foreclosure action is filed to decrease the number of homeowners who prematurely leave their homes.

Servicers must communicate accurate and timely information to their counsel to avoid wasted judicial time and the filing of frivolous motions.

Homeowners should be notified when a lender has decided to charge-off a loan, cancel a sale or otherwise abandon a foreclosure.

Dual tracking is alive and well, despite efforts to the contrary. It needs to finally and completely end.

The loss mitigation system is still too slow, too long and too confusing. The industry can, and should, agree to one short set of paperwork that can be completed and processed in a manner that does not drag on for years.

Lenders that have no interest in the asset should waive their mortgages to allow homeowners and municipalities ways to transfer the property to an occupying buyer.

**B. The Court Process**

The court process begins and ends with knowledgeable judges. Judges need to understand the implications of vacating judgments on the homeowner and the community. Courts are best able to control the time a foreclosure remains in process. Unfortunately, courts are also overburdened and understaffed. Policymakers need to address those issues as well.

Judges need to be educated as to the many implications of setting aside a foreclosure judgment.

Requiring creditors to comply with Trial Rule 60 would end most of the abuses.

Courts should better control their dockets by dismissing foreclosure actions that have been open with no activity for long periods of time.

All deficiency amounts should be accurately recorded in the record and readily accessible to the consumer.
C. Policy-Makers

This problem will grow as the economy improves. Creditors and debt collectors, who previously saw no hope of recovery, will soon have wages to garnish. Simple steps can be taken now to prevent this from becoming a second foreclosure debt crisis.

The re-securitization of zombie mortgage debt needs to be closely monitored by regulators.

The debt buying industry must be required to have complete and accurate information of the deficiency judgment and the documents to prove it, before collection proceedings can be initiated.

Lenders should be required to inform homeowners when they cancel a sheriff’s sale, not just when they initiate one.

These suggestions are all simple, easily implemented steps. I am not the first to offer many of them. We are in a position to mitigate the possible fallout of the foreclosure crisis. Policymakers can choose to get ahead of the problem or wait to clean up another mess. I encourage them to choose the former. As the evidence shows, it is not the homeowners who are walking away from their mortgage; it is the mortgage industry that has walked away from the homeowners. It is long since passed the time to turn them around.
SUITABILITY AND NON-MALEFICENCE: A PROPOSAL FOR INSURANCE PRODUCER REGULATORY REFORM

Mark Franke*

I. INTRODUCTION

There are worse things in life than death. Have you ever spent an evening with an insurance salesman? —Woody Allen

Let’s face it: spending time with an insurance agent is probably not on the top of the list of things you love to do. But when you buy a new car, add an addition to your house, or get a new job that boosts your earning capacity, calling your agent is surely near the top of the list of the things you have to do. We call our agents—in statutory parlance, “producers” —tell them about the change of our circumstances and, as painlessly and quickly as possible, aim to get the coverage we need. While we vary in our solicitude, to some extent those of us who use an agent to obtain coverage for our risks inevitably rely on our agents to understand these risks and obtain for us coverage at a reasonable cost; we ask our agents to take care of us, trusting that they will exercise basic diligence in their service to us and will “tell the truth and . . . keep their promises.”

But should we as a matter of course? Perhaps. After all, as

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* The University of Michigan Law School, J.D. 2013.
2 See, e.g., PRODUCER LICENSING MODEL ACT OF 2005.
a general principle, “[t]rust saves time and money... allow[ing] [us] to use the talents of strangers” on matters about which we lack expertise.\textsuperscript{4} Attendant to such trust, however, lies the menace of its abuse and the cost of protecting ourselves from the harm that would result from exploitation.\textsuperscript{5} So perhaps not. While the law generally should conform to our reasonable expectations,\textsuperscript{6} such reliance must be objectively reasonable for a court to give recompense for any resulting harm.\textsuperscript{7} Even if judges are loath to impose any duties commensurate to such reliance, agents are not so reluctant to invite duty, to varying degrees, from unwary consumers.\textsuperscript{8} This paper proposes a new statutory framework of duties for the regulation of insurance producers to address the trust consumers’ place in producers. It aims to impose duties on producers that are tailored to allow for a reasonable level of reliance by consumers on professionals of this type.

Heightened duties may arise by contract or statute.\textsuperscript{9} They may also be implied in a relationship, such as the duty of care in tort law\textsuperscript{10} or in special relationships wherein one party reposes trust and confidence in another to act in his best interest and the other accepts such trust.\textsuperscript{11} There are, generally, two moving parts which may be tinkered with to arrive at the appropriate cocktail of duties: duty of care and duty of loyalty. The duty of care is essentially a duty to exercise proper diligence required by the task

\textsuperscript{4} Tamar Frankel, Trust and Honesty: America’s Business Culture at a Crossroad 49 (2006).

\textsuperscript{5} See supra note 3, at 1291.


\textsuperscript{7} See id.

\textsuperscript{8} See, e.g., TWG Insurance, http://www.twginsurance.com (last visited May 5, 2013) (suggesting that it will obtain “the best coverage at the lowest cost”); Stillwell Insurance, http://www.stillwellinsurance.com/home.html (last visited May 5, 2013) (suggesting that the broker will find insurance companies “best suited to your individual needs” and admonishing that “it is to your advantage to have a trained professional to look out for your interests”).


\textsuperscript{10} Where there is a foreseeable victim of a foreseeable harm which could result from the actions of an actor, the actor is generally held to have a duty to take reasonable steps to prevent such harm. See Tarasoff v. Regents of Univ. of California, 551 P.2d 334, 342 (Cal. 1976) (citing cases).

\textsuperscript{11} See, e.g., Broomfield v. Kosow et. al, 212 N.E.2d 556, 560 (Mass. 1965) (holding that the depositing of trust must be accompanied by the acceptance of such trust for a fiduciary relationship to arise).
Suitability and Non-maleficence

at hand. The duty of loyalty is the duty of an agent not to enrich himself at the expense of his agent; it is the renunciation of self, “however hard the abnegation.” When we entrust ourselves or our property to another we accordingly may do so in two ways: (1) by trusting the other will exercise sufficient thoughtfulness (care) or (2) by trusting the other to renounce their self-interest in favor of ours (loyalty). These moving parts, however, have been sliced up and re-grafted into a so-called “suitability standard” in the context of broker-dealers of financial securities. The suitability standard is less onerous than full fiduciary duties but treats broker-dealers as more than mere salespersons. A similar standard, together with other specific rules, has now been set forth in the Dodd-Frank Act for the regulation of mortgage brokers. Following the trend set by this adaptation of the suitability standard in the Dodd-Frank Act, in this paper I shall propose a modified version of the suitability standard for insurance producers and a rule not to harm when choosing among suitable contracts, what I will term a “non-maleficence” rule. Together, these will create an appropriate cocktail of care and loyalty tailored specifically to the insurance producer context.

This paper begins with two premises. First, that consumers always rely upon producers to take care of their needs. Second, that producers should not enrich themselves at the expense of the customer. There are, correspondingly, two problems this paper aims to address. The first—that there is no duty for insurance producers to sell insurance contracts suitable to the customer—arises out of the deficiency of the common law of agency and the failure of licensing strategies to separate all the chaff from the grain. The second—that there is nothing that prevents producers from steering consumers to contracts which lead to better compensation outcomes for the producer while

14 The application of a suitability standard to life insurance producers has been suggested before. See generally Richard J. Wirth, My Customer’s Keeper: The Search for A Universal Suitability Standard in the Sale of Life Insurance, 24 W. NEW ENG. L. REV. 47 (2002). Professor Wirth’s study, however, focused on the appropriate calculations for defining the scope of a customer’s need for life insurance in connection with a possible suitability analysis and the correspondingly appropriate life insurance products. See id. at 63-69. The current study focuses on applying a suitability requirement and non-maleficence rule to all insurance producers.
costing the consumer more—arises out of compensation arrangements that may lead to a producer steering a consumer to an insurer or a policy that puts more dollars in the producer’s pocket.

The law regulating the placement of consumer insurance contracts by insurance producers is fractured. As a matter of the common law, it is a complicated question of fact to whom producers owe their allegiance as agents. Moreover, there is usually no duty to advise the customer on the appropriateness of a given insurance contract for the particular customer. The law generally treats producers as the mere salesmen that were the subject of Mr. Allen’s lament. But, due to the high verification costs and lack of expertise with respect to consumers of insurance contracts, the law does not reflect the reasonable expectation that producers will take care of the consumer purchasers. While increasing requirements may increase transaction costs, this may be offset by increased trust in markets that accompanies the better advice and the reduction of information asymmetries.

In the area of compensation arrangements that cause producer-customer conflicts of interest, some states address the problem through a broker fee disclosure requirement. Others require, upon request, commission and quote comparison disclosures. Even if these disclosures provide the information needed for the market to solve these conflicts of interest, the efficacy of disclosures to consumers is questionable. Moreover, the market for consumer insurance contracts is not such that information is widely incorporated into the price that consumers are willing to pay. Lastly, all states license producers, but licensing fails to ensure that each transaction is consummated

15 For a discussion of agency, see infra Section III.A.1.
16 For a discussion of producer duties under the common law, see infra Section III.A.2.
17 See Frankel, supra note 4, at 52 (noting the relationship between monitoring costs and heightened duties); see also Daniel Schwarcz, Reevaluating Standardized Insurance Policies, 78 U. Chi. L. Rev. 1263, 1325 (2011) (noting the low likelihood that consumer insurance purchasers would understand the contracts, even if they had access to them).
19 For a discussion of fee and compensation disclosures, see infra Section III.C.B.
with the consumer’s interest in mind. This paper will use the examples of the suitability requirements imposed upon brokers of financial securities by Financial Industry Regulatory Authority (FINRA), the self-regulating organization (SRO) of the financial industry, the record-keeping requirements imposed on securities brokers by the U.S. securities laws, the anti-steering provisions of the Dodd-Frank Act applicable to residential mortgage brokers, and the rules promulgated pursuant to Dodd-Frank and the securities laws by the Securities and Exchange Commission (SEC) and the Consumer Financial Protection Bureau (CFPB), all of which provide useful models for the regulation of insurance producers. Before arriving at its end, this paper will begin with a brief introduction to the categories of insurance producers. It will follow with an exposition of the two problems this paper’s proposal aims to ameliorate and, in so doing, exposit and critique the current regulation of insurance producers through the common law, licensure, and compensation disclosure regimes.

II. INTRODUCTION TO INSURANCE MARKET PRODUCERS

As a preliminary matter, it is important to make clear that the contracts which insurance producers broker are adhesion contracts, as this is essential to the nature of a producer’s role in the transaction. While contrary to the classical contract law notion that a contract should be a “meeting of the minds,” adhesion contracts have come to be accepted because they facilitate a more efficient economy. These contracts reduce transaction costs, notwithstanding the risk that the terms may unfairly protect the party who offers them. To protect against such risk, state legislatures may expressly dictate acceptable terms for the insurance contracts or delegate the authority to approve the terms of contracts to state regulators. In light of the regulatory oversight of the contract terms and the fact that, in

20 For a discussion of licensing regimes for insurance producers, see infra Section III.C.A.
21 See 1-1 CORBIN ON CONTRACTS § 1.4 (1993) (internal citation omitted).
22 Id.
23 Id.; see, e.g., Texas Ins. Code, Tit. 10, Subtit. 1, Ch. 2301, Subch. A, § 2301.006 (requiring that the insurance commissioner approve of any form used for writing property and causality insurance prior to use by an insurance company).
most cases, consumer insurance contracts cover relatively small risks, direct negotiation is not necessary.\footnote{Lee R. Russ, Couch on Insurance 3d. § 1:2 (2012).} It follows that it is equally unnecessary to have an agent of the insurer with authority to negotiate terms of the contract to broker the transaction. As such, most consumer contracts are consummated through a third party producer without such authority.\footnote{Id.}

An insurance producer is “an individual or . . . firm, with some degree of independence from the insurer, which stands between the buyer and the seller of insurance.”\footnote{J. David Cummins & Neil A. Doherty, The Economics of Insurance Intermediaries, 73 J. Risk & Ins. 359, 360 (2006).} There are a few types of insurance producers: exclusive agents, managing general agents, brokers, and independent agents. Exclusive agents act as an authorized and exclusive representative of one, or primarily one, insurer.\footnote{Id. at 360-61.} Managing the general agents are a specialized type of broker who can underwrite on behalf of insurers and place contracts with insurers.\footnote{See Managing General Agent (MGA), IRMI, http://www.irmi.com/online/insurance-glossary/terms/m/managing-general-agent-mga.aspx (last visited May 5, 2013).}

Brokers are generally understood to be firms who serve as market makers with a multi-regional scope and providing a wide range of sophisticated services such as modeling risk, managing captive insurers, loss control services, and risk modeling and management.\footnote{Cummins & Doherty, supra note 26, at 361.} Brokers are generally considered to be agents of the insured, notwithstanding that they often consummate “agency appointment” contracts undertaken with the insurers.\footnote{Id.} Independent agents are sometimes characterized as non-exclusive agents of the insurer,\footnote{See Agent/Broker Compensation Disclosure, Zurich in North America, http://www.zurichnaproducercompensation.com/Welcome.aspx (last visited May 5, 2013) (noting that Zurich “value[s], and customers rely on, agents’ and brokers’ trusted professional advice” and that “brokers and independent agents are not employed by Zurich”).} and sometimes as independent of the insurer.\footnote{Cummins & Doherty, supra note 26, at 361.} The line between brokers and independent agents blurs as a practical matter, for they often perform nearly identical services to the purchasers of policies,\footnote{See, e.g., id.} but independent agents tend to be smaller, regional service providers to primarily small
businesses and consumers. Cummins and Doherty suggest that the true distinction between brokers and independent agents is the volume and breadth of services offered. The use of terms in the industry for the various intermediaries is, in a word, muddled.

Baker and Logue note that a purist might insist that the term agent should only be used to describe someone who acts as an agent of the insurer. The taxonomy of producers, however, is immaterial to this study, as its proposal is to apply a blanket suitability standard and non-maleficence rule upon all producers who broker consumer insurance contract transactions.

III. THE PROBLEMS

A. Problem 1: Producers Have No Duty to Advise

Notwithstanding that insurance producers are often the only person the end consumer interacts with at the time of contract formation; producers in general have no duty to guide the consumer to a contract that is suitable to their needs. This section will describe more fully the first problem this paper aims to address through the imposition of a modified suitability requirement. It will lay out the common law principles of agency

34 Id.
35 Cummins & Doherty, supra note 26, at 361.
37 TOM BAKER & KYLE LOGUE, INSURANCE LAW [Manuscript Ch. 2, page 41] (3d ed. 2013) (on file with author). It appears that California is one state which actually adheres to this framework, calling only those producers not appointed and without actual authority to bind the insurer a “broker” and those producers who are appointed, who have a delineated scope of actual authority in their agency contract. Stephen L. Young, When May Broker-Agents Charge Fees?, at 1-2, http://www.ibawest.com/pdf/Articles/WhenMayBrokerAgentsChargeFees.pdf. In addition, insurers are required to file notice with the California Department of Insurance when any such appointment is made. Id.
38 The proposed duty framework contained herein should be applied to both individual producers acting on their own behalf and upon larger producers, those fitting Cummins and Doherty’s definition of “broker,” see supra notes 29-30 and accompanying text, by the acts of its employees according to respondeat superior principles.
applicable to insurance producers and the limited duties they owe the consumers they serve.

1. Agency

Insurance brokers sit in a curious position: as they providing a service to the consumer, while being paid by insurance companies. Who is their master? Where do their loyalties lie? Is an insurance broker only a market maker? Is an insurance broker an advisor to the policy purchaser? Or both? Is the insurance broker an agent of the insurer? Are there reasons to believe that a particular insurance broker has a special relationship to the policy purchaser such that the latter reposes trust and confidence in the former? These questions permeate the common law duties owed by an insurance broker to the consumer purchaser. The answers to these questions determine the scope of a broker’s duties to a purchaser.

Depending on the facts and circumstances of a given transaction, courts come out differently on the question of who is a producer’s principal. Obviously, this is a fact-intensive inquiry, requiring judicious analysis by the fact finder, which this paper proposes replacing with a new standard and rule imposed upon all producers who transact with consumers.

The extent of a producer’s duties to consumer purchasers of insurance is limited in part because producers are generally considered special agents. In the classical sense, an agent is a fiduciary of its principal and is subject to his or her principal’s control. An agent must “act loyally for the principal’s benefit in all matters connected . . . [to] the agency relationship.” There are two types of agents: general and special. A general agent is one with authority to act on behalf of his principal in a series of transactions involving ongoing service. A special agent is one

39 See 1-2 Responsibilities of Insurance Agents and Brokers § 2.10.
41 See Schimmel Fur Co. v. American Indem., Co., 440 S.W.2d 932, 938 (Mo. 1969) (holding that the question of whether a broker is an agent of the insured, the insurer, or both is a question of fact).
42 RUSS, supra note 24, at § 46:1, at 46-7.
43 See RESTATEMENT (THIRD) OF AGENCY § 1.01 (2006).
44 RESTATEMENT (THIRD) OF AGENCY § 8.01 (2006).
45 RESTATEMENT (SECOND) OF AGENCY § 3 (1958). Note that the third restatement abandoned the definitions of general and special agents.
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who is “authorized to conduct a single transaction or a series of transactions not involving continuity of service.” As a special agent, therefore, producers have no ongoing duties to any policy purchaser for whom they broker a contract.

Moreover, an insurance producer often acts as a dual agent, that is, as an agent of the insured in some respects and an agent for the insurer in others. For instance a broker may act as an agent for the insurer by collecting premiums and delivering them to the insurer and as an agent for the insured in the brokering of an insurance contract. The key to the dual agency concept is that the dual roles must not create a conflict of interest.

Most case law and scholarship on agency principles applicable to producers focuses on the extent to which acts or statements of producers can be imputed to insurers. Enough cases have been decided and enough has been written on the circumstances under which acts of an insurance producer may be imputed to the insurer. This paper is not concerned with the circumstances under which acts or statements of a producer may be imputed to the insurer or admitted as parol evidence. It is concerned with imposing duties upon all producers who face the consumers in the insurance marketplace to encourage trust and efficiency in the consumer insurance markets.

2. Broker Duties at Common Law

What is the scope of a producer’s duty to his customer? In general, it is very limited in scope and, consistent with the notion that they are special agents, circulates around the transaction brokered. Because the contracts offered to consumers are adhesive, the primary activity of the producer is the delivery of the contract. As such, there are three sets of facts under which a policy purchaser may have a viable cause of action: (1) where the broker fails to deliver the insurance promised; (2) where the broker fails to obtain certain specific coverage requested; or (3)

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46 Id.
47 RUSS, supra note 24, at § 46:38, at 46-84.
48 Id.
50 Id. at § 2.07[4][c][ii] (2012).
52 See, e.g., 1-2 Responsibilities of Insurance Agents and Brokers § 2.05 (2013).
where the broker fails to obtain the amount of coverage requested.\textsuperscript{53}

Brokers do not have any duty to determine the appropriate amount of insurance for a particular purchaser of a policy.\textsuperscript{54} Likewise, they generally do not have a duty to advise on the coverage that a purchaser should obtain.\textsuperscript{55} Similarly, there is no duty to explain the coverage.\textsuperscript{56} In general, there is no reasonableness lens applied to the facts surrounding a transaction. That is, any argument that the broker should have known coverage was needed in a particular situation will likely fail.\textsuperscript{57} In essence, the only duty owed to the purchaser is to obtain and deliver the policy requested by the purchaser.\textsuperscript{58} That is, with the rare exception, insurance producers are generally treated as mere salespersons.\textsuperscript{59} They merely present a quote, fill out the forms, accept the payment, and deliver the policy promised. While this duty might catch outright fraud, abusive, or dishonest behavior in connection with the delivery of the policies requested,\textsuperscript{60} the common law courts are reluctant to impose any kind of duty upon brokers, notwithstanding the inevitable reliance upon them by consumers.

Under certain circumstances, a special relationship might arise between a broker and the insured such that a duty to advise

\begin{footnotes}
\item[54] RUSS, supra note 24, at § 46:38, at 46-88.
\item[55] See, e.g., Nelson v. Davidson, 456 N.W.2d 343 (Wis. 1990) (finding no duty to advise client to get additional coverage for underinsured motorist coverage); Wang v. Allstate Ins. Co., 592 A.2d 527, 532 (N.J. 1991) (finding no duty to advise on the scope of coverage for a homeowner’s policy).
\item[57] See, e.g., May v. United Services Ass’n of America, Inc., 844 S.W.2d 666 (Tex. 1992) (rejecting that a broker should have known from the facts surrounding the transaction that certain coverage was needed).
\item[60] For example, in addition to the administrative penalties in a Lancaster County, PA case against a local broker, it is likely that these duties would capture the same activity. See, e.g., Tim Mekeel, \textit{Lancaster County insurance broker accused of overcharging customers}, LANCASTER ONLINE (Mar. 19, 2013, 4:10 PM), http://lancasteronline.com/article/local/827977_Lancaster-County-insurance-broker-accused-of-overcharging-customers.html.
\end{footnotes}
the insured exists. For instance, in Michigan, a duty to advise may arise where the broker misrepresents the scope of coverage.61 This essentially equates to a duty to correct the misrepresentation. Similarly, if the broker gives inaccurate advice to a purchaser, the same duty to correct is triggered.62 Lastly, if the purchaser makes an ambiguous request for coverage, the broker must advise to the extent necessary to decide what coverage the purchaser is trying to obtain.63

A special relationship may also arise depending on how a broker holds himself out. For instance, a Georgia court held that a broker who was receiving compensation for advice and holding himself out as a specialist in ensuring adequate coverage was bound by a duty to advise.64 Other courts have admitted parol evidence to show that a special relationship arose by implication. For instance, a New Jersey court held that where the insured asked for the “best available” coverage, that the insurance broker had a heightened duty to ensure that this was met.65 The court based its holding on a reliance rationale—because the insured gave the broker discretion to obtain the best available coverage, there was a heightened duty to exercise this discretion in a way that obtained that end.66

Relatedly, but conceptually distinct, courts in some jurisdictions have suggested that brokers might be subjected to a heightened professional duty of care.67 In negligence causes of action, the care exercised by defendants is evaluated against a hypothetical reasonably prudent person standard.68 This inquiry, though, is tied to the circumstances of the conduct in question.69 In occupations where you must be a specialist the law accordingly imposes the standard of care normally exercised by people in the profession.70 In light of the relatively low barriers to licensing, imposing professional liability upon brokers may be

63 Id.
66 Id.
67 See Sakall, supra note 40, at 995 (citing cases).
69 See id.
overreaching, although it has been proposed.\textsuperscript{71} Even with heightened educational requirements as may be required under the proposed change of law in this paper, imposing professional liability will not induce consumers to bring actions against negligent producers, as the damages at issue here are relatively small.\textsuperscript{72} Also, insurance producers are categorically different than other professionals, such as lawyers and doctors, whose allegiances must be pure in order to adequately serve their client’s interest. Such professionals are entrusted generally with property and issues of much higher consequence. Conversely, producers are market makers, albeit in a specialized field, so, while no duty to advise is inappropriate, a full professional standard of care is likewise inappropriate.

