IN THE SUPREME COURT OF OHIO

SHARON WILBORN, *ET AL.*,	:	
	:	CASE NO. 2007-0558
PLAINTIFFS-APPELLANTS,	:	
	:	(ON APPEAL FROM THE SEVENTH
-V-	:	APPELLATE DISTRICT, MAHONING
	:	COUNTY, CASE NO. 04-MA-182)
BANK ONE CORPORATION, *ET AL.*,	:	
	:	
DEFENDANTS-APPELLEES.	:	

BRIEF OF *AMICI CURIAE* EQUAL JUSTICE FOUNDATION, THE OHIO STATE LEGAL SERVICES ASSOCIATION, SOUTHEASTERN OHIO LEGAL SERVICES, NORTHEAST OHIO LEGAL SERVICES, LEGAL AID OF WESTERN OHIO, ADVOCATES FOR BASIC LEGAL EQUALITY, THE LEGAL AID SOCIETY OF COLUMBUS, THE LEGAL AID SOCIETY OF CLEVELAND AND THE COALITION ON HOMELESSNESS AND HOUSING IN OHIO IN SUPPORT OF THE PLAINTIFFS-APPELLANTS

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STATEMENT OF THE INTERESTS OF THE *AMICI CURIAE*

The Equal Justice Foundation (EJF) is a statewide nonprofit organization located in Columbus. It was established in 1996 to represent the poor and others who otherwise would not have access to the legal system. EJF has filed lawsuits, including class-action litigation, on behalf of the disabled, minorities, migrants, children, the aging, victims of predatory lending and consumer scams, tenants denied their rights, and victims of police abuse. EJF has brought or defended many actions involving mortgage foreclosures, many caused in substantial part by the injection of attorneys' fees as an insurmountable obstacle preventing the resolution of loan default issues.

The Ohio State Legal Services Association (OSLSA), a nonprofit corporation formed in 1966, is the primary provider of civil legal services to the low-income people of Appalachian Ohio. OSLSA's Southeastern Ohio Legal Services program (SEOLS), which has offices in nine southeastern Ohio communities serving thirty counties, opened ninety cases involving a threat to the homes of low-income people during the fifteen months ending March 31, 2007. OSLSA also provides support services, including training, coordination of advocacy, technical assistance, and publications on housing, consumer, and mortgage defense law, to all of Ohio's legal aid societies through its State Support Center in Columbus.

Northeast Ohio Legal Services (NOLS) is a publicly funded, non-profit corporation that provides free legal services in civil matters to low-income individuals living in a ten county region of central northeast Ohio. Preserving the homes of low-income individuals by providing representation in foreclosure proceedings is one of its

major priorities. Frequently in foreclosure cases, reinstatement of the mortgage or some other settlement and compromise is the best and perhaps only hope of saving a client's home. It is NOLS' experience that every dollar owed becomes crucial and the inclusion of attorneys' fees by the industry create a significant impediment to the resolution of foreclosure cases of low-income individuals.

Legal Aid of Western Ohio, Inc. (LAWO) and Advocates for Basic Legal Equality, Inc. (ABLE) are non-profit corporations organized under the laws of the State of Ohio. LAWO and ABLE provide free, high quality legal assistance to low-income persons in thirty-two counties in northwest and west central Ohio who cannot afford to hire a private attorney to help them with their legal problems. LAWO and ABLE represent low-income persons and groups in a variety of areas including consumer, civil rights, family law and housing law. An increasing number of LAWO and ABLE clients need help with mortgage foreclosure and debt collection cases that frequently involve predatory loans, house flipping, and other illegal lending practices. Mortgage provisions that automatically require the borrower to pay attorney fees as a condition of reinstating a mortgage often force involuntary relocation of our clients. It is important to LAWO and ABLE clients that lenders seek attorney fees as allowed by law only for fair and reasonable actual costs incurred by the lender, and that lenders not allow the demand for attorney fees to become an undue barrier to otherwise reasonable agreements that would allow clients and their families to remain in their homes.

The Legal Aid Society of Columbus (LASC) represents low income persons and seniors in cases involving basic human necessities such as housing, unemployment,

public benefits, consumer, access to health care, domestic violence and family law in a six-county area of central Ohio. Often the clients face a number of economic challenges, and the addition of legal fees to reinstate a mortgage in foreclosure will cause many LASC clients to lose homes that they might otherwise have been able to save. This creates a cascading problem of foreclosure, abandonment of homes, and the deterioration of many communities.

