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The Global Subprime Crisis as Explained by the Contrast Between American Contracts Law and Civil Law Countries' Laws, Practices, and Expectations in Real Estate Transactions

Celeste M. Hammond

Ilaria Landini

THE GLOBAL SUBPRIME CRISIS AS EXPLAINED BY THE CONTRAST BETWEEN AMERICAN CONTRACTS LAW AND CIVIL LAW COUNTRIES' LAWS, PRACTICES, AND EXPECTATIONS IN REAL ESTATE TRANSACTIONS: HOW THE LACK OF INFORMED CONSENT AND THE ABSENCE OF THE CIVIL LAW NOTARY IN THE UNITED STATES CONTRIBUTED TO THE GLOBAL CRISIS IN SUBPRIME MORTGAGE INVESTMENTS

*Celeste M. Hammond**
*Ilaria Landini***

INTRODUCTION

A significant aspect of the continued subprime mortgage crisis in the United States is the general lack of understanding or actual misunderstanding that borrowers often have of their loan obligations and of the default remedies available to their lenders. Subprime borrowers sign notes and mortgage documents that give subprime lenders security interests in their homes. Although these subprime borrowers may lack subjective consent, they are virtually always bound by the terms of the documents they have signed. This result reflects the American public policy and legal rule that a contracting party's subjective consent is not required. This is true even in the case of "form" contracts, which are the basis for subprime mortgage loans.[1] Global investors who purchased mortgages on the secondary market suffered serious losses. Global investors also purchased securitized products that combined numerous sub-

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* Professor of Law and Director of Center for Real Estate Law, The John Marshall Law School, J.D. University of Chicago Law School; ACREL Fellow; CRE.
** Studio Legale Landini e Associati, Milan Italy, Visiting Scholar, The John Marshall Law School.
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1 *See* Kathleen C. Engel & Thomas J. Fitzpatrick IV, *False Security: How Securitization Failed to Protect Arrangers and Investors from Borrower Claims*, *in* 11-17 SUFFOLK UNIV. LAW SCH. LEGAL STUDIES RESEARCH PAPER SERIES 1, 2 (Carter G. Bishop & Kathleen C. Engel eds., 2011), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1791642## ("There is extensive debate about what constitutes a subprime loan. We use the term subprime to mean any loan including Alt-A products that would not qualify as a prime, conforming loan under Fannie Mae or Freddie Mac guidelines."); *see also*, Celeste M. Hammond, Professor of Law, The John Marshall Law Sch., Subprime: Real Estate Frauds, Mortgage Frauds and Legal Certainty 12 (Jan. 28, 2008) (transcript *available at* http://ssrn.com/abstract=1410259) (indicating there is no comprehensive definition of what is or is not a subprime loan, other than non-conforming or risky).

prime mortgages into one product for sale on the secondary market, resulting in a severe negative impact,[2] perhaps equaling or exceeding [that] in the U.S.[3]

Global investors who purchased securitized American subprime residential mortgages may have assumed, incorrectly, that the more protective consumer laws in their own countries applied.[4] Global investors may have misplaced their reliance on the borrowers' informed consent and even on the notion that the mortgages were suitable for the borrowers who made them.[5] Global investors may also have misplaced their faith in the American regulatory system, including the Securities and Exchange Commission[6] and ratings agencies, when they bought interests in securitized American residential subprime mortgages.[7] A recent Second Circuit Court of Appeals case held that ratings agencies have no liability for their 'opinions,' no matter how sternly presented to investors, for knowingly (or negligently) being in error.[8]

Moreover, global investors, especially those in civil law legal systems, may have incorrectly assumed that a role similar to that of the civil law notary exists in the American residential mortgage process. In civil law countries, a civil law notary supervises and approves all transactions involving real estate, including mortgages, and provides counseling to borrowers about the suitability of their loan obligations.[9] The assumption that the United States applies a civil notary process and a misunderstanding of the actual U.S. loan process partially explains global enthusiasm for investing in the American loan market. This investment enthusiasm caused the subprime mortgage market to balloon, and explains the expanded scope of the global crisis that resulted.[10]

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[2] *See* Kenneth W. Dam, *The Subprime Crisis and Financial Regulation: International and Comparative Perspectives*, 10 CHI. J. INT'L L. 581, 609 (2010).

[3] *See id.* at 608-611 (discussing analysis of effects on banks in Germany that purchased US-origin securitized mortgage products and used US "originate-to-distribute securitization as practiced in the U.S.").

[4] *See* KATHLEEN C. ENGEL & PATRICIA A. MCCOY, THE SUBPRIME VIRUS: RECKLESS CREDIT, REGULATORY FAILURE AND NEXT STEPS 5-6, 11 (2011) [hereinafter SUBPRIME VIRUS] ("For the sake of individual citizens and for sake of financial stability worldwide, the country must take consumer protection seriously.").

[5] *See* Eamonn K. Moran, *Wall Street Meets Main Street: Understanding the Financial Crisis*, 13 N.C. BANKING INST. 5, 50 (2009).

[6] *See id.* at 94-99 (suggesting need for an overhaul of SEC and other regulatory changes); *see also* Nelson D. Schwartz, *U.S. is Set to Sue Dozen Big Banks Over Mortgages*, N. Y. TIMES, Sept. 2, 2011, at A1 (discussing lawsuits that Federal Housing Finance Agency planned to file against several major banks based on argument that those banks failed as lender to conduct adequate due diligence).

[7] *See* Dam, *supra* note 2, at 619-20 (indicating that although ratings agency problem and capital adequacy problem were not seen as "initial problems" with lending securities, they were part of specific regulatory issues involved and that "financial engineering" by banks was ignored as a possible cause of losses in long run). By "financial engineering," Dam means "the process by which financial institutions seek to enhance profits and gain customers for their financial products and services by devising ways to avoid existing rules that would otherwise constrain them." *Id.* at 620 n.148. Dam refers to GILLIAN TETT, FOOL'S GOLD: HOW THE BOLD DREAM OF A SMALL TRIBE AT J.P. MORGAN WAS CORRUPTED BY WALL STREET GREED AND UNLEASHED A CATASTROPHE, 167-254 (2009). *See also* Moran, *supra* note 5, at 50 (stating that global investors sought higher returns and invested in U.S. assets supported by statements that were misleading on the risks of those securities).

[8] *In re* Lehman Bros. Mortgage-Backed Securities Litigation, 650 F.3d 167, 188 (2d Cir. 2011).

[9] Lars de Vries, *Conveyance of Real Estate, The Role of a Civil Law Notary*, NOTARY OFFICE SPS, http://www.notarysps.com/conveyance.htm (last visited Nov. 14, 2011).

[10] *See, e.g.*, Moran, *supra* note 5 (identifying the financial engineering of securitization as part of the reason for subprime lending growth); *see also* Dam, *supra* note 2, at 11 n. 5.

Ignorance of the law is not an excuse.[11] Neither for the consumer, nor for the investor, does failure to know the law provide protection. The global consequences of this basic principle have been striking. Investors all over the world misunderstood, to their detriment, several important aspects of American contracts law, specifically as applied to the residential mortgage industry.[12] The law provides no relief and no excuse from liability for American borrowers who pledged their homes as security without understanding the contracts they signed.

Many who misunderstood the intricacies of American mortgage law and practice and invested in securitized mortgage products will have little reprieve from their ignorance.[13] Kathleen Engle and Thomas T. Fitzpatrick IV foresee potential liability of Residential Mortgage Backed Securities ("RMBS") investors to borrowers.[14] Kenneth Dam argues that "an analysis of the subprime crisis and proposed solutions is incomplete if international and comparative perspectives are not brought to bear."[15] The goal of this Article is to focus on some of the misplaced assumptions that may have tempted global investors to buy yet another product "made in America." A comparison of American residential real estate law and practice, as well as the mortgage law and procedures, with those in countries dependent on a civil law notary completes the perspective. An explanation for why global investors misunderstood American residential mortgage law can be seen by comparing the American contracts law applied to consumer transactions like residential mortgages, with the European Union's ("EU") use of a civil law notary in the preventative administration of justice.

Part I of this Article reviews American real estate law and the basic process by which borrowers made subprime mortgages. The lack of transparency in this process explains the failure of both borrowers and global investors to understand the obligations and risks of subprime mortgage loans. Part II of this Article reviews relevant American contracts law and practice. Part III compares the EU Directive approach to consumer contracts with the American analogue.

Part IV of this Article examines the significance of civil law notary's absence in the creation of American residential real estate mortgages. Part V concludes by arguing that a better understanding of the differences in law and real estate practice between the American and European systems is essential to being an informed investor in mortgages and other real estate assets.

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[11] *See* Pamela H. Bucy, *Corporate Ethos: A Standard for Imposing Corporate Criminal Liability*, 75 Minn. L. Rev. 1095, 1184 (1991).

[12] *See* Moran, *supra* note 5, at 35.

[13] *See generally* Moran, *supra* note 5 (summarizing the history and causes of the financial crisis based in the subprime mortgage investments).

[14] Engle & Fitzpatrick, *supra* note 1.

[15] Dam, *supra* note 2, at 582.

I. THE AMERICAN REAL ESTATE LAW AND INDUSTRY PRACTICE LACKS TRANSPARENCY FOR BORROWERS AND INVESTORS

A. Real Estate Law and Practice Surrounding the Creation of Residential Mortgage Loans

1. Professionals Involved

The most common professional participants in residential real estate lending transactions are: (i) Mortgage brokers who represent lenders and 'sell' borrowers on particular types of mortgages, ranging from conventional mortgages[16] to those labeled as subprime;[17] (ii) Originating lenders; (iii) Escrow agents; (iv) Attorneys; (v) and Title insurance companies that provide protection to the buyer, owner, or borrower in the Owner's Policy and to the lender in the Loan Policy against certain types of title defects. Each state is separately responsible for regulating the qualifications of the professionals working in their respective jurisdictions,[18] with additional federal regulations that apply to most lenders and preempt contrary state law. In most instances, each of these professionals must be licensed in the state in which the property involved is located.[19] Generally, licensure requires specific training, education, and testing.[20] The details of these requirements, however, are not consistent across the country.[21]

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[16] A conventional mortgage is a real-estate mortgage not "backed by government insurance." BLACK'S LAW DICTIONARY 1102 (9th ed. 2011).

[17] A subprime loan is a "mortgage or home-equity loan, made to one whose financial condition and creditworthiness are poor, creating a high risk of default. A subprime loan usually has an adjustable interest rate that is low at inception, to help a financially weak borrower qualify, then rises over the life of the loan." BLACK'S LAW DICTIONARY 1021 (9th ed. 2011). Subprime loans give higher rates of interested (at least 2 percentage points higher) to borrowers who are a higher risk to the lender (generally with credit scores of 620 or below). Mara Lee, *Subprime Mortgages: A Primer*, NPR (Mar. 23, 2007), http://www.npr.org/templates/story/story.php?storyId=9085408; *see also* SUBPRIME VIRUS, *supra* note 4, at 34 (discussing non-conventional, non-traditional, and subprime mortgages).

[18] *See, e.g., Federal Regulations*, CALIFORNIA OFFICE OF REAL ESTATE APPRAISERS, http://www.orea.ca.gov/html/FederalRegulations.shtml (last visited July 29, 2011) (stating that the Appraisal Subcommittee of the Federal Financial Institutions Examination Council advises states to adopt individual organizational structures for appraiser certification, licensing, and supervision).

[19] 12 AM. JUR. 2D *Brokers* § 10 (2011).

[20] 12 C.J.S. *Brokers* § 15 (2011). *See also Become a Real Estate Agent in New York,* MORTGAGE DAILY NEWS, http://www.mortgagenewsdaily.com/real_estate_license/New_York.asp (last visited Sept. 5, 2011) (noting that New York State requires completion of a 72 hour course); *Become a Real Estate Broker in Georgia*, MORTGAGE DAILY NEWS, http://www.mortgagenewsdaily.com/real_estate_license/Georgia.asp (last visited Sept. 5, 2011) (noting that the state of Georgia requires 75 hours of real estate coursework or other approved educational requirements).

[21] *See, e.g., Become a Real Estate Agent in Texas,* MORTGAGE DAILY NEWS, http://www.mortgagenewsdaily.com/real_estate_license/Texas.asp (last visited Sept. 5, 2011) (noting that the state of Texas requires completion of 270 hours of approved core real estate coursework, an additional 630 hours of related coursework, and two years active sales work to acquire a brokerage license); *Become a Real Estate Agent in New Hampshire,* MORTGAGE DAILY NEWS, http://www.mortgagenewsdaily.com/real_estate_license/New_Hampshire.asp (last visited Sept. 5, 2011) (noting that the state of New Hampshire requires only 40 hours of real estate coursework); *Become a Real Estate Agent in Vermont,* MORTGAGE DAILY NEWS, http://www.mortgagenewsdaily.com/real_estate_license/Vermont.asp (last visited Sept. 5, 2011) (noting that the state of Vermont requires only 40 hours of real estate coursework).

a. Mortgage Brokers

Most residential mortgages in today's American market, particularly in the subprime market, are initiated by mortgage brokers who earn commissions if they persuade borrowers to take a loan and execute the mortgage. This commission is the Yield Spread Premium. Mortgage brokers made larger commissions on subprime loans than on conventional mortgage loans if the terms of the subprime loan were[22] less advantageous to the borrower.[23]

Borrowers rely heavily on the information provided by these mortgage brokers.[24] Yet, with few exceptions,[25] the lender-borrower relationship does not constitute a fiduciary one, but instead is an arm's-length relationship "where each party seeks its own economic interest, rather than a relationship of trust and confidence."[26] Indeed, there is evidence that brokers have misled borrowers about important aspects of residential mortgages.[27] Additionally, mortgage brokers have misled originating lenders and others in the chain of owners, including securitized mortgage investors, when the brokers falsify information about the borrowers.[28] Kenneth Dam concludes: "As time has passed, the view has gradually become more dominant that mortgage lending practices were most at fault for producing the subprime mortgage crisis . . . ."[29]

b. Originating Lenders

The change in the lender's role during the growth of subprime lending was dramatic. Prior to the creation of the subprime market, residential lenders dealt directly with borrowers.[30] Most often, a savings and loan had the authority, pursuant to government regulation, to make mortgage loans limited to the deposits it held. It retained the mortgages it made and derived profit only from the interest paid on these loans. As the residential mortgage market evolved, mortgage lenders began selling the loans that originated with them. This was the

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22 *See* Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010) [hereinafter Dodd-Frank Act] (prohibitting unfair, deceptive or abusive acts or practices).