All “duties” discussed above could, however, be treated simply as creatures of contract. An oral contract to obtain an insurance policy, even if the policy would last for more than one year, is not barred by the statute of frauds.\textsuperscript{73} An oral agreement to obtain a policy as instructed is likely per se enforceable.\textsuperscript{74} But even if it were not, in the event that the consumer purchaser changes its position in reasonable reliance on the producer’s promise to obtain the policy, promissory estoppel would likely bar any defense on statute of frauds grounds.\textsuperscript{75}

In any event, the duties imposed upon producers are minimal under the common law and they do not at all conform to the reasonable expectation that to some extent insurance agents will take care of people by providing them with policies that are suitable to their situations. Indeed, many even invited reliance by consumers to varying degrees.\textsuperscript{76}

\footnotesize{\textsuperscript{71} See generally Sakall, supra note 40, at 995.  
\textsuperscript{72} See, e.g., Leslie Scism, Insurance Fees, Revealed, (March 30, 2012 5:08PM EDT), http://online.wsj.com/article/SB1000142405270230417710445730393020277033 6.html (noting that on a $1000 brokered automobile insurance policy, the commission would be roughly $150-200).  
\textsuperscript{73} 4-12 CORBIN ON CONTRACTS §12.8[II][A] (citing cases).  
\textsuperscript{74} See Saunders, 224 Cal. App. 2d at 909 (suggesting that the duty of a broker to obtain the policy it promises could be characterized as an oral contract).  
\textsuperscript{75} See RESTATEMENT (SECOND) OF CONTRACTS §139.  
\textsuperscript{76} See supra note 8 and accompanying text.}
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B. Problem 2: Compensation Arrangements Causing Conflicts of Interest

This section will now outline the second problem this paper aims to ameliorate through the non-maleficence rule, namely, how compensation arrangements between producers and insurers creates conflicts of interests between producers and consumers. This is a recognized problem, the solution for which has been disjointed among the states.

Compensation for insurance brokers can come in four basic forms: salaries, commissions, bonuses, and fees. Depending on whether a broker is self-employed or not, the compensation sources may differ. Typically, a large portion of an insurance broker’s income comes from commissions. Commissions are usually calculated as a proportion of the premium amounts paid by the insured. Compensation may also be based upon volume of sales, that is, the number of policies sold, or tied to the profitability of the contract for the insurer. Producers may also charge broker fees. Commissions are paid by the insurer,


essentially splitting the premium with the producer.\textsuperscript{83} In addition, broker fees are paid by the insured.\textsuperscript{84}

As a basic matter, it stands to reason that since commissions are paid on the total premium amounts, the producer will have an incentive to try and push premiums higher by covering more risks. The more risks covered, the higher the premiums.\textsuperscript{85} In the alternative (depending on the producer’s go-to-market strategy and the contractual compensation arrangements with carriers), the producer might also aim to sell as many policies as possible. Also, where one insurer pays a higher commission rate, a broker will have an incentive to steer consumers to such insurer over another, even if that policy will cost the consumer purchaser more.\textsuperscript{86} In the case of sales targets, the incentive may be in the opposite direction. If a broker is employed by a brokerage house that pays bonuses based upon hitting sales targets, this may create incentives to sell policies that do not adequately cover risk—whether by risk type, in coverage amount, or with higher deductibles—in the pursuit of higher sales figures.

\textbf{C. Other Regulatory Methods and their Deficiencies}

Aside from the common law duties, or lack thereof, there are also other statutory and regulatory methods of regulating insurance producers, two of which are licensure and


\textsuperscript{84} See Stephen L. Young, \textit{When May Broker-Agents Charge Fees?}, at 1, http://www.ibawest.com/pdf/Articles/WhenMayBrokerAgentsChargeFees.pdf (suggesting that fees may be charged by brokers, so long as disclosed).


\textsuperscript{86} Depending on the phase of the underwriting cycle, insurers may pay higher commissions. For instance, early in the cycle where they are trying to build out their pool in a specific risk type or geography, they may pay higher commissions to induce brokers to push their insurance products over a competitors’. See Conwell, \textit{supra} note 36, at 2.
compensation disclosure. While these may eliminate some degree of the two problems at issue here, they do not suffice for the reasons outlined below.

1. Licensure

Broker licensing regimes among the states are more or less uniform. The National Association of Insurance Commissions (NAIC) began an effort to make licensing uniform in 1999 with the Producer Licensing Model Act (PLMA). As of 2009, the federal Government Accountability Office reported 47 states had adopted this act. The NAIC followed the PLMA with issuing standards for licensure, which, by 2008, the NAIC boasted had been adopted in large part by many states. These standards, among other issues, address things like minimum age, citizenship, education level, acceptable versions of study and verifications on such study, test procedures, standards, retesting rules, background checking procedures, and minimum personal integrity standards. As with other professional licensing regimes, these circulate around minimum competency and character standards.

While competency standards exist to make sure that the broker we rely upon is worthy of our trust in the subject matter, character standards make sure that brokers are not predisposed to morally untrustworthy acts. The PLMA provides in section 12 the bases upon which a license may be denied, not renewed, or revoked. The grounds for denial, non-renewal or revocation of a license ambulate back and forth between fraudulent or dishonest acts, such as outright fraud or forgery, to criminal or morally
reprehensible acts, such as felony convictions or not complying with any child support obligation to which a licensee is subject.\textsuperscript{94} Violation of any insurance law may also constitute a ground for denial.\textsuperscript{95}

This framework points to actions, which serve as proxies for competency and moral trustworthiness, which correspond with predispositions for adequate care and loyalty. In this sense, by a broadly sweeping sorting mechanism, licensure attempts to address the same issues that the duties of care and loyalty do. Licensing standards do a good amount of work to sort the grain from the chaff, but they do not require a producer to provide policies suitable to the consumer purchaser. Moreover, they do not prohibit the sale of a higher priced policy in order to get a higher commission unless such an act rises to the level of an unfair trade practice.\textsuperscript{96}

2. Fee Disclosures

In 1998, insurance regulators in New York became aware of additional fees being charged, in addition to commissions, by brokers. In a circular, the regulator noted that the charging of these fees absent disclosure gave rise to “a perception that brokers are conflicted in their loyalties.”\textsuperscript{97} Moreover, the circular noted that the charging of these fees may violate section 2110 of the New York Insurance Law, which prohibits dishonest and untrustworthy practices by brokers.\textsuperscript{98}

This is a wider issue that has been recognized by the community of insurance commissioners of many states. In 2006, the President of the NAIC noted that state commissioners had continued to examine the potential for conflicts of interests that arise from undisclosed fees and commissions.\textsuperscript{99} In 2004, Eliot

\textsuperscript{93} Id. \S 12 (A)(8), (12).
\textsuperscript{94} Id. \S 12 (A)(2), (6), (13).
\textsuperscript{95} PRODUCER LICENSING MODEL ACT OF 2000, \S 12(A)(2).
\textsuperscript{96} See id. \S 12(A)(7).
\textsuperscript{98} Id.
Spitzer sued March & McLennan Cos., Aon, and Willis Group—the three largest brokerage houses in the U.S.—alleging that the brokers had been steering its clients toward certain insurance carriers in exchange for additional payments from such carriers.\textsuperscript{100} There were other similar suits against smaller producers.\textsuperscript{101} More recently, the Federation of Risk Management Associations called upon the European Parliament to pass laws requiring basic fee disclosures by producers as well.\textsuperscript{102}

Some fee disclosure rules require only disclosure of fees additional to commissions paid by insurers.\textsuperscript{103} New York’s Insurance Regulation 194 requires disclosure of not only fees but also commission amounts, if the consumer requests it after an initial required disclosure by the broker that he or she “will receive compensation . . . in whole or in part on the insurance contract the [producer] sells . . . .”\textsuperscript{104} This initial disclosure may be performed orally or in writing.\textsuperscript{105} The initial disclosure does not have to include any factors which affect the amount of compensation the broker will receive;\textsuperscript{106} it must only state that the consumer can obtain additional information on the “nature, amount and source” of the compensation upon request.\textsuperscript{107} The consumer may also obtain a list of “alternative quotes presented to the producer” by the carriers.\textsuperscript{108}

Disclosure has been deemed a sufficient solution to other


\textsuperscript{101} See Kristof, \textit{supra} note 100 (noting the suit and $2 million settlement of suit brought by Spitzer against Universal Life Resources of Del Mar, Cal. and the action also waged against Universal Life Resources by the California insurance commissioner).

\textsuperscript{102} Sarah Veysey, \textit{FERMA Urges fee disclosures for all insurance buyers}, \textit{Business Insurance} (March 19, 2013 10:13AM), http://www.businessinsurance.com/article/20130319/NEWS04/130319819.\textsuperscript{103} See, e.g., Cal. Code of Reg., Tit. 10, Ch. 5, Subch. 1, Art. 6.8, § 2189.3(d) (requiring disclosure of fees in accordance with an Appendix A); see also Cal. Code of Reg., Tit. 10, Ch. 5, Subch. 1, Art. 6.8, Appendix A (providing that fees are payments made by the policy purchaser to the broker are in addition to commissions that may be paid by carrier).

\textsuperscript{104} 11 N.Y.C.R.R. § 30.3(a)(3).

\textsuperscript{105} 11 N.Y.C.R.R. § 30.3(a).

\textsuperscript{106} 11 N.Y.C.R.R. § 30.3(a)(3).

\textsuperscript{107} 11 N.Y.C.R.R. § 30.3(b)(1).

\textsuperscript{108} 11 N.Y.C.R.R. § 30.3(b)(2).
problems in financial products regulation, such as the U.S. securities laws. The securities laws, however, presuppose that, because the capital markets are presumptively efficient, that all public information is incorporated into the price of the security.\footnote{See Basic Inc. v. Levinson, 485 U.S. 224, 247 (1988).} Therefore, the reasoning goes, it is immaterial whether the end purchaser reads or understands the disclosure, as dutiful equity analysts, being the soldiers of efficiency that they are, pore over the disclosure forms and the price shifts according to their buy/sell recommendations.

Consumer insurance contracts are not traded on an exchange. Therefore, it is less likely that information is necessarily incorporated into the price that consumer purchasers are willing to pay for insurance contracts. Also, the Regulation 194 disclosures are not going to sophisticated analysts, but to the consumers themselves. It is an open question whether, even if the purchasers do request the additional disclosure, that they read and understand them. The disclosure forms produced by Independent Insurance Agents and Brokers of New York, Inc. (IIABNY), a private trade group,\footnote{See INDEP. INS. AGENTS AND BROKERS OF NEW YORK, About us, http://www.iiabny.org/AboutUs/Pages/default.aspx (“IIABNY exists to fulfill the educational, political, and business interests of our . . . agencies and . . . employees”).} allow for the compensation to be disclosed in a percentage or number.\footnote{INDEP. INS. AGENTS AND BROKERS OF NEW YORK, Statement of Compensation, Ownership Interest, and Prohibition Against Rebating, available at http://ny.iiaa.org/Advocacy/Reg194/2_Comp_Ownership_Rebating.pdf.} Most people understand the difference between a proportion and an absolute number, but would they be willing to do calculations? The tables IIABNY provides for the comparison of quotes are more promising. They lay things out plainly enough including, most importantly, the compensation that the producer will receive.\footnote{See INDEP. INS. AGENTS AND BROKERS OF NEW YORK, Description of Alternative Quotes, available at http://ny.iiaa.org/Advocacy/Reg194/2_AltQuotesPresented_PC.pdf.}

If whether entrusting ourselves to our brokers is reasonable depends on the cost of verifying the truth and honesty of their assertions,\footnote{See FRANKEL, supra note 4, at 52.} these disclosures may reduce monitoring costs. The efficacy of such monitoring depends directly on whether the information is requested and, if so, whether it is read and understood. Even if consumers do not make disclosure
requests, the fear of requests might deter unscrupulous practices as well.

The New York Department of Financial Services stated to the author that they do not have any data on how often consumers actually request the additional disclosures because “agents are not required to report this information to [the department].”114 To the author’s knowledge, there are no public sources of such data either. Perhaps Regulation 194 has curbed unscrupulous practices, but this would depend on how often additional disclosures are requested, whether consumers read and understand the information provided, what consumers do with the information, or whether reputational risk provides a sufficient deterrent. The SEC recently published a study showing that most Americans surveyed lacked basic financial literacy,115 which may cast doubt on the efficacy of disclosures directly to consumers. While reputational risk may have some deterrent effect, it is not clear that it is sufficient.116 Moreover, the duties imposed or implied by law or equity have replaced in large part the norms that bind closely-knit communal societies with the transition to a modern market-based economy wherein economic incentives lead to moral hazard.117 Thus, reputational risk may be insufficient to deter unscrupulous steering by producers, even if it has some minor demonstrable deterring effect.

IV. THE SUITABILITY STANDARD

A suitability standard applies to broker-dealers118 of

114 E-mail from Patricia Douglas, Ass. Ins. Examiner, Consumer Assistance Unit of the New York Department of Financial Services, to the author (May 3, 2013, 2:00PM EDT) (on file with author)
115 SEC. & EXCH. COMM’N, STUDY REGARDING FINANCIAL LITERACY AMONG INVESTORS (AUG. 2012), AT III, AVAILABLE AT HTTP://WWW.SEC.GOV/NEWS/STUDIES/2012/917-FINANCIAL-LITERACY-STUDY-PART1.PDF.
116 At least as far as the large brokerage houses are concerned, the specter of a reputational stain may be limited in efficacy where cash flow is king. See Kenneth J. St. Onge, Aon Will Begin Accepting Contingent Commissions Again, Insurance Journal (Aug. 2, 2010), available at http://www.insurancejournal.com/magazines/features/2010/08/02/159998.htm (noting that, notwithstanding five year prohibition on the same under the Spitzer settlement, Aon would begin to accept contingent commissions again).
117 See Brescia, supra note 18, at 313.
118 A broker is a person in the business of effecting transactions in securities on the account of others. 15 U.S.C.A § 78c(a)(4)(A). A dealer is a person in the business of buying and selling securities on its own account. 15
financial securities under FINRA rules, the securities laws, and now, pursuant to Dodd-Frank, residential mortgage brokers as well. This section will introduce the suitability standard as applied to both, the additional rules added by Dodd-Frank for mortgage brokers to supplement and will tailor the suitability standard to that context.

A. Introduction to the Standard as Applied to Broker-Dealers

The suitability standard essentially requires that a broker-dealer know his customer and, given this knowledge, make recommendations upon some reasonable basis that the product is suitable specifically to the customer.119 This standard imposes a lighter duty than full fiduciary duties, which is generally viewed as the highest standard under the law.120 It essentially operates as a pared down duty of care. Implicit in the notion of finding a suitable product is a certain amount of diligence. One must study the terms of the instrument, its volatility, its historical returns and future outlook in order to determine if it is a good investment. In addition, the suitability standard requires the broker-dealer to consider the particular customer’s appetite for risk and investment goals and compare prospective securities available for purchase against them.

Where a broker-dealer of securities recommends a security to an investor, the broker-dealer must conclude, first, that the investment product in question would be suitable for that investor.121 That is, if a product recommended by a broker-dealer were to turn out a sham product, then the broker-dealer might be held to have not discharged its obligations under this prong if he could have discovered the sham with reasonable diligence. Second, the broker-dealer must look to the particular customer in question and determine whether the product is suitable to the consumer specifically based on the individual’s characteristics,
such net worth, finances, investment goals, risk aversion, and tax status.\textsuperscript{122}

While Rapp suggested that the FINRA suitability standard does not prescribe a care standard,\textsuperscript{123} this is not entirely correct. He was correct to state that the standard operates more as an \textit{ex post} mechanism for evaluating the reasonableness of a particular recommendation made by a broker in light of the investment goals of the purchaser.\textsuperscript{124} But, just because the FINRA rule does not state the level of attention to the purchaser’s interests required does not mean that there is no standard of care. Indeed, the standard is stated in the rule itself—reasonableness—a standard that permeates the Anglo-American common law and which has a definite and clear meaning, even if it is always tied to the facts and circumstances to which it is applied. These rules incorporate the common law concept of reasonableness.\textsuperscript{125} Reasonableness in this context means that if a reasonably prudent stockbroker would not have recommended the stock in light of its risk profile and the investment goals of the purchaser, then such recommendation is not reasonable.

The SEC, through Rule 17(a)(3)(17), also requires broker-dealers who deal in securities transactions with individuals to obtain relevant information in order to make a customer-specific suitability determination. Aside from personal biographical and contact information, this rule requires that broker-dealers obtain account investment objectives (e.g., for retirement), the annual income of the individual, his or her net worth, and whether he or she is employed in a brokerage firm.\textsuperscript{126} The text of the rule states that broker-dealers “shall make and keep . . . the following books and records” of which the above records are included.\textsuperscript{127} But it also excuses any non-compliance of a broker-dealer on account of the “neglect, refusal, or inability” to provide relevant information by a customer.\textsuperscript{128} So long as a broker-dealer makes a good faith

\begin{footnotes}
\item[122] Id.
\item[124] See id.
\item[125] Cf. Pasquantino v. United States, 544 U.S. 349, 358 (2005) (noting in the context of statutory interpretation that “long-established and familiar principles” of the common law are presumed to be retained unless statutory purpose indicates clear contrary purpose).
\item[126] 17 C.F.R. § 240.17a3(a)(17).
\item[127] 17 C.F.R. § 240.17a3(a) (2013).
\end{footnotes}
effort to obtain the required information, they will not run afoul of the rule. But broker-dealers function as market makers for whom the regulators tailored a rule, which corresponds to what the regulators deem to be appropriate given their function.

Administratively, the efficacy of any suitability standard requires information gathering and record keeping effort requirements. The good faith excuse, while to an extent undermining the efficacy of the broker-dealer suitability standard, reflects what might be called a forearm’s length nature of the transaction. While not a full arm’s length away such that no duties at all are required, full fiduciary duties are not imposed either. The issue lies in the “reasonable basis” requirement of the suitability standard. In the absence of required record keeping, there is little evidence to refute any reasonable basis manufactured ex post.

SRO’s, in this case FINRA, must enforce compliance with these rules. Non-compliance by an SRO may result in the SRO’s suspension of authority to regulate its members, the revocation of its registration with the SEC, and censure or other limitations on its activities. Similarly, the SEC may also do the same to any member of the SRO in order to protect the interests of investors. It follows that the teeth of these enforcement mechanisms when it comes to the broker-dealers transacting with purchasers of securities is in the prevention of members from working in the industry.

However, a private plaintiff may also bring an action under Rule 10(b)(5), which prohibits misrepresentations and fraud committed with scienter in connection with the purchase or sale of a security. The Supreme Court has stated that this private right is available to purchasers and sellers of the securities. In order to bring an action under 10(b) for breach of the suitability requirement, a plaintiff must prove:

(1) that the securities purchased were unsuited to the

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132 Id., 19(h)(2) (2013); see also id. 3(b) (2013). (including in the definition of “member” any broker-dealer “who agrees to be regulated by [an SRO]”).
buyer’s needs; (2) that the defendant knew or reasonably believed the securities were unsuited to the buyer’s needs; (3) that the defendant recommended or purchased the unsuitable securities for the buyer anyway; (4) that, with scienter, the defendant made material misrepresentations (or, owing a duty to the buyer, failed to disclose material information) relating to the suitability of the securities; and (5) that the buyer justifiably relied to its detriment on the defendant’s fraudulent conduct.135

B. Suitability Standard as Applied Mortgage Brokers

The Dodd-Frank Act takes the suitability rule and modifies it to the context of regulating mortgage brokers and tailors it with additional rules specific to this context. In addition to its myriad of other reforms, the Dodd-Frank Act of 2010 addresses the activities and qualifications of mortgage brokers, which it terms “mortgage originators.”136 First it requires that all mortgage brokers be duly qualified and registered or licensed as required under state or federal law and that such brokers have a unique identifying number which it places on all documents associated with any transaction they broker.137 It also imposes upon depository institutions a duty to ensure that these requirements are met.138

But, the Act goes further. It directly imposes upon the brokers a modified suitability requirement. A broker may not steer a consumer to undertake any residential mortgage that “the consumer lacks a reasonable ability to repay” or that has “predatory characteristics or effects.”139 These rules apply to creditors, the ultimate counterparty to the mortgages, as well.140 Regulation Z, promulgated by the Consumer Financial Protection Bureau pursuant to its obligation to do so under the Dodd-Frank Act (but not yet adopted on the date this article went to print), prescribes “ability to repay” information that

136 See Dodd-Frank Wall Street Reform and Consumer Protection Act, 15 U.S.C. § 1602 (2013) (amending the Truth in Lending Act to define a mortgage originator as anyone “takes,” “assists a consumer in obtaining or applying to obtain,” or “offers or negotiates terms of” a residential mortgage loan).
137 Id. § 1639a-b (adding Section 129B(b)(1)(A)-(B) to the Truth in Lending Act).
138 Id. (adding Section 129B(b)(2) to the Truth in Lending Act.
139 Id. (adding Section 129B(b)(3)(A) to the Truth in Lending Act).
140 See id. § 1639c.
mortgage brokers must collect.  

1. Additional Rules for Mortgage Brokers

Moreover, a broker may not steer a consumer to a mortgage that is not a “qualified mortgage” if the consumer qualifies for a qualified mortgage. A qualified mortgage is a mortgage that lacks certain characteristics, for instance, negative amortization, interest-only payment, balloon payments, or terms that exceed 30 years along with stricter underwriting requirements. This essentially equates to a prohibition on selling a consumer on a mortgage, which has characteristics that are known to be problematic for consumer mortgage borrowers if a mortgage that lacks these characteristics is available. These provisions are likely due to the lack of regulation of the terms of mortgages leading up to the financial crisis. This is a point of contrast with the consumer insurance contract terms, which are subject to regulatory approval by state commissioners of insurance. However, the qualified mortgage rule is still instructive as it serves as the model for the anti-maleficence rule proposed here.

Dodd-Frank goes even further. It places a blanket ban against financial incentives paid to mortgage brokers by any person at all on account of the terms of the mortgage contract it brokers. It also totally disallows the receipt of compensation from both the creditor mortgagor and the consumer mortgagor. Both of these provisions obviously raise a conflict of interests concern between the mortgage broker and consumer mortgagor.

Having laid out now the suitability requirement as applied to broker-dealers and mortgage brokers, the study now turns to the proposed framework for producer regulation.

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141 See generally 12 C.F.R 1026.43(c) (1)-(2) (2013). See Note
142 See 12 C.F.R. 1026.43(e) (2013). See Note
143 See, e.g., supra note 23 and accompanying text.
145 Id.
V. SUITABILITY AS ALTERNATIVE TO THE DEFECTS OF THE COMMON LAW AND LICENSURE REGIMES

Like the Dodd-Frank Act did with mortgage broker regulation, this paper proposes a suitability rule modified to the producer regulation context and supplemented by an additional rule to address the unique regulatory challenges of this context. As shown above, the common law in general treats producers as mere salespersons. But, like mortgage brokers and broker-dealers of securities, producers perform a much larger role in the consumer insurance markets than the duties the common law imposes upon them would suggest. As of 2004, at least 32% of the personal lines market was intermediated by some type of producer. As of 2009, when you combine personal lines with property and casualty insurance, almost 50% of the market is brokered by independent agents or brokers. If the producer has no duty to advise them, then how do they know if they are getting the appropriate coverage for their risks?

A suitability standard, tailored to the facts of the insurance industry, should be applied to producers in order to ameliorate any under- or over-coverage that may result from either a lack of care or steering to unsuitable contracts by producers. As I will show below, together with the non-maleficence standard, a suitability standard would curb producers’ incentives to offer products unsuitable to their customers. Moreover, legislatures and regulators should consider imposing the compliance onus on the insurers to make sure their producers adhere to these requirements. This will help to discourage the wastefulness of fighting for access to deeper pockets by imputation of producer acts to the insurer that has plagued the common law on this subject. Beyond this, it would

147 See Cummins & Doherty, supra note 26 at 363 (noting that 32% of total personal lines insurance market intermediated by independent agents or brokers and that some is also brokered by exclusive agents). As of 2009, it appears that number was roughly the same. Madelyn Flannagan & Peter van Aartrijk, 2009 Property-Casualty Insurance Market: Opportunities & Competitive Challenges for Independent Agents and Brokers, 5 INDEPENDENT INSURANCE AGENTS AND BROKERS OF AMERICA, at http://www.independentagent.com/Resources/Research/SiteAssets/MarketShareReport/IIABA-Marketshare-Report-2010.pdf (last visited Sept. 27, 2013) (see table entitled “2009 Personal lines”).