The Legal Aid Society of Cleveland, founded in 1905, is the law firm for low-income families in Northeast Ohio. Legal Aid's mission is to secure justice and resolve fundamental problems for those who are low income and vulnerable by providing high quality legal services and working for systemic solutions that empower those we serve. The attorneys of the Legal Aid Society of Cleveland represent clients in civil law cases and primarily address issues of consumer law, housing law, domestic relations, immigration, community development, and issues of health, education, work and income. Defending consumers in foreclosure litigation is and has been a significant part of Legal Aid's practice, including settlement negotiations that often result in the reinstatement of loans. In that vein, the Legal Aid Society of Cleveland joins this *amicus curiae* brief because the issue before the Court impacts upon the ability of consumers to access the availability of loan reinstatement as a practicable option. As such, clarification of Ohio's public policy on the payment of attorney fees as an element of loan reinstatements is of central interest to consumers and the clientele that are served by Legal Aid.

The Coalition on Homelessness and Housing in Ohio is a non-profit corporation organized to advocate for the end of homelessness and for the availability of decent, safe,

fair, affordable housing particularly for low income Ohioans. COHHIO has more than 600 organizational members throughout the State of Ohio, numbers of which represent homeowners and borrowers who are victims of predatory mortgage lending.

STATEMENT OF THE CASE AND OF THE FACTS

The *Amici* herewith adopt the Statement of the Case and of the Facts as set forth in the Brief of the Plaintiffs-Appellants.

ARGUMENT

For more than a century the American Rule reigned supreme in Ohio: contract clauses requiring defendants to bear the burden of plaintiffs' attorneys' fees in the absence of statutory authorization or bad faith were deemed contrary to public policy and, therefore, unenforceable. *Miller v. Kyle* (1911), 85 Ohio St. 186 and its predecessors. A score of years ago, some judicially created, narrow exceptions were recognized, citing ostensibly new circumstances. *Worth v. Aetna Cas. & Sur. Co.* (1987), 32 Ohio St.3d 238, and *Nottingdale Homeowners' Assn. v. Darby* (1987), 33 Ohio St.3d 32. It is now clear, however, that the brave new mortgage market world is reason alone for the Court not to reward home mortgage lenders by abandoning the American Rule on fees. In addition, the Court should, as matter of law, decline to widen the exceptions. In short, the *Amici* urge the Court to reverse the Seventh District Court of Appeals and hold for the plaintiffs-appellants' proposition of law that the Court has agreed to review.

I. THE BRAVE NEW MORTGAGE MARKET IS REASON ALONE FOR THE COURT NOT TO REWARD HOME MORTGAGE LENDERS BY ABANDONING THE AMERICAN RULE ON FEES.

If this court accepts the Seventh District Court's recounting of the evolution of the *Miller* rule, then it must concede, as did that court, that changed circumstances might require reconsideration of debt-related fee shifting. While the court below paid lip

service to *Miller*, it said two 1987 cases[1] reflected a newer social and economic context for attorney fee considerations. The Seventh District failed to recognize the even newer social and economic context. *Amici* argue that the American mortgage lending market has thoroughly transformed since 1987, and these radical changes require that this Court consider the one-sided attorney fee "condition" in mortgage reinstatement provisions in a new and very different light.

Borrowers looking for money; or money looking for borrowers? In 1987 the mortgage market's predominant driving force was borrowers looking for money. However, by 2000 that fundamental market dynamic was supplanted by a reversed and counterintuitive market driver: money looking for borrowers. Since the 1990s this new dynamic in the global capital markets has increasingly powered the mortgage lending industry. The fundamental change in mortgage lending suggests that this court reassess the commercial realities underlying most home mortgages and the related and tragic foreclosure wave flooding the Ohio courts. Indeed, this case presents the court with an opportunity to reexamine traditional, long held but no longer correct notions about how