23 *See Yield spread premium*, THE TRUTH ABOUT MORTGAGE.COM, http://www.thetruthaboutmortgage.com/mortgage-dictionary/yield-spread-premium (last visited Sept. 5, 2011).

24 Debra Pogrund Stark & Jessica M. Choplin, *A License to Deceive: Enforcing Contractual Myths Despite Consumer Psychological Realities*, 5 N.Y.U. J.L. & BUS. 617, 617 n.2 (2009) ("Indeed, courts have taken judicial notice that companies train their employees on providing information on the products and services that they are selling, knowing that the consumers principally rely on this information especially if the product or service is complicated.").

25 *See* Wyatt v. Union Mortgage Co., 598 P.2d 45, 50 (Cal. 1979) (holding that mortgage brokers owe fiduciary duties to borrowers under California real estate and agency laws).

26 Frank A. Hirsch, Jr., *The Evolution of a Suitability Standard in the Mortgage Lending Industry: The Subprime Meltdown Fuels the Fires of Change*, 12 N.C. BANKING INST. 21, 23 (2008).

27 *See* Engel & Fitzpatrick, *supra note* 1, at 12 (indicating that fraud claims have been brought and recognized in situations where borrowers were given misleading information about the interest rate, brokers made promises made to obtain the best rates for borrowers, and misleading information was given about the purposes of the documents that borrowers were signing); *see also* Lloyd T. Wilson Jr., *Effecting Responsibility in the Mortgage Broker-Borrower Relationship: A Role for Agency Principles in Predatory Lending Regulation*, 73 U. CIN. L. REV. 1471 (2005).

28 *See id.*

29 Dam, *supra* note 2, at 605.

30 *See* Georgette Chapman Phillips, *The Jumbled Alphabet Soup of the Collapsed Home Mortgage Market: ABCP, CDO, CDS and RMBS*, 18 U. MIAMI BUS. L. REV. 143, 143 (2010).

first step in the development of RMBS.[31] Loan originators no longer retained any equity interest in mortgages packaged as RMBS and began to make money by collecting fees for originating the loan and for servicing the loan once it was complete, rather than through the interest paid throughout the loan's lifetime.

The incentive to make money in this new way also affected the underwriting standards of the originating lenders. Generally, the relationship between borrowers and originating lenders is an arm's-length transaction.[32] A lender has no duty or inclination to determine whether the borrower has an ability to repay the loan.[33] In the period between 2001 and 2006, loan to value ratios, the percentage of the property's value that is mortgaged, rose from 79.8% to 89.1%.[34] The percentage of loans that had loan to value ratios of 100% increased to 33%, and the percentage of loans requiring limited documentation as to the borrower's employment, debt, and other factors relevant to the ability to repay the mortgage increased to 44%.[35] Loans that had both 100% loan to value ratios and limited documentation increased from 1% to 15% during the same period.[36] Indeed, Eamonn Moran argues that "by divorcing mortgage originators from the risk of default, securitization[37] reduced lenders' traditional incentive to scrutinize their borrowers and encouraged excessive risk-taking and improper risk assessments."[38] Moreover, the securitization of subprime mortgages rose from 50.4% in 2000 to 81.2% in 2005.[39]

Some commentators have blamed the securitization process as the cause of the global crisis. Hernando de Soto analyzes the impact of securitization from the perspective of basic property doctrine.[40] According to De Soto, "[a] whole bunch of people . . . left the body of property law as has been practiced in the world over the last 100 years-because that's when property really came to exist- and they went to an area of law called securitization."[41] He points out that "securitization has not respected any of the elements of property that I mentioned (standard types of property which can be recognized, no DDOs or credit swaps).[42] "So

[31] *See generally id.* at 146-52 (discussing the history of the evolution of the RMBS industry).

[32] Hirsch, *supra* note 26.

[33] *See* Moran, *supra* note 5, at 15 (comparing recent lender conduct with lenders' earlier reluctance to make a mortgage loan if the borrower's ability to repay was in doubt).

[34] Dam, *supra* note 2, at 593. Converserly, conventional, prime mortgages have been characterized as having an 80% or lower loan to value ratio. Throughout this article, "conventional" and "prime" are used interchangeably.

[35] *Id.* at 593-94.

[36] *Id.* at 594 n.50.

[37] Securitization is the process used by banks to pool mortgage loans, separate the cash flow from the receivables, and convert the cash flow into bonds secured by the mortgages. Kathleen C. Engel & Patricia A. McCoy, *Turning a Blind Eye: Wall Street Finance of Predatory Lending*, 75 FORDHAM L. REV. 2039, 2045 (2007) [hereinafter *Turning a Blind Eye*]. Securitization is accomplished by selling the loan pool on the secondary market, which is independent of the lender, so that the secondary market takes title to the loan pool or "bundle." *Id.* A two-tiered structure effectively insulates the investors purchasing the bundle from the lender's creditors and the lender's abusive loan practices. *Id.* at 2045, 2076.

[38] Moran, *supra* note 5, at 48.

[39] Todd J. Zywicki & Joseph D. Adamson, *The Law and Economics of Subprime Lending*, 80 U. COLO. L. REV. 1, 52-53 (2009).

[40] Hernando de Soto, Opening address to International Bar Association Annual Conference in Buenos Aires: Law Connects (Oct. 12, 2008), http://www.int-bar.org/images/downloads/Hernando_de_Soto_speech_from_IBA_%202008_Annual_Conference_Opening_Ceremony_Final.pdf.

[41] HERNANDO DE SOTO AND PROPERTY IN THE MARKET ECONOMY 84 (D. BENJAMIN BARROS ED., 2010).

[42] de Soto, *supra* note 40.

property has to got to be in a place where everything is standardised, it's got to be accountable, it's got to be functional, you've got to make it liquid, it's got a network, it's got to protect transactions, and it's got to be recorded."[43] He concludes by criticizing securitization: "So what I can tell you about this is what property does, is effectively it creates one of the world's most important information systems that ever existed. You really know who owns what. . ."[44] Due to the particular type of capital securitization that is the basis of the financial crisis, it is not clear how many banks own claims and property in the U.S. market that are subprime mortgages.[45] "Once you have taken property and the clarity that property is supposed to bring to human connections, you have brought havoc to the market, and that's what happened in subprime."[46] Indeed, American courts struggle with foreclosure lawsuits that are brought against borrowers where the plaintiff cannot prove it owns the mortgage.[47]

c. Escrow Agents

In some parts of the United States, escrow agents act as intermediaries to hold funds and documents during a real estate transfer. For example, a seller signs the deed conveying title to the new owner, but it takes time for the funds to actually transfer from the buyer's bank to the seller. During that time, the escrow agent holds the deed so that the transfer is not completed until the buyer has made full payment. Conversely, the buyer would not want to give the seller full payment without being protected against the seller failing to convey title. The escrow agent can hold the funds, the documents, or both so that each party is fully protected from any action or failure to act by the other. In the context of a mortgage transaction, the borrower signs the note and the mortgage (or trust deed), thus creating the borrower's obligation to repay the loan and providing the lendor with a security interest in the home. In some parts of the United States, title insurance companies serve as escrow agents. In those places, the title insurance company serves as the escrow agent for both the borrower and the lender, in addition to issuing its loan title insurance policy for the lendor's benefit. Any potential conflict of interest in the title company is excused and is unnoticed by the borrower. The explanation that has sustained this widespread practice is that the title company "wears different hats" for each of its two functions. In other locations, real estate agents or lawyers act as escrowees to hold funds in a fiduciary capacity.

d. Attorneys

The degree to which attorneys are involved in residential real estate transactions varies greatly from one part of the United States to another. In many jurisdictions, borrowers rely on the advice of mortgage brokers and title agents or escrowees. In these jurisdictions, attorneys for individual borrowers are completely absent. Only the lender is represented by an attorney for the purposes of drafting loan documentation and supervising the escrow arrangement through which the mortgage is executed. Even when separate lawyers represent the

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43 *Id.*
44 *Id.*
45 *See id.*
46 *Id.*
47 *See, e.g.*, U.S. Bank Nat. Ass'n v. Ibanez, Nos. 08 MISC 384283(KCL), 08 MISC 386755(KCL), 2009 WL 3297551 (Mass. Land Ct. Oct. 14, 2009, *aff'd*, 458 Mass. 637 (2011).

buyer and seller, their roles are limited and generally do not involve giving advice on the business aspects of the transaction or on the risks of defaulting on the loan.[48]

An illustrative example of the limited role for the buyer/borrower's attorney exists in Illinois, a jurisdiction where attorneys regularly represent parties to a residential transaction. The author was representing her son and his wife when they sold their house in late 2006, a time when prices were at an all-time high. The buyers did have an attorney representing them, but, as is typical and expected, the attorney gave no explanation or advice about the economic aspects of the mortgage or its terms. Additionally, because the buyer is bound to close the transaction once the financing contingency has been met, there is no opportunity for re-negotiating the terms of the mortgage at the closing, which is when the buyer/borrower's attorney normally reviews the loan documents for the first time. At the time of the closing, it is too late to change the mortgage terms.

In this example, the mortgage was subprime. The annual interest rate was ten percent while the current rate for a conventional mortgage was only six percent. The buyers had a gross family income of $50,000. The mortgage loan amount was $300,000. In sum, this means that the borrowers would be paying $30,000 of their income, sixty percent of their gross income, solely for the interest on the mortgage. The recommended ratio of mortgage payments to income is thirty percent, not the sixty percent ratio this transaction reflects.[49]

Yet, in this case it would have been unethical or even unprofessional for the sellers' attorney to comment on the terms of the buyers' loan product.[50] Also, the buyer/borrowers' attorney either did not consider it to be his role to offer an opinion on the business aspects of the mortgage terms or, more likely, did not appreciate that this mortgage was unsuitable[51] for this particular client. Even if the buyer did not have attorney representation, it would have been inappropriate, if not unethical, for the sellers' attorney to point out an error or to provide the sort of counsel that a civil law notary would provide.[52] In the United States, the role and education of the transactional attorney is the same as for the litigator. This adversarial model is the basis for lawyering in court and in a transactional setting.[53]

Many subprime mortgages are re-financings of prior mortgages. Many subprime borrowers re-finance to get cash out of their homes or to avoid the trigger of an Adjustable Rate Mortgage ("ARM")[54] that would cause the interest rate to increase.[55] Subprime mortgage re-financing rarely involves attorneys for the borrowers. Closings of these mortgages

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48 Compare the role of civil law notary with that of the attorney. *See* discussion *infra* Part IV.

49 *See infra* Part II.C on the suitability of a loan for a particular borrower.

50 PETER L. MURRAY & ROLF STURNER, THE CIVIL LAW NOTARY- NEUTRAL LAWYER FOR THE SITUATION 110 (2010).

51 *See* discussion *infra* Part II.C on the absence of a suitability requirement.

52 MURRAY & STURNER, *supra* note 50, at 110.

53 *See id.* at 155 (comparing the role of the civil law notary who is liable to all the parties for an authenticated mortgage); *see also* Celeste M. Hammond, *Borrowing from the B Schools: The Legal Case Study as Course Materials for Transaction Oriented Elective Courses: A Response to the Challenges of the MacCrate Report and the Carnegie Foundation for the Advancement of Teaching Report on Legal Education*, 11 TRANSACTIONS: TENN. J. OF BUS. L. 9 (2009).

54 An Adjustable Rate Mortgage ("ARM") is a mortgage with an interest rate that is initially lower than that of a fixed-rate mortgage, whose interest rate is periodically adjusted according to the cost of funds to the lender. Webster's Third New International Dictionary, Unabridged. Merriam-Webster, 2002. http://unabridged.merriam-webster.com (Jun. 19, 2011).

55 ROBERT SHILLER, THE SUBPRIME SOLUTION: HOW TODAY'S GLOBAL FINANCIAL CRISIS HAPPENED, AND WHAT TO DO ABOUT IT 50 (2008).

occur in the title insurance office with no attorneys present. A closing administrator, as agent for the lender, may be the only person the borrower encounters.

e. Title Insurance

The title insurance company conducts a search of the local recorder's office where deeds, mortgages, and other documents relating to real property ownership are filed. The purpose of this search is to identify possible interests of other parties in the real estate, including notices of *lis pendens* that indicate if litigation has begun that may affect title; government records of liens for federal, state, and local taxes; and other risks.[56]

The underwriting department of the title insurance company determines what risks could affect a particular transaction and whether the transaction involves a purchase of real estate, a mortgage on real property, or other ownership interest in real estate.[57] The title insurance company issues an insurance policy that covers any defects in the real estate title that exist at the time the policy is issued.[58] The underwriting department determines the premium required for the policy based on its risk assessment.

In no event does the title insurance company review or comment on the mortgage loan terms, either as an economic policy or as a legal duty. It does not comment on the risks to the borrower upon default, or the suitability of the particular loan for the borrower.[59] Regarding the mortgage, the title insurance company wears its "hat" as agent and fiduciary only for the lender. Thus, the role of the title insurance industry in real estate transactions, including mortgages, in the United States is very different from of the role of the civil law notary in Europe.