148 See Flannagan & van Aartrijk, supra note 147, at 5 (48.8%).

149 For discussions of imputation of producer acts to insurers, see supra notes 51-52.
give attorneys general a clear, centralized strategy for rooting out producer carelessness and conflicted actions.

The provisions of Dodd-Frank related to mortgage brokers are instructive, because the relationship between a mortgage broker and a consumer borrower is similar to the relationship between a producer and consumer purchaser. Both are the face that the end consumer sees and interacts with. Before the financial crisis, mortgage brokers were primarily paid on two bases, through direct fees paid by the borrower and through contingent payments from the ultimate creditor based on the interest rate increases from a baseline, which increase with the yield spread premium (and so the profitability of the loan to the creditor). These compensation sources, in essence, directly correspond to the broker fees and the contingent payment sources of income discussed above in connection with producer compensation.

Moreover, there are huge information asymmetries between producers and consumer purchasers of insurance, just like between mortgage brokers and consumer mortgagors. Depending on the type of insurance, consumers may only purchase the coverage in question a few times in their lives. As noted above, a New Jersey court once held that a producer who was asked to obtain the “best available” coverage was under a duty to do just that based upon a reliance rationale and the reposing of discretion in the producer. While not requiring a producer to obtain the “best available” policies, the suitability standard proposed here is based on the same rationale, as to a certain extent consumers always repose discretion in their producers.

Additionally, consumer insurance policies are not available for review pre-purchase. Even if they were, however, there is scant likelihood that the average consumer would know

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151 See Id.
152 See supra, notes 81-82 and accompanying text.
154 See Sobotur, 491 A.2d at 737.
155 Schwarcz, supra note 17, at 1318-25.
what they say.\textsuperscript{156} While the average producer might also have doubts as to what they say, they are in a better position to find out and, therefore, the onus should be upon the producer.\textsuperscript{157} This is exactly the scenario wherein it is reasonable for a person to rely on the person selling the consumer a policy. An untrained person, who has spent his time and efforts developing alternative skills to offer the world, cannot be expected to understand everything he needs to know in order to get the coverage he needs.\textsuperscript{158}

\textbf{A. Producer Suitability Recommendations}

The first step of a producer suitability standard would be relatively easy. Assuming that the producer delivers accurate data to the insurer, the quotes and contracts provided to the producer should satisfy the first step of a suitability standard, namely, that the policies offered be suitable to some consumers. But producers should also have a duty to know their customer, at least as to elements relevant to obtaining the appropriate coverage consistent with the consumer purchaser’s appetite for self-insuring, co-insurance, and deductible levels. For instance, state regulators could require that producers gather information such as, in the case of property insurance, an official appraisal on the value of the property they wish to insure and the extent to which the policy purchaser wants that value covered, which would include a discussion of the relationship between the scope of coverage and/or higher premiums. The same could go for a discussion of co-insurance and deductible levels. These types of discussions would be akin to a discussion of investment objectives and appetite for risk as a securities broker might have with his client. They could impose a duty to ensure compliance upon insurers, to lessen the regulatory burden and place on the entities that can most easily bear it.

In general, producers now only ask questions related to the risks covered. For instance, for home insurance, they may ask the customer if there is a swimming pool, whether the house’s exterior is flammable (e.g., wood) or inflammable (e.g., stone), and the address of the home and its appraised value. Some of the

\textsuperscript{156} Id. at 1325.


\textsuperscript{158} See Frankel, \textit{supra} note 4, at 49 (noting the importance of relying on others for efficiency reasons).
better producers may ask for information related to the motivation for getting insurance.

Under the proposed suitability standard, the producer should also be required to discuss the consumer purchaser’s appetite for bearing risk of losses through self-insurance, or increasing deductibles or co-insurance levels. Based on this information, then, the producer should go and obtain policy quotes that match the consumer’s level of risk aversion. They should also advise the consumer specifically what types of exposure they would be subject to under each policy.

The producer should also be required to obtain the appraised value and only insure up to that value. Insurers are bound only to pay for the replacement value of property, subject to the policy limits, by the principle of indemnity. Therefore, even if the market value of a house in a neighborhood where housing prices are rising suggest a higher resale value, the appraised value would be the better marker of value that the producer should use so as not to extract premiums higher than what the insurer would ever have to pay out in an attempt to increase premiums.

Courts have gone so far as to say that to impose any duty to advise upon brokers would be too onerous for them, as they generally lack the necessary education and knowledge to advise purchasers properly. Not imposing these duties makes sense in light of the relatively low educational requirements for becoming a licensed broker in most states. I believe this view is unacceptable. The fact that the only actor who transacts directly with the producer justifies a basic advising duty. Like a broker-dealer or a mortgage broker, producers do much more than take orders and fill them. They hold themselves out as people the

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161 For instance, the National Association of Insurance Commissioners (NAIC) reported in 2008 that at least 35 states had adopted the recommended standard that no high school diploma is required. Nat’l Ass’n of Ins. Commissioners, NAIC Producer Licensing Aggregate Report of Findings, Feb. 19, 2008, http://www.naic.org/documents/committees_ex_pltf_plwg_PLC_assessment_aggregate_report.pdf. The motivation for recommending such a low education level is not elucidated in the report. This paper suggests that educational requirements should be raised, at least to the extent necessary to give effect to the suitability standard and non-maleficence rule proposed here.
consumer public needs and as people who will hold themselves to a basic level of care.

The suitability requirement, however, does not adequately address the potential for conflicts of interest that arise out of the compensation arrangements between insurers and producers. Indeed, for this reason, Dodd-Frank required the SEC to produce a study to evaluate whether a higher standard should be applied to broker-dealers. In the study, the SEC recommended that a higher fiduciary standard should be imposed upon broker-dealers. This was met with extreme approbation from the industry. In the same way that broker-dealers “are not just order takers,” producers are not just order takers, as consumers inevitably rely on them to some extent and have no way to evaluate their veracity. Nor do consumer purchasers of insurance get the opportunity to review the policy beforehand.

Where fee disclosure requirements attempt to do this, they either fail to provide the necessary information regarding the compensation from insurers to producers. Even if they provide sufficient information, the disclosures are made to consumers who may lack the appropriate sophistication to evaluate them. It would be better to just impose a rule that prevents the harm that concerns us, which this paper’s non-maleficence rule aims to do.

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165 See Elizabeth MacBride, *Fiduciary Standard Soon May Regulate Broker-Dealer Deals*, CNBC.COM, (April 29, 2013, 12:00AM EDT), http://www.cnbc.com/id/100662116 (quoting former SEC chairman Arthur Levitt who commented that the imposition of the new standard “is extremely important, otherwise the industry wouldn’t be fighting it”).

166 Id. (quoting Arthur Levitt).

167 See Schwarcz, *supra* note 17 at 1318-25 (discussing the lack of transparency and unavailability of consumer insurance contracts for review pre-purchase).
B. Producer Non-Maleficence Rule

Similar to mortgage broker regulations, where Congress found that a suitability standard alone was not sufficient, so too does this paper propose a non-maleficence rule to address a challenge unique to insurance producer regulation. To further curb any incentive on account of the compensation arrangements between insurers and producers, additional legislative-teeth are needed. Instead of an all-out ban on incentive arrangements like in Dodd-Frank, which may be needed at times for legitimate reasons such as filling out the pool of risks in a given market, the non-maleficence rule would state:

[W]here there are two policies which are equally suitable to the particular consumer but with different compensation outcomes for the producer, the producer may not choose to sell the policy which leads to a better compensation outcome for him, unless that policy is equal or less in price than the policy which would lead to the worse compensation outcome for him.

In this way, the producer would practice non-maleficence, in that he would not harm the consumer by choosing the policy that leads to a better outcome for him.

Maleficence would be measured in the price paid. The benefit of this rule would be in its ease of administration. Bright line rules are administratively convenient and, therefore, efficient. While bright line rules can create a “blueprint for fraud” or other surreptitious non-compliance, this non-maleficence rule does not exist in a vacuum. Indeed the first prong of this proposed reform is a standard-based care requirement. Only after the collection of all possible insurance contracts is delimited to those suitable substantively to the particular customer before the producer, then the inquiry abandons any further substantive inquiry for a pure comparison in terms of premium prices. The producer may not simply sell a lower priced contract if he reasonably cannot argue that it substantively meets the needs of the consumer.

168 See infra note 172-83 and accompanying text.
169 See Atwater v. City of Lago Vista 532 U.S. 318, 3547 (2001) (Justice Souter commenting that bright line rules lead to administrative convenience).
This simple approach is appropriate. Imposing upon producers any higher duty would, firstly, be unnecessary in light of the relatively small risks that are covered through consumer insurance contracts.\textsuperscript{171} Second, a higher duty may impose too high a cost on the producer in terms of worry and administrative effort than is justified by the compensation received.\textsuperscript{172} Lastly, a blanket proscription of financial incentives may actually impede the underwriting cycle, a key peculiarity of the insurance business, and may also impede competitiveness of the insurance markets.

This last point bears additional consideration. Depending on where an insurer is in its underwriting cycle, which is the period of time during which an insurer’s profits go from a high point to a low point and then back again,\textsuperscript{173} an insurer may pay higher commissions in the first high point, when they are trying to attract more business, and lower rates during the time when they are trying to reestablish profitability.\textsuperscript{174} The underwriting cycle is a creature peculiar to the insurance industry.\textsuperscript{175} It is a product of the supply of insurance contracts in a given market, which arises as a result of insurers flooding a market with contracts in an effort to capitalize on a profit opportunity.\textsuperscript{176}

Profit opportunities are often driven by a rise in interest rates, which increases returns on investments insurers make in the capital markets.\textsuperscript{177} The glut of supply drives premium rates down,\textsuperscript{178} which increases actuarial insolvency risk. When a rash of losses occur then, the premiums charged then do not cover the losses and then insurers are either forced out of business, tap into reserves (which decreases return on equity) or have to be propped up by affiliates.\textsuperscript{179} Following this, the insurers who survive the downward sloping profit period are able to charge higher premiums and restore profitability.\textsuperscript{180}

As an initial matter, we might ask why we tolerate the

\textsuperscript{171} See supra note 24 and accompanying text.
\textsuperscript{172} See Scism, supra note 72.
\textsuperscript{174} Conwell, supra note 36 at 2.
\textsuperscript{175} Nye, et al., supra note 172, at 1525.
\textsuperscript{176} Id.
\textsuperscript{177} Id. at 1526.
\textsuperscript{178} Id.
\textsuperscript{179} See generally, id.
\textsuperscript{180} Id.
underwriting cycle. Basically, it is a product of the business model. Where premiums equal expected losses from an insured pool, insurance companies make no profit off of premiums. Therefore, profit must come from somewhere, which is through investment in the capital markets. To induce market participants to enter the market, there must be some profit incentive and, since this incentive in this context arises from returns on investments, we tolerate this because the insurance markets are essential to the operation of society.

Allowing competitive commission arrangements, combined with adequate solvency oversight by state insurance regulators, can encourage efficiency in the consumer insurance markets and ensure that large conglomerates are not extracting rents from the market. The tension between the commission arrangements and the non-maleficence rule will allow for competition while also protecting the consumer from conflicted steering by producers. Because the terms of insurance contracts are reviewed and approved by regulators, the predatory terms concern present in the residential mortgage markets is inapplicable to the consumer insurance market. Therefore, the non-maleficence rule only requires that, among suitable contracts, the producer may not choose one that results in a better compensation outcome for him if that contract will cost the customer more.

Enforcement of this producer suitability and non-maleficence rule should allow for a private right of action along

182 See id.
183 See Insurance Asset Management: Internal, External, or Both?, NATIONAL ASS’N OF INS. COMM’N, ET AL. at http://www.naic.org/capital_markets_archive/110826.htm (last visited Sept. 27, 2013) (“Insurance companies, by their very nature, accumulate substantial amounts of cash that are used to purchase invested assets.”).
185 I define rent-seeking here as the act by one party to a contract increasing its wealth without any correlative value creation for its counterparty. That is, it is the extracting of wealth from an already established and static reservoir of value. See Ward Farnsworth, THE LEGAL ANALYST 66 (2007).
186 See, e.g., supra note 21.
the lines allowed under the broker-dealer suitability standard. However, due to the relatively low damages, there may be little incentive for private actors to bring suits. Therefore, imposing a duty upon insurers to make sure that any producer who brokers its insurance contracts, much like what is proposed under Dodd-Frank with respect to the ultimate mortgage creditor whose residential loans are brokered by mortgage brokers. Insurance commissions could periodically review compliance and recommend to attorneys general where investigations are appropriate in addition to unfair trade practices actions.

VI. CONCLUSION

In his characteristically adenoidal tone, Woody Allen might be tempted to amend his statement: “There are worse things than death, have you ever spent an evening reading about insurance producer regulation?” The regulation of insurance producers, while perhaps not demanding of popular attention, is a perennial issue for insurance professionals—forever on the minds of scholars, practitioners, regulators and industry participants. While strides have been made in recent years to lessen the conflicts of interest created by the compensation arrangements through disclosure regimes, the efficacy of these is questionable. Similarly, the common law and licensure regimes are wholly inadequate in protecting the consumer purchasers of insurance reasonable reliance upon producers.

While more study should be completed on what factors producers should consider when determining whether a policy is suitable, the consumer purchaser’s appetite for bearing risk, the replacement value of the property and the motivation for buying insurance should be considered. After searching for suitable policies, the producer should be bound by a non-maleficence rule, where he must give the consumer the best priced option, no matter the compensation outcome for the producer. In the event that there are two suitable options with equal price but differing compensation outcomes, the producer may choose the one with the better compensation outcome in order to ensure that insurers

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187 See Scism, supra note 72.
188 But see Leslie Alderman, Getting a Guide for the Jungle of Individual Health Policies, NEW YORK TIMES, at B5 (Sept. 11, 2010) available at http://www.nytimes.com/2010/09/11/health/11patient.html?_r=0 (discussing in part the advisability of calling state insurance regulators to determine if any complaints have been filed against a broker before using them).
can ride their underwriting cycle through offering higher commissions where required to build market share, which will have the effect of increasing competitiveness in the market for consumer insurance.
THE LEGAL HISTORY OF CREDIT IN FOUR THOUSAND YEARS (OR LESS)

Michael L. Starzec

It is easier to write about money than to acquire it; and those who gain it make great sport of those who only know how to write about it. - Voltaire

I. IN THE BEGINNING, THERE WAS CREDIT. . .

Archaeologists record the oldest known medium of currency as a 3,600-year-old clay tablet, found in Mesopotamia, which entitled the bearer to receive a quantity of barley at harvest time from a man named Amil-mirra. Generally, it’s wise to defer to Indiana Jones, especially when one’s life depends on knowing which cup is the Holy Grail. Since my life is not in the balance, I can feel safe in disagreeing with Indy and asserting that a tablet is not money: it’s a contract. But more specifically, a contract based on credit: the bearer supplied goods in the past relying on repayment in the future. Using terms with which we are familiar, the holder of the tablet was the creditor while Amil-mirra, was the debtor. Thus, it could be said this unwieldy chunk of rock may actually be the first credit card.

From our modern perspective, it may be surprising to recognize the concept of credit has existed since the dawn of civilization. Yes, the contract is graven in stone. Yes, the contract amounted to barter. Regardless of the context, it is inescapable that people were peaceably trading and basing those transactions on credit. This is not surprising. As Adam Smith noted, man seemed born with a “propensity to truck, barter and exchange one

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thing for another.” In the same way, it has been man’s nature to regulate those transactions.

Even Amil-mirra’s transaction was regulated, under Hammurabi’s Code, famously known for the principle of Lex Talonis, an eye for an eye, interest rates were regulated and creditors were actually forbidden to seize a debtor’s assets as restitution. In fact, under the Code, if a creditor seized grain or livestock, not only must the creditor return it, but his illegal action forfeited his claim.

While this seems enlightened, the reason for this liberality is somewhat less than progressive. In ancient times, debt was not secured by property or wealth: The debtor was security. Thus, if you could not pay, the creditor made you a debt-slave for a proscribed period of time to work off the obligation. That being said, a potential debt-slave could avoid servitude, by nominating his wife, kids or a slave to work it off. As the Code artfully puts it: “If any one fail to meet a claim for debt, and sell hims elf, his wife, his son, and daughter for money or give them away to forced labor: they shall work for three years in the house of the man who bought them, or the proprietor, and in the fourth year they shall be set free.” Undoubtedly, this made for uncomfortable Thanksgiving dinners.

Obviously, lugging around rocks as contracts was not particularly efficient. Neither was it particularly easy to transact business. But man would find ways to make business easier. In fact, it can be said the story of mankind is the story of a steady evolution making trade simpler and more efficient. Likewise, throughout history, regulation evolved: sometimes helping that process and sometimes hurting it.

II. MAKING MONEY

It did not take long for man to devise a more portable medium of exchange: money. Money not only eliminates the need to tote around your wares and then chisel the deal into slabs of

5 Id.
6 Id.
7 Id.
rock, it allows for efficient calculations of value, contracts to take place over greater distances and time, and creates a means of storing wealth that will not rot or spoil.

Initially, commodities themselves were a form of money, each culture creating their measures of value based on what mattered to them. Chocoholics might be pleased to know the Aztecs actually used cacao seeds as money, an interesting choice given historical records showing the Aztecs possessed gold in enough abundance to attempt to bribe Cortes, an unfortunate act which only served to fuel his greed. But, as noted, the value of the seeds as ‘money’ was limited to the Aztec culture; European pirates seized a ship which happened to be full of cacao seeds. Jack Sparrow dumped it overboard, thinking it rabbit dung. Likewise, I am sure both pirates and Aztecs would look at our paper money and plastic debit cards with a jaundiced eye.

Likely due to durability, precious metals served a similar function until governments began to mint coins. In the western world, Herodotus credits the ancient kingdom of Lydia, located in what is now western Turkey, as being first nation to coin money. Not that Herodotus heralded this economic revolution with much fanfare. Disappointingly, the creation of money is relegated an offhanded comment in a paragraph dominated by denigrating comments about the Lydian’s predilection to prostitution as a significant source of national revenue. With what may be the first recorded left-handed compliment, Herodotus charitably noted the Lydian way of life was not unlike the Greeks, “[a]part from the fact that they prostitute their daughters.”

This perspective on commerce is reflective of contemporaneous Greek attitudes. Both Plato and Aristotle condemned charging interest. In Plato’s Laws he stated “no one shall . . . lend upon interest; and the borrower should be under no obligation to repay either capital or interest.” Plato ascribed to

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9 JACK WEATHERFORD, THE HISTORY OF MONEY 17 (Crown Publ’g 1997).
10 Id.
12 Id.
13 Id.
the philosophy that one should only lend to one’s friends. While a grand suggestion, not repaying your pals generally led to the ancient practice of “unfriending.”

His student, Aristotle, took an even stronger position. To Aristotle, there were two types of wealth-gathering: household management and retail trade. Becoming wealthy through the work of your own hands was “necessary and honorable.” On the other hand, it was:

[U]nnatural . . . [for] men gain from one another. The most hated sort, and with the greatest reason, is usury, which makes a gain out of money itself, and not from the natural object of it. For money was intended to be used in exchange, but not to increase at interest. And this term interest, which means the birth of money from money, is applied to the breeding of money because the offspring resembles the parent. Wherefore of any modes of getting wealth this is the most unnatural.15

After reading that, who doesn’t want to skip the Super Bowl and tune in for the Adam Smith versus Aristotle grudge-match debate?

Despite Herodotus’ disparagement and Platonic/Aristotelian snobbery, the Lydian invention was widely accepted and copied by governments in the region and beyond. Government sponsorship allowed an impartial standard to be set which also served as source of revenue: the difference of the stated value of the coin versus the actual metal content. For example, using modern measurements, an ounce of gold may be worth $600.00 therefore a newly minted one ounce gold coin should be worth $600.00. However, when ancient governments produced the coin, they would debase it by replacing some of that gold with another metal. It still weighed an ounce but it was not an ounce of gold. Not surprisingly, the unused gold ended up in the government’s pocket.16

III. People Prefer Profits to Plato

We have seen that the ancients, in rapid fire succession,

created contracts, regulated creditor/debtor relationships and cast off the last shackles of the Stone Age by creating coins. These developments were timed almost perfectly for the rise of Rome. With its vast size, comparable peacefulness and efficient road network, trade over vast distances became possible.

As is well known, the Romans unashamedly ripped off the entire Greek pantheon and its culture, contriving to cover up this plagiarism by changing everyone’s names. That being said, the Romans were all about practicality and not about philosophy for, unlike the Greeks, they did not condemn commerce. Instead, they differentiated between productive credit, used for business growth and investment, and consumptive debt, which were personal loans for consumer goods. The former was praiseworthy while the latter was not. In the later stages of the Roman Empire, their views on interest were codified in Justinian’s Code which proscribed their maximum legal rates.

**IV. THE NEW MATH**

When Rome fell, Europe fractured along warring ethnic lines. While they may not have realized it, they had one thing in common: the yoke of Roman numerals. Remarkably, this remaining vestige of the empire served to stagnate the West’s economic evolution for almost a thousand years. Roman numerals made basic addition and subtraction cumbersome and the calculation of interest or depreciation nearly impossible. This changed in 1202, when Leonardo Fibonacci introduced Europe to the Hindu-Arabic numeral system and the concept of zero in his treatise, *Liber Abaci* (Book of the Abacus). The son of a Pisan customs official in what is now Bejai, Algeria, Fibonacci was exposed to this rational system of math, and mastered it. But the true genius of his mastery was his presentation of the new theories. Rather than writing a dry collection of arithmetic formulae, he taught concepts by way of real world business examples, such as the computation of interest and used

19 FERGUSON, supra note 2, at 32.
20 Id.
commodity trading as the theme for the entire work. Soon Abacus schools erupted all over northern Italy and their graduates became the first corporate CEOs.

With this new knowledge, a host of complex mathematics was made possible, leading to greater trade, greater volumes of lending and the birth of international banking. But more than that, it created lending structures outside of government or church control, lending not only to those entities, but also to the common trader and merchant. This democratization of lending was an important component in the development of Western economic models.

V. LOSING MY RELIGION

So now, everyone could easily calculate interest but there was a small hurdle, most governments adhered to biblical strictures against usury or interest on loans. In fact, Psalm 15 asks “Lord, who shall abide in thy tabernacle?” In response, it is said one of the persons who may abide in the tabernacle is one “that putteth not out his money to usury.” Ouch.

To get around issues of morality, the bankers, likely in cahoots with lawyers, simply changed the name of their new lending product from a loan to a “bill of exchange.” A merchant would receive their money in the form of a bill of exchange at their local bank. They would present the bill to receive their money at a different bank in a different town, agreeing that they would pay a slightly higher amount than the actual loan. See your Holiness? No interest! It’s just a service charge.