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[1] *Worth v. Aetna Cas. & Sur. Co.* (1987), 32 Ohio St.3d 238, 513 N.E.2d 253, and *Nottingdale Homeowners' Assn. v. Darby* (1987), 33 Ohio St.3d 32, 514 N.E.2d 702. We do not agree that either of these cases should control upon their fundamentally dissimilar facts (commercial indemnity contract and foreclosure to collect condominium association fees) but we note that this court succinctly stated what we believe the appropriate rule is here based upon the facts of this case:

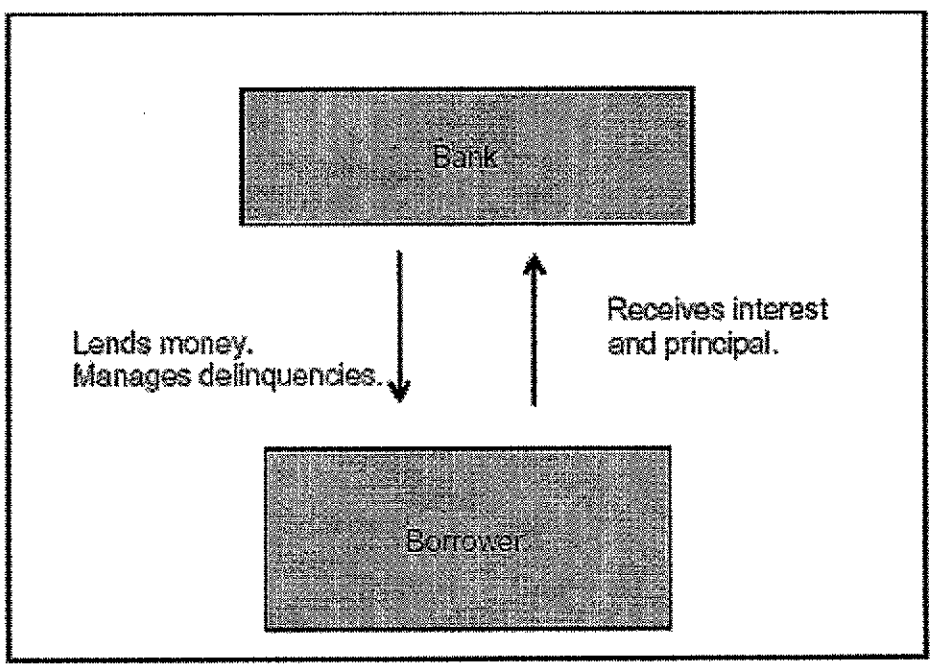
> When a stipulation to pay attorney fees is incorporated into an ordinary contract, lease, note or other debt instrument, it is ordinarily included by the creditor or a similar party to whom the debt is owed and is in the sole interest of such party. In the event of a breach or other default on the underlying obligation, the stipulation to pay attorney fees operates as a penalty to the defaulting party and encourages litigation to establish either a breach of the agreement or default on the obligation. In those circumstances, the promise to pay counsel fees is not arrived at through free and understanding negotiation.

Worth, 33 Ohio St.3d at 242-43.

mortgage loans are originated, funded, sold and serviced. *Amici* contend that Ohio's judicial foreclosure process desperately needs policy adjustments that will meet this new, and too often treacherous, "top down" industry dynamic that is visiting incomprehensible suffering and damage across Ohio.

Perhaps the most concise presentation of just how radically the home mortgage market has changed is contained in two graphics prepared by the FDIC.[2] The first diagram presents the "old fashioned" understanding of how mortgage lending happens.