2. The Mortgage Loan Process

Those borrowers who eventually obtain loans from subprime lenders start the process by a visit to or from a subprime mortgage broker. Prime and subprime mortgage brokers are separated by the type of mortgage loan they market. Prime mortgage brokers do not market subprime mortgages and vice versa. Therefore, a borrower who decides to visit a subprime mortgage broker would be sold a subprime mortgage, even if the borrower qualified for a prime or conventional mortgage that has more pro-borrower characteristics, such as lower interest rates, lack of pre-payment penalties, and fixed interest rates.[60] It would not matter whether the loan was to support the purchase of a home (in which case the real estate sales broker may have provided a referral to the subprime broker) or was for the purpose of refinancing an existing mortgage (in which case the mortgage broker may have engaged the borrower through heavy marketing tactics).[61] The separation of the prime and subprime mortgage processes means that if a borrower meets with a subprime mortgage broker, that bor-

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[56] 46 C.J.S. *Insurance* § 1514 (2011).
[57] *See id.*
[58] *See id.*
[59] *See id.*
[60] *See* Shelley Smith, *Reforming the Law of Adhesion Contracts: A Judicial Response to the Subprime Mortgage Crisis*, 14 LEWIS & CLARK L. REV. 1036, 1088-89 (2010) [hereinafter Shelley Smith] (reporting that thirty-five to fifty percent of subprime borrowers would have qualified for prime mortgages).
[61] *See generally* Stark & Choplin, *supra* note 23 (discussing some of these practices).

rower would be encouraged to apply for a subprime loan, even in situations where the borrower may have qualified for a less onerous conventional mortgage.[62]

The mortgage broker owes a fiduciary duty to the lender. The broker is trained strictly to market products that borrowers will readily accept, while being the only agent in a position to explain the terms of the transaction. However, as has been widely reported by those who have studied the role of the subprime mortgage broker, the sales pitches are elaborate in detail and are designed to "deflect attention away from things the consumers might normally look at. . . ."[63] Nevertheless, consumers obtaining mortgage loans expect companies to honor oral representations made to them; even law students believe what they are told.[64]

B. Subprime Borrowers do not Appreciate the Legal Consequences of Agreeing to the Mortgage Notes or of Transferring Security Interests in their Homes to Lenders

With respect to subprime mortgages in the United States, it is likely that the borrower does not understand the costs of a prepayment penalty, will not be able to satisfy the increased monthly installment payments after the initial "teaser" rate of an ARM, and/or does not understand the high origination fees or other onerous terms of his loan. Nor would the typical subprime borrower appreciate the high risk of defaulting on the loan with their low underwriting scores. And, in the event of a default, the borrower is likely not aware of or cannot imagine that the lender will gain ownership and possession of his home through foreclosure. Debra Stark and Jessica Choplin provide a number of explanations for consumer misunderstandings in their empirical study of consumer conduct prior to becoming obligated on contracts for consumer goods and services, including residential mortgage loans.[65] They found that, generally, consumers do not read the text of binding legal documents carefully.[66] Consumers have developed a misplaced trust on the sales person; here,the subprime mortgage broker.[67] Consumers have difficulty imagining problems that might arise from the borrower-broker relationship.[68]

Additionally, consumers are influenced by a phenomenon known as the "sunk cost effect." Sunk costs are the past costs that the consumer has already committed to the transaction and cannot be refunded. This causes consumers making residential mortgage loans to complete a transaction solely because they have committed resources, attention, and time to the transaction.[69] Indeed, the statistics show that the average borrower's ability to repay his debts, based upon earnings and cost of living, has not kept pace with the massive debt increases that have been occurring since the 1990s.[70] Yet mortgage debt rose so dramatically,

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62 *See* BRENT C. SMITH, HOMER HOYT INST., THE SUBPRIME MORTGAGE MARKET, A REVIEW AND COMPILATION OF RESEARCH AND COMMENTARY 14 (2007), http://www.hoyt.org/subprime/subprime_review_no_exec_summary.pdf.

63 In re First Alliance Mortgage Co., 471 F. 3d 977, 985 (9th Cir. 2006).

64 *See* Stark & Choplin, *supra* note 24 at 688-99 (reporting on an empirical study regarding contracts and the expectations of public and first year law students at the John Marshall Law School).

65 Stark & Choplin, *supra* note 24.

66 *Id.* at 699.

67 *Id.* at 677, 684.

68 *Id.* at 666-67.

69 *Id.* at 667.

70 *See U.S. Cost of Living on the Rise*, NATIONAL PUBLIC RADIO (Aug. 19, 2008), http://www.npr.org/templates/story/story.php?storyId=93731981.

that by 2007 it represented seventy-five percent of gross domestic product, up from forty-six percent in the 1990s.[71] It is no wonder that nearly one million foreclosures were reported in the United States for the third quarter of 2010.[72] In Nevada, one in four houses was in foreclosure in 2009.[73] These high default mortgages are precisely the mortgages that investors believed would be producing income.

C. The Regulation of Subprime Mortgages Failed to Protect RMBS Borrowers or Investors[74]

A review of government regulation of the residential mortgage process will not only enhance understanding of how regulations were intended to function, but will also serve as an introduction to understanding how abuses are addressed only *after* the mortgage is executed and only through litigation. In the United States, there is no civil law notary who oversees at the transaction from its inception to determine if consumer protections have been met.[75] For instance, preliminary meetings between the parties with a the civil law notary present can potentially identify problematic issues. When the notary advises both of the parties to a mortgage and serves impartially, both parties are informed and can make informed, educated decisions.[76] The civil notary's standard practice is to send a draft of the contract at least fourteen days before signing to all parties and to read the documents aloud as part of the authentication process during the closing. Both of these practices may protect the borrower *before* execution of the mortgage.[77]

In the United States, two groups of regulations apply to mortgages: The Truth In Lending Act ("TILA"), which is operative at the time of application for the mortgage, and the Real Estate Settlement and Procedures Act ("RESPA"), which is operative at closing.[78] Both acts are technical and difficult for residential borrowers to understand. Furthermore, the borrower may have difficulty comparing each act's requirements with the information supplied by the mortgage broker and contained in the documents prepared by the originating lender. Though the information provided by the broker, such as the appraisal value or the borrower's income, assets, and liabilities, might be inaccurate, the use of inaccurate information is still deemed sufficient to fulfill the minimal underwriting requirements of the loan originator.[79]

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[71] Colin Barr, *The $4 trillion housing headache*, CNNMONEY (May 27, 2009), http://money.cnn.com/2009/05/27/news/mortgage.overhang.fortune/index.htm.

[72] *See Foreclosure Activity Increases 4 Percent in Third Quarter* (Oct. 13, 2010), http://www.realtytrac.com/content/press-releases/q3-2010-and-september-2010-foreclosure-reports-6108 (reporting 930,437 foreclosure filings in the third quarter of 2010).

[73] Dan Levy, *U.S. Foreclosure Filings Jump 23% to Record in Third Quarter*, BLOOMBERG, Oct. 15, 2001, *available at* http://www.bloomberg.com/apps/news?pid=newsarchive&sid=afofq9_za8Is.

[74] *See* Dam *supra* note 2, at 620 (commenting that U.S. regulators did not worry about non-U.S. purchasers of RMBS securities, especially in view of the "decentralization of international financial regulation to individual countries"); *see also* Moran *supra* note 5, at 45 (arguing that the absence of regulation for the larger securities that were sold to investors was a "central cause of the current financial crisis").

[75] *See, e.g.*, SHILLER, *supra* note 55, at 134 (arguing that a civil law notary would have mitigated the home price escalation and mortgage excesses that played a role in the crisis). *See also infra* Part IV.

[76] *See* MURRAY & STURNER, *supra* note 50, at 45.

[77] *Id.* at 48-50.

[78] Patricia A. McCoy, *Rethinking Disclosure in a World of Risk-Based Pricing*, 44 HARV. J. ON LEGIS. 123, 127-28 (2007).

[79] *See id.* at 134-37.

When the subprime mortgage deal is completed, even with inaccurate information, a commission for the mortgage is paid to the broker, as well as fees for the originating lender.[80] These government regulations are not enforced *before* the mortgage is executed by the borrower.[81] Enforcement depends only on *subsequent* litigation.[82] Furthermore, there is nothing in American legal practice similar to the civil law notary to ensure that the parties understand the transaction and are giving their willing consent.[83]

1. Federal Regulatory Scheme

In the United States, real estate practices in general, including mortgages, are subject to state level regulation. However, because of federal involvement in the sphere, the most significant law comes from federal regulation.[84] In recognition of the complexity of the modern mortgage process, several federal laws and regulations have been enacted to protect residential borrowers. However, the protections afforded by these laws was limited.[85] They generally fall into the two categories: (i) Disclosure requirements and (ii) Restrictions on the characteristics of "high-interest" loans.

2. Truth In Lending Act ("TILA")[86]

Passed In 1968,[87] TILA requires lenders to disclose all finance charges associated with a loan in terms of an Annual Percentage Rate ("APR"), which includes all finance charges.[88] In addition, TILA requires disclosure of the amount financed,[89] the payment schedule,[90] the total amount that will ultimately be paid,[91] and information about any variable interest rate.[92]

Amended by the Home Ownership and Equity Protection Act ("HOEPA") in 1994,[93] TILA now includes certain restrictions for "high-interest" loans.[94] There can be no balloon payments, no negative amortization, no interest rate increases upon default, and no

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[80] *See id.* at 137.
[81] *See* MURRAY & STURNER, *supra* note 50, at 108.
[82] *See id.* at 109 (arguing that there is "no immediate public enforcement presence at crucial times in transactions that are subject to considerable public regulation in various forms," which often results in the borrower being neither represented by an attorney nor protected in a preventative way by government regulation).
[83] *See generally id.* (reporting the German Civil Law notary's role as preventative in the administration of justice).
[84] Under the U.S. system of federalism, a federal law takes precedence over a state law. Although states have the ability to impose stricter standards in some circumstances, they cannot impose any provisions that conflict with federal laws.
[85] *See*, Dodd-Frank Act, *supra* note 22.
[86] Truth in Lending Act, 15 U.S.C. §§ 1601-67f (2009).
[87] Truth in Lending Act, Pub. L. No. 90321, 82 Stat. 146 (1968).
[88] Truth in Lending, 12 C.F.R. § 226.18 (2011).
[89] *Id.* § 226.18(b).
[90] *Id.* § 226.18(g).
[91] *Id.* § 226.18(h).
[92] *Id.* § 226.18(f).
[93] Truth in Lending Act, 15 U.S.C. § 1601 (2009).
[94] *Id.* § 1639.

prepayment penalties more than five years after the original loan date.[95] These high-interest loans cannot be based on the value of the collateral alone, but must also consider the borrower's ability to repay the debt.[96] In addition, TILA provides that these loans cannot be refinanced unless it is in the borrower's best interest.[97]

As laudable as these new for high-interest loan requirements appear, their impact is minimal. The definition of high-interest loans makes these provisions applicable in only two situations. The first is when the APR exceeds the yield on treasury securities of the same period of maturity by eight percentage points for first-lien loans, or by ten percentage points for subordinate-lien loans.[98] The second situation in which these provisions are applicable is when the total points and fees associated with the loan exceed the greater of either eight percent of the loan amount or $400.[99] In order to comply, lenders could, and did, simply limit their notes to fall just below these trigger rates. In spite of the TILA disclosure requirements, none of the information provided to borrowers allows them to know if the terms they are getting are the best available, or aids them in fully understanding the terms' implications with respect to their ultimate ability to make required payments.

3. Real Estate Settlement and Procedures Act ("RESPA")[100]

Enacted in 1974, RESPA requires that each borrower be given a booklet explaining the costs and nature of the real estate settlement process,[101] a good faith estimate of the charges the borrower will incur in connection with that process,[102] and a standardized form completed for the borrower that itemizes the costs of settlement.[103] There is no requirement that borrowers demonstrate that they have read or understand any of these materials.

4. Home Ownership and Equity Protection Act ("HOEPA")

Two provisions of HOEPA deserve mention. First, HOEPA requires that, in connection with home mortgages based on an ARM loan, borrowers be provided with a statement indicating that the interest rate and monthly payment can increase and stating the maximum monthly payment that could be required should the interest rate on the loan reach its maximum.[104] Second, HOEPA does extend liability for violations of its provisions with respect to high-interest loans to assignees, thus superseding the normal holder in due course rules.[105] Unfortunately, the ease with which the HOEPA triggers can be avoided cuts off the benefits that it provides to residential borrowers.[106]

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95 12 C.F.R. § 226.32(d).
96 *See id.* § 226.34(a)(4).
97 *See id.* § 226.34(a)(3).
98 *Id.* § 226.32(a)
99 *Id.*
100 Truth in Lending Act, 15 U.S.C. §§ 1601-67f (2009).
101 12 U.S.C. § 2604(a)-(d) (2011).
102 12 U.S.C. § 2604(c) (2011); Real Estate Settlement Procedures Act, 24 C.F.R. § 3500.7(a) (2011).
103 12 U.S.C. § 2603(a) (1996).
104 15 U.S.C. § 1639(a)(2)(B) (2009).
105 *Id.* § 1641(a).
106 For a review of these federal regulations and their contribution to the subprime loan crisis, see Rayth T. Meyers, *Foreclosing on the Subprime Loan Crisis: Why Current Regulations are Flawed and What is Needed to Stop Another Crisis from Occurring*, 87 OR. L. REV. 311, 328 (2008).

A considerable amount of the analysis generated by the subprime mortgage crisis has focused on the limitations and failures of federal regulations to prevent or correct the problems.[107] One way to look at the situation is to note that there is no government enforcement mechanism functioning at the time of the closing. This is in contrast with the civil law notary process.