The salutary effect of the bills of exchange was they removed the difficulty of the use of money, a development we just heralded five paragraphs ago. Lighter than clay tablets, coins were still a burden to carry about in large quantities. As result, trade increased because this private precursor to paper money made transactions easier and faster. No more waiting for a

22 Id.
23 WEATHERFORD, supra note 10, at 72.
25 See Psalms 15:5.
26 WEATHERFORD, supra note 10, at 73-74.
27 Id. at 74.
28 Id.
delivery of gold coin, carted on the backs of mules, subject to
brigands, pirates or tolls levied by each of the feudal dominions
through which your caravan had the misfortune to travel. Weatherford provides an excellent illustration:

In 1338, a shipment of coins required three weeks to
wend its way from Rouen . . . to Avignon . . ., a distance
of just over four hundred miles. By contrast, a bill of
exchange could be sent in a mere eight days and if it
was stolen, the thief could not redeem it. Despite the
extra cost of 8 percent to 12 percent, a bill still proved
cheaper than the cost of hiring an armed escort for a
shipment . . . Bills of exchange helped to free money
from its spatial limitations.29

Other barriers conquered by bills were the limitation of
only lending the supply of coins on hand and reliance on a single
currency. This allowed more money to be put into use without
the need for the inflationary act of minting more coins. Soon, the
bills were exchanged in place of coins, circulating to third, fourth
and fifth parties, just like the paper money we know today.30

It was not long before government became entwined with
the production of paper money. In the United States, the first use
of paper money occurred in 1690 in the Commonwealth of
Massachusetts who needed to find a way to pay for a boondoggle
attempt to capture Quebec City.31 The paper promised
redemption in gold or silver coins and these slips were utilized in
trade alongside gold and silver coins.32 This pre-dated the
creation of the British Central bank by four years which, from its
outset, issued paper currency backed by redemption in precious
metals. As we will see, the existence of a central bank is a
necessary prerequisite to the formation of a system of credit.33
Like bills of exchange, this paper had value because the holder
had faith they could exchange their paper for metal. As you might
expect, convenience aided faith and ensured almost no one
cashed in their paper.

29 Id. at 75.
30 Id.
31 EVANS & SCHMALENSEE, supra note 16, at 28-29.
32 Id.
33 MARION ARCHIBALD ET. AL., MONEY: A HISTORY, 177 (Jonathan
VI. PAPER TO PLASTIC

By the 1980’s, every major government had removed their currencies from a gold or silver standard. Therefore, unlike the 1690’s or the 1960’s for that matter, our money retains value not because of faith in its backing by gold, but on faith alone; the dollar is worth a dollar because we believe it is.

In the last twenty years, we have gotten even further disconnected from associating our money with anything physical. Old Amil-mirra thought it was pain to lug around that barley contract. In the 21st century, we actually decided paper money was too cumbersome. Thus, five millennia later, Amil-mirra’s tablet was replaced by a weightless plastic card. Your money is now digits on a computer or smart phone screen. Remember that business transaction from Rouen to Avignon that took 8 days? It can now be completed with a mouse click which sends invisible, instantaneous transmissions of binary code that passes for money and is completed in an eighth of a second.

VII. GIVE AMERICA SOME CREDIT

But where did credit cards come from? America has had credit since its foundation. Records demonstrate installment credit was being offered by New York furniture retailer Cowperwaite and Sons as far back as 1807. Revolving credit is a somewhat different animal. Its roots are found in the National Banking Act of 1863, which created nationally chartered banks even though the first national credit cards would not be issued for another century. Further centralizing and standardizing the banking system was the creation of the Federal Reserve in 1913. The key component of the Reserve System was the requirement of all nationally chartered banks to become members and thereby be regulated by the Fed. Thus, the charge plate was set.

Interestingly, for much of American history, consumer lending was not a part of the portfolio of U.S. banks. The merchants themselves would provide the financing for the purchases and leave to the larger loans to the banks. Credit cards stepped into the shoes of merchant lenders, allowing them to cut costs and risk, putting those on the third-party bank. Thus, “credit cards provided a platform that made borrowing and

34 MANDELL, supra note 17, at 14.
36 Id. at 51.
The modern credit card allegedly began in 1949 when Frank McNamara, president of a credit company, realized he left his wallet at home in the midst of meal out. He called his wife who dutifully arrived with the money. This led to an epiphany of sorts: a club card to pay for restaurant outings so that lack of cash was not a deterrent. Extravagantly naming the initial use of the card the “The First Supper” a legend was born. Unfortunately, such grandiosity tends to diminish the credibility of Diner’s Club’s origin.

At this time, the Diner’s Club card was made out of paper, not plastic. In my extensive study of 1950’s and early 1960’s culture, I’ve watched at least three seasons of Mad Men, it does not seem it was customary for Don Draper to jam paper cards in his pocket, hoping they wouldn’t get mangled. In other words, the card, like Frank’s cash, would still be in his wallet and he would still have to answer to Mrs. Frank. Further research proved my instincts were correct: Diner’s Club was not even the first revolving account credit card.

Credit, no pun intended, goes to the venerable department store, Bloomingdale’s. In 1938, the store introduced what it called a permanent budget account which allowed customers the option of not paying off their bill every month, aggregating total purchases into a single sum that could be paid over time at the cost of interest charges. Previous forms of credit, such as installment payments and charge cards may not have required payment at the time of purchase. However, the retailer did expect full payment over six months or, with a charge card, payment in full when billed at the end of the month.

This led to stores having credit managers who were scolds and moralizers, reducing interest in patronizing certain retailers due to embarrassment. It was presumed wives, who generally frequented these department stores, needed to be stopped from their spendthrift ways, so that the haranguing credit manager
acted *in loco husbandis*. Contrary to this conceit, personal experience has shown overspending is an equal opportunity issue.

Now that we know the origin of revolving credit, let us return to Diner’s Club. In fairness, while it may not have been the first revolving charge account, it was the first effort to forge a universal card. Your Bloomie’s account only worked at Bloomie’s. McNamara’s goal was to have his card operate at any restaurant anywhere in the world. To that end, McNamara started out recruiting restaurants and giving cards to select individuals so that, by 1951 there were 42,000 members who paid $18.00 a year for membership. Under the agreement, a member restaurant paid 7% of the cardholder’s bill to Diner’s Club. What was the restaurant owner getting out of this transaction? The owner believed that by accepting Diner’s Club cards, they would attract new business. At the end of 1951, Diner’s Club made $60,000 in pre-tax income. By 1958, after absorbing a competitor and moving into hotels and car rentals, gross profits topped $40 million.

This expansion concerned American Express. Famously known as the issuer of traveler’s cheques, Amex saw Diner’s Club as a danger to its travel related business. As a result, it entered the credit card field in 1958, buying up other Diner’s Club competitors to even the playing field as the premier high-end traveler’s club. They charged a higher membership fee, to suggest it was more prestigious, but lured merchants to its banner by offering a merchant rate 2% lower than Diner’s Club.

But we are still not quite at our modern credit card. Indisputably, Diner’s Club and Amex were universal cards but their business was not consumer loans, it was travel and dining. The first bank to issue a general use credit card was Bank of America to its customers in California, beginning in 1958. Initially, merchants were reluctant to sign agreements to accept this card but Bank of America made it hard to refuse when the

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43 Id. at 102.
44 EVANS & SCHMALENSEE, supra note 16, at 54.
45 MANDELL, supra note 17, at 3.
46 Id.
47 EVANS & SCHMALENSEE, supra note 16, at 54.
48 EVANS & SCHMALENSEE, supra note 16, at 54.
49 EVANS & SCHMALENSEE, supra note 16, at 58.
50 Id. at 59.
51 Id. at 57.
bank mass issued the card to some 60,000 area residents.\textsuperscript{52} By the spring of 1959, the number of participating merchants rose from 800 to 25,000.\textsuperscript{53} After losses of $45 million in 1960 due to a host of issues, it turned its first profit in 1961.\textsuperscript{54}

The year 1958 saw Chase Manhattan enter the credit card field. It hastily exited the field when selling its credit card division to American Express in 1962.\textsuperscript{55} Seven years later, Chase repurchased the division and joined with Bank of America, which had begun marketing its credit card as BankAmericard.\textsuperscript{56} Despite this bi-coastal union, both cards were regional, limited to California and New York respectively whereas, at this stage, both Diner’s Club and Amex were global players in their specialized area of travel and entertainment.\textsuperscript{57} However, bank cards had the potential for explosive growth, they could attract a broad range of merchants and utilized a different business model: no membership fees and earning revenue strictly from merchant fees and finance charges.

In 1966, BankAmericard’s in-state rivals, United California Bank, Wells Fargo, Crocker National Bank and the Bank of California, united to form the Interbank Card. Interbank Card’s name changed to Mastercharge in 1969, and by 1979, was known as Mastercard.\textsuperscript{58} Likewise, in 1970, BankAmericard reincorporated as National BankAmericard. Four years later, the card became accepted outside the U.S., and in light of its now international reach, it renamed itself Visa in 1976.\textsuperscript{59}

As the two card networks expanded, they each attempted to woo other banks: BankAmericard using a franchise system and Interbank by offering cooperative opportunities.\textsuperscript{60} Of the two options, more banks preferred Interbank’s system because under Interbank’s system, the bank marketed a jointly owned brand rather than sublimating their identity to BankAmericard.\textsuperscript{61} In this

\textsuperscript{52} Id.
\textsuperscript{53} Id.
\textsuperscript{54} Id. at 57.
\textsuperscript{55} Id. at 60.
\textsuperscript{56} Id.
\textsuperscript{57} Id.
\textsuperscript{60} EVANS & SCHMALENSEE, supra note 16, at 64.
\textsuperscript{61} Id.
way, Interbank member banks could still harbor their own dreams of national expansion if interstate banking requirements were lifted.62

However, under either system, members were required to sign exclusivity agreements. For example, if a bank signed with Visa, it was barred from offering Mastercard products.63 This practice subjected Visa to anti-trust concerns, which will be discussed later in greater detail.64 Notwithstanding this cutthroat marketing, Visa and Mastercard actually *cooperated* to create uniform operational standards for this emerging credit card system.65

Refusing to be subordinate to their growing competitors, regional banks tried to create competing bank networks for their own card.66 For example, in Illinois, five banks created the Midwest Bank Card, which eventually comprised a network of 600 banks in Illinois, Indiana and Michigan.67 Despite these efforts, the regional partnerships lacked expertise, and individual banks reluctantly began aligning with the two growing powers. 68

This had a salutary effect of hastening standardization of credit practice due to Visa’s and Mastercard’s previous coordination on the architecture of the system; interoperability became a foundation of the modern card system.69

**VIII. THE DEATH OF A SALESMAN**

The birth of a national system of credit changed the landscape of credit altogether. In the past, stores had issued the credit. After the success of Bloomingdale’s model, other department stores in the post-war era followed suit.70 Yet, in the space of a generation, an entirely new model was overtaking the world of consumer credit. As seen by the previous section, banks, formerly unconcerned with small-scale consumer lending, were suddenly very interested in this line of business.

In the wake of World War II, economic and lending

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62 *Id.*
64 *Id.*
65 *Id.* at 63.
66 *Id.*
67 *Id.*
68 *Id.* at 64.
69 *Id.* at 65.
70 HYMAN, *supra* note 37, at 106.
incentives had changed. Returning soldiers were ready to start families, while generous VA loans promised mortgages on homes with almost no money down.\textsuperscript{71} Even non-veterans could enjoy low mortgage costs via FHA loans, bought by Fannie Mae.\textsuperscript{72} Between 1944 and 1950, housing construction exploded from 114,000 single family detached homes to 1.7 million.\textsuperscript{73} Combined with the creation of the federally subsidized Eisenhower highway system, the predominantly urban landscape became a suburban vista with 60 million people moving to the suburbs by 1980.\textsuperscript{74}

Having moved from the city into a larger living space, new homeowners were left with a problem that made retailers salivate: additional rooms to furnish.\textsuperscript{75} In furnishing homes, revolving credit gave homeowners the flexibility to buy on credit and pay at their own rate rather than having to exercise miserly saving.\textsuperscript{76} From cars to appliances to furnishings, everything could be bought on credit.\textsuperscript{77} Religious and social mores about debt had clearly changed: credit and installment lending climbed from $2.6 billion in 1945 to $103.9 billion in 1970.\textsuperscript{78} The rise of American economic hegemony out of the devastation of World War II coincided with an increase in wages and optimism, a decline in the fear of credit, and a softening of the so-called Protestant work-ethic.\textsuperscript{79}

Therefore, a store that refused to offer credit or favored cash over sales was subject to a competitive disadvantage.\textsuperscript{80} Instead, most stores offered such credit, not only as an impetus to buy but also to promote customer loyalty.\textsuperscript{81} However, the growth of discount chains like K-Mart and Target ate into the customer base of high-end department stores.\textsuperscript{82} They, too, offered credit but with lower margins, they were eager to find someone else to bear the costs and the risk.\textsuperscript{83}

\begin{itemize}
\item[\textsuperscript{71}] ROBERT D. MANNING, CREDIT CARD NATION: THE CONSEQUENCES OF AMERICA’S ADDICTION TO CREDIT, 37 (Basic Books 2000).
\item[\textsuperscript{72}] Id.
\item[\textsuperscript{73}] Id.
\item[\textsuperscript{74}] Id.
\item[\textsuperscript{75}] HYMAN, \textit{supra} note 37, at 76.
\item[\textsuperscript{76}] Id. 105-106.
\item[\textsuperscript{77}] Id. 96.
\item[\textsuperscript{78}] Id. at 38.
\item[\textsuperscript{79}] Id. at 34-36.
\item[\textsuperscript{80}] HYMAN, \textit{supra} note 37, at 106.
\item[\textsuperscript{81}] Id. at 109.
\item[\textsuperscript{82}] HYMAN, \textit{supra} note 37, at 119.
\item[\textsuperscript{83}] Id. at 139.
\end{itemize}
The economic downturn of the 1970s further altered the landscape: more shopping than ever occurred at discount rather than department stores.84 Department store credit was feasible in a booming economy because it was based on quick repayment usually six months or less, somewhat limiting the danger of store borrowing to pay for their customer’s purchases while they waited for repayment.85 However, in the economic downturn, people were unable to afford the higher prices of department stores and turning more strongly to discounters.86 In order to keep their costs low, discounters did not want to create their own card system nor borrow money (and pay interest on that borrowing) to fund store purchases.87 As a result, discounters welcomed the advent of third-party credit cards.88 By the end of the 1970s, most department stores were accepting national brand credit cards.

Logistically, in this new economy, the change made sense. Most purchases were now being done on credit, and the pace was increasing.89 In the past, retailers provided proprietary cards, in which the retailer was responsible for borrowing money to pay for the customer’s purchase, relying on the hope that they would be repaid.90 Consequently, retailers had more capital tied up in credit loans than in merchandise.91 Thus, when banks began lending for consumer goods purchases, it made sense for retailers to allow banks to take on that risk rather than assume it themselves.

IX. DEBT CAN BE TAXING... EXCEPT WHEN IT’S NOT

The acceptance of credit and accumulation of debt were not simply functions of a changing economy and social mores. Part of the reason for this cultural change was the unforeseen consequences of legislation.

During World War II, the federal government lowered the tax brackets so that the middle class, formerly exempt from taxation, was required to shoulder the burden.92 Nonetheless, in

84 *Id.* at 151.
85 *Id.* at 139.
86 *Id.* at 151.
87 *Id.* at 143.
88 *Id.* at 140.
89 Evans & Schmalensee, *supra* note 16, at 40
90 *Id.* at 119.
91 *Id.* at 139.
92 *Id.* at 123.
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making them subject to taxation, the middle class now had access to the same tax deductions utilized by wealthy individuals and businesses.93

In 1913, the passage of the Sixteenth Amendment, creating the income tax, allowed for the deduction of all interest. In that era, most loans were business loans and, as such, their interest was deductible as a business expense.94 With the application of the new tax code, an individual’s mortgage, credit and installment interest were now deductible as well, giving consumers an incentive to borrow.95 In addition, the creation of FHA in the 1930s led to the government—subsidized 30 year mortgage, thereby conditioning people to accept what used to be unacceptable: long term debt.96

When the Sixteenth Amendment was passed, it was presumed that few individuals would ever pay taxes.97 Clearly, it was not imagined that laws intended for businesses would eventually be utilized to make a TV purchase seem like a wise tax decision.98 Likewise, the government planners who saw home construction as the solution to the Depression did not consider it might be a means to change attitudes on long term debt.99 Nor could the authors of the G.I. Bills that rewarded our soldiers for their service have imagined its impact on the accumulation of consumer debt. Like anything else, many different and seemingly unconnected strands came together to form history, even with something as mundane as a credit card.

X. DANCING BETWEEN THE RAINDROPS

While these programs may have helped shape a new consumer viewpoint, what is clear is that no enabling statute created the credit card. Perhaps the most striking aspect of the rise of the credit card is how its legal existence was a consequence of tangentially related laws and cases. Specifically, “[c]onsumer credit has been subject to a large variety of legal controls. . . of

93 Id.
94 Id.
95 Id. at 124.
96 Id. at 87, 222 (arguing that the 1986 tax reform bill, which removed all interest deductions but mortgage interest, combined with the meteoric rise in home values, is partially to blame for the crash of 2008: consumers took out second mortgages to pay for lavish spending and to pay-off credit cards).
97 Id. at 115.
98 Id. at 116-117.
99 Id. at 89.
general application like the usury laws and . . . bankruptcy, fraud and duress and some of . . . special application like the small loans laws and the Retail Installment Sales Acts.”  

That was about to change.

XI. REGULATION Z

The Truth in Lending Act (“TILA”), passed by congress in 1968, become the first legislation to statutorily address credit cards. The statute states,

...economic stabilization would be enhanced and the competition among the various financial institutions and other firms engaged in the extension of consumer credit would be strengthened by the informed use of credit. The informed use of credit results from an awareness of the cost thereof by consumers. It is the purpose of this subchapter to assure a meaningful disclosure of credit terms so that the consumer will be able to compare more readily the various credit terms available to him and avoid the uninformed use of credit, and to protect the consumer against inaccurate and unfair credit billing and credit card practices.

The regulations implementing the statute are codified at 12 CFR Part 226. Subsection (B) of the addresses open-ended or revolving credit card accounts. Commonly, these regulations are entitled Regulation Z.

Okay, I know you are asking the same question I did. Why are they called Regulation Z? While I can assure you it does not authorize creation or citizenship for zombies, there is no explanation. Even the internet has no surmise on the origin of the name other than an anonymous poster at Ask.com who claims it is named Regulation Z because Z is the 26th letter of the alphabet and these regulations were the 26th set of regulations dealing with home mortgage financing and lending practices. I am not sure if I buy this, given that the citation in the Code of Federal

103 Id.
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Regulation is 12 C.F.R. §226, not §26. Instead, considering the dry nature of the reading, perhaps “Z” refers to their anti-insomniac applications.

Regardless of the source of its name, these rules would serve as the primary backbone governing credit card issuers until the 2009 Credit Card Accountability, Responsibility and Disclosure Act (CARD).105 Under TILA, the Federal Reserve served as the body to promulgate and administer the rules to the credit card industry. As of July, 2011, under the Dodd-Frank Wall Street Reform and Consumer Protection Act, TILA’s general rule making authority was transferred to the Consumer Financial Protection Bureau, an entity created by the same act.106

**XII. IN ANTI-TRUST WE TRUST**

Anti-trust laws also impacted the nature of the credit cards we know today. As noted above, the terms of Visa’s agreements forbade Mastercard issuing banks from issuing Visa cards or handling transactions with Visa merchants.107 In 1971, Worthen Bank and Trust attempted to associate with both Visa and Mastercard, but when Visa chose to enforce its exclusivity agreement, the bank filed an antitrust lawsuit against Visa.108 The case settled eventually, but Worthen’s action sparked similar challenges to the Visa agreement from its competitors. As a result, in 1974, Visa sought a business clearance review from the Department of Justice for its practices.109 When the Department declined to hold that Visa’s exclusivity agreement was not a violation of anti-trust laws, Visa removed all restrictions against Visa members also offering Master Card products, thereby ushering in the practice of dual acceptance.110

However, Visa’s membership agreement still maintained exclusivity agreements against other issuers. In 1989, Sears sought membership in Visa, a request Visa refused, going so far as to enact a membership rule that denied Visa membership to

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107  EVANS & SCHMALENSEE, supra note 16, at 70.
110 Id. at 278.
anyone issuing Discover or American Express cards.\footnote{SCFC ILC, Inc. v. Visa, 936 F.2d 1096, 1097 (10th Cir. 1991).}

In an effort to bypass that by-law, a Sears’ subsidiary, SCFC ILC acquired Mountain West, a small Utah thrift institution which possessed membership in Visa. When the small thrift which had 5,800 Visa accounts suddenly ordered 1.5 million Visa cards to start a new “Prime Option” credit card, Visa refused.\footnote{Id. at 1098.} Mountain West sued for an injunction to force approval of the delivery of the 1.5 million cards, which was granted in district court. Visa appealed and overturned the order, remanding the case for further proceeding.\footnote{Id.} Eventually, a final determination was reached in 1994 when the 10th Circuit found Visa committed no anti-trust violation because the by-law did not bar Sears from access to the credit card market.\footnote{SCFL ILC, Inc. v. Visa USA, Inc., 36 F.3d 958, 971 (10th Cir 1994).} Given Sears owned Discover, there was no evidence Sears could only produce the Prime Option Card with Visa’s help or that exclusion from a joint venture with Visa prevented issuing the new card as a Discover product.\footnote{Id.; In Re Visa Check/Master Money Antitrust Litigation, 96 CV 5238.}

In 1996, Wal-Mart, in a class action where it was joined by rival Sears and nearly five million other retailers, sued Visa and Mastercard for violations of anti-trust laws on the grounds that it was illegal to require retailers who accepted a Visa debit card to also accept Visa credit cards.\footnote{EVANS & SCHMALENSEE, supra note 16, at 267.} Seven years later, the case settled for approximately $2.5 billion dollars and with Visa and Mastercard agreeing to allow merchants to take debit cards without being required to take credit cards.\footnote{Id. at 267.}

Yet, even in the wake of Wal-Mart’s class action, the concept of Visa/Mastercard duality remained unchallenged. Finally, in 2003, these practices were found to violate the law.\footnote{United States v. Visa U.S.A., Inc., 163 F. Supp. 322, 340–42 (S.D.N.Y. 2001), aff’d, 344 F.3d 229 (2d Cir. 2003).} The Second Circuit dismissed arguments that the exclusionary rules were necessary to promote cohesion between Visa and Mastercard and that “in any event the anticompetitive effects outweigh the procompetitive.”\footnote{Id. at 243; See generally, K. Craig Wildfang et al., The Persistence of Anti-Trust Controversy and Litigation in Credit Card Networks, 73 ANTITRUST LAW 675 (studying the interaction of credit cards and anti-trust
Most recently, Mastercard, Visa and some of the larger banks settled another class action suit, involving about 7 million U.S. merchants, a case centered on claims that the defendants unlawfully conspired to fix swipe fees for merchants.\textsuperscript{120} The settlement was reached on behalf of a class of roughly 7 million U.S. merchants who accept Visa and MasterCard credit cards and debit cards.\textsuperscript{121} In the settlement, Visa agreed to pay some $4.4 billion and Mastercard $790 million.\textsuperscript{122} Both parties also agreed to reduce swipe fees, fees paid by merchants to issuers for each card use, while they retool their rules on such transactions. In addition, retailers could now impose a surcharge for use of credit cards (presumably assessed on the consumer) subject to caps and disclosures.\textsuperscript{123}

\section*{XIII. A Plague of Plastic}

We have already examined the first consumer protection rules, Regulation Z, promulgated in the wake of the passage of TILA in 1968. Two years later, Illinois banks can be credited with the dubious distinction of being the reason for the next set of federal and state legislation drafted to protect consumers.\textsuperscript{124}

As mentioned above, when credit card networks began to emerge, regional banks attempted to create their own networks by getting cards to consumers whether they asked for them or not..\textsuperscript{125} Sadly, the axiom against keeping up with the Joneses is a cautionary tale for banks as well as consumers.