Borrowing Under the Traditional Borrower/Lender Relationship



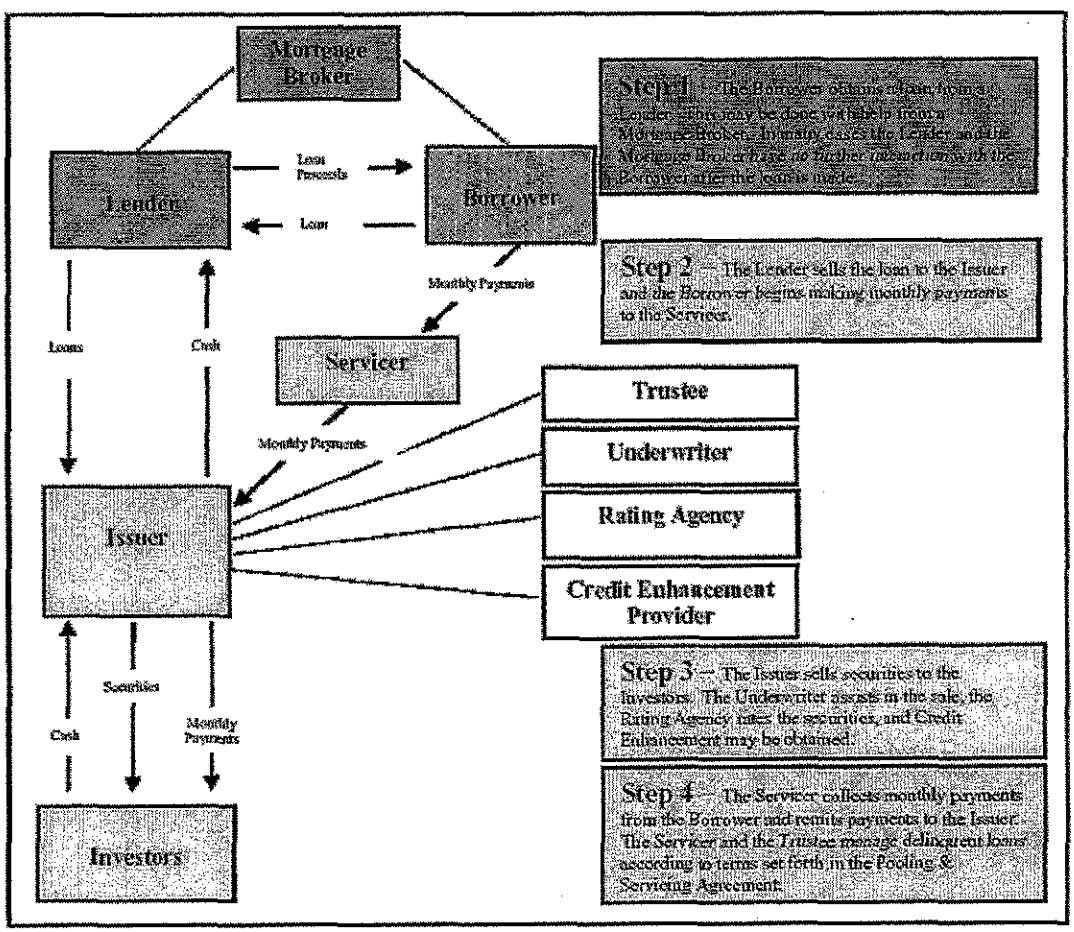
Under this simple, basically bipolar relationship the bank probably held the resulting mortgage in its own portfolio and thereby accepted the risk of the borrower defaulting on

[2] "Possible Responses to Rising Mortgage Foreclosures", Testimony of Sheila C. Bair, Chairperson, FDIC, before the Committee on Financial Services, U.S. House of Representatives, April 17, 2007.

the loan over its 15 to 30 year term. In this scenario *the borrower approached the lender* for funds to buy a home, or sometimes to refinance the home. It was unheard of for the lender to "push market" its mortgage products to potential borrowers with direct mail and telephone come-ons for ridiculously unrealistic mortgage loans. The lender was probably smaller, locally based and controlled limited, local funds for home mortgage lending. Driven by the need to radically expand the capital pool available for home mortgages following World War II, this straightforward local relationship has been replaced by a complex, global secondary mortgage market that has transformed not just how mortgages are funded, but also, how mortgages are marketed to and originated with borrowers.

The new mortgage industry has morphed into an incredibly complicated set of interdependent networks summarized in the diagram below, again courtesy of the FDIC:

Borrowing Under a Securitization Structure



The congressionally chartered Government Sponsored Enterprises (GSEs) – Fannie Mae, Freddie Mac and their related agencies, Sallie Mae and Ginnie Mae – pioneered this capital aggregating system. It was remarkably adept at putting together groups of mortgages and selling their collective cash flows to investors. The investor funds could then be put immediately back into the post-war American housing expansion where the old, locally funded system was now proving woefully inadequate to the task. As a rule, these GSEs were very conservative in the kinds of mortgages they would accept for packaging and re-sale to investors. However, in the 1990s "private" mortgage backed securities emerged as an alternative secondary market to take on riskier "non-conforming" subprime mortgages for sale to investors. This private "mortgage backed securities" (MBS) market grew exponentially with the broader acceptance of riskier and more profitable subprime (and later on, other non-conforming) loans. In 2000, $53 billion in subprime loans were securitized and sold in this relatively new private market. By 2005 that number had grown to $465 billion. Investors couldn't get enough of these new-fangled, high margin securities.