D. Securitizing Subprime Mortgages Led to Misinformed Global Investment

The securitization of home mortgages[108] supplanted the traditional model of local community financing of residential purchases as early as the 1930's with the creation of Fannie Mae and Freddie Mac as government-sponsored enterprises ("GSEs").[109] Securitization is the process used by banks to pool mortgage loans, separate the cash flow from the receivables, and convert the cash flow into bonds secured by the underlying mortgages.[110] This is accomplished by selling the loan pool on the secondary market, which is independent of the lender, so that the secondary market purchaser takes title to the loan pool or "bundle."[111] This two-tiered structure effectively insulates the investors purchasing the bundle from the lender's creditors and the lender's abusive loan practices.[112] A colleague of the author, Allen Kamp, who often speaks as "Grandpa Rabbit," describes RMBS in the following manner:

> Well, it's a quaint fund using a sophisticated econometric model, with fudge factors (the cognoscenti call them 'add-ons'), plus the application of our own experiential insight—we seek to maximize gain and minimize risk, using securitization sliced and diced tranches to add value and thus realize value and growth. Our products are continually evolving, with a move to smarter indices and investing in front of the curve. We marry fundamental indexing with portable alpha from a fixed income portfolio.[113]

Nevertheless, this RMBS system provides benefits, including increased availability of capital for loans nationally, lower costs to borrowers, and diversification of risks to lenders and investors.[114]

Though securitization is not all bad, the "originate to distribute" securitization model, where the original lender completes loans for the sole purpose of reselling them in

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[107] *See* Shelley Smith, *supra* note 60, at 1038 (maintaining additionally that after the Great Depression, "the government failed to exercise its authority to regulate financial institutions under existing laws and regulations").

[108] *See* Zywicki & Adamson, *supra* note 39 (describing the securitization process).

[109] *See* Dam, *supra* note 2, at 623; *see also* David Reiss, *The Federal Government's Implied Guarantee of Fannie Mae and Freddie Mac's Obligations: Uncle Sam Will Pick up the Tab*, 42 GA. L. REV. 1019, 1029-30 (2008) (explaining that mortgage securitization has been occurring for decades); *see also* Hammond, *supra* note 1, at 7-9.

[110] *Turning a Blind Eye*, *supra* note 37, at 2045.

[111] *Id.*

[112] *Id.* at 2045, 2076. *But see* Engel & Fitzpatrick, *supra* note 1, at 73 (arguing that investors may be held ultimately liable to the borrowers).

[113] Allan Kamp, Wall $treet Rabbit, (2008) (unpublished work on file with author).

[114] *See* Dam, *supra* note 2, at 623.

larger groupings,[115] coupled with the absence of significant regulatory control were both causes of the financial crisis. It may even be that the legal firewall protecting the actions of subprime mortgage brokers and lenders, will not extend to protect RMBS investorsfrom ultimate liability.[116]

The assumption that the Securities and Exchange Commission ("SEC") regulated RMBS is unfounded. Jonathan Macey, Geoffrey Miller, Maureen O'Hara, and Gabriel Rosenberg conclude:

> The primary assumption is that the mortgages are not securities, and the brokers who sell them are not securities broker-dealers, and therefore the customers who deal in mortgages do not qualify for the standard consumer protection scheme available to people who deal in securities. The second assumption is that even where the issuance of a mortgage is part of a securitization process in which the mortgage payments will be bundled together with other mortgage payments and sold as securities the protections of the SEC's catch-all antifraud provision, Rule 10 b-5, do not apply.[117]

Many commentators also blame the ratings agencies for being overly optimistic about the securitized subprime mortgages.[118]

II. AMERICAN CONTRACTS LAW ADOPTS A FORMALISTIC APPROACH REGARDING REQUISITE CONSENT, EVEN FOR THE FORM CONTRACTS USED IN SUBPRIME MORTGAGES

A. The Promissory Note

In addition to the mortgage, which transfers a security interest in the residence to the lender, the principle document used to create a residential mortgage is the promissory note, which is a contract that creates a debt obligation in the borrower. To make the promissory note and mortgage enforceable against the borrower, only objective consent is required, *i.e.*, the borrower need only to sign the paper incorporating an agreement to create an enforceable contract. There is no requirement that the borrower understand the contract terms or the impact of the agreement in terms of personal liability for repayment or of the risks to his property rights. Current American contracts law has its foundation in the basic contractual elements that were recognized by the common law of England, expressed by court pronouncements and legislative enactments.[119] While the laws developed from these two sources were initially distinct from one another, there was interaction between them from as early as the medieval period of 1150-1575. As Britain moved from a loose amalgam of locally ruled jurisdictions to a nation with a centralized legal authority, statutes were enacted that reflected

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[115] *See* Moran, *supra* note 5, at 44.

[116] *See* Engel & Fitzpatrick, *supra* note 1, at 73 (arguing that investors may be held liable ultimately to the borrowers).

[117] Jonathan Macey et al., *Helping Law Catch Up to Markets: Applying Broker-Dealer Law to Subprime Mortgages*, 34 J. CORP. L. 789, 791-92 (2009).

[118] *See, e.g.*, Dam, *supra* note 2, at 63; *see also* SUBPRIME VIRUS, *supra* note 4, at 47-51.

[119] The terms "legislative," "regulatory," and "statutory" will be used interchangeably throughout most of this paper. *See* discussion *infra* Part II.D.

the best of common law and equity to emerge from the courts, or that established new rules to reflect the shift in power to the national level.[120]

In early common law, a contract was simply an agreement reached by negotiation of an offer and its acceptance by the parties to the contract.[121] While this is a simple concept, complexity is inherent in evaluating what constitutes either the offer or its acceptance. As late as the end of the eighteenth and beginning of the nineteenth centuries, courts required a subjective "meeting of the minds" for a finding of contract formation.[122] By the late 1800s, the "objective will" of the parties became the standard for contract formation and interpretation.[123]

The underlying rule of contracts law with regard to the parties' objective intent was applied by United States Supreme Court Justice Oliver Wendell Holmes in 1881. Justice Holmes stated: "The law has nothing to do with the actual state of the parties' mind. In contract, as elsewhere, it must go by externals and judge parties by their conduct."[124] Judge Learned Hand described this concept when he wrote:

> A contract has, strictly speaking, nothing to do with the personal, or individual, intent of the parties. . . . If . . . it were proved by twenty bishops that either party, when he used the words, intended something else than the usual meaning which the law imposes upon them, he would still be held, unless there were some mutual mistake or something else of the sort.[125]

Using the Holmes terminology, the "external" fact of a signature on a written contract is viewed as conclusive evidence of acceptance of the terms of the contract. This is true because "a party is [found to be] bound by the reasonable impression the party creates. . . . A party who signs an instrument manifests assent to it . . . ."[126] This line of reasoning also incorporates the duty of a party to read what he or she is signing. One is found to have read a document regardless of any proof to the contrary.[127]

B. The Futility of Arguing a Subprime Mortgage Instrument as an Unconscionable Agreement or Contract of Adhesion

The form contracts used to create subprime mortgages and RMBS investments may be considered contracts of adhesion or unconscionable agreements under American contracts law, but neither doctrine protects the borrower or, ultimately, the investor.

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120 Much of this history is detailed in Kevin M. Teeven, *A History of Legislative Reform of the Common Law of Contract*, 26 U. TOL. L. REV. 35, 36-52 (1994).
121 *Id.*, at 36-52.
122 E. Allen Farnsworth, *"Meaning" in the Law of Contracts*, 76 YALE L.J. 939, 944 (1967).
123 *Id.* at 945.
124 OLIVER WENDELL HOLMES, THE COMMON LAW 242 (Mark DeWolfe Howe ed., 1963).
125 Hotchkiss v. Nat'l City Bank, 200 F. 287, 293 (S.D.N.Y. 1911).
126 7 JOSEPH M. PERILLO, CORBIN ON CONTRACTS § 29.8 (rev. ed. 2002).
127 *Id.* Yet the European Directive on Unfair Contract Terms provides for a different result, *See* discussion *infra* Part III; *see also* Stark & Choplin, *supra note* 23, at 705-06 (discussing Restatement Second of Contracts in Section 211(3) and the attempt to reconcile failure of authentic consent and certainty of contract). *Cf.* Omri Ben-Sharar, *The Myth of the 'Opportunity to Read' in Contract Law*, 5 EUR. REV. CONT. L. 1, 10 (2009), *available at* home.uchicago.edu/omri/publications.html (dismissing the effect of greater disclosure because of the failure of consumers to read or understand contracts).

1. Contracts of Adhesion

Subprime mortgages are a type of adhesion contract.[128] *Corbin on Contracts* places these contracts in the category of form contracts, where one party prepares the terms and offers it to the other party on a take it or leave it basis.[129] Adhesion contracts are "standard-form contract[s] prepared by one party, to be signed by another party in a weaker position. . ."[130] This type of agreement has become the norm in both commercial and consumer transactions.[131] Common elements of these contracts are the take-it-or-leave-it attitude and the use of "boiler-plate" language unrelated to the specific transaction. Fundamentals of contract law are so firmly entrenched in modern interpretation that judicial analysis and legislation have struggled to come to terms with the widespread use of adhesion contracts. As early as 1917, scholars were writing about these form contracts.[132] It has also been recognized that the "adherents" to these contracts seldom read the standard terms and, even if they do read them, they are not likely to understand them.[133]

Suggestions for reform in the legal treatment of adhesion contracts may offer better protection to consumers than current law.[134] Significant commentary and scholarship have developed that challenge some of the basics assumptions of adhesion contracts. Discussion of the implications of adhesion contracts and their interpretation were included in the writings of Karl N. Llewellyn.[135]

It has been recognized that the use of the printing press to produce contracts created a block-contract for one side to take or leave. This scenario arises in those cases where the contract ceases to be "a matter of dicker, bargain by bargain, and item by item" and becomes "a matter of mass production of bargain, with the background . . . filled in not by the general law but by standard clauses and terms, prepared often by one of the parties only."[136] Llewellyn generally found nothing objectionable, as these agreements were an overall reasonable element of efficient commerce.[137] Unless clauses were "utterly unreasonable," the lack of specific assent was irrelevant.[138]

Taking a variety of approaches, other commentators have argued that greater change is needed in contract law, as these standard form agreements no longer accurately represent the historical nature of contract negotiation as a process requiring the parties to bargaining for and agree to terms. Shelly Smith argues for a revision of the judicial approaches to adhesion

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[128] Shelley Smith, *supra* note 60, at 1040 (classifying residential subprime mortgages as contracts of adhesion "because their terms are selected by professional lenders for unsophisticated borrowers who have no choice but to accept the lenders' terms or forego purchasing their home").
[129] COLIN KELLY KAUFMAN, CORBIN ON CONTRACTS § 5591 (Supp. 1980).
[130] BLACK'S LAW DICTIONARY 366 (9th ed. 2009).
[131] Mo Zhang, *Contractual Choice of Law in Contracts of Adhesion and Party Autonomy*, 41 AKRON L. REV. 123, 145 (2008).
[132] *E.g.*, Nathan Isaacs, *The Standardizing of Contracts*, 27 YALE L.J. 34 (1917).
[133] Todd D. Rakoff, *Contracts of Adhesion: An Essay in Reconstruction*, 96 HARV. L. REV. 1174, 1179 (1983) (listing scholarly articles and empirical studies supporting the notion that adherents do not read adhesion contract provisions); *see also* Stark & Choplin, *supra* note 24, at 691-99.
[134] *See, e.g.*, Shelley Smith, *supra* note 60, at 1110-21; *see also* discussion *infra* Part III.
[135] *See, e.g.*, Karl N. Llewellyn, *Book Reviews*, 52 HARV. L. REV. 700 (1939) (reviewing O. PRAUSNITZ, THE STANDARDIZATION OF COMMERCIAL CONTRACTS IN ENGLISH AND CONTINENTAL LAW (1937).
[136] *Id.* at 700.
[137] *Id.* at 701-02.
[138] *Id.* at 704.

contracts, specifically in the context of subprime mortgages.[139] She proposes that a standard of informed consent be developed that goes beyond the simple disclosure requirements contained in federal law.[140]

2. Unconscionabilty

An analysis by Edith Warkentine demonstrates that court decisions have largely failed to adopt any of the approaches recommended by scholars to reform the law of adhesion contracts.[141] Rather, courts have attempted to apply concepts of unconscionability to adhesion contracts.[142] She concludes that these judicial efforts are inadequate to address the most problematic aspects of adhesion contracts and argues that a standard of "knowing consent" be established.[143] She outlines the elements of "knowing consent" as requiring:

> (1) That the unbargained-for term be conspicuous; (2) that the importance of that term be explained so that the adhering party understands its significance; and (3) that the adhering party objectively manifests its assent to that term separately from its manifestation of assent to undertaking a contractual obligation.[144]

In the modern world, where form reigns over function during the negotiation of contractual relationships or contract terms, the restricted use of adhesion contracts and the recognition of an unconscionability defense to adhesion contracts both aim to protect the unsophisticated, weaker party.[145] Nevertheless, others have argued that even requiring disclosure of terms is not worth the cost economically.[146]

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[139] Shelley Smith, *supra* note 60, at 1110-21.

[140] *Id.* For an alternative argument, see Joshua Fairfield, *The Cost of Consent: Optimal Standardization in the Law of Contracts*, 58 EMORY L.J. 1401, 1408, 1458 (2009) (arguing against a requirement of informed consent in standard contracts because of costs).

[141] Edith R. Warkentine, *Beyond Unconscionability: The Case for Using "Knowing Consent" as the Basis for Analyzing Unbargained-for Terms in Standard Form Contracts*, 31 SEATTLE U. L. REV. 469 (2008). *See infra* Part II for a discussion of judicial approaches to adhesion contracts.

[142] Warkentine, *supra* note 141, at 471.

[143] *Id.* at 472-73.

[144] *Id.* at 473; *see also* Engel & Fitzpatrick, *supra* note 1, at 113-18 (explaining the differences between substantive and procedural unconscionability and the difficulties in convincing a court that a loan contract is unconscionable).

[145] For an alternative argument, *see* Randy E. Barnett, *Consenting To Form Contracts*, 71 FORDHAM L. REV. 627 (2002) (challenging the conclusions and recommendations of scholars who have argued for development of new standards of contract interpretation for contracts of adhesion).

[146] *See, e.g.*, Fairfield, *supra* note 140.