In 1966, Marine Midland Bank had tested two ways of exhorting customer interest in its card: sending credit card applications to some customers and actual cards to others.\textsuperscript{126} To

\begin{flushleft}

\textsuperscript{121} Id.

\textsuperscript{122} Id.

\textsuperscript{123} Id.


\textsuperscript{125} HYMAN, supra note 37, at 156.

\textsuperscript{126} Id.
\end{flushleft}
ensure an accurate measure, they controlled the distribution, ensuring that the recipients in both groups were similarly placed in terms of income and worth. In total, 33,357 applications were sent versus 731 credit cards. While the disparity in cards versus applications was enormous, the response was entirely reversed: only 0.7% of the applications were returned while 19% of the cards sent in the mail were used within 60 days; in other words, cards had a response rate 27 times the response of applications. Not surprisingly, Marine Midland began direct mailing their cards. Even if the cards were never used, the bank was able to sell merchants on how many cards were technically in the hands of potential customers. Marine Midland was not alone. As noted earlier, an Illinois dominated Midwest banking coalition was determined to form a rival credit card network. In their myopic focus on getting cards to their customers before anyone else did, they spawned a mass mailing strategy of Biblical proportions, issuing five million cards in a single month.

The initial threshold was low: Any customer without bad credit would get a card. But their effort was not limited simply to customers. Under the Illinois Constitution of 1870, branch banking was banned. The only lessening of that restriction was made in 1967, which permitted a drive-in facility within 1500 feet of the main bank. This geographical limitation led to the purchase of mailing lists of persons who owned stock, had expensive cars, membership in certain organizations or clubs, business owners. . . you get the picture.

Unfortunately, no one coordinated this process to eliminate persons who might appear on more than one of those lists. A businessman with a new car purchase, stock and a

127 Id.
128 Id.
129 Id. at 156-57.
130 Id. at 157.
131 Id.
132 EVANS AND SCHMALENSEE, supra note 16, at 63.
133 HYMAN, supra note 37, at 158.
134 Id. at 159.
135 Id.
137 HYMAN, supra note 37, at 159.
138 Id.
prestigious club membership received seven cards on the same
day while another received eighteen cards, including one for each
of his three boys, aged nine to thirteen.\textsuperscript{139} At the same time, a
woman received cards from two separate banks; unfortunately,
she had been dead five months.\textsuperscript{140} As if giving credit to the dead
were not enough, babies and small children also received cards in
the mail.\textsuperscript{141} Federal Reserve Board member Andrew F. Brimmer
explained this at a congressional hearing: “Babies with sizable
savings accounts—frequently opened by grandparents—could
not be distinguished from adults.”\textsuperscript{142}

If you think that this could not get worse, it does. You see,
the banks also \textit{publicized} that they were mailing these cards at
the holiday season so that post-office temps, criminals and
perhaps the neighbor you didn’t like, pilfered your mail and post
box.\textsuperscript{143} Enterprising criminals also knew the adage “location,
location, location” applied even in crookery, targeting multifamily
homes and apartments where they knew they could collect the
most plastic.\textsuperscript{144} Lacking the activation protocols we have today, a
simple forged signature started the spending spree. Bloomberg
estimates losses ranged between $6 million to $12 million, or $43
million to $85 million in 2012 dollars.\textsuperscript{145}

This led to federal law addressing the subject and the
Credit Card Liability Act in Illinois, which states:

No person in whose name a credit card is issued without
his having requested or applied for the card or for the
extension of the credit or establishment of a charge
account which that card evidences is liable to the issuer
of the card for any purchases made or other amounts
owing by a use of that card from which he or a member
of his family or household derive no benefit unless he
has indicated his acceptance of the card by signing or

\begin{footnotes}
\item[139] \textit{Id.}
\item[140] \textit{Sean Vanatta supra note 122; The Great Chicago Christmas Credit Card Fiasco of 1966: Echoes, Bloomberg} (Dec. 24, 2012 5:30 PM), http://www.bloomberg.com/news/2012-12-24/the-great-chicago-christmas-credit-card-fiasco-of-1966-echoes.html. (While Bloomberg’s author thinks this strange, Chicago has long allowed the dead vote so why not give them credit cards?)
\item[141] \textit{Id.}
\item[142] \textit{Id.}
\item[143] \textit{Id.}
\item[144] \textit{Id.}
\item[145] \textit{Id.}
\end{footnotes}
using the card or by permitting or authorizing use of the card by another. A mere failure to destroy or return an unsolicited card is not such an indication.146

Regarding collection actions filed in such instances, the law required:

When an action is brought by an issuer against the person named on the card, the burden of proving the request, application, authorization, permission, use or benefit as set forth in Section 1 hereof shall be upon plaintiff if put in issue by defendant. In the event of judgment for defendant, the court shall allow defendant a reasonable attorney’s fee, to be taxed as costs.147

As to liability, the Act held:

Notwithstanding that a person in whose name a credit card has been issued has requested or applied for such card or has indicated his acceptance of an unsolicited credit card, as provided in Section 1 hereof, such person shall not be liable to the issuer unless the card issuer has given notice to such person of his potential liability, on the card or within two years preceding such use, and has provided such person with an addressed notification requiring no postage to be paid by such person which may be mailed in the event of the loss, theft, or possible unauthorized use of the credit card, and such person shall not be liable for any amount in excess of the applicable amount hereinafter set forth...148

For those who were subject to fraud from the shotgun mailing, the statute limited liability in such actions. If the card had no signature pane, liability was limited to $25.00 and those with a signature panel to $50.00. Wisely, the practice was banned entirely by the Unsolicited Credit Card Act of 1977.149

146 Credit Card Liability Act, 815 Ill. Comp. Stat. 145/0.01 (2013).
147 Credit Card Liability Act, § 145/1.
148 Credit Card Liability Act, § 145/2.
149 Credit Card Liability Act, § 150/1.
XIV. AND NOW... THE SUPREMES

The earliest case in the modern credit card era attempting to discern the nature of the credit card contract took place in 1954. It did not involve consumers or collections but was a regulatory action. A company called Master Charge (presumably no relation to what eventually became Master Card) appealed a ruling that found Master Charge was denied a permit to issue capital stock because it had not procured a license as a lender under the Small Loan Law.150 To Master Charge, what it was doing was nothing like a loan because it was not delivering money. Under their business plan, for a charge of $5.00 per year, it issued cards to persons deemed to be good credit risks, which entitled them to purchase, on credit, merchandise or service at stores, hotels and restaurants listed in its booklet. At the point of sale, the cardholder would sign an invoice and Master Charge would agree to purchase, without recourse, at a discount from 6 to 10 percent any of the invoices the listed retailer chose to sell and assign to it. Master Charge would bill the cardholder for the face amount of the invoices and the cardholder will pay the same.151 Master Charge insisted that a loan of money is a contract by which one delivers a sum of money to another, and the latter agrees to return at a future time a sum equivalent to that which he borrowed.152 Thereby, a law that could apply only to loans of money was not intended to apply to loans of credit.

The court would not play semantic games. It upheld the commissioner’s decision finding that there is no essential difference between a loan and a sale of credit, so Master Charge was required to license under the Small Loans Act.153

While not a Supreme Court case, it is a useful preface demonstrating that the primary obstacle to creating a universal card was the assumption that issuers were subject to state law.154 It would take almost a quarter century for the Supreme Court to review such perceived limitations. Yet, like so much of the credit card’s legal history, the fact the case involved a credit card was tangential to the decision.

In Marquette Nat. Bank of Minneapolis v. First of Omaha Service Corp, a unanimous court found state usury laws did not

151 Id.
152 Id.
153 Id.
154 EVANS AND SCHAMALENSEE, supra note 32, at 69.
apply to nationally chartered banks.\textsuperscript{155} This was First of Omaha’s second go-around with this argument, having come out the loser of a similar case in Iowa. While the federal court in that case had refused to enjoin the card program, the Iowa Supreme Court held usury laws were applicable.\textsuperscript{156} As a piece of trivia, after this loss, the Omaha hired Robert Bork, Ronald Reagan’s failed Supreme Court nominee, to argue the instant case before the Supreme Court.

The First National Bank of Omaha (Omaha Bank) was a nationally chartered bank located in Nebraska.\textsuperscript{157} In the war of BankAmericard v. Interbank (Visa) it chose to join the BankAmericard network.\textsuperscript{158} Given its proximity to Minnesota, Omaha Bank solicited for new cardholders in Minnesota.\textsuperscript{159} The Minnesota cardholders they reenrolled were charged the interest rate permitted by Nebraska law (18\%) on unpaid balances.\textsuperscript{160} However, this interest rate was in excess of that permitted by Minnesota law (12\%).\textsuperscript{161} The Marquette National Bank of Minneapolis (Marquette), a Minnesota-chartered national banking association, also enrolled in the BankAmericard plan, brought suit in Minnesota against Omaha Bank to enjoin the operation of Omaha Bank’s card until such time it complied with Minnesota’s usury law.\textsuperscript{162} The trial court rejected Omaha Bank’s contention that the National Bank Act preempted Minnesota’s usury law.\textsuperscript{163} On appeal, Omaha Bank asserted 12 U. S. C. §85 authorized any national banking association to charge on any loan interest at the rate allowed by the laws of the State where the bank is located.\textsuperscript{164} The Minnesota Supreme Court reversed and the U.S. Supreme Court granted certiorari.\textsuperscript{165}

At the outset, Justice Brennan observed Omaha Bank is a national bank which makes it an instrumentality of the Federal government, created for a public purpose, and as such is necessarily subject to the “paramount authority of the United

\textsuperscript{156} Fisher v. First Nat’l Bank of Omaha, 548 F.2d 255, 548 (8th Cir. 1977).
\textsuperscript{157} Marquette Nat’l Bank, 439 U.S. at 301.
\textsuperscript{158} Id. at 302.
\textsuperscript{159} Id.
\textsuperscript{160} Id.
\textsuperscript{161} Id.
\textsuperscript{162} Id. at 304.
\textsuperscript{163} Id. at 306.
\textsuperscript{164} Id.
\textsuperscript{165} Id. at 307.
States,” meaning the interest rate that Omaha Bank could charge is governed by federal law.\textsuperscript{166}

Marquette did not disagree Omaha Bank was an entity whose locus was in Nebraska.\textsuperscript{167} Instead, it contended that a national bank which systematically solicits Minnesota residents for credit cards to be used in Minnesota merchants must be considered to be ‘located’ in Minnesota.\textsuperscript{168} The court disagreed with this argument as well, holding that the credit extended was granted by Omaha Bank in Nebraska, that the finance charges were assessed by the bank in Omaha, and all payments on unpaid balances are remitted to the bank in Omaha.\textsuperscript{169} Furthermore, the bank issued its BankAmericards in Omaha, after credit assessments made by the bank in that city.\textsuperscript{170}

Failing that, the bank attempted to argue Omaha Bank’s credit card plan adversely affected the marketplace.\textsuperscript{171} Justice Thurgood Marshall was particularly interested in learning how Marquette could be at a competitive disadvantage when the competition was charging interest 6% higher than Marquette.\textsuperscript{172} When Marquette’s attorney insisted on the point, Marshall rhetorically asked if other gas station owners would object if its competitor tripled their price.\textsuperscript{173}

When the unanimous court finished writing the decision, I am sure they had no engage in self-congratulation; \textit{Brown v. Board of Education} this was not. To them, and I am sure most legal observers, this was a by-the-numbers application of the supremacy clause. But, in the world of credit cards, it changed everything.

Previously, usury laws limited the development of a national card industry because they limited the bank’s ability to market their cards nationally, or as you can see from \textit{Marquette}, regionally due to the differences in rates. Each state would require the issuer to administer an entirely different program.\textsuperscript{174}

\textsuperscript{166} Marquette Nat’l Bank of Minneapolis, 439 U.S. at 309 (citing Davis v. Elmira Savings Bank, 161 U.S. 275, 283 (1896)).
\textsuperscript{167} \textit{Id.} at 309.
\textsuperscript{168} \textit{Id.} at 312.
\textsuperscript{169} \textit{Id.} 310-11.
\textsuperscript{170} \textit{Id.}
\textsuperscript{171} \textit{Id.} at 314.
\textsuperscript{173} \textit{Id.} at minutes 25:20 to 25:29.
\textsuperscript{174} \textit{Evans & Schmalensee}, \textit{supra} note 16, at 69.
After *Marquette*, three major changes occurred. First, nationally chartered banks began to move from the state they had chartered in to ones with less restrictive usury laws, such as South Dakota and Delaware.\(^{175}\) Second, in order to restrain banks from leaving their states, shedding jobs and tax revenue, states began to eliminate their usury caps. For example, New York went from 12% caps to complete elimination of caps except for credit cards, which they allowed to rise to 25%.\(^{176}\) Finally, with fewer interest rate differentials, banks could now begin true national mass-marketing.\(^{177}\)

**XV. Do you have any case law for that?**

On the state level, cases involving credit cards were also running through the system. While certainly not exhaustive or scientific, a search on Lexis in its state court case database from 1901 to the present shows the first opinion on personal liability on credit card was in 1960. In *Union Oil Company v. Lull*,\(^{178}\) the defendant was sued by Union for $1,454.25 in charges. Unfortunately, the charges were unauthorized and Lull claimed he did not know about the charges until he received his bill on May 26, 1958 at which time he immediately canceled the card by telegram.\(^{179}\)

The terms of the card, printed on the back, stated the account holder guaranteed payment for services or products rendered “to anyone presenting this card” even if the charges were unauthorized.\(^{180}\) Lull claimed he was unaware of the liability because the manner by which the terms were conveyed (being on the back of the card) would not lead a cardholder to suspect they were part of a contract.\(^{181}\)

The court held that Lull’s misconception would not allow him to escape liability.\(^{182}\) This is likely because there was some factual evidence to show Lull knew the card was missing early in May. However, after an extensive review of the case law, while the court said the terms could be applied against Lull, it noted

\(^{175}\) *Id.*

\(^{176}\) *Id.* at 70.

\(^{177}\) *Id.* at 70.

\(^{178}\) *Union Oil Co. of Cal.* v. *Lull*, 349 P.2d 243, 245 (Or. 1960).

\(^{179}\) *Id.* at 246.

\(^{180}\) *Id.* at 247.

\(^{181}\) *Id.* at 249. *Id* at 246-47.

\(^{182}\) *Id.* at 250.
Union’s right to recover under the guaranty agreement for unauthorized purchases was conditioned on Union’s exercise of reasonable care in making inquiries as to the identity of the purchaser. As this was a cross-country gas buying spree, the court was essentially requiring Union to produce cashiers to testify from each station where the card was used. I’m guessing Lull won Part II.

In contrast, another identity theft liability case, filed subsequent to the TILA and Regulation Z had a different outcome. In Nat’l Commercial Bank & Trust Co. v. Malik, the bank sued the owner of a store for an act of good customer service. A customer accidently left a credit card at the defendant’s store. The storeowner found it and immediately notified the customer who promised to retrieve the card in six days. The defendant’s employee agreed to hold the card until then. Thereafter, the card was used to make $3,304.01 in unauthorized charges.

The bank did not sue their customer, choosing instead to sue the storeowner, claiming he had wrongfully allowed the card to fall into possession of an unauthorized user, that the cardholder had assigned their claims against the storeowner to the bank, that the loss of the card was occasioned by the owner’s negligence and breach of an alleged bailment of the card.

Relying almost exclusively on TILA, the court noted the Act places the burden of proof on the issuer to demonstrate they provided notice of the potential liability of unauthorized use to the cardholder. In looking to the allegations of the complaint, the court noted it did not allege compliance with the notice provisions of TILA. Indeed, notice to merchants is not a part of TILA, rendering it impossible for the bank to make such a claim.

With the bank arguing it stepped into the cardholder’s shoes via an assignment, the court analyzed the rest of the

183 Id. at 253.
185 Id. at 866.
186 Id.
187 Id.
188 Id.
189 Id.
190 Id. at 867.
191 Id.
192 Id. at 866-67 (the court cited the notice provisions found in TILA).
allegations under that theory.193 According to basic assignment law, an assignee receives the same rights as the assignor.194 In looking at the dictates of TILA, the court properly noted the cardholders who lost the card would have had no liability to pay for the unauthorized uses.195 Consequently, they would have suffered no damages.196 Therefore, “the claims of the plaintiff assignee... are therefore claims without damages.”197 The first Illinois case examining credit cards appears to be a criminal matter: People v. Roberts.198 It is notable for Robert’s defense which led to an interesting formulation of the credit card contract. In this case, Roberts was convicted of forgery for purchasing $3.00 worth of gas with a credit card.199 The forgery claim was based on the signed sales slip.200 He appealed.201 While admitting he was not the authorized user of the card and that the signature on the slip was not that of the authorized user, he asserted the signature was only a deceptive practice, not forgery and that the slip was not an instrument capable of defrauding another, language that was a statutory requirement.202 Roberts claimed the sales slip, combined with the credit card itself, may constitute a document but the failure to allege the existence of a credit card account was fatal to the indictment.203 The court disagreed, utilizing the reasoning similar to a later civil case, Garber v. Harris Trust, holding the credit card itself simply establishes a line of credit exist while the sales slip, like a check, purports to make use of the credit.204

XVI. THE NATURE OF THE CREDIT CARD

As the credit card was beginning to gain popularity, legal scholars were attempting to use familiar common law notions of contract and the commercial code to analyze the credit card contract. As early as 1960, the California Law Review tried,
without success, to fit itself into the existing legal framework of letters of credit or credit offered by the seller itself.\textsuperscript{205} As the article’s title makes clear, the involvement of a third-party lender to consumer purchases confounded the legal scholars. As previously discussed, bank lending for consumer purchases, was unknown, both from a business or legal perspective. With some pride, it can be said that Illinois courts were first to answer the riddle posed in the California Law Review. That is, Illinois formulated the almost universally accepted definition of the credit card contract.

In \textit{Garber v. Harris Trust}, the plaintiff received notice of the card issuer’s intent to modify the terms of his account.\textsuperscript{206} Garber sued, representing a class, asserting the credit card contract was formed when the card was issued so that the issuers could not unilaterally change the terms without new consideration.\textsuperscript{207} Harris and other banks in the class maintained issuance of the card was merely a standing offer to extend credit.\textsuperscript{208} One needed to use the card before there was a contract.\textsuperscript{209} Therefore, the issuers could modify the terms at will without new consideration.

The court agreed the card itself was a standing offer, which meant each use of the card is a separate contract governed by the terms and conditions in place at the time of each use.\textsuperscript{210} Because the card is only an offer, the issuer could modify the terms at will.\textsuperscript{211}

In dismissing Garber’s claim that issuers were bound to honor the same terms forever, the court reviewed a basic concept of contract law: consideration.\textsuperscript{212} Garber asserted providing credit information and submitting to a credit check constituted consideration.\textsuperscript{213} The court found for a performance or a return promise to constitute consideration, it must be bargained for.\textsuperscript{214} When you apply for credit, there is no bargaining: if you wanted

\begin{flushright}
\textsuperscript{207} \textit{Id.}
\textsuperscript{208} \textit{Id.} at 1311.
\textsuperscript{209} \textit{Id.}
\textsuperscript{210} \textit{Id.} at 1312.
\textsuperscript{211} \textit{Id.}
\textsuperscript{212} \textit{Id.} at 1313.
\textsuperscript{213} \textit{Id.}
\textsuperscript{214} \textit{Id.}
\end{flushright}
the card, you had to submit to those checks.

The court also found there was no mutuality of obligations.215 If you never use the card, you were not subject to the terms.216 Likewise, if the consumer never makes a charge, the issuer does not have to perform its duties under the contract.217 With this understanding, the terms, if they were a contract, had no effective termination date.218 As such, the cardholder agreement was a contract of indefinite duration which, by its nature, was terminable or modifiable at will under long standing contract law.219

In fact, the court held modifications could also have a retroactive effect on balances accrued under the old terms.220 Any unpaid balances would be subject to the new terms, but only if the cardholder uses the card after modifications were sent.221 By using the card, the cardholder essentially “refinanced his existing balance under new arrangement.”222

Garber was decided almost a quarter century ago. Notwithstanding its age, Garber has come to be known nationally as the most reasonable explanation of the formation of a credit card contract.223 Indeed, its reasoning provided the basis of several recent Illinois decisions involving credit card complaint pleading standards: Portfolio Acquisitions v. Feltman, Asset Acceptance v. Tyler and Razor Capital v. Antaal.224

215 Id.
216 Id.
217 Id.
218 Id. at 1313-14.
219 Id. at 1314.
219 Id.
220 Id.
221 Id. at 1315.
222 Id. (citing Beck v. First National Bank (Minn 1978) 270 N.W.2d 281)
XVII. THE BIGGEST UNINTENDED CONSEQUENCE OF THEM ALL

Whether or not one believes former Vice President Al Gore, it may be said with some confidence that Garber made e-commerce possible. By focusing on the act of using the card, not a physical signature, it enabled us to enter an era where we need not leave home to engage in trade. The impact of e-commerce is such that the phrase Black Friday is stated synonymously with its modern counterpart Cyber Monday, even if ‘cyber’ has fallen out of favor as the adjective de jour to describe on-line activities.

In 1999, William M. Daley, then head of the Commerce Department, in a report on the new phenomenon of e-commerce, stated its promise was a “future with more opportunity for all Americans.” This statement was made even as the report noted e-commerce accounted for less than 1% of the economy. Daley was not far off. In 2012, worldwide e-commerce sales accounted for $1 trillion dollars in sales. In the U.S. alone, $364 billion in sales were recorded.

The internet as we know it, with portable access via a mobile device possessing more computing power than the computers in existence in 1999, would not have occurred without the creation of the credit card and the cashless society. Government, in this instance, encouraged its growth with the passage of the Electronic Signatures in Global and National Commerce Act, cleverly going under the acronym of ESIGN. The stated purpose of which was to facilitate the use of electronic records and signatures in interstate and foreign commerce by ensuring the validity and legal effect of contracts entered into electronically.

As you recall in Marquette, some twenty-five years before E-Sign was passed, made clear national banks were not bound by state laws regarding usury. Seeing the potential of e-commerce,

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226 Id.
228 Id.
Congress avoided any lag in states amending their laws by ESIGN explicitly pre-empted state laws to impose uniformity regarding electronic transactions. The statute also provides that should a state enact the Uniform Electronic Transactions Act (EUTA) a model state law, any deviation was limited to state statutes meeting certain conditions. It specifically forbade states from adopting EUTA with modifications to force non-electronic delivery methods for documents or to enact laws giving greater weight to physical documents over electronic forms. Accordingly, Illinois passed the Illinois’ Electronic Commerce Security Act, eliminating physical signatures in all statutes save those that met the limited exceptions found within ESIGN.

**XVIII. CONCLUSION**

Our story began with the understanding that commerce and credit have been intertwined since before recorded time. Despite the passage of thousands of years, Aristotle’s concept of creditors being something unnatural has persisted. Credit cards, now regulated more strongly by the CFPB and the Card Act, have been called a drug by some and worse by others. These extreme views do not help discussions on the causes of our current financial problems.

Unfortunately, we as humans, suffer what Alan Greenspan presciently described as “irrational exuberance.” By that he meant we always seek ways to get rich quickly despite ample centuries of evidence. In the 17th century, it was the Dutch and tulips (yes, that is not a typo). A century later, it was the French and the “Mississippi Company” in which the government invested so much, it crippled the French economy for a decades.236 Around the same time, England had to work through

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231 Id.
232 Id.
235 This unusual investment choice is discussed in detail in MIKE DASH, TULIPOMANIA: THE STORY OF THE WORLD’S MOST COVETED FLOWER & THE EXTRAORDINARY PASSIONS IT AROUSED (Random House 2001).
236 FERGUSON, supra note 1, at 139-58.
For us, it has been the stock market crash of 1929, which precipitated the Depression, and more recently the tech-stock bubble and our most recent real estate bubble.

What makes such bubbles possible in the incredible interconnectivity of the world economy? Without realizing it, this interconnectivity touches each of us personally. If you have a 401(k), it is very likely you are investing in a bank that issues credit cards and want that 401(k) to grow. Growth in stock value requires profitability and sales, meaning, the bank needs more credit card customers and more credit card purchases. While no one likes collection attorneys, if we want the costs of borrowing to be low and stock prices to remain high, we need creditors and their attorneys to recover these losses. If done ethically and with an understanding of the consumer’s circumstances, some good can come of these efforts, both for the creditor and for the consumer, as they may, over time, eliminate debt and restore their credit.

Like anything in life, credit cards can be a boon or, in the wrong circumstances, be a great evil. It is likely that our natural fear and distrust of credit has much to do with the instinctive fear that a change in circumstances can lead to financial ruin. Almost like the post-war era, in the real estate boom, many of us may have shed our instinct to plan for the worst. The economy changes every day and new vehicles of lending and loaning will always be with us, stepping just ahead of regulation or a true understanding of the consequences. In the end, it is we, as citizens and consumers, who must make informed personal choices and political selections to insure against the turbulence of the modern economy.

\[237\] Id. at 158.
CONSUMER LITIGATION FINANCING IN ILLINOIS: SEEKING SECURITY AND LEGITIMIZATION THROUGH REGULATION

Michael J. Howlett*

I. INTRODUCTION

The Consumer Litigation Financing, also known as Consumer Litigation Funding, ("CLF") industry has been the subject of an increasing number of commentaries and legislative initiatives across the United States. To date, relatively few jurisdictions have directly regulated the industry via statute, largely through industry-backed bills. Additionally, several jurisdictions have regulated the industry through non-statutory means, including judicial rulings, voluntary agreements, and consent decrees. Illinois has previously attempted to regulate the industry on two occasions. After passing legislation out of the State Senate, the bill failed in the House in 2010. Last session, several bills failed to pass the Illinois General Assembly, which would statutorily recognize and regulate the practice of CLF, but the sponsor has indicated plans on pushing for passage in the upcoming 2014 legislative session. The bill, while substantively similar to industry-backed statutory schemes in other jurisdictions, presents some unique provisions which have not been tested yet in other jurisdictions. This article will begin with a brief overview of the industry and the methods of regulation in other jurisdictions. Further, this article will analyze the unique provisions of the Illinois legislation, and the pending bill as a whole, in light of the relevant Illinois case law and the lobbying efforts surrounding the proposed legislation.

Ultimately, the industry’s push for regulation will in effect, if not by purposeful design, achieve legitimization and

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protection for the industry from legal challenges. The currently-stalled legislative proposals would provide this legitimization. However, any of the proposals would also take the important steps toward protecting consumers of legal services through general regulatory oversight, capping interest rates, and allowing for a consumer protection study and a sunset provision to reevaluate the regulations after sufficient information is compiled.

II. OVERVIEW OF THE INDUSTRY

The Third-Party Litigation Financing industry has three general segments: (1) Corporate Litigation Finance, (2) Direct funding to law firms, and (3) CLF. It is the third of these segments which merits, and thus far has attracted, the most judicial and legislative attention. This is primarily for two, facially apparent, reasons. First, in the other industry segments, the interests at stake are purely pecuniary as opposed to the compensation for damages sought in a personal injury case. Second, the parties seeking the funding in the first two segments are much more sophisticated actors than most personal injury plaintiffs. As a result, much of the newly passed regulation has focused on CLF, leaving the other segments to be regulated by investment and business-to-business lending statutes.

Generally, there is a dearth of hard data concerning the CLF industry and the characteristics of funding arrangements. However, there are a number of sources and facts that help sketch a rough outline of the industry. First and foremost, it bears noting that the $100 million industry\(^1\) typically advances low dollar amounts to consumers, generally ranging from $1,750 to $4,500,\(^2\) or phrased another way, 10% to 20% of the plaintiffs expected award.\(^3\) That being said, several of the cases far exceeded this amount, with at least one consumer receiving an advance of $177,500.\(^4\) It is also worth noting that the majority of funding is used by consumers to cover rent or mortgages during litigation, with the greatest percentage aimed at preventing

\(^1\) Binyamin Appelbaum, Lawsuit Loans Add New Risk for the Injured, N.Y. TIMES, Jan. 16, 2011.


\(^3\) Appelbaum, supra note 1.

foreclosures.\textsuperscript{5}

While the sums advanced to consumers generally are small, the interest charged on the advance seems to vary widely, depending on the case or funding company. The figure that is most often presented by the industry is 3-5\% monthly compounding interest,\textsuperscript{6} which can, in itself, be in excess of 60\% Annual Percentage Rate ("APR").\textsuperscript{7} However, that figure is exclusive of fees on the advance, and is by no means standard. One company, LawCash, based out of Brooklyn, New York, reported their average APR on a funding agreement was 16-48\%.\textsuperscript{8} The American Legal Finance Association—a national business association representing the CLF industry—admits that just a few years ago, the typical monthly percentage was 10\%.\textsuperscript{9}

As would be expected, sources that are not connected to the industry paint a much different picture. A variety of sources have reported APR's at 100\%,\textsuperscript{10} 50\% of the advanced amount owed in interest after six months,\textsuperscript{11} or even up to 280\%.\textsuperscript{12} Clearly, there are at least a few instances of corporate actors charging far beyond the self-proclaimed industry standard interest rates.

The rationale behind higher rates is the potential risk in such funding arrangements. Nearly without variation, these funding arrangements are non-recourse, meaning the CLF company has no legal recourse to collect either the principal amount or the interest if the consumer is unsuccessful in their suit or awarded an amount less than what is owed.\textsuperscript{13} Facialy, this is a valid argument. The higher the risk the company takes, the

\textsuperscript{5} Gail Markels, Third Party Litigation Financing - Public Policy Aspects, Conference of Western Attorneys General, July 7, 2011.
\textsuperscript{6} Garber, supra note 2, at 12.
\textsuperscript{9} American Legal Finance Association, Legal Finance: Myth v. Fact, and How ALFA is Helping, AMERICAN LEGAL FINANCE ASSOCIATION (May 1, 2013), http://www.americanlegalfin.com/alfa1/LinkClick.aspx?fileticket=rTxg4YCm3vA%3D&tabid=71&mid=553 [hereinafter “Myth v. Fact”].
\textsuperscript{10} Appelbaum, supra note 1.
\textsuperscript{11} Id.
\textsuperscript{12} Lawsuit Fin., 683 N.W.2d at 240.
greater their interest rate should be, particularly if they have no recourse should the consumer’s suit be unsuccessful. However, far from providing funding for each and every interested consumer, the companies have a rigorous internal review, conducted by attorneys employed by CLF companies. The process is so rigorous that CLF companies have roughly a 70% rejection rate for funding requests, with some companies having individual rejection rates of nearly 95%. Further, it is common industry practice for funding companies to require that the consumer be represented on a contingency fee basis, adding another validator in the form of an attorney agreeing to bear the costs of litigation in expectation of an award or settlement.

III. CRITIQUES OF CONSUMER LITIGATION FINANCE

Just as payday loans and the subprime lending market before it, CLF incurs its fair share of criticism from consumer protection advocates. Unlike payday loans and subprime lending, the industry also attracts criticisms from tort reform advocates. The consumer protection criticism centers on several aspects of the CLF industry: namely unduly high interest rates, transparency issues, and inflated claims of risk. Tort reform advocates criticize the industry for its potential effects on the quality and length of litigation, settlement amounts, and attorney client privilege.

Far and away, the majority of consumer protection critiques of CLF focus on the issue of predatory rates. Just as

15 Appelbaum, supra note 1.
16 Lawrence Schaner, Third-Party Litigation Funding in the United States, REVISIT DE ARBITRAGEM E MEDIACAO Jan.-Mar., 175, 186 (2012).
18 See generally McKinney, supra note 7; Lawsuit Fin., 683 N.W.2d at 590.
with payday loans, the CLF industry is being criticized for charging extraordinarily high rates, evidenced by interest charges of up to 280%.\textsuperscript{20} Even if the 280% APR is considered to be an outlier, rates of 100% APR have been consistently reported.\textsuperscript{21} In fact, the CLF industry itself has admitted to historically charging 10% monthly compounding interest,\textsuperscript{22} far above statutorily authorized lending rates for other types of high-risk cash advances.\textsuperscript{23} Further, even though it is true that the industry as a whole has lowered the monthly percentages charged to consumers, 2 - 4% monthly compounding interest can often be in excess of 60% APR,\textsuperscript{24} in addition to the charges and fees companies typically charge. Even these lower rates are nearly double the statutorily authorized amounts for payday loans,\textsuperscript{25} and are certainly higher than credit card and traditional bank lending rates.\textsuperscript{26}

In response to claims of predatory lending, the industry’s typical response is that these higher rates are justified by the level of risk they assume in lending to consumers who may lose their case, precluding the company from recovering.\textsuperscript{27} While this argument is logically sound, the claims of risk may be inflated. Far from funding any risky suit where the plaintiff needs funding to bring their case, CLF companies generally have a rigorous vetting process, with in-house lawyers pouring over the case to determine not only the probability of success, but also a likely award amount.\textsuperscript{28}

In light of this vetting process, it is unlikely that many of the funded cases do not yield repayments to the companies. As such, the argument that the high-risk nature of the loans necessitates high interests rates, while not theoretically inaccurate, may not be an accurate representation of the real risks

\begin{footnotesize}
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\item \textsuperscript{20} Lawsuit Fin., 683 N.W.2d at 240.
\item \textsuperscript{21} Appelbaum, \textit{supra} note 1.; Caitlin Ginely, \textit{States Are Battleground in Drive to Regulate Lawsuit Funding}, \textit{THE CENTER FOR PUBLIC INTEGRITY}, (May 1, 2013), http://www.publicintegrity.org/2011/02/02/2160/states-are-battleground-drive-regulate-lawsuit-funding.
\item \textsuperscript{22} Myth v. Fact, \textit{supra} note 9.
\item \textsuperscript{24} McKinney, \textit{supra} note 7.
\item \textsuperscript{25} 205 ILL. COMP. STAT. 670/15 (2012).
\item \textsuperscript{26} Garber, \textit{supra} note 2, at 10.
\item \textsuperscript{27} Martin, \textit{supra} note 8, at 65.
\item \textsuperscript{28} Oasis Approval Factors, \textit{supra} note 14.
\end{itemize}
\end{footnotesize}
faced by the industry. Unlike payday lenders, CLF companies have attorneys vetting consumer’s suits, determining both the likelihood and potential amount of an award or settlement. As noted above, this process results in an industry-wide rejection rate of 70% for funding requests, with individual rejection rates of nearly 95%. In fact, LawCash reported losing money on only 4% of its cases in a two year period. By means of comparison, payday lenders have a default rate of 10-20%, far above most CLF companies. This apparent disparity between claims of risk and rates charged has led one commentator to note: “The realistic risk of non-recovery [sic] seems very little in comparison to the interest rate and is therefore unjustifiable in relation to the high cost of loans to the consumer.”

Related to the criticism of high rates, opponents of CLF are troubled by transparency issues surrounding the industry. In soliciting potential consumers, the industry generally uses television advertising, often in the same tenor and tone of payday lenders and structured settlement and annuity purchasers. While the commercials tout quick access to much needed cash, conspicuously absent is any information relating to the interest rates, terms of the lending agreements, or length of the agreement.

The selective non-disclosure of terms does not end with advertisements. Former CLF company employees have reported that they were instructed not to mention rates to consumers

30 Appelbaum, supra note 1.
31 Id.
33 Martin, supra note 8, at 73.
35 Taubman, supra note 29, at 35.
37 Cash Net USA, It’s Done With CashNetUSA, CASH NET USA (May 1, 2013), http://www.cashnetusa.com/blog/its-done-with-cashnetusa/.
unless asked directly. In another instance, a consumer was quoted a relatively modest APR of 39%, but was later charged upwards of 76% of the loan amount after the first year. Apparently the practice was so widespread in the state of New York that then-Attorney General Eliot Spritzer entered into an agreement requiring a code of conduct and setting base industry practices for New York CLF companies.

The final consumer protection argument against CLF focuses on the core business model of the industry, specifically that it is a for-profit business with little to no interest in justice. The gist of the argument is that these companies, like any investor, are concerned with rates of return, regardless of any underlying benefits provided or detriments caused to the legal system. Rather than being concerned with providing access to the judicial system for those who could not otherwise seek justice and compensation for injury, the industry is more concerned with profit. Buford Capital’s CEO Chris Buford’s comments are illustrative of the view that pervades the industry: “We’re fundamentally a capital provider. We take a share of the ultimate recovery, having taken the risk of funding the case. Forget this being about the law or litigation - we’re providing risk funding for an investment in the same way as in any other sector of the market. If the investment pays off we make a return on the capital we’re investing.” In light of that frank self-assessment of the industry, it is clear that the argument that the CLF industry is unconcerned with considerations of justice is not unfounded. That being said, being unconcerned with justice is not the same as promoting injustice, and certainly does not preclude the industry from encouraging justice, even if it is not a primary goal.

While the consumer protection arguments against CLF

39 Appelbaum, supra note 1.
40 Id.
41 Assurance of Discontinuance Pursuant to Executive Law §63(15) In the Matter of Plaintiff Support Services, Inc.; Pre-Settlement Finance, LLC; QuickCash, Inc.; Magnolia Funding, LLC BridgeFunds Limited; Plaintiff Funding Corporation d/b/a LawCash; Oasis Legal Finance Co., LLC; The Whitehaven Group, LLC; New Amsterdam Capital Partners LLC d/b/a LawMax, N.Y. Att'y Gen. (2005).
43 Id.
44 Id.
are certainly valid and troubling, most of the criticism in academia and most of the opponents lobbying against the industry in state legislatures are focused on tort reform generally. Instead of opposing the industry because of its impacts on consumers, the critics and opponents focus on the effects to the legal system as a whole, particularly any increase in litigation or awards amounts.

The first and most pervasive tort reform criticism of CLF is the effect on the quality and quantity of litigation.\textsuperscript{45} On its face, this is a logical argument: the more money given to consumer initiating actions will increase the overall number of suits and incentivize consumers with frivolous claims to bring suit by removing the risk. The argument of increased quantity of litigation is also straight forward: the basic business model of the industry is to provide money to consumers who have claims that are likely to be victorious to pay for expenses during the course of the litigation. Logically, absent this funding, it is unlikely that the consumer would be able to bring their suit.

While there is insufficient data on the American CLF industry to confirm or deny this claim, Australia has seen a 16.5\% increase in litigation following the acceptance of the industry.\textsuperscript{46} The largest increases in Australia were in class actions and insolvency suits, which are not generally funded by the CLF industry in the United States, and are prohibited in most statutory schemes regulating the industry.\textsuperscript{47} However, it should be noted that this argument is proffered by traditional tort reform advocates, such as the U.S. Chamber of Commerce and the American Tort Reform Association,\textsuperscript{48} which represent parties with little interest in injured parties receiving compensation, as they typically are the defendants in suits. This argument is further cast into doubt by the fact that most companies require a consumer to have legal representation on a contingency fee basis

\textsuperscript{45} Garber, \textit{supra} note 2, at 28-31.
\textsuperscript{46} Beisner, \textit{supra} note 19.
and to have already filed their suit to obtain funding.\footnote{Oasis Approval Factors \textit{supra} note 14; Garber, \textit{supra} note 2, at 29.}

Directly related to the argument that CLF will increase the overall volume of litigation is the argument that an increase in litigation will be caused by frivolous claims being filed as a form of speculation. Again, as with quantity, the quality argument appears to be facially sound: the less risk there is to the party to bring a suit, the more incentivized he will be to bring a long-shot suit that has the potential for a high award but may not be meritorious. While this argument is also typically advanced by the tort reform lobby,\footnote{Joyce, \textit{supra} note 48.} it is cast into doubt for much the same reasons as the quantity argument. The high denial rate of 70%\footnote{Appelbaum, \textit{supra} note 1.} coupled with the contingency fee representation requirement\footnote{Oasis Approval Factors, \textit{supra} note 14.} suggests that a frivolous claim would likely not make it through a CLF company’s internal assessments. Moreover, a frivolous lawsuit, likely to be thrown out and unlikely to settle, would be a poor investment and a bad business strategy for the company.\footnote{Myth v. Fact, \textit{supra} note 9.}

Aside from impacts on the litigation process itself, the tort reform critics of CLF argue the industry negatively impacts settlements, both in the length of time it takes to settle a case and because it may force a consumer to forego an otherwise reasonable settlement offer on account of their obligation to the CLF company.\footnote{Rancman v. Interim Settlement Funding Corp., 99 Ohio St. 3d 121, 124-25 (2003).} Both of these arguments stem from the same underlying concern that litigation funding artificially inflates the value of a claim, dis-incentivizing reasonable settlement amounts, and prolonging litigation.\footnote{Joyce, \textit{supra} note 48.} This force manifests itself in two ways. First, the funding provided to consumers will likely make the consumer disinclined to take early settlement offers because the funding ameliorates their pressing need to settle early—even if the settlement is fair.\footnote{Mariel Rodak, \textit{It's About Time: A Systems Thinking Analysis of the Litigation Finance Industry and Its Effect on Settlement}, 155 U. Pa. L. REV. 503, 522 (2006).} Second, and nearly the opposite of the first, as the litigation continues the consumer may be disincentivized to settle later in the process because of the mounting
interest and fees arising from the funding.57

This later argument is of particular concern, and was the
basis for the Ohio Supreme Court decision to ban the practice in
2003,58 though it was later overturned by the Ohio state
legislature.59 In Rancman v. Interim Settlement Funding Corp,
the Ohio Supreme Court held that CLF was prohibited as
champertous in Ohio because it impedes the settlement of the
underlying case.60 The funding arrangement in the case
effectively barred the consumer from settling for anything less
than $28,000 in order to receive any portion of a settlement.61
This is before taking into account the consumer’s own internal
settlement amount. This additional deduction, beyond that of a
contingency fee, has the potential to make any reasonable
settlement offer effectively too low, and force the consumer to
push for trial in the hopes of a greater jury award.62

The final argument advanced by tort reform critics of
CLF is the industry’s effect on attorney client privilege, and to a
lesser degree the effect on the work product doctrine. Generally,
attorney client privilege protects the right to prevent disclosure of
certain information communicated in confidence between an
attorney and his or her client.63 This privilege is generally waived
if the confidential information is communicated to a third party.64
The work product doctrine is an extension of this privilege, which
protects documents prepared for litigation or in reasonable
anticipation of litigation.65 As such, the concern regarding CLF is
that attorney client privilege will be waived when an attorney or
the consumer communicates the particulars of the claim to the
company assessing the claim.66 While an inadvertent waiver of

57 Rancman, 99 Ohio St. 3d at 124.
58 Id.
60 Rancman, 99 Ohio St. 3d at 124.
61 Id.
62 Rancman, 99 Ohio St. 3d at 124.
63 BLACK’S LAW DICTIONARY 1317 (9th ed. 2009) (“client’s right to refuse
to disclose and to prevent any other person from disclosing confidential
communications between client and attorney”).
65 BLACK’S LAW DICTIONARY 1746 (9th ed. 2009): “Tangible material or
its intangible equivalent — in unwritten or oral form — that was either
prepared by or for a lawyer or prepared for litigation, either planned or in
process.”
66 Grace Giesel, Alternative Litigation Finance and the Work-Product
Doctrine, 47 WAKE FOREST L. REV. 1083, 1096 (Winter 2012).
the privilege is certainly a cause for concern, the risk appears to be minimal. Most statutes and proposed bills specifically exempt communications to funding companies from waiving the privilege. Further, the investment interests of the CLF industry would be ill-served if in assessing claims the client is placed in a weaker position waiving the privilege.

In assessing the entirety of the arguments against CLF, all are serious issues with potential harm to consumers and further burden an already expensive and overused court system. Yet, most of the above arguments can be ameliorated either by comprehensive regulation or by taking into account the self-interest of the industry, with the exception of the high interest rates and their corresponding effect on settlements. The effects on settlements cannot be regulated because it rests on the internal motivations of consumers who need compensation for injuries, compensation that will be naturally reduced by their obligation to the funding company. So long as interest rates remain high, the effect on settlements is likely to remain.

IV. ARGUMENTS IN FAVOR OF CONSUMER LITIGATION FINANCE

Despite the arguments against CLF, in certain circumstances, the service provides a measurable social utility by allowing underprivileged plaintiffs to bring a claim. Arguments in support of the industry generally center on two points: the benefits provided to underprivileged consumers, allowing them to bring claims when they otherwise could not, and internal control measures and safeguards which protect consumers and limit the potential negative impacts of the industry.

The most compelling argument in support, and the most difficult to rebut, is the social utility the industry provides. Regardless of the business motivations of the industry, the fact remains that their services allow consumers to bring claims for compensation when they would be otherwise unable. The typical

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69 Myth v. Fact, supra note 9.
phrase used is “keys to the court house for the poor.” Moreover, the supporters of the industry argue that the funding advanced to the consumer is typically a relatively small amount, in the tens of thousands of dollars. Further, these relatively low amounts are typically sought, and used for legitimate and important financial obligations. The single largest use of funds is to prevent foreclosures, with many instances of the funds also being used for basic living necessities such as food, and not for litigation or attorney fees.

The industry is providing an undeniably positive social function, truly granting the proverbial keys to the courthouse. However, the price that accompanies this apparent godsend cannot be overlooked. Since CLF companies charge an amount which can take nearly all of the proceeds, the question must be asked - is the consumer in any better of a position by taking this funding?

The general industry response to that question is “yes.” The industry contends, and logic would suggest, that financial assistance to low income consumers early in litigation will increase their bargaining power, which allows them to withstand low settlement offers. While this is undoubtedly true, it does not account for the arguments of exceedingly high rates and such rates forcing consumers to forego potentially reasonable settlement offers, opting to go to trial in search of a higher award.