C. The Absence of a Suitability Requirement Under American Contracts Law Contributed to the Subprime Mortgage Crisis.[147]

Suitability requirements under American federal securities law[148] and the disciplinary rules of Self-Regulatory Organizations[149] in the stock industry impose a duty on security brokers to recommend only those securities that are suitable to the customer's circumstances. Before making a recommendation to a customer, security brokers are required to consider the customer's investment goals and risk thresholds.[150] If the broker does not do so, he or she risks disciplinary action or being sued in a private cause of action for fraud or deceit. In lawsuits against a broker who fails to consider an investment's suitability for the plaintiff investor, fraudulent and deceitful intent are necessary elements of a successful action.[151]

Common law fiduciary duty and the duty of reasonable care may imply a suitability duty in mortgage transactions. No statute explicitly or constructively imposes a suitability requirement on mortgage brokers or lenders in mortgage transactions. However, common law fiduciary duty and the duty of reasonable care may be construed to hold mortgage brokers and lenders accountable for not considering the suitability of a mortgage loan to the goals and risk thresholds of a mortgage borrower.[152] Thus far, and perhaps ironically, neither the subprime borrower nor the RMBS investor has been considered to be within the protections of the suitability doctrine.[153]

Existing case law about the arm's-length relationship between the borrower and the lender holds that borrowers are liable on contracts, including mortgage notes, even when the loan is not suitable for them. This is due, in part, to the fact that the law does not require the lender to ensure that the borrower is able to repay the loan.[154] Nevertheless, prior to the increased availability of subprime loans, most residential lenders did not make loans where the borrower's ability to repay was questionable.[155] Frank Hirsch explores the underlying public policy issues surrounding the adoption of suitability principles into mortgage case law. In one case, public policy supports the adoption of suitability principles because of thereduced risk that borrowers will default on their loans.In the other case, public policy would reject the adoption of suitability principles because doing so would reduce access to home ownership, especially for low income and minority citizens.[156] As a result, subprime borrowers are much more likely than conventional borrowers to default, because suitability or, in other words, the

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[147] *See generally* Hirsch, *supra* note 26.

[148] 15 U.S.C. § 78j(b) and 17 C.F.R. § 240.10b-5 are frequently interpreted as requiring security brokers to provide suitable securities for customers to avoid violating the fraud and deceit prohibitions.

[149] Securities industry firms that do business with the public are required to join Self-Regulating Organizations ("SROs") and abide by their regulations. *See* Aaron Smith, Note, *A Suitability Standard for Mortgage Brokers: Developing a Common Law Theory*, 17 GEO. J. ON POVERTY L. & POL'Y 377, 381 (2010) [hereinafter Aaron Smith]. SROs imposing suitability duties include the National Association of Securities Dealers, the Financial Industry Regulatory Authority, and the New York Stock Exchange.

[150] Aaron Smith, *supra* note 149, at 380.

[151] *Id.* at 379.

[152] *Id.* at 381.

[153] *See* Macey et al., *supra* note 117, at 791-92, 815.

[154] *See* Hirsch, *supra* note 26, at 23.

[155] *See id.*

[156] *See id.* at 26-30.

borrower's ability to meet the loan obligation, is not an element in determining the terms of the loan[157]

Thus, the law requiring only objective consent, combined with the very limited role of the borrower's attorney in the American residential lending process produces mortgages that the borrower, can neither understands nor afford. Moreover, the evolution of contract law in the United States means that courts refuse to modify or invalidate contract terms that do not reflect the parties' subjective consent.

D. The Development of U.S. Contract Law Has Tended to Prefer the Lender Over the Borrower

The codification of American contract law principles supports the validity of subprime mortgages, even where borrower does not know the terms and does not exhibit subjective consent. In early England, legislation was drafted to establish new rules of law or to counteract discrepancies in common law that had developed due to conflicting rulings in different courts.[158] Over time, legislation was increasingly used to memorialize custom and precedent articulated by the courts.[159] As early as the medieval period, regulations governing contracts were established.[160] The most significant of these regulations in the context of the subprime mortgage crisis are the Statute of Frauds, the Parol Evidence Rule, and the Holder in Due Course Doctrine.

1. Statute of Frauds

One of the most significant and long-lasting legislative additions to English contract law was the Statute of Frauds enacted by the British Parliament in 1677.[161] The Statute of Frauds was enacted in response to concerns that the terms of oral agreements, or contracts, could easily be the subject of conflicting claims of parties attempting to either enforce fraudulent terms or evade agreed upon terms. The Statute of Frauds required that certain contracts, including contracts that could not be performed within more than one year, such as notes supporting mortgages, be reduced to writing and signed by the party to be bound in order to be enforceable.[162] The requirement that conveyance of interests in land be in writing, which includes mortgages, remains in effect as part of English law today and is also part of American law.

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[157] *See* discussion *infra* Part III.A.2. *But see* Hirsch, *supra* note 26, at 28 (noting that the Mortgage Bankers Association disagrees and argues that the primary reason for defaults are not loan product choice, but rather family or economic challenges, such as unemployment or loss of income (43.5%), illness or death in the family (22.8%), excessive obligations (10.4%), and marital difficulties (8.4%)).

[158] Teeven, *supra* note 120.

[159] *Id.* at 35.

[160] For example, one such regulation established "standards for weights and measures [and] warranties of quality for the sale of food." *Id.* at 36. Another, the Statute of Usury of 1545, prohibited penalties on interest above ten percent. *Id.* at 45.

[161] The Statute of Frauds, 29 Car. 2, c. 3, (1677). The Statute of Frauds was originally entitled, "An Act for the Prevention of Frauds and Perjuries" and was commonly referred to as, "A Statute for the Prevention of Frauds and Perjuries." *An Act for Prevention of Frauds and Perjuryes*, *in* 5 Statutes of the Realm 839-42 (John Raithby ed., 1819).

[162] *See* 4 CAROLINE N. BROWN, CORBIN ON CONTRACTS §12.1 (Joseph M. Perillo ed., rev. ed. 1997) (detailing the history of the Statute of Frauds).

2. Parol Evidence Rule

The parol evidence rule is related, in part, to finding objective consent to contract terms, but really developed as a result of the implications of the Statute of Frauds.[163] The parol evidence rule is a substantive rule of law and provides that once an agreement is reduced to writing, external evidence will not be admitted to vary or contradict the writing.[164] Notably, oral statements made by lenders and mortgage broker agents (which consumers believe to be an enforceable part of the transaction) do not vary the written terms of the subprime mortgage documents. Exceptions to this rule apply under specific limited circumstances, such as ambiguity in the contract itself, certain types of mistake, illegality, accident, or fraud.[165] The formal requirement that the civil law notary read aloud the entire document in a mortgage transaction may have the effect of warning the residential borrower not to rely on any comments, representations, or promises that are not part of the document as it is written.[166]

A version of the parol evidence rule has been codified in the Uniform Commercial Code.[167] As a result of the widespread recognition of the rule, the homeowners' ability to challenge their mortgage obligations based on a lack of subjective consent is limited to the narrow exceptions to the parol evidence rule. Unless the mortgagor can prove that the mortgage or the accompanying note was void based on illegality, mistake, or accident, or voidable because of fraud, the borrower does not have the ability to challenge these contracts. Even when such proof is available, courts are limited in the relief that they can grant. If contracts are void, they are completely unenforceable.[168] As most mortgagors intend to enter into at least some agreement with the lender, they have no claim that their signatures were made by mistake or accident.

Although there is a complex regulatory framework for mortgages in the United States,[169] subprime mortgages are legal. Thus, the only claim homeowners likely have is that their consent was obtained by fraud or misrepresentation with respect to certain elements of the underlying contracts. Under these circumstances, courts will not rewrite the contractual bargain the parties entered into, but will only apply the equitable remedy of reformation in order to make the writing reflect the actual agreement.[170] Clear and convincing evidence is required to prove not only the conflict, but also the actual terms intended by the parties.[171]

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163 COLIN K. KAUFMAN, CORBIN ON CONTRACTS § 572C (Supp. 1980).

164 6 PETER LINZER, CORBIN ON CONTRACTS § 25.2 (Joseph M. Perillo ed., rev. ed. 2010).

165 *Id.* § 25.19.

166 *See* MURRAY & STURNER, *supra* note 50, at 32 (discussing the fourth step of the modern German civil law notary in reading the documents: "The idea is that the notary will explain the transaction and documents to all the parties at the same time, answer any questions, read the documents aloud, and only then secure the parties' signatures.").

167 U.C.C. § 2-202 (2011). The parol evidence rule is also codified in the statutes of various States. *See, e.g*, OR. REV. STAT. §41.740 (2009); UTAH CODE ANN. §78B-25-615 (LexisNexis 2011); GA. CODE ANN. §9-12-43 (2010).

168 59 C.J.S. *Mortgages* § 128 (2009).

169 Federal laws include the Real Estate Settlement Procedures Act of 1974 (RESPA), 12 U.S.C. § 2601(a) (2001), the Truth in Lending Act (TILA), 15 U.S.C. § 1601(a) (2001), and the Home Ownership and Equity Protection Act of 1994 (HOEPA), 15 U.S.C. § 1639 (2001).

170 PERILLO, *supra* note 126, § 28.45.

171 *Id.*

3. Holder in Due Course Doctrine

During the Medieval Period, merchants commonly used bills of exchange to allow third parties to transfer goods and money to other people, eliminating the need to carry large sums of cash to the trade fairs that were the major venues of European commercial trading.[172] Originally, the documents creating these relationships were complex and detailed.[173] To support and encourage trade, and later in recognition of the assignment of notes used outside of commerce for other debt situations, more uniform standards emerged to protect the interests of those who relied on these instruments.[174] First codified in England's Bills of Exchange Act of 1882, the holder in due course doctrine protects assignees of negotiable instruments from most claims of fraud, duress, mistake, breach of duty, or illegality that the original maker of the instrument might have against the original beneficiary.[175] In practice, application of the holder in due course doctrine inhibits the homeowners' ability to attack the unfair contract terms of their mortgage obligations simply because the doctrine's principles limit the use of many contract defenses against the assignees of mortgage notes.

Long before the subprime crisis developed, Kurt Eggert challenged the application of the holder in due course doctrine in his critical analysis of predatory lending practices.[176] He argues that, in part, this doctrine encourages fraud because those lending, bundling, and securitizing mortgages know that any potential personal liability will be essentially eliminated because the purchasers of mortgage derivatives would be holders in due course against whom no claims could be made.[177] Kathleen C. Engel & Patricia A. McCoy expanded this analysis in a 2007 article in which they maintained that

> [S]ecuritization inflicts negative externalities on subprime borrowers in at least four ways. First, securitization funds small, thinly capitalized lenders and brokers, thus enabling them to enter the subprime market. These originators are more prone to commit loan abuses because they are less heavily regulated, have reduced reputational risk, and operate with low capital, helping to make them judgment-proof. Second, securitization dilutes incentives by lenders and brokers to avoid making loans with excessive default risk by allowing them to shift that risk to the secondary market, which has other ways to protect itself. Third, securitization denies injured borrowers legal recourse against assignees by triggering the holder-in-due-course rule and impeding work-outs. Lastly, securitization drives up the price of subprime loans because investors demand a lemons premium for investing in subprime mortgage-backed securities.[178]

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172 *See* Kurt Eggert, *Held Up in Due Course: Codification and the Victory of Form over Intent in Negotiable Instrument Law*, 35 CREIGHTON L. REV. 363, 404 (2002) (detailing the development of the creation and use of negotiable instruments).

173 *See id.* at 406.

174 *Id.* at 408. *See also id.* at 382.

175 *See id.* at 377.

176 *Id.* at 364-65.

177 *Id.* at 365.

178 *Turning a Blind Eye*, *supra* note 37, at 2041.

Lemon is a term for high-risk loans and the secondary market originally cherry-picked loans involving less risk.[179] However, bundling removes the lenders' incentive to carefully underwrite loans, which results in an exorbitant premium. Who knew there would be so much fruit in lending?[180]

In a recent article analyzing risks to the investor, rather than to the borrower, Kathleen C. Engel & Thomas J. Fitzpatrick IV predict that owners of subprime RMBS will be denied a security interest in the real estate and will be left in the position of an unsecured creditor.[181] Some courts in foreclosure actions have ruled that, where documents were not recorded or processed correctly, the documents will not support a finding of a mortgage, *i.e.*, a security interest in the land.[182]

III. EU LAW UNDER THE DIRECTIVE: "UNFAIR CONTRACT TERMS"[183] AFFORDS MORE PROTECTION TO LESS SOPHISTICATED PARTYS IN CONSUMER TRANSACTIONS THAN AMERICAN CONTRACT LAW

A. Development of the Unfair Contract Terms Directive

The European Union ("EU") is an economic and political partnership of twenty-seven countries, or Member States.[184] The EU has the power to enact legislation through Directives, Regulations, and Decisions.[185] Generally, a Directive is a legislative act of the EU that requires Member States to achieve a particular goal.[186] Directives set a desired result and are binding upon each Member State, but allow the national authorities of each Member State to choose the form and method of reaching the directive's goal.[187] Directives differ from Regulations in that Regulations are self-executing and are legally enforceable in the Member States on the same level as each country's national laws enacted without the Member States enacting any implementing measures.[188] EU Directives provide "certain end results that must be achieved in every Member State."[189] National authorities must "adapt their laws to meet these goals, but are free to decide how to do so."[190] Modification of the Member State's Civil Code is just one of several possible ways to achieve this result.