Aside from the social utility provided by the industry, the other main argument in support of the industry is aimed at ameliorating the perceived ills of the industry. In response to the aforementioned criticism, the American Legal Financing Association and its members have adopted the Best Practices Code of Conduct. The six point voluntary agreement consists of the following pledges: (1) obtaining a written acknowledgement from the consumer’s attorney; (2) the agreement between the company and the consumer will not constitute ownership of the claim and the company will not direct or interfere with the litigation; (3) companies will not advance money in excess of the

70 Martin, supra note 8, at 73.
71 Markels, supra note 5; Myth v. Fact, supra note 9, at 1.
72 Markels, supra note 5.
73 Id.
consumer’s needs; (4) companies will not intentionally overfund cases; (5) companies will not engage in false advertising or intentionally mislead a client; and (6) companies will not offer to or pay commission or referral fees to attorneys for recommending clients.75

Certainly all of these provisions are commendable and have the potential to address the concerns of both consumer and tort reform advocates alike. However, the Code of Conduct is less magnanimous than it may appear at first glance. The Code of Conduct was created immediately after and is heavily based on an agreement between the industry and the Attorney General Spitzer of New York.76 Following a review of the business practices of several companies in New York, Attorney General Spitzer entered an agreement with the companies, for which each company was charged a $5,000 fee for “costs”.77 The agreement regulated practices much in the same way as the subsequent code of conduct; yet, the New York agreement went much further in regulating the industry,78 and shares many of the regulatory provisions in subsequent legislation backed by the industry.79 Moreover, while the Code of Conduct does amend some of the critics concerns, it is notably silent on permissible interest rates.80

An additional argument in support of the industry rests on its internal assessment measures as a control on frivolous litigation. In assessing this argument, the practices of Oasis Legal Finance are illustrative of wider industry practices. Oasis funds cases only after a number of criteria have been satisfied.81 For instance, Oasis will only fund personal injury cases where there were severe injuries, particularly if they resulted in time off work.82 Oasis generally does not fund soft tissue injury cases because of the volatility in assessing awards.83 Additionally, Oasis assesses the defendant in the case, with “strong liability” often being determinative, as well as the defendant’s ability to pay

75 Industry Best Practices, supra note 74.
76 Assurance of Discontinuance, supra note 41.
77 Assurance of Discontinuance, supra note 41; Industry Best Practices, supra note 74.
78 Assurance of Discontinuance, supra note 41.
80 Assurance of Discontinuance, supra note 41.
81 Oasis Approval Factors, supra note 14.
82 Id.
83 Id.
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damages. As previously noted, Oasis is in line with the industry practice of requiring consumers to be represented on a contingency fee basis, ensuring that another party be equally willing to “assume the risk of winning the case.” Finally, and perhaps most illustrative, Oasis requires a “sufficient margin for investment” before agreeing to fund a case. In addressing the margin of investment, Oasis looks to other liens and expenses that will be paid out of litigation proceeds. Oasis examines these liens because CLF obligations are typically the lowest priority claims on litigation proceeds, as would be the case under several of the prospective Illinois bills that would regulate the industry.

As with the voluntary Code of Conduct, Oasis’s approval factors address the criticism of tort reform advocates. Yet, it also serves to undercut the argument that CLF provides access to underprivileged consumers. It is clear that the overall interest of the company is a return on its investment, and not the actual need of the consumer.

In assessing the totality of the arguments for and against the industry, it is clear that some are more pervasive, and therefore more critical to address in any regulatory scheme. These issues are the high interest rates and the corresponding effects on settlements on the one hand, and the undeniable fact that the funding, despite its profit driven motives, provides a tangible benefit to low income consumers seeking to pursue a legal claim on the other.

V. CURRENT REGULATORY SCHEMES

To date, several jurisdictions have taken on the task of regulating the industry, with the apparent intent of amplifying the social utility of the CLF industry while accounting for the accompanying social ills. Jurisdictions that have regulated the industry have done so in three distinct ways: (1) judicial oversight, (2) executive agreements and regulation, and (3) statutory regulation of the industry.

Several jurisdictions have held third party financing of litigation to be invalid either under champerty or usury. Champerty is generally defined as “an agreement between a

84 Id.
85 Id.
86 Id.
87 Id.
88 See infra pp. 123, 130.
stranger to a lawsuit and a litigant, by which the stranger pursues the litigant’s claim as consideration for receiving part of any judgment proceeds; the act of maintaining, supporting or promoting another person’s lawsuit.”

In one example previously discussed, the Ohio Supreme Court held that third party finance of litigation was void as champertous. Nevertheless, several years after that case decided, the Ohio state legislature overturned the ruling and passed a regulatory scheme supported by the industry.

Other jurisdictions have had more success in regulating litigation funding agreements by judicial ruling. In Oklahoma, the Tenth Circuit prohibited certain third-party funding agreements as champertous. In Parks v. American Warrior Inc., a party agreed to pay for a third of the cost of litigation in return for 40% of the proceeds. The court found the agreement to be “clearly champertous,” because it was “officious intermeddling in a suit which in no way belongs to one, by maintaining or assisting the party, with money or otherwise, to prosecute or defend it.”

Perhaps more relevant than third-party funding generally, several jurisdictions have specifically struck down forms of CLF as either usurious or champertous. In an example from Michigan, the state Supreme Court struck down a CLF agreement as usurious. In Lawsuit Financial, LLC v. Curry, the court held that non-recourse loans were still loans, regardless of their non-recourse nature. Because the agreements were found to be loans, the agreements were held to be usurious, as interest rates of 280% far exceeded Michigan’s maximum lawful annual interest rate of seven percent.

While non-recourse loans are not generally seen as loans by most jurisdictions and therefore not subject to usury laws, a Colorado State Appellate Court ruled in Oasis Legal Finance et. al. v. Suthers that such financial agreements are loans for the purposes of regulation. In reviewing an appeal of a granted

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89 BLACKS LAW DICTIONARY 262 (9th ed. 2009).
90 See infra pp. 113.
93 Parks, 44 F.3d at 893.
94 Id.
95 Lawsuit Fin., 683 N.W.2d at 240.
96 Id.
97 Id.
motion for partial summary judgment de novo, the court affirmed the district court’s ruling that a non-recourse provision does not remove a funding agreement from the definition of the term loan under the state Uniform Consumer Credit Code ("UCCC"). In affirming the lower court, the appellate court held that debt, including contingent debt, falls under the broad definition previously adopted by the Colorado Supreme Court as aligning with the UCCC’s underlying purpose of protecting consumers.

The court rejected the litigation finance companies’ arguments that the loans were non-recourse, on the grounds that the companies have recourse if the consumers break their contracts - for example, if consumer wins and does not or cannot pay the principle plus interest and fees. As such, while usury was not at issue in the appellate review of the partial summary judgment, it is entirely foreseeable that when the UCCC is applied in full force, the agreements could be found to be usurious.

In another such example, a Minnesota court ruled CLF to be void as champertous, similar to the Ohio Supreme Court opinion in Rancman. A Minnesota State Appellate Court ruled in Johnson v. Wright that an agreement contingent upon the outcome of litigation would be champertous. While the court held that the agreement at issue was not champertous as it was not contingent upon the outcome of the case, the court did find the agreement champertous in assigning a percentage of the proceeds, and therefore a percentage of the legal claim, to the lender.

While several courts have held that non-recourse funding agreements are not loans for the purpose of regulation, jurisdictions are split on the issue. Some courts have held that the non-recourse nature of these funding agreements renders them beyond the scope of the relevant jurisdiction’s usury laws.


99 Id. at *10-13.
100 Id. at *10-11.
101 Id. at *15.
102 Id. at *17.
103 Johnson v. Wright, 682 N.W. 2d 671, 677 (Minn. App. 2004).
104 See infra pp. 113.
105 Johnson, 682 N.W. 2d at 677.
106 Id.
107 See Dopp v. Yari, 927 F. Supp. 814, 822 (D.N.J. 1996) (stating a litigation funding agreement is not usurious because it was a joint undertaking between the parties involved); See also Kraft v. Mason, 668 So. 2d 679, 684 (Fla. Dist. Ct. App. 1996) (holding because the profit or interest was
Though certain jurisdictions have succeeded in generally protecting consumers and the legal system from champertous agreements, judicial oversight on this matter is a crude mechanism. Relying on judicial oversight tends to lead to “all or nothing” regulation. Recognizing this, several jurisdictions have taken a different approach - regulating the industry through the state executive branch. The prime example of this is Maryland, where the Commissioner of Financial Regulation entered into a consent order with Oasis Legal Finance in response to licensing complaints against the company. In response to the complaints, Maryland issued a cease and desist order to end all of Oasis’s litigation financing. In response to the cease and desist order, Oasis denied allegations that the agreements were loans or advances under Maryland law, and therefore subject to the Maryland usury laws. Nevertheless Oasis agreed to cease business conduct until Maryland amends the relevant laws. In addition to having operations ceased in the state, Oasis received a $105,000 fine.

In another aforementioned example, former New York Attorney General Spitzer entered into an agreement with CLF companies in 2005. In addition to the provisions that led to the adoption of the ALFA Code of Conduct, the agreement added additional provisions specifically aimed at consumer protection. These provisions include: (1) disclosure and itemization of fees and APR; (2) a five day cancellation policy; and (3) a natural language provision for those who do not speak English or Spanish. These provisions generally serve as the basis for legislation in several other jurisdictions.

contingent, the transaction cannot constitute usury); See also Anglo-Dutch Petroleum Int’l, LLC v. Haskell, 193 S.W.3d 87, 94 (Tex. App. 2006). (indicating a litigation funding agreement where the investor’s return on investment is contingent on a company’s recovery cannot be usurious).

108 Consent Order, supra note 23; Assurance of Discontinuance, supra note 41.
109 Consent Order, supra note 23.
110 Id.
111 Id.
112 Id.
113 Assurance of Discontinuance, supra note 41.
114 See infra pp. 116.
115 Assurance of Discontinuance, supra note 41.
116 Assurance of Discontinuance, supra note 41.
To date, the CLF industry has backed successful legislation recognizing and regulating the industry in three states, Ohio, Maine, and Nebraska. Generally, the relevant statutes of these three states are substantively the same, with minor differences: (1) disclosure of rates, fees and funding amounts; (2) five day cancellation policies; (3) prohibiting companies from affecting the outcome of the case; (4) mitigating impacts on attorney client privileges; (5) prohibiting commissions and referral fees for lawyers; (6) banning companies from making decisions with regards to the course of litigation; and (7) establishing the priority of liens, with the CLF companies’ interest as the lowest priority. Specifically, the statutes capped the number of months during which fees can be charged at either 36 or 42. Notably absent in any of the laws is a cap on the interests rates and fees to be charged.

VI. RELEVANT ILLINOIS STATUTES AND CASE LAW

Illinois has not yet addressed the issue of CLF directly, and the law is currently in a state of flux. The only case dealing with the issue in Illinois was a suit over a choice of venue clause in a funding agreement signed in North Carolina, where the court held that an agreement entered into in North Carolina could not be litigated in Cook County. Nevertheless, a look at Illinois statutes and case law is illustrative in assessing whether CLF could be successfully challenged, absent the proposed regulatory scheme supported by the industry and its allies.

The common law and statutory provision most generally applicable to CLF is maintenance. Maintenance is defined as “assisting in prosecuting or defending a lawsuit to a litigant by someone who has no bona fide interest in the case.” Further, Illinois has a statute specifically prohibiting maintenance,
well as barratry, which is essentially the continuing practice of maintenance.\textsuperscript{127} The statutory prohibition on maintenance has been interpreted by Illinois courts as the officious intermeddling in a suit by one who has no interest and is not a party by maintaining a party, financially or otherwise, with a view toward promoting litigation.\textsuperscript{128} Illinois does allow selfless maintenance when the recipient of the support is either one’s family member or a person who is impoverished.\textsuperscript{129}

Related to maintenance is the offense of champerty. Further, Illinois courts have interpreted champerty as an agreement to pay for litigation in return for part of the proceeds. In other words, “an essential element necessary to constitute champerty [is] an agreement to divide the proceeds of litigation.”\textsuperscript{130} While champerty is not specifically recognized by statute in Illinois, it has not been abolished by statute, surviving in common law.\textsuperscript{131} It should be noted that while champerty does not apply to contingency fee arrangements in Illinois, direct lending to a client by a lawyer is still prohibited.\textsuperscript{132} In fact, only the civil-law jurisdiction of Louisiana,\textsuperscript{133} and a minority of other jurisdictions including Alabama, Minnesota, Mississippi, Montana, North Dakota, and Texas permit lawyers to lend to clients under certain circumstances.\textsuperscript{134}

The final basis for challenging CLF has been usury laws. Usury is an excessive rate of interest charged above the legal amount to the borrower of money.\textsuperscript{135} Illinois has regulated interest rates of similar high risk funding agreements, such as Consumer Installment Loans (“payday loans”), setting the interest rate cap at 36% APR.\textsuperscript{136} Therefore, any APR above 36% would

\textsuperscript{127} 720 ILL. COMP. STAT. 5/32-11 (2009).
\textsuperscript{129} 720 ILCS 5/32–12 (2009).
\textsuperscript{131} Milk Dealers Bottle Exch. v. Schaffer, 224 Ill. App. 411, 415 (1st Dist. 1922).
\textsuperscript{132} ILL. STATE BAR ASS’N, Ethics Ops. 295 (1968).
\textsuperscript{133} LA ST. BAR ART 16 RFC Rule 1.8.
\textsuperscript{136} Consumer Installment Loan Act, 205 Ill. Comp. Stat. Ann. 670/15
be considered usurious under the Consumer Installment Loan Act. While consumers and state officials have had success in challenging or regulating CLF agreements on the basis of usury, it is unlikely that this would be an effective challenge in Illinois. This is because under Illinois law, an agreement for which repayment is based on an uncertain contingency cannot be usurious. Since CLF is contingent upon the consumer receiving an award or settlement, it is highly unlikely that CLF could be successfully challenged on these grounds, as in other such jurisdictions.

The state of the law in Illinois regarding these offenses as applied to third-party litigation funding is by no means settled. The last Illinois Supreme Court case addressing third-party funding of litigation was decided in 1914. In Reiman v. Morrison, a party had an agreement whereby he would recover one-half of any interest in stolen property another party received from pending litigation. The Court held that such an agreement was not void as champerty because the party had not agreed to bear any of the direct costs of the litigation. In upholding this agreement, the Court laid out how to successfully challenge an agreement as champertous: to make a case of champerty, “it must be shown that the cost and expenses of a suit... are paid or agreed to be paid by one not a party to the suit.”

The last Illinois state appellate court opinion addressing third-party funding of litigation was decided in 1989. In Puckett v. Empire Stove Co., a landlord assigned their claim to a tenant to bring suit against a manufacturer of a defective gas valve, in return for terminating the tenant’s right to contribution from the landlord. The court held that the arrangement was not champertous since the landlord was not a stranger to the suit. While upholding this particular arrangement, the court in Puckett noted: “champerty and maintenance have been

(See infra pp. 116-118.)

137 See infra pp. 116-118.
139 See supra pp. 120-22.
140 Gregory, supra at note 122.
141 See generally Rieman v. Morrison, 264 Ill. 279 (1914).
142 Id. at 281.
143 Id. at 282.
144 Id. at 286.
146 Id. at 427.
147 Id.
disapproved by the courts as public policy because a litigious person could harass and annoy other.\textsuperscript{148}

Finally, the Illinois State Bar Association has previously issued an opinion on the topic of third-party financing, stating that it is not unethical for an attorney to assist a client in obtaining loans related to litigation.\textsuperscript{149} However, the opinion was narrowly tailored to situations where the loan was used to pay attorney fees, not where lump sums of money were given to clients to cover basic expenses.\textsuperscript{150}

In light of the state of the law in Illinois, and the successful challenges to the funding in other jurisdictions, it is foreseeable that a consumer could successfully challenge a funding agreement in an Illinois court. This uncertainty is troubling to the industry, and is presumably the driving purpose behind their push for regulation. Generally, CLF companies are averse to having their funding arrangements go to trial, and they prefer settlements.\textsuperscript{151}

For instance, the head of a Brooklyn-based CLF company was quoted as saying, “\textit{[e]verything that might have to go before a judge, you stay away . . . we don’t want judges to shine a light on us.}”\textsuperscript{152} This animosity to judicial review seems to be predicated on the idea that judges perceive a “smell of predatory lending” on the industry.\textsuperscript{153} Clearly, the judicial challenges to agreements in various jurisdictions have incentivized the industry to fund cases expected to settle before trial.

Yet, even if the industry is successful in keeping their agreements out of the glare of judicial review, there is still the risk of state executive officers challenging and regulating the industry, as occurred in Maryland and New York.\textsuperscript{154} The reality is that if a consumer is successful at trial, his award will be likely greater than any amount for which he could settle. After finding success in Nebraska, Maine and especially Ohio by successfully preempting or even overturning legal challenges to funding, the stage is set in Illinois for a successful industry push for CLF

\textsuperscript{148} \textit{Id.}
\textsuperscript{150} Gregory, \textit{supra} note 122.
\textsuperscript{151} Appelbaum, \textit{supra} note 1.
\textsuperscript{152} \textit{Id.}
\textsuperscript{153} Martin, \textit{supra} note 8, at 63.
\textsuperscript{154} Assurance of Discontinuance, \textit{supra} note 41; Consent Order, \textit{supra} note 23.
friendly regulation.

**VII. PENDING ILLINOIS LEGISLATION**

Turning to the previous attempts at statutory recognition of CLF in Illinois, the failed 2010 attempt, Senate Bill 3322,\(^{155}\) ("SB 3322") was substantively similar to the bills passed in other jurisdictions.\(^ {156}\) Additionally, the most recent attempt to regulate the industry in Illinois, House Bill 2301 ("HB 2301") as introduced, was roughly the same proposal as offered in SB 3322.\(^ {157}\) HB 2301 would have created the Non-Recourse Civil Litigation Funding Act.\(^ {158}\)

Unlike other jurisdictions, the opponents of CLF, and particularly the Illinois Chamber of Commerce and the Institute for Legal Reform, offered a competing proposal.\(^ {159}\) House Bill 2300 ("HB 2300") would have regulated CLF as the state regulates other cash advance arrangements, such as payday loans, under the Consumer Installment Loan Act.\(^ {160}\) Notably, this would cap the interest rate of CLF agreements at 36% APR.\(^ {161}\) Additionally, the bill would require disclosure of the agreement to both the court and the defendant.\(^ {162}\)

HB 2300 and HB 2301, as introduced, quickly lost support, in favor of a succession of compromise amendments to HB 2301. House Committee Amendment 1 to HB 2301 ("HCA 1") added additional provisions to those in the previous legislation and HB 2301: (1) a natural language contract requirement for non-English speakers; (2) a prohibition on funding for class action suits; (3) a prohibition on attorneys and law firms having a financial interest in CLF companies who provide funding for their clients; (4) a cap on payments to only proceeds from the pending litigation; (5) a requirement for companies to only receive an assignment of a contingent right to receive proceeds from a


\(^{156}\) See *supra* pp. 17.


\(^{158}\) *Id*.


\(^{162}\) H.B. 2300, *supra* note 160.
claim, and not an assignment of the claim itself, which is not to be
determined as a percentage of the proceeds; (6) an allowance for
companies to fund a consumer who has previously been funded
by another company without purchasing the assignment of the
first company; (7) caps of specific charges to the consumer;
codification of the claim priority of the company; and (8) caps on
the fee assessment at 36 months.\footnote{163}

While many of these provisions were instituted in various
other jurisdictions, Illinois also proposed a provision that is
wholly unique. HCA 1 proposed a dual lending provision,
providing that consumers seeking litigation funding would have
the option of entering into a non-recourse funding agreement or a
traditional loan regulated under the Consumer Installment Loan
Act (“CILA”).\footnote{164} If the CILA option was taken, the APR would be
capped at 36%, as it is for other CILA loans, such as payday
loans.\footnote{165} If the non-recourse funding option were taken, the
interest rate would be capped at 36% APR with an additional
monthly 3% deferment fee.\footnote{166} Further, it should be noted that the
CILA option would be regulated under CILA, and not generally
under the Act.\footnote{167}

HB 2301 was subsequently amended by House Committee
Amendment 2 (“HCA 2”), adding: (1) additional disclosure
sections; (2) CLF is assignable and not to be construed as a loan
or investment for the purpose of regulation; (3) licensure
requirements; (4) a data reporting plan to compile a consumer
protection study; and (5) a sunset provision repealing the bill for
re-passage following the culmination of the consumer protection
study.\footnote{168} The data collected by this provision would include the
number of transactions, the amount of funding in each
transaction, the number of transactions required to be repaid, the
average annual fee rate, and the total number of transactions
where the company received full repayment, partial repayment
and no repayment.\footnote{169} HCA 2 also contains a superiority clause,
meaning that in the event of a conflict between the legislation and

2013).
\footnote{164} Id.
\footnote{165} Id.
\footnote{166} Id.
\footnote{167} Id.
2013).
\footnote{169} H.B. 2301, Comm. Amend. 2 supra note 168.
other state laws, this legislation supersedes those other laws.\footnote{170}{Id.} While Oasis continued its support of this proposal and the Illinois Chamber continued its opposition, the Illinois Trial Lawyers Association reserved judgment on HCA 2. Perhaps because of this, HCA 2 to HB 2301 failed to pass out of committee before the relevant House deadline, and was re-referred to the Rules Committee pursuant to House Rule 19.\footnote{171}{Rules of the Illinois House of Representatives, Ill. House R. 19(a).}

That was not the end of the push for regulation during the 98th General Assembly. State Representative Andre Thapedi (D - 32nd) the sponsor of the previous bills, amended HB 531, a shell bill which had been passed out of committee earlier in the session and was on 2nd Reading in the House, with a regulatory scheme similar to HCA 2. House Amendment 1 (“HA 1”) made several changes to HB 531. While HA 1 to HB 531 preserved the choice-of-loan provision, it changed the percentages for non-recourse loans from 36% with a 3% monthly deferment fee to 36% with a 1.5% bimonthly deferment fee.\footnote{172}{H.B. 531, Comm. Amend. 1, 98th Gen. Assem., 1st Reg. Sess. (Ill. 2013).} HA 1 to HB 531 also changed the required disclosures to the consumer, requiring the disclosure of the total dollar amount owed to the company at 30 day intervals for 1080 days, after which no fees could be assessed.\footnote{173}{Id.} Additionally, the amendment added that notwithstanding notice of the non-recourse funding agreement, the consumer’s attorney is not responsible for paying or ensuring payment of the obligation.\footnote{174}{H.B. 531, Comm. Amend. 1, supra note 172.}

An additional amendment was also filed for HB 531. HA 2 to HB 531 offered several changes to HA 1, specifically: (1) excluding entities that engage in commercial to commercial business transactions from regulation under the act; (2) requiring disclosures of the total dollar amount owed at 180 day intervals, as opposed to 30 days under HA 1, for 1,080 days; (3) shortening the cancelation window from 10 days to 7 days; (4) deleting the provision added in HA 1 that notwithstanding notice of the non-recourse funding agreement, the consumer’s attorney is not responsible for paying or ensuring payment of the obligation; (5) deleting the provision prohibiting funding of class action suits; and (6) adding that nothing in the act shall cause non-recourse
lending to be deemed a loan or investment and such agreements cannot be regulated as such.\textsuperscript{175}

Additionally, like HA 1, HA 2 to HB 531 preserves the choice-of-loan provision, but changes the interest rate caps for non-recourse funding arrangements back to 36\% with a 3\% monthly deferment fee from the 1.5\% bi-monthly fee in HA 1.\textsuperscript{176} Finally, HA 2 would delay the sunset provision and date of consumer protection study from May 31, 2015 to May 31, 2019.\textsuperscript{177} Neither HA 1 nor HA 2 contained the superiority clause contained in HCA 2 to HB 2301.\textsuperscript{178} HA 2 to HB 531 was supported by the traditional supporters of the industry including Oasis and several other CLF companies, the Illinois Trial Lawyers Association, and the American Legal Finance Association. The opponents to the industry were also largely the same, but were joined by the Illinois Department of Financial and Professional Regulation, the department tasked with regulating the industry under the various bills and amendments.

Despite the rush of amendments to HB 531, it failed to meet the 3rd Reading deadline and was re-referred to the Rules Committee pursuant to House Rule 19.\textsuperscript{179} As it stands now, HCA 2 to HB 2301 and both HA 1 and 2 for HB 531 are effectively stalled for the duration of this legislative session, but will be pending in the Rules Committee in January 2014, following the veto session. Rep. Thapedi, after accommodating the various stakeholders in HA 1 to HB 531, still did not expect any of the stakeholders to fully support HA 1.\textsuperscript{180} Thapedi recognized that many of the stakeholders will “equally work against the bill because they are not getting everything that they want.”\textsuperscript{181} Nevertheless, the Thapedi thinks “the bill that’s filed is soup, and . . . it’s ready to go.”\textsuperscript{182} As such, it is entirely foreseeable that Rep. Thapedi will continue his press for statutory recognition and regulation of the industry.

\textsuperscript{175} H.B. 2301, Comm. Amend. 1, \textit{supra} note 163.

\textsuperscript{176} \textit{Id}

\textsuperscript{177} \textit{Id}

\textsuperscript{178} H.B. 531, Comm. Amend. 1, \textit{supra} note 172.


\textsuperscript{180} Andrew Maloney, \textit{Lawsuit Loans Face Regulation in Illinois General Assembly}, \textit{CHICAGO DAILY LAW BULLETIN}, Apr. 16, 2013.

\textsuperscript{181} \textit{Id}

\textsuperscript{182} \textit{Id}. 
VIII. ANALYSIS OF THE BILLS

In assessing the competing provisions offered during the legislative session, it is worth noting the various pieces of legislation were largely industry bills. Oasis has been the strongest and most vocal supporter of the House proposals, supported in their efforts by the American Legal Finance Association. This is further evidenced by the overwhelming similarity between the initially proposed HB 2301 and legislation passed in other jurisdictions. Obviously, there are certain provisions contained in the various proposals that are not part of the industry’s ideal bill. Nonetheless, the substance of the bill will still accomplish the goal of legitimizing the industry through statutory recognition. That the industry wants to ensure the practice remains legal in Illinois should go without saying; Cook County is one of the largest unified court systems in the world.\footnote{http://www.cookcountycourt.org/ABOUTTHECOURT/OfficeoftheChiefJudge.aspx (Last visited Sept. 28, 2013).} The industry would certainly be willing to go to great lengths to ensure its continued operation in such a large market.

Perhaps most notable about the lobbying efforts behind the bill was the shifting stance of the Illinois Trial Lawyers’ Association (“ITLA”). Traditionally a strong voice in the state capitol, ITLA supported several versions of the legislation but not all. The combined weight of their lobbying strength when added to that of the CLF industry could prove to be the decisive factor in passing a regulatory scheme in 2014.

It is also worth noting that the opponents of the bill are generally the tort reform advocates that have opposed the industry’s lobbying efforts elsewhere. The Illinois Chamber of Commerce and the Institute for Legal Reform, a wing of the U.S. Chamber of Commerce, were the lead opponents of the measures in Illinois. While their opposition may be tangentially related to consumer protection, the Chambers’ main interest is in limiting litigation since its members are often the defendants, mimicking the U.S. Chamber’s opposition.\footnote{See infra p. 111.} As such, this seems to be a compromise bill in a true sense of the term, in that the tort reform advocates achieved victories with the inclusion of the sunset provision, ban on referral fees, and interest rate caps on an other-
wise industry supported bill.\footnote{185} 

To the substance of the bills, as stated above, any of the pending amendments, if passed, would accomplish the industry’s goal of statutory recognition and regulation of the industry. This seems to be of the utmost importance to the industry, as it would circumvent the harsh judicial review process imposed by other jurisdictions.\footnote{186} As previously noted, members of the industry see judicial oversight as the worst possible form of scrutiny and regulation to which the industry could be subjected.\footnote{187} There is no greater example of this process than Ohio, where the industry engaged in an extensive lobbying effort to overturn the State Supreme Court’s decision to strike down all CLF arrangements.\footnote{188}

The industry’s fear of judicial review and oversight striking down funding arrangements would likely be completely amended should the pending legislation be passed. Taking champerty first, it is almost certain that any claim would be unsuccessful should any of the pending proposals be passed. Since champerty only survives at common law in Illinois,\footnote{189} any legislative enactment would supersede the claim, unless the legislation were struck down as unconstitutional.

The impact on usury challenges would be much the same. Aside from the fact that usury has been found not to apply to non-recourse loans in Illinois,\footnote{190} even the CILA loans authorized under provisions would not be seen as usurious since any loan would be capped at 36\% APR.\footnote{191} Any funding agreement charging less than that rate would not be usurious by definition.

It is unclear how statutory prohibition on maintenance would be interpreted in light of the pending proposals. The picture is most clear for HCA 2 to HB 2301, which includes a superiority clause.\footnote{192} This clause, were it to be enacted, would effectively protect the industry from any challenge based on


\footnote{186} See infra pp. 119-22.

\footnote{187} See infra pp. 128.

\footnote{188} See infra pp. 111.

\footnote{189} See infra pp. 125-26.

\footnote{190} Aldrich, 260 Ill. App. at 365-66.

\footnote{191} H.R. 531, Comm. Amend. 1, supra note 172.

\footnote{192} H.R. 2301, Comm. Amend. 2, supra note 168.
maintenance. It is unclear, though unlikely, whether a challenge based on maintenance would be successful should either HA 1 or HA 2 to HB 531 pass since they lack a superiority clause. 193

In comparing the unique provisions of the Illinois proposals to regulatory schemes in other jurisdictions, the provision that is the furthest departure from other jurisdictions is the choice-of-loan mechanism. No other jurisdiction that has regulated CLF has authorized a recourse loan agreement. 194 In theory, this is fundamentally divergent from other schemes. In practice, it is likely that this will operate as if the consumer sought a payday loan instead of litigation financing to support themselves during the initial stages of litigation. While the relative evils of payday loans may be argued, it remains that such cash advances are legal and regulated in Illinois. 195 Moreover, it is likely that this provision was included to allow currently operating CLF companies to continue operations during the three month period allowed for the Illinois Department of Financial and Professional Regulation to go through the rule-making and licensure process.

The Illinois proposals also differ from other statutory regulations of the industry by prospectively implementing a cap on interest rates. Alternatively capped at 36% with a 3% monthly deferment fee 196 and 36% with a 1.5% bi-monthly deferment fee, 197 the bills, if passed, would cap the allowable interest rates at roughly 72% APR plus the deferment fees. While this is certainly high, much higher than most loans, it is worth noting that this would be a ceiling. The loan would still not have to be paid back if the consumer’s claim was unsuccessful, and competition would likely drive the interest rates lower in most instances. This is certainly extraordinarily high at first blush, and, in light of the choice-of-loan provision, may drive consumers to opt for the traditional CILA loan, with little consideration of the recourse nature of such a funding agreement.

193 H.R. 531, Comm. Amend. 1, supra note 172.
196 H.B. 531, Comm. Amend. 1, supra note 172.
While the choice-of-loan and rate cap provisions are important steps and are sure to meet resistance from both proponents and opponents of the industry, the most important provisions in the bill are the data reporting, consumer protection study, and sunset provision. The single biggest hurdle in assessing and regulating the industry to date has been the lack of data regarding the particulars of the industry. On each side of the debate parties generally rely on anecdotal evidence. While it is true that many of the companies use hard data to support their arguments, it is generally limited and unverifiable, as it comes from internal records. Regardless of which bill ultimately passes, by requiring all CLF companies to report hard data on their funding agreements, the consumer protection study that would be submitted to the General Assembly on the eve of the sunset provision will provide vital data necessary in evaluating the effectiveness of the regulatory program.

The previously unregulated nature of this industry means that it is highly unlikely that any regulatory package will be perfect. The sunset provision allows the critics of the legislation an opportunity to seek further regulation in two to five years, depending on which amendment is ultimately adopted and passed. Further, it gives the industry an opportunity to prove its merits, and achieve the legitimization it is seeking.

IX. CONCLUSION

CLF is a hotly contested issue in law review articles, and in court rooms and state legislatures across the country. It is in the latter that the proponents and opponents have debated the issue in Illinois. After a half dozen proposals, and several parliamentary maneuvers, the issue has stalled for the 2013 legislative session, waiting in committee for the 2014 legislative session.

Merely because the industry is supporting such regulation does not mean that the regulations are per se weak or inadequate. A cursory glance shows that the regulations proposed will serve a workable canvas for additional provisions to be added, either during the legislation process or on the re-passage of the legislation following the sunset provision. Even without accounting for amending the proposal, the provisions common to the various proposals - interest rate caps, bans on referral fees, natural language provision, cancellation policy, disclosure of terms and fees, and priority of claims - all address vital concerns
of both the tort reform lobby and consumer protection advocates. The choice-of-loan provision will certainly cause some regulatory issues and the interest rate caps on the non-recourse loans have a high sticker price, making the recourse loan an attractive option. But such issues will arise when attempting to regulate any industry which was pervasively unregulated. That is why the most important provision in any of the pending bills will likely be the consumer protection study and sunset provision.

CLF certainly has its unsavory aspects, but it does serve a social good, and the pending legislation is a good starting point, contingent of course upon the results of the proposed consumer protection study.
2012 FTC STUDY ON CREDIT SCORES: 98% ACCURATELY REFLECT CREDIT RISK

Joseph Axelrod*

I. INTRODUCTION

One of the Federal Trade Commission’s (“FTC”) many duties is to regulate the credit system in the United States. In 2003, Congress passed The Fair and Accurate Credit Transactions Act (“FACTA”) and mandated that the FTC create a series of reports that document the prevalence of credit score inaccuracies. This note will explain the make-up of the credit reporting industry in the United States, describe the history of FACTA, summarize the first four reports from the FTC, and analyze the most recent report published by the FTC which includes the results of a study the FTC has planned and conducted since 2004. The finding that has garnered the most attention from the report is that one in every five consumers has an error in their credit report. However, a more important statistic is being overlooked: approximately 98% of credit reports contain information that allows a lender to make an accurate risk assessment of potential borrowers.

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1 In FTC Study, Five Percent of Consumers Had Errors on Their Credit Reports That Could Result in Less Favorable Terms for Loans, FEDERAL TRADE COMMISSION, /ftc.gov/opa/2013/02/creditreport.shtm, (February 11, 2013); Victimized By Credit Reports, N.Y. TIMES (February 12, 2010), http://www.nytimes.com/2013/02/13/opinion/victimized-by-credit-reports.html?_r=1&; The Accuracy of Information of Credit Reports, http://www.amazon.com/Accuracy-Information-Credit-Reports-ebook/dp/B00BGCBK64 (last visited Oct. 5, 2013) (using the 20% error rate to describe the report in the Amazon marketplace; the report cost $4.99 on Amazon, but can be downloaded for free from the FTC website)[hereinafter Media Coverage].

2 See FED. TRADE COMM’N, REPORT TO CONGRESS UNDER SECTION 319
II. THE CREDIT REPORTING INDUSTRY

The United States credit reporting industry is a private industry that collects and sells the personal and financial data of American citizens. The data collected includes the following: identifying information, credit account information, public records including liens and legal judgments against the consumer’s property, collection accounts and collection agencies, and inquiries from companies requesting the consumer’s reports. Creditors, stores, and other establishments provide this data. The credit furnishers then give the information to the credit reporting agencies ("CRAs") voluntarily. Currently, there are three national CRAs that control the market: Experian, Equifax, and Transunion.

The CRA’s generate reports, known as risk scores or credit scores, and sell the reports to financial institutions and other companies that analyze financial risk. The higher a person’s credit score is, the more likely it is for a financial institution to do business with that person or charge a lower interest rate on the credit distributed. At the moment, the credit industry contains information on about 200 million consumers. The effect that a consumer’s credit score has on their ability to adequately control their financial future makes it critical that reports showcase an accurate portrayal of that person’s financial history and is the reason why Congress has made an effort to regulate CRAs.

III. THE FAIR AND ACCURATE CREDIT TRANSACTIONS ACT OF 2003

FACTA was passed by Congress in December of 2003 as a bipartisan measure to amend the Fair Credit Report Act of 1996 ("FCRA"). Congress enacted the FCRA to protect consumers amid the growth of the credit reporting industry. The
prevalence of inaccurate, misleading, irrelevant or outdated information in consumers’ credit reports motivated congress to act.  

Members of Congress passed FACTA to address the same problems that caught the attention of their predecessors who enacted FCRA. The following provisions were included in FACTA to solve the problems Congress identified: (1) establish the right of every American to receive one free credit report a year; (2) mandate a warning notice to be sent out to consumers if a merchant is going to report negative information about them, and (3) establish a financial literacy commission, among other provisions. The Senate and the House of Representatives shared the intention to improve the quality of credit information in the country and supported the passage of FACTA.

IV. SECTION 319 OF THE FAIR AND ACCURATE CREDIT TRANSACTIONS ACT OF 2003

FACTA imposed a duty on the FTC to create biennial reports on the status of the American credit industry starting in 2004 through 2014. The study was meant to report on “the accuracy and completeness of information contained in consumer reports prepared or maintained by CRAs and find methods for improving the accuracy and completeness of such information” The FTC completed its most recent report in December, 2012 and it was made available to the public in February, 2013. It differs greatly in methodology from previous studies about the credit industry.

Section 319 of The Fair and Accurate Credit Transactions Act of 2003 states the following:

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12 Id at §319(a).
13 2012 FTC Report, supra note 2, at 6, 8-9 (referring to reports done by US PIRG which only used consumer data; Policy and Economic Research Council, which used consumer, CRA and data furnisher data but used a sample representative of the U.S. census and not a sample of diverse credit scores; and The Federal Reserve Board, which only used CRA data).
(a) STUDY REQUIRED.—Until the final report is submitted under subsection (b)(2), the Commission shall conduct an ongoing study of the accuracy and completeness of information contained in consumer reports prepared or maintained by consumer reporting agencies and methods for improving the accuracy and completeness of such information.

(b) BIENNIAL REPORTS REQUIRED.—

(1) INTERIM REPORTS.—The Commission shall submit an interim report to the Congress on the study conducted under subsection (a) at the end of the 1-year period beginning on the date of enactment of this Act and biennially thereafter for 8 years.

(2) FINAL REPORT.—The Commission shall submit a final report to the Congress on the study conducted under subsection (a) at the end of the 2-year period beginning on the date on which the final interim report is submitted to the Congress under paragraph (1).

(3) CONTENTS.—Each report submitted under this subsection shall contain a detailed summary of the findings and conclusions of the Commission with respect to the study required under subsection (a) and such recommendations for legislative and administrative action as the Commission may determine to be appropriate.

V. THE FOUR BIENNIAL STUDIES PERFORMED BY THE FTC PRIOR TO THE 2012 REPORT

The 2012 FTC Report is the first report, out of five total, conducted by the FTC and its researchers pursuant to §319 of FACTA (“Section 319”) that produced significant data. The first four reports concentrated on constructing the methodology of the study.14

14 See 2012 FTC Report, supra note 2; See FED. TRADE COMM’N, REPORT TO CONGRESS UNDER SECTION 319 OF THE FAIR AND ACCURATE CREDIT TRANSACTIONS ACT OF 2003, 2-3 (2010); See FED. TRADE COMM’N, REPORT TO CONGRESS UNDER SECTION 319 OF THE FAIR AND ACCURATE CREDIT TRANSACTIONS ACT OF 2003, 2-3 (2008); See FED. TRADE COMM’N, REPORT
The first study in 2004 reported on the make-up of the credit system in the United States, studied the most likely places in the system to contain errors, researched other studies that have been done on the United States’ credit system, and described a possible methodology to implement in a nationwide survey. In the next biennial report in 2006, the FTC conducted a pilot study that focused on the most effective ways to generate useful results about credit score accuracy. The FTC performed preliminary interviews with consumers and found that when there were problems with credit scores, consumers did not follow up and contest them; and the ones who did contest tended to have higher scores. In order to get a representative sample of how the dispute process works and include consumers in various credit score ranges, the FTC decided to give researchers flexibility to be able to recruit participants and actively help them through the dispute process.

The 2008 report implemented the findings of the previous pilot study and performed a second pilot study to fine tune the research process. The report found that 5.5% of the participants had material errors on their credit reports, however, the report concedes that the participants were not representative of the nation and therefore did not rely on the results as significant. This pilot study was done to refine the study methodology, not collect statistics about the nation’s credit system.

The FTC and its researchers sent out mailings to entice people to join the study. They concentrated on informing many different demographics by sending out the mailings through various financial institutions as well as through a random


16 Id. at 2.

17 Id. at 4.

18 Id. at 6.

19 See FED. TRADE COMM’N, REPORT TO CONGRESS UNDER SECTION 319 OF THE FAIR AND ACCURATE CREDIT TRANSACTIONS ACT OF 2003, 1(2008) (Citing only seven out of 128 participants found a material error on their score).

20 Id. (“the pilot studies serve only as a vehicle to improve the design of a national survey”).
selection process where names were taken from public information sources.\textsuperscript{21} Despite their efforts, the FTC still found that consumers with lower credit scores (generally under 760) were underrepresented.\textsuperscript{22} Another problem the initial pilot study found was getting consumers to dispute errors on their reports once they were discovered. To solve this problem, researchers prepared dispute letters and provided pre-paid postage for consumers who identified an error.\textsuperscript{23} The 2008 study left the FTC with two questions: (1) How to achieve a representative sample amid a likely non-response bias linked to consumers with lower credit scores; and (2) How to measure the effectiveness of the FCRA dispute process.\textsuperscript{24}

The FTC answered the unresolved questions sufficiently enough to allow the Office of Management and Budget to approve the final study design in 2009. Subsequently, the 2010 FTC Report described the final study design.\textsuperscript{25} The sample included 1,000 consumers randomly selected who reviewed their credit reports with an expert contracted for the study.\textsuperscript{26} The FTC chose participants representative of the general population using the following factors: credit scores, age, gender, and regional diversity.\textsuperscript{27} If a consumer found an error, the credit report was sent to the Fair Isaac Corporation (“FICO”)\textsuperscript{28} to categorize the potential error. FICO analyzed potential errors and informed the consumer whether the error would impact their credit score. The consumer then had the option to dispute the error through the FCRA dispute resolution process.\textsuperscript{29} The FTC hoped the study would enlighten the public on the effectiveness of the FCRA dispute process and what type of information had the greatest

\textsuperscript{21} Id. at 6-7 (mailings were sent from the following institutions or lists: random direct mail, Members of Navy Federal, members of Commerce Bank, members VITA program, and miscellaneous contacts).

\textsuperscript{22} Id. at 4; also See Id at 9.

\textsuperscript{23} Id. at 8.

\textsuperscript{24} Id. at 12 (considering non-response bias as the idea that there is a positive correlation between consumers who tend not to respond to invitations to the study and consumers who have low credit scores).

\textsuperscript{25} FED. TRADE COMM’N, REPORT TO CONGRESS UNDER SECTION 319 OF THE FAIR AND ACCURATE CREDIT TRANSACTIONS ACT OF 2003, 1(2010).

\textsuperscript{26} Id. at 3.

\textsuperscript{27} Id.

\textsuperscript{28} FICO is a nationally recognized and respected credit score generator.

\textsuperscript{29} FED. TRADE COMM’N, REPORT TO CONGRESS UNDER SECTION 319 OF THE FAIR AND ACCURATE CREDIT TRANSACTIONS ACT OF 2003, 2 (2010).
VI. THE 2012 FTC REPORT

The FTC’s goal when it mandated the biennial reports was to provide a reliable data set on the credit report accuracy in the United States.\(^{31}\) This is consistent with the overall goals of FACTA, which include improving the resolution methods of consumer disputes and the accuracy of consumer records.\(^{32}\) The FTC did not publish target goals for the amount of credit report inaccuracies expected in the system. Still, the results of the study were fit in the same ranges found in other studies done on the industry, even though the FTC used a different methodology than most of those studies.\(^{33}\)

The main focus from most media outlets, including the official FTC press release regarding the report, was that 20% of Americans had an error on their credit report.\(^{34}\) According to the report, 206 consumers of the participating 1,001 consumers had at least one error on their credit reports which was fixed after completing the FCRA dispute process.\(^{35}\)

For consumers who care about practical effects on their credit score this figure is not the most relevant piece of data from the 2012 FTC study. For example, out of the 206 consumers with an error on one of their reports, only 129 ended up with a change in their credit score after the error was corrected. Thus, 13% of consumers had errors that actually affected their credit scores.\(^{36}\) Moreover, not all the consumers who found errors in their credit reports found them on all of their credit reports. Except for a small percentage, each participant received three credit reports. Overall, 13% of all credit reports had errors, relatively less than the amount of total consumers who found errors (20%). This means, most errors were found on one or two of the reports.

\(^{30}\) Id. at 7.

\(^{31}\) 2012 FTC Report, supra note 2, at 1.


\(^{33}\) 2012 FTC Report, supra note 2, at 55 (stating that a study done on credit report accuracy using only CRA information cited that 2.5%-12.5% of reports had errors and a study done using only consumer information found that 79% of reports had errors).

\(^{34}\) Media Coverage, supra note 1, at 1.

\(^{35}\) 2012 FTC Report, supra note 2, at 36 (See table 4.1 Data Summary).

\(^{36}\) 2012 FTC Report, supra note 2, at 36 (See table 4.1 Data Summary).
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instead of all three. Any error on a consumer’s credit report is troublesome, but if a consumer’s entire credit history is not affected by the error because it only shows up selectively, it will have less of a negative impact. The percentage of credit reports that resulted in an actual credit score change after the errors were fixed was 7%. An actual score change is what hurts consumers in the market place, not the fact that an error exists. These figures reduce the importance of the actual effect of the 20% error rate on the American consumer.

The fact that that 13% of consumers have errors on their credit reports and 7% of all credit reports have errors that could cause a score changes is a more important than the fact that 20% of consumers have an error on a credit report. Ultimately, the effect of the error bares more importance than the mere existence of the error.

The impact that certain errors, or the subsequent credit score change, have on that consumer’s ability to obtain credit is the most useful information for the consumer. This particular information is not as clearly stated in the report. The FTC claims there is “no established rule or threshold for classifying the significance of a credit score change as minor or major because the impact of a change in score is dependent on the current score.” Despite this, the FTC found evidence that lenders used the following ranges of FICO scores to group and indicate the risk of potential borrowers: 300-620, 620-679, 680-719, 720-779, and 780-850. According to the 2012 FTC study, 2.2% of all credit scores resulted in a range increase from a credit score change, and no credit scores in the study resulted in a credit score decrease. This means that almost 98% of all credit scores are reliable tools for lenders or other interested parties to use when calculating their risk for a deal involving the extension of credit to consumers, if relying on the credit score ranges used by the FTC. These numbers have the largest real world affect.

37 2012 FTC Report, supra note 2, at 36. (Out of the 1,001 participants 33 consumers were unable to obtain three credit reports making the sample size 2,968 credit reports as opposed to the expected 3,003 credit reports).
38 2012 FTC Report, supra note 2, at 36.
39 2012 FTC Report, supra note 2, at 36.
40 2012 FTC Report, supra note 2, at 43.
41 2012 FTC Report, supra note 2, at 45.
42 2012 FTC Report, supra note 2, at 47.
VII. CONCLUSION

It is understandable that the FTC and others decided that the biggest takeaway from the 2012 FTC report was that one in five credit reports in America contain an error. Inherently, it is beneficial for consumers to check their credit histories and make sure they are correct. The piece of data that media outlets most widely reported will likely motivate consumers to do just that. A person’s credit report is an intimate and private history of that person’s financial life and should reflect each and every person accurately. Even if it is slim, there is a chance that finding an error on a credit report can put a consumer in a higher credit range.

On the other hand, FACTA was created to amend the FCRA and decrease inaccuracies in credit reports. Section 319 of FACTA was narrowly tailored to create a study on the “accuracy and completeness of information contained in consumer reports” and to inform recommendations of ways to improve on the results. The study shows there is still room for improvement in our credit system, and the ultimate goal should be zero informational errors in our credit system. Nevertheless, the report contain a positive result: a large majority of America’s credit reports, 98%, provide an accurate basis for a lender to assess the risk of potential creditors.