Nearly twenty years ago, European legislation began transitioning away from upholding consumer contracts to the creation of consumer protection legislation (especially in-

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179 *Id.* at 2041.
180 *Id.* at 2048-49.
181 Engel & Fitzpatrick, *supra* note 1, at 53-54.
182 *Id.* at 54.
183 Council Directive 93/13, 1993 O.J. (L 95) 29 (EEC) [hereinafter Unfair Terms Directive].
184 *Basic Information on the European Union*, EUROPA, http://europa.eu/about-eu/basic-information/index_en.htm (last visited Aug. 19, 2011).
185 *Legislation and Treaties*, EUROPA, http://europa.eu/documentation/legislation/index_en.htm (last visited Aug. 19, 2011).
186 *Application of EU Law: What are EU Directives?*, EUROPEAN COMMISSION, http://ec.europa.eu/eu_law/introduction/what_directive_en.htm (last visited Dec. 12, 2011) [hereinafter *What are EU Directives?*].
187 *Id.*
188 *Application of EU Law: What are EU Regulations?*, EUROPEAN COMMISSION, http://ec.europa.eu/eu_law/introduction/what_regulation_en.htm (last visited Aug. 19, 2011).
189 *What are EU Directives?*, *supra* note 186.
190 *Id.*

volving form contracts)[191] which were less protective of the weaker party.[192] Protection of consumers' and users' rights was implemented through the enactment of four Directives: Doorstep Selling 85/577/EC; Distance Selling 97/7/EC; Sale of Consumer Goods and Guarantees 99/44/EC; and Unfair Contract Terms 93/13/EC.[193] The goal of all four Directives is to provide consumer protection and to foster a fair and competitive internal market.[194] Only the Directive on Unfair Contract terms 93/13/EC applies to mortgages.

1. Italian Example of Implementation of Unfair Contract Terms Directive

Regarding the Unfair Contract Terms Directive, Italy adopted specific provisions affecting consumer contracts[195] that were added to the Italian Civil Code ("C.c.").[196] These provisions were adopted in response to the mandatory Directive on Unfair Contract Terms 93/13/1993. That Directive introduces the concept of "good faith" to prevent significant imbalance in the rights and obligations of consumers. Articles 1469 bis – 1469 sexies (later replaced by Articles 33-38 of the C.c.) were considered to integrate and not to amend the provisions of the prior articles 1341 C.c. and 1342 C.c.[197] Whereas the earlier provisions of Articles 1341 C.c. and 1342 C.c. refer to the formal requirement of the weaker party's knowledge of the contract's provisions to avoid being deemed as unfair, modern articles 1469-bis-1469 sexies C.c. require that there be individual negotiation of these provisions.[198] The clauses specified in Article 36 (which has replaced articles 1469-bis-1469 sexies C.c.) are always considered unfair and unenforceable, despite any negotiation.[199]

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191 A. TORRENTE & P. SCHLESINGER, MANUALE DI DIRITTO PRIVATO 472 (2007) (discussing European Council Directive number 13, year 1993, 93/12/EC); *see also* Unfair Terms Directive, *supra* note 183.

192 *See, e.g.*, Regio Decreto, 16 marzo 1942, n. 262, Codice Civile [C.c] [Civil Code] art. 1341, *available at* http://www.jus.unitn.it/cardozo/obiter_dictum/codciv/codciv.htm [hereinafter C.c.] ("Standard conditions prepared by one of the parties are effective as to the other, if at the time of formation of the contract the latter knew of them or should have known of them by using ordinary diligence."). In any case conditions are ineffective, unless specifically approved in writing, which establish, in favor of him who has prepared them in advance, limitation of liability, the power of withdrawing from the contract or suspending its performance, or which impose time limits involving forfeitures on the other party, limitations on the power to raise defenses, restriction on contractual freedom in relation with third parties, tacit extension or renewal of the contract, arbitration clause or derogations from the competence courts. MARIO BELTRAMO ET AL., 4 THE ITALIAN CIVIL CODE AND COMPLEMENTARY LEGISLATION 28 (2009). *But see* C.c., *supra* note 192, art. 1370 ("Provisions contained in the standard conditions of a contract or in forms or formularies which have been prepared by one of the contracting parties, are interpreted, in case of doubt, in favor of the other.").

193 *See General Contractual Rights*, EUROPEAN COMMISSION, http://ec.europa.eu/consumers/rights/gen_rights_en.htm (last visited Oct. 30, 2011).

194 *Id.*; *see also* MASSIMILIANO MUSTARDING ET AL., *Italy*, *in* E-COMMERCE LAW IN EUROPE AND THE USA 329 (2002).

195 Specifically, 1469 bis-1469 sexies were added to the Italian Civil Code.

196 Italy enacted the Provisions for the Compliance with the Obligations Deriving from Italy's Membership of the European Communities. Legge 6 febbraio 1996, n. 52 (It.).

197 *See* P. Piccoli, *Riflessi sull 'attivita' notarile della normative di cui alla legge 6 febbraio 1996 n.* 52 (*Clausole abusive nei contratti stipulati con i consumatori*), VITA NOTARILE, 1996, at 1097 (discussing unfair terms in consumers' contract)*; see also* TORRENTE & SCHLESINGER, *supra* note 191, at 472-73.

198 MUSTARDING ET AL., *supra* note 194, at 334-35.

199 C.c., *supra* note 192, art. 36. Additionally, the free movement of people, goods, and services across the European Member States' borders suggest the need for uniform, clear, simple, and *ad hoc* consumer rules throughout the Member States' individual laws. *See* MARTIN EBERS, *Unfair Contract Terms Directive (93/13)*, *in* CONSUMER LAW COMPENDIUM 341 (2008), *available at* http://www.eu-consumer-law.org/study_en.cfm (last

Later, as a result of the conclusions of the Green Paper, which was published in 2001 and discussed consumer protection,[200] the EU issued a Directive concerning unfair "business-to-consumer commercial practices" in the internal market.[201] This Directive aimed to reduce differences in the laws of each Member State and to eliminate competition distortions in the EU market that were caused by the lack of uniform consumer rules at the Community level.[202] Thus, the Directive concerning unfair business-to-consumer commercial practices in the internal market, led to the replacement of Italian Article 1469 ter- Article 1469 sexies of C.c. with Article 142 of Legislative Decree number 206 of 6 September 2005. This Legislative Decree became as the Consumer's Code.[203]

2. The Italian Consumers' Code

The Italian Consumers' Code "brings together, coordinates, and simplifies" all the Italian provisions relating to consumer law.[204] "The Italian consumer protectionpolicy reflects the guidelines of the EU programme.[205] Consumers' and users' rights are now protected in Part III ("the Consumer Relationship"), Title I ("Consumer Contracts in General") of the Italian Consumers' Code.[206] It should be noted that Articles 1341 C.c. and 1341 C.c. applied only to contracts prepared by one party, like American 'form' contracts.[207] The Consumers' Code applies to one-party contracts, but also applies to contracts that have been negotiated by both parties, including contracts between a consumer and a professional.[208]

Article 33 of the Consumers' Code defines the principles of unfair terms and continues with the specific identification terms that are regarded as unfair.[209] The Consumers' Code distinguishes terms that are always considered unfair (Article 36)[210] and terms that are presumed unfair unless proven otherwise (Article 33). Article 33 provides:

> In contracts entered into between consumers and professionals, terms shall be considered unfair where, contrary to good faith, they cause a significant

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visited Dec. 14, 2011); MUSTARDING ET AL, *supra* note 194, at 333; *and* Christiana Cicoria, *The Protection of the Weak Contractual Party in Italy vs. United States "Doctrine of Unconscionability"*, at 13, http://www.uniformterminology.unito.it/downloads/papers/cicoriaprotection.pdf.

200 *See* COMM'N OF THE EUROPEAN COMMUNITIES, GREEN PAPER ON EUROPEAN CONSUMER PROTECTION (2001), *available at* http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:52001DC0531:EN:NOT (stating that the Green Paper's purpose "is to launch an extensive public consultation on the future direction of EU consumer protection" and to analyze its possible future development.).

201 Council Directive 2005/29/EC, 2005 O.J. (L 149).

202 *Id.*

203 For an in-depth examination of the Consumers' Law in the European Union Member States, see EBERS, *supra* note 199, at 364.

204 EUROPEAN COMM'N, ITALY 2 (2010), *available at* http://ec.europa.eu/consumers/overview/country_profile/IT_web_country_profile.pdf.

205 *Id.*

206 Decreto Legislativo [D.L.] 6 settembre 2005, n. 206, Codice del Consumo art 33-38 (It.), *available at* http://www.ecc-netitalia.it/inglese (follow "European and Italian Legislation" hyperlink; then follow "Consumer Code" hyperlink) [hereinafter Consumers' Code].

207 C.c., *supra* note 192, art. 1341-42.

208 Consumers' Code, *supra* note 206. *See also* GUIDO ALPA & VINCENZO ZENO-ZENCOVICH, ITALIAN PRIVATE LAW 216 (2007).

209 Consumers' Code, *supra* note 206, art. 33.

210 *Id.* art. 36.

> imbalance in the rights and obligations arising under the contract, to the detriment of the consumer. Terms are presumed unfair, unless proved otherwise, where they have the object or effect of:. . .
>
> l) providing for an extension of the consumers' acceptance to terms with which he had no real opportunity of becoming acquainted before the conclusion of the contract;
> m) enabling the professional to alter the terms of the contract unilaterally, or the futures of the product or service to be supplied, without valid reason which is specified in the contract . . .
>
> t) burdening the consumer with expiry deadlines, limitations on his right to refuse the fulfillment of his obligations, derogations from the jurisdiction of the courts, restrictions in evidence available, shifts in the burden of proof, restrictions on freedom of contract in relationships with third parties;
>
> u)establishing as forum in case of dispute, a jurisdiction other than the place where the consume is resident or has his domicile of choice.[211]

Under Article 34, unfair terms are those that, following an assessment of the case, show an imbalance between the consumer's duties and professional's rights. The nullity of the unfair terms depends on a subjective evaluation of the circumstances existing during the negotiation and conclusion of the contract. Article 34, "Assessment of the unfair nature of terms," provides that:

> 1) The unfair nature of a term shall be assessed by taking into account the nature of the goods or services for which the contract was concluded and by referring to all the circumstances existing at the time of conclusion of the contract, and to the other terms of the same contract or of another contract upon which it is dependent.
>
> 2) Assessment of the unfair nature of the terms shall relate neither to the definition of the main subject matter of the contract nor the adequacy of the consideration for the goods or services, in so far as these terms are in plain intelligible language.
>
> 3) Terms which reproduce provisions of law or which reproduce provisions or implement principles contained in international conventions to which all Member States of the European Union or the European Union itself are contracting parties shall not be unfair.
>
> 4) Terms or aspects of terms that have been individually negotiated shall not be unfair.
>
> 5) *For contracts concluded by signing a pre-formulated form or standard contracted designed to regulate certain contractual relations in a uniform way, the professional shall bear the burden of proving, that the terms or aspects of terms have been individually negotiated with the consumer, even though they have been prepared unilaterally by the profession.*[212]

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211 *Id.* art. 33.
212 *Id.* art. 34 (emphasis added).

Article 35 imposes an obligation of transparency and defines a rule of interpretation in favor of the sole consumer. Article 35, "Form and interpretation," provides:

> 1. In the case of contracts where some or all terms are presented to the consumer in writing, these terms must always be drafted in plain, intelligible language.
>
> 2. Where there is doubt as to the meaning of a term, the interpretation that is most favorable to the consumer shall prevail . . .[213]

Article 36 provides that only the unfair terms are null, not the entire contract. Such nullity has been qualified by the Italian doctrine *nullita' di protezione* ("protection nullity") because it operates only for the consumer's benefit and it may be imposed by the Court if beneficial for the consumer. Article 36, "Nullity for protection of consumers," provides:

> 1. Terms considered to be unfair pursuant to Articles 33 and 34 shall be null, while the remainder of the contract shall remain valid.
>
> 2. Terms shall be null, even if they have been individually negotiated, where they have the purpose or effect of: a) excluding or exempting liability of the professional in the event of the death of the consumer or personal injury to the latter resulting from an act or omission of that professional; b) excluding or exempting the actions of the consumer *vis a vis* the professional or another party in the event of total or partial non-performance or inadequate performance by the professional; c) providing for an extension of the consumer's acceptance to terms with which he had no real opportunity of becoming acquainted before the conclusion of the contract;
>
> 3. Nullity shall only operate for the benefit of the consumer and may be ascertained ex officio by the court.
>
> The vendor shall have rights of recovery from the supplier for damage suffered as a result of the declaratory judgment of nullity of the terms declared unfair.
>
> 4. All contractual terms that have the effect of depriving the consumer of the protection given by the present Title by providing that the law applicable to the contract shall be the law of a non-Member country, shall be null, if the contract has a closer connection with the territory of Member State of the European Union.[214]

Finally, Article 143 stresses the intention of providing for strong consumer protections and for fair commercial practices establishing the consumer's rights. Those rights are inalienable and any covenants in conflict with the Consumers' Code are void. Article 143 of Part 6, "Final provisions," states that:

> 1. Consumer rights given by the Code shall be inalienable. Any event in conflict with the provisions thereof shall be null.

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[213] *Id.* art. 35.
[214] *Id.* art. 36.

> 2. If parties choose to apply any other law than that of Italy to a contract, consumers shall still be entitled to the basic protection afforded to them by this Code.[215]

As detailed below, it is likely that American subprime, and especially predatory, residential mortgage loans would have been considered nullities under the Unfair Contract Terms Directive, as implemented by Italy.

Although this Article does not purport to provide a comprehensive analysis of the impact that the Unfair Contract Terms Directive would have had on such mortgage loans, it seems fair to point out particular provisions of the Directive. Additionally, because of the integrative structure of the Directive with the Member States' legislation, the limited analysis here will incorporate the Italian Consumers' Code.

The definition of "consumer" purports to include borrowers executing residential mortgage loans under Article 2(b) of the Directive.[216] Article 3(1) provides that "a contractual term which has not been individually negotiated shall be regarded as unfair if, contrary to the requirement of good faith, it causes a significant imbalance in the parties rights and obligations. . .to the detriment of the consumer."[217] Promissory notes and residential mortgages that contain prepayment penalties, acceleration clauses, and due on sale clauses would likely fit into the unfair terms category. Moreover, the lack of a suitability process in American subprime mortgage loans would appear to violate the principle of good faith.

Additionally, the form contracts used in American subprime mortgage loans would likely fall under the Italian law category of "not individually negotiated." Article 3(2) of the Unfair Terms Directive states: "A term shall always be regarded as not individually negotiated where it has been drafted in advance and the consumer has therefore not been able to influence the substance of the term, particularly in the context of a pre-formulated standard contract."[218]

The Annex to the Directive provides a "non-exhaustive list of the terms which may be regarded as unfair."[219] The Annex includes several categories of terms that are typically found in American subprime mortgages. One category describes an unfair term as one "requiring any consumer who fails to fulfill his obligation to pay a disproportionately high sum in compensation."[220] That description could include the penalties for prepayment and liquidated damages clauses that are often found in a subprime note or mortgage. A second category, providing that a term "irrevocably binding the consumer to terms with which he had no real opportunity of becoming acquainted before the conclusion of the contract,"[221] could include the form documents that are not presented to the borrower until the closing of an American subprime mortgage loan transaction, even when the borrower is represented by an attorney. A third category of terms regarded as unfair is "if the final price is too high in relation to the price agreed when the contract was concluded."[222] However, this third cate-

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215 *Id.* art. 143.
216 Unfair Terms Directive, *supra* note 183, art. 2(b), at 31.
217 *Id.* art. 3(1), at 31.
218 *Id.* art. 3(2), at 31.
219 *Id.* art. 3(3), at 31.
220 *Id.* Annex 1(e), at 33.
221 *Id.* Annex 1(i), at 33.
222 *Id.* Annex 1(l), at 33.

gory excludes "price-indexation clauses, where lawful, provided that the method by which prices vary is explicitly described."[223] Assuming the variable rate is explicitly described in the American subprime mortgage documents, the Directive does not seem to characterize such a provision as unfair on the basis that the rate is variable alone.

Two additional provisions in the Annex of the Unfair Terms Directive could be applied to some of the most predatory aspects of subprime mortgages. The provision "limiting the seller's or supplier's obligation to respect commitments undertaken by his agents or making his commitments subject to compliance with a particular formality"[224] seems directed at the protections of the Statute of Frauds and parol evidence rule hat insulate the lender against a borrower's claims for oral representations, particularly those from mortgage brokers and loan originators. An additional provision characterizes as unfair a term "giving the seller or supplier the possibility of transferring his rights and obligations under the contract, where this may serve to reduce the guarantees for the consumer, without the latter's agreement."[225] This Article would apply to the holder in due course status of transferees and assignees of notes and mortgages, as is typical in the securitization process.

IV. AN ABSENCE OF CIVIL NOTARIES IN THE U.S. SUBPRIME MORTGAGE PROCESS RESULTS IN AMERICAN SUBPRIME BORROWERS RECEIVING LITTLE OR NO LEGAL ADVICE DURING THE MORTGAGE PROCESS: GLOBAL INVESTORS MAY HAVE ASSUMED THE OPPOSITE

European Civil Law countries employ civil law notaries rather than the pubic law notary generally used in common-law countries. Civil law notaries are "highly-trained, licensed practitioners providing a full range of regulated legal services" and often receive the same education as attorneys, though without the training in trial advocacy.[226] A comparison of the American process for real estate subprime mortgages with the civil notary process used in European mortgage practices will reveal that profoundly different protections exist for the unrepresented or inadequately represented residential borrower. Through interviews with civil law notaries and economists in Italy, Belgium, Luxembourg and the Netherlands, the authors have obtained information about the special function of civil notaries in advising consumers before they commit to the terms of a loan, including the residential mortgage borrower.[227] In a recent book, Peter L. Murray and Rolf Sturner have indicated support for the idea of using a civil notary as an advisor to unrepresented consumers in the loan process.[228]

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[223] *Id.* Annex 2(d), at 34.

[224] *Id.* Annex 1(n), at 33.

[225] *Id.* Annex 1(p), at 33.

[226] Kevin Neary, *An Explanation of Notaries in Civil Law Countries*, DONNELLY NEARY & DONNELLY (Apr. 26, 2011),http://www.dndlaw.com/news/viewdetails.asp?ID=173; *see also* Pedro A. Malavet, *Counsel for the Situation: The Latin Notary, a Historical and Comparative Model*, 19 HASTINGS INT'L & COMP. L. REV. 389, 464-75 (1996) (discussing education requirements and licensure).

[227] These include Eliana Morandi, Emiel Maasland, Yves Montangie, Paolo Piccoli, and Karel Tobback.

[228] MURRAY & STURNER, *supra* note 50, at 54-55 (comparing the adversarial common law systems that "theoretically require two or more professionals to ensure that every party receives adequate legal advice and assistance" and the neutral advice from a notary who is liable to all of the parties and concluding that in the common law systems the ideal is often too expensive for the weaker party and "in practice one of more parties frequently go unrepresented in order to save time and cost").

In Italy and other Civil Law countries which require a civil law notary to supervise transfers of property, the notary will review and explain to the consumer the terms and consequences of signing a mortgage note (a contract) and the mortgage itself (a transfer of a security interest in real estate).[229] Civil Law Notaries investigate the will of the parties.[230] This special and different counseling role of the civil law notary, as opposed to the limited role of the American attorney, is significant with regard to legal questions as to the borrower's consent to the contract and contract terms. This is especially true when the contract transfers the consumer's economic rights to a lender, such as a security interest in the consumer's real property.

A. Italian Latin Notaries' Duties to Consumers Regarding Standard Consumer's Contracts: An Example of the Civil Law Notary's Role[231]

The preventative function of the civil law notary in representing all parties requires the notary to ensure that all parties understand the real meaning of the contract and other transactional documents and that all parties give formal consent, rather than merely signing documents and thus giving only objective consent.[232] Until the notary is convinced that the documents reflect the subjective will of all parties, the notary will not authenticate the documents.[233] Latin Notary Law, number 89 of 16 February 1913 ("L.N."), and the Code of Conduct approved by the Consiglio Nazionale de Notariato on 5 April 2008 govern the Italian Latin Notary's activity in detail.[234] In particular, Chapter I ("On the form of notarial deeds") of Title III ("On Notarial deed") of the Latin Notary law describes how the Latin notary must draft the authentic deed in order to comply with Italian law.[235] The Latin notary, as the public officer empowered by the Italian government, must execute valid, trustworthy, and reliable

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229 *See* Jacques Pourciel, *Continental Law Antidotes to the Subprime Mortgage Turmoil*, CONSEIL SUPERIEUR DU NOTARIAT, http://www.fondation-droitcontinental.org/upload/docs/application/pdf/2010-08/round_table_1_me_pourciel.pdf.

230 For an alternative view, see Wayne Barnes, *The French Subjective Theory of Contract: Separating Rhetoric from Reality*, 83 TUL. L. REV. 359 (2008). Although he denies that French contract rules require subjective consent, even in consumer transactions, Barnes does not discuss the role of the civil law notary in contract formation. *See id.*

231 We selected Italian Latin Notary for a focus on the role of the civil law notary. The title "Latin Notary" has been historically used interchangeably with the term "Civil Law Notary." Boyd F. Campbell & Ronald G. Neiwirth, *Civil Law Notaries: Something New in Alabama*, 64 ALA. LAW. 169 (2003). *See also* Peter L. Murray, *Real Estate Conveyancing in 5 European Union Member States: A Comparative Study*, COUNCIL OF THE NOTARIATS OF THE EUROPEAN UNION, http://www.cnue-nouvelles.be/en/000/actualites/murray-report-final.pdf (Rev. Nov. 27, 2007) (comparing residential conveyancing costs in Estonia, France, Germany, Sweden, United Kingdom, but not Italy, with the United States).

232 *See* Pourciel, *supra* note 229.

233 Unlike American notary publics, civil law notaries confirm and attest acts and are often appointed by the government of the European nation in which they practice. *The Italian Notary Public: the Notaio,*" ENTERING EUROPE, http://www.entering-europe.eu/italy/notary.php (last visited Sept. 11, 2011).

234 Legge 16 febbraio 1913 n.89 (It.), *available at* http://www.genghinieassociati.it/acrobat/notarile/Legge%2016%20febbraio%201913%20n.89.PDF [hereinafter L.N.]; PRINCIPLES OF PROFESSIONAL ETHICS OF NOTARIES (National Council of Notaries 2008) (It.), *available at* http://www.notariato.it/export/sites/default/it/notariato/chi-siamo/allegati-chi-siamo/Deontologia2008.pdf [hereinafter Code of Conduct].

235 L.N., *supra* note 234, art. 47-60.

legal documents so that that the documents are legally secure, reliable, and enforceable.[236] To ensure the validity and reliability of the legal documents, as well as their privileged evidentiary strength and enforceability, Article 28 L.N. provides that the notary cannot execute an authentic deed if the deed is expressly prohibited by law or if execution of the documents would be contrary to public morality or public order.[237]

The notary is responsible for certifying all the facts involved in the transaction and complying accurately and precisely with the Latin Notary Law in the Code of Conduct.[238] The high level of formalism in Italian Latin Notary Law means that no interruptions are permitted as the notary reads the authentic deed to the parties. Conversely, in the U.S. a common tactic for unscrupulous mortgage brokers is to disrupt the consumer from carefully reading the documents. The authentic deed is prepared after the parties understood its terms and approved them.[239] The notary executes the deed pursuant to Article 47 L.N., and, should he disregard the legal requirements, he is liable for civil, criminal, and disciplinary actions.[240]

Article 47 L.N. requires that the Latin notary draw up the authentic deed before the parties and, unless otherwise provided by law, before two qualified witnesses.[241] After the Latin notary ascertains the parties' true intentions, the law requires that the notary have control over and responsibility for executing an authentic deed.[242] In practice, the parties, after negotiating and reaching a basic agreement, generally set up meetings with the Latin notary to explain their intentions. The notary investigates each party's will by making inquiries, reflecting on the goals each party desires to attain, ensuring that the parties' agreement complies with all applicable Italian law, explaining the legal effects and consequences of the agreement to all parties, ensuring that the legal consequences of the deed are desired by the parties, and giving the parties the most effective and least expensive legal solution and advice.[243] After completion of the investigation and as a result of this intercourse with the parties, the notary draws up a deed in a clear and accurate way so as to prevent possible litigation.[244]

The process of ascertaining the parties' real intentions, and of explaining the effects and legal consequences of their agreement, is necessary for the notary to comply with his duty to advise and inform the parties.[245] This process typically takes two or more meetings with the notary and one or both of the parties.

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236 *See Responsibilities of the notary*, CONSIGLIO NAZIONALE DEL NOTARIATO, http://www.notariato.it/en/italian-notaries/who-we-are/responsibilities-of-the-notary.html (last visited Dec. 17, 2011).

237 L.N., *supra* note 234, art. 28 ("Il notaio non puòo' ricevere o autenticare atti se essi sono espressamente proibiti dalla legge, o manifestamente contrari al buon costume o all'ordine pubblico.").

238 Code of Conduct, *supra* note 234.

239 Authentic deeds are documents with "special legal trustworthiness, because they are drawn only if they are in accordance with all the relevant law provisions, so as to avoid a possible future annulment of the act." *Notariale Professional Services*, NOTAIO GIOVANNI LIOTTA, http://www.notaioliotta.it/services.html (last visited Dec. 17, 2011).

240 L.N., *supra* note 234, art. 47. *See* Code of Conduct, *supra* note 234, art. 36, 37.

241 L.N., *supra* note 234, art. 47.

242 *Responsibilities of the notary*, *supra* note 236.

243 *Id.*

244 *Id.*

245 *Id.*

In order to comply with the law requiring the notary to draw up reliable legal documents,[246] the notary assists all parties impartially and neutrally.[247] Article 51, sections 3, 4, and 7 L.N. require the notary to check the identities of all parties and each party's capacity and legal power to complete the transaction.[248] In addition, the notary is required to determine that all the facts presented are verified and that any documents and enclosures annexed to the deed are legally certain.[249]

Considering the notary's duties, some scholars conclude that the execution of an authentic deed in the presence of a notary authenticates the agreement. These scholars believe that the specific approval of unfair provisions required by Italian Civil Code ("C.c.") Article 1341, which provides that terms cannot be enforced against a non-drafting party unless the term is individually agreed to in writing, is inconsistent with provisions Articles 47 and 51 (no. 3, 4,and 7) L.N, which provide that terms in an authenticated deed are enforceable. The Corte di Cassazione[250] has ruled that the provisions contained in an authentic deed are enforceable, even if they might be considered conditions prepared by only one of the parties which would not otherwise be enforceable under Article 1341 C.c.[251] Thus, the authenticated contract supervised by a notary supersedes the Article 1341 C.c. requirement of specific approval of each term, even if the term is unfair under Article 1341 C.c.[252] While there is no specific rule requiring that the notary insert an explicit approval clause into a provision that might be unfair, the practice is to do so.

B. The Application of the Consumers' Code and the Notary's Role to Unfair Provisions in Bank Loan Agreements: The 2006 Study

The Commission of Civil Study of the Consiglio del Notariato, issued a study on May 13, 2006 regarding unfair provisions in banking loan agreements ("Study").[253] It reviewed basic Italian mortgage laws and the responsibilities of the Latin notary in authenticating banking loan agreements.[254] For example, Article 2808 C.c., "Establishment and effects of mortgages," provides: "A mortgage gives the creditor a right to expropriate the property made liable to secure his claim, even against a third person transferee and a preference in being paid from the proceeds of the expropriation."[255] A mortgage can be imposed on the property of the debtor or of a third party, and is established by means of an inscription in the

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246 L.N., *supra* note 234, art. 1 ("Latin notaries are public officials who receive inter vivos and mortis cause deeds, award these public faith, and takes in deposits of these documents, releasing copies, certificates and excerpts upon request.")

247 *See* Code of Conduct, *supra* note 234, art. 1, 31, 41.

248 L.N., *supra* note 234, art. 51.

249 *Responsibilities of the notary*, *supra* note 237.

250 CORTE SUPREMA DI CASSAZIONE, *available at* http://www.cortedicassazione.it/ (last visited Nov. 14, 2011).

251 Cass., sez. un., 10 gennaio 1992, n. 193, vita not 1992, 761 (It.).

252 Cass., sez. un., 21 settembre 2007, n. 18917, I (It.). For the financing agreement, *see* Cass., sez. un., 28 agosto 2004, n. 17289, I (It.).

253 CONSIGLIO NAZIONALE DEL NOTARIATO, CODICE DEL CONSUMO: CLAUSOLE VESSATORIE NEI CONTRATTI DI MUTUO BANCARIO ED INTERVENTO DEL NOTAIO, No. 327/2006 (2006), *available at* http://www.notariato.it/it/primo-piano/studi-materiali/studi-materiali/contratti-codice-consumo/237.pdf [hereinafter STUDY]. A "study" is a review issued on important legal topics by the Italian Notary organization, *id.*

254 *Id.*

255 C.c., *supra* note 192, art. 2808.

immovable property records.[256] This definition of a mortgage is close enough to the American concept to permit comparisons here.

The Study makes several conclusions. The leading scholars and the judgments of the Corte di Cassazione agree that there is an inconsistency between the provisions of Article 1341 C.C. and Articles 33-38 of the Consumers' Code, and also with 47 L.N. and 51 L. N. prescribing the obligations of the notary. The Study concludes that the wisest procedure is for the notary to require explicit approval of any provisions that might be considered unfair when executing contracts between a consumer and a professional, including banking loan agreements.[257] The Study also concludes that notaries should include a specific contractual clause stating: "In compliance of Article 1341 and 1342 of the Italian Civil Code, the party, (name of the weaker party), declares to know and explicitly approve the following clauses," or "For the execution of the present agreement the parties jointly agree to adopt the standard general conditions as set up by (name of the party proposing the standard conditions) in the Annex hereto attached that they declare to know and explicitly approve. The (name of the consumer or of the weaker party) declares to explicitly approve clause number relating to (limitations of liability)."[258] Also, because Article 34(4) of the Italian Consumers' Code provides that terms or aspects of terms that have been individually negotiated shall not be considered unfair, once the consumer and the professional or business have jointly agreed to the individual terms, the terms can no longer be deemed unfair and will be considered legally binding.[259]

C. The Notary's Role in the Negotiation Phase of a Consumer Agreement

The Study explains and discusses various opinions about the effect of notary participation on the validity of terms that would otherwise be considered unfair and null under Article 28 L.N. and provisions of the Consumers' Code.[260] Some scholars consider the a Latin notary's execution of an authentic deed containing potentially unfair terms as certification that such terms have been individually negotiated.[261] Others conclude that the Consumers' Code and Articles 1341 C.c. and 1342 C.c. apply to the execution of a public deed because the weaker party's protection is brought about by the Latin notary as a public officer.[262] The third view concludes that the notary's activity consists merely of reading the deed to the parties who then approve and underwrite or sign the deed.[263] Under this view, the notary's activities are not considered as a guarantee that the potentially unfair contract provision have been negotiated by the parties. Thus, the notary's services in authenticating the deed may not negate the unfair nature of the term proposed by the professional or business and the notary may not know if the term has been negotiated or whether they can be considered "negotiated" under Article 34(4) of the Consumers' Code.[264]

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256 *See* 6 MARIO BELTRAMO ET AL., THE ITALIAN CIVIL CODE AND COMPLEMENTARY LEGISLATION, 7-8, 40, 43 (rev. ed. 2010) (discussing articles 2808, 2821, 2657, and 2658).

257 *See* STUDY, *supra* note 253.

258 *Id.*

259 Consumers' Code, *supra* note 206, art. 34. *See* Council Directive 2005/29/EC, *supra* note 204.

260 *See* STUDY, *supra* note 253.

261 *See id.* at 23-24.

262 *See id.* at 5.

263 *See id.* at 4.

264 *Id.* at 11.

The Study underscores the conclusion that sometimes the notary does not know the circumstances or has not been informed of the circumstances surrounding the potentially unfair terms.[265] In such cases, the mere inclusion of unfair terms in an authentic deed does not necessarily involve the application of Article 28 L.N., holding the notary liable and subject to disciplinary action.[266]

D. How the Role of Notaries, Explained in the Study, Functions in Context of Banking Loans

Italian banks, like their American counterparts, use form contracts to memorialize loan agreements.[267] In spite of the use of form contracts, the Study explains that the notary may play an active role during the negotiation of a standardized bank contract by advising and informing the parties.[268] The notary has a duty to inform all parties of the consequences that the Consumers' Code would have on the validity and the effectiveness of the contractual terms.[269] This includes informing the parties if a term conflicts with the Consumers' Code and, if a conflict exists, the notary must provide an adequate solution by replacing or deleting the invalid provision.[270] If the notary fails to meet these duties, the notary can be subjected to discipline by the regulatory commission and can be liable to the parties.[271]

The Study suggests a number of procedures through which the parties can achieve a fair agreement. First, the notary might mediate the negotiation of the unfair terms, offering amendments or deletion of clauses violating the Consumers' Code.[272] Second, when the notary reads the deed to the parties, he could provide explanations and clarifications regarding the content of the terms .[273] Third, because the notary is involved early in the negotiation process, he could assist the parties in re-negotiating the unfair clause before it is memorialized in writing.[274] The notary may carry out this re-negotiation in his preliminary report that states the property's legal status and is sent to the parties before the finalization of the authentic deed.[275] This preliminary report is significant because, similar to the American loan process, it is unlikely that the European bank officer has the authority to edit the contract after the authentic deed is drafted. Additionally, it is unlikely that the borrower, who is relying on receiving the proceeds of the loan, will insist on amending the terms of the contract after a deed has been drafted.

Although the notary cannot initiate a negotiation or re-negotiation between the parties, he is required to highlight unfair terms and to ensure that the parties consciously sub-

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265 *See id.* at 25-26.

266 *See id.* at 26.

267 *See* Erika Arban, *The Doctrine of Strict Compliance in the Italian Legal System*, 23 ARIZ. J. INT'L & COMP. L. 77, 82 (2005) (discussing the use of the form contracts allowed under Article 1342).

268 *See* STUDY, *supra* note 254.

269 *Id.* at 43.

270 *See id.*

271 *See* Ariel Nachman, *The Italian Notary*, CAMERA DI COMMERCUI E INDUSTRIA ISRAEL-ITALIA, http://www.italia-israel.com/The+Italian+Notary (last visited Dec. 17, 2011).

272 *See* STUDY, *supra* note 254, at 43.

273 *See id.*

274 *See id.*

275 *See id.*

scribe to them.[276] If, despite the notary's information and advice, the parties have agreed to unfair terms, the notary will not suffer any negative consequences when he or she authenticates the loan agreement, as long as the notary has disclosed the unfair terms. The notary will not be liable because the notary has fulfilled his duty to provide the information required for the parties to give their informed consent to the loan agreement.

Despite the general principle of requiring objective consent to conclude a contract, counseling or advice of the civil law notary in Italy and other Civil Law countries supports the ability of all parties to give informed consent. Thanks to the advisory and informational roles of the civil notary, which require an explanation of the legal effects and consequences of the contract and contract terms, the contract will more accurately reflect the parties' intentions. Moreover, acting as a public officer subject to statutory laws, the notary must draw up reliable deeds to reflect the parties' intentions, or the notary may be subject to civil, criminal and disciplinary consequences.[277]

The professional role of the civil law notary, as the gatekeeper of legal certainty,[278] has protected EU countries that rely on the notary from economic problems in their own real estate markets similar to the American subprime mortgage crisis. In fact, the role of the civil law notary as a public officer has reduced the risks of fraud and the circulation of fake documents that have become a source for invalidating mortgage documents in the United States.[279] However, European investors purchasing global products, which included RMBS, have suffered losses to their portfolios.

V. CONCLUSION: BETTER UNDERSTANDING OF COMPARATIVE LAW DIFFERENCES IN THE LAW AND PRACTICE OF REAL ESTATE TRANSACTIONS IS ESSENTIAL

A. Understanding these Differences will Better Inform Global Investors Purchasing Mortgages and Other Real Estate Assets

Global investors may have been less enthusiastic about investing in securities that included American subprime residential mortgages if the investors had understood the differences in the mortgage practices between civil law countries and the United States. Both American contract law, which requires only objective, rather than informed, consent, and the Uniform Commercial Code's holder in due course doctrine indicate that borrowers who obtained subprime mortgages on their residences did not appreciate the risk of these financial products.[280] Since the American system has no equivalent to the civil law notary, the risk that

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[276] *See* ROGER VAN DEN BERGH & YVES MONTANGIE, ERASMUS COMPETITION & REG. INST, THEORY AND EVIDENCE ON THE REGULATION OF THE LATIN NOTARY PROFESSION 22 (2006), http://www.seor.nl/media/files/law-and-economics-notaries.pdf.

[277] Nachman, *supra* note 271.

[278] Eliana Morandi, *Il Notaio: Alternativa Civilistica alla Title Insurance?*, Presentation at the Congresso Nazionale del Notario, 5 (Sept. 21, 2005), http://www.notariato.it/export/sites/default/it/primo-piano/congressi-convegni/xli-congresso-naz-notariato-pesaro/OKMorandi.pdf.

[279] *See Responsibilities of the notary*, *supra* note 236.

[280] *See* David Reiss, *Subprime Standardization: How Rating Agencies Allow Predatory Lending to Flourish in the Secondary Mortgage Market*, 33 FLA. ST. U. L. REV. 985, 999-1000 (2006).

borrowers will default on such mortgages is controlled by only the very limited government regulation of lenders, the same regulations that fell to the control of market forces.[281]

These financial products were securitized and sold globally without disclosing the risk that borrowers might default. Furthermore, these securities were not regulated by the Federal Securities and Exchange Commission and were rated by private agencies aligned with market producers.[282] This being the case, it is likely that increased transparency would have discouraged investment in the broad, speculative RMBS market. If there had been more transparency, global investors may have viewed these products as too speculative or risky to include in an investment plan. Ironically, the inflated residential real estate values in the United States may not have occurred, or may not have occurred to such a large extent if not for such intense global investment. The speculative market, which created an increase in both subprime residential mortgages and RMBS in the United States, also contributed to the downturn in the values of both U.S. residential markets and RMBS. Thus, in European civil law countries, the subprime crisis has been a crisis only for financial investors, not for the residential real estate market itself. Conversely, in the United States, the real estate crisis and the financial turmoil created a vicious circle that was broken only by the unprecedented actions of the Federal Government and the Federal Reserve.

B. A Starting Point for American Transactional Attorneys: Appreciating the Role of "Attorney for the Transaction" Played by Civil Law Notary inMost of Europe and Other Civil Law Countries

The civil law notary is a highly experienced and trained transactional attorney (*e.g.* Ten years of transactional experience plus additional educational attainment and passing an examination are required in Italy).[283] Civil law notaries provide a non-adversarial approach to achieving the parties' goals, as well as protecting the public in general, by ensuring that transactions accurately reflect the parties' intentions and be less subject to dispute and litigation in the future.[284] Too many American transactional attorneys believe that the civil law notary's function is merely to perform the title registration as seen in the Torrens System or to provide title insurance, an American invention and industry.[285] American attorneys are reluctant to study the role of the civil notary because of their tendency to value the American approach and reject international approaches. Additionally, until now, there has been a total lack of an adequate comparison of the two systems.[286]

While recent attention in the United States has been directed to reviewing the civil law model in the area of civil dispute resolution, a process that is less adversarial than the American tradition of trial by jury, little attention has been paid to comparative transactional justice. So, while American legal education has begun to consider alternative dispute resolution methods, including mediation and arbitration, and while there is a growing recognition of

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281 *See generally id.*
282 *See generally id. See* THE FIN. CRISIS INQUIRY COMM'N, PUB. NO. 111-21, FINANCIAL CRISIS INQUIRY REPORT 6, 279 (2011).
283 Neary, *supra* note 226.
284 *See Responsibilities of the notary*, *supra* note 236.
285 BARLOW BURKE, THE LAW OF TITLE INSURANCE 1-3 (3d ed. 2004).
286 *See* MURRAY & STURNER, *supra* note 50 (providing an excellent comparison of the U.S. adversarial transaction system with the civil law notary systems in Germany, France, Sweden, and Estonia—although only for residential transactions).

the role of the transactional attorney, there has been no comparative law review of the transactional side of legal practice.[287] Hopefully, attention to these aspects of comparative law and practice will prepare American lawyers to better serve their transactional clients, including those involving real estate, both domestically and internationally. Understanding the comparative lawyering process and notarial model will enable American lawyers to do what transactional lawyers do best: Collaborate with parties to support a win-win result.

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[287] It is noteworthy that American law Professors in their trade organization, the Association of American Law Schools (AALS) started a section on Real Estate Transactions, rather than Real Estate Law, in 2003 and that a new section on Transactional Law was created recently. Legal educational course materials in fields where transactions are at least as relevant as litigation now are available: *e.g.* DANIEL B. BOGART & CELESTE HAMMOND, COMMERCIAL LEASING – A TRANSACTIONAL PRIMER (2d ed., 2011); *see also,* STEVEN BENDER ET AL., MODERN REAL ESTATE FINANCE & LAND TRANSFER – A TRANSACTIONAL APPROACH (3d ed., 2008); *see also* DEBRA P. STARK, RESIDENTIAL REAL ESTATE LAW: A TRANSACTIONAL SKILLS ANALYSIS (2003); *see also* GEOFFREY DURHAM ET AL., COMMERCIAL REAL ESTATE TRANSACTIONS: A PROJECT & SKILLS BASED APPROACH, (2d ed., 2010) and RICHARD S. GRUNER ET AL., INTELLECTUAL PROPERTY IN BUSINESS ORGANIZATIONS: CASES AND MATERIALS (2006); Celeste M. Hammond, *Borrowing from the B Schools: The Legal Case Study as Course Materials for Transaction Oriented Elective Courses: A Response to the Challenges of the MacCrate Report and the Carnegie Foundation for the Advancement of Teaching Report on Legal Education,* 11 TENN. J. OF BUS. L. 9 (2009).