Along the way, the dynamic for mortgage originations shifted from the traditional borrower-driven market to an investor-driven market. The higher returns on subprime loans coupled with the rising real estate values created a false sense of subprime's diminished risk in the capital markets. Investors began to demand more and more of these high yield subprime MBS vehicles to invest in. Wall Street investment banks began putting together "shelf" security filings with the Securities Exchange Commission, empty vessels that were created *in anticipation of subprime loans that had not yet been*

originated. As recently as 2006, investor demand for these securities seemed endless, creating pressure to loosen standards even more on the originating side of the market, where brokers and lenders interacted with borrowers. Underwriting standards fell precipitously, leading to increasingly sloppy and reckless loans. The results have come home to roost and appear in the graph below.[3]

The graph is a representation of the default rates over time (months) for subprime loan "vintages" written between 2000 and 2007. The more vertical the line, the faster the loans from that year are going into default. What is clear from this vintage representation is that the loans originated after 2004 became more and more problematic, indicating underlying problems with the fundamental principles of sound underwriting. While the media picked up on these problems beginning in 2004, the investor appetite for the securitized loans and their (initial) high returns only grew. [4]

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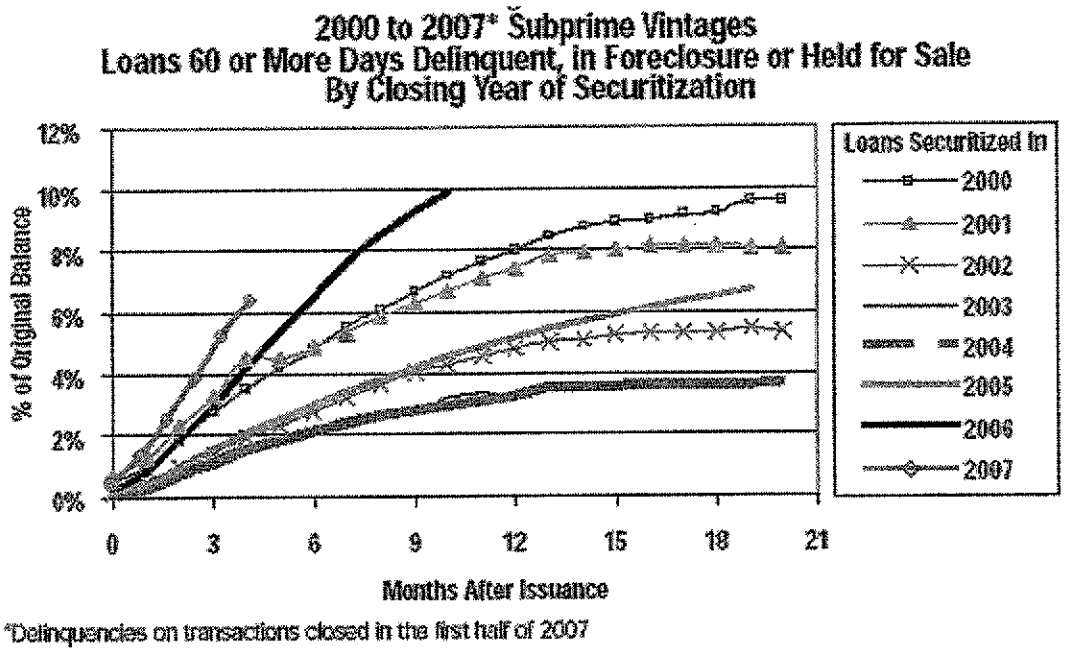
[3] *US Subprime Mortgage Market Update: September 2007*, Moody's Special Report, October 2007,
available at:
http://www.moodys.com/moodys/cust/research/MDCdocs/03/2007000000444240.pdf?frameOfRef=structured

[4] From BusinessWeek feature on the increase in Option ARM loans that appeared the fall of 2006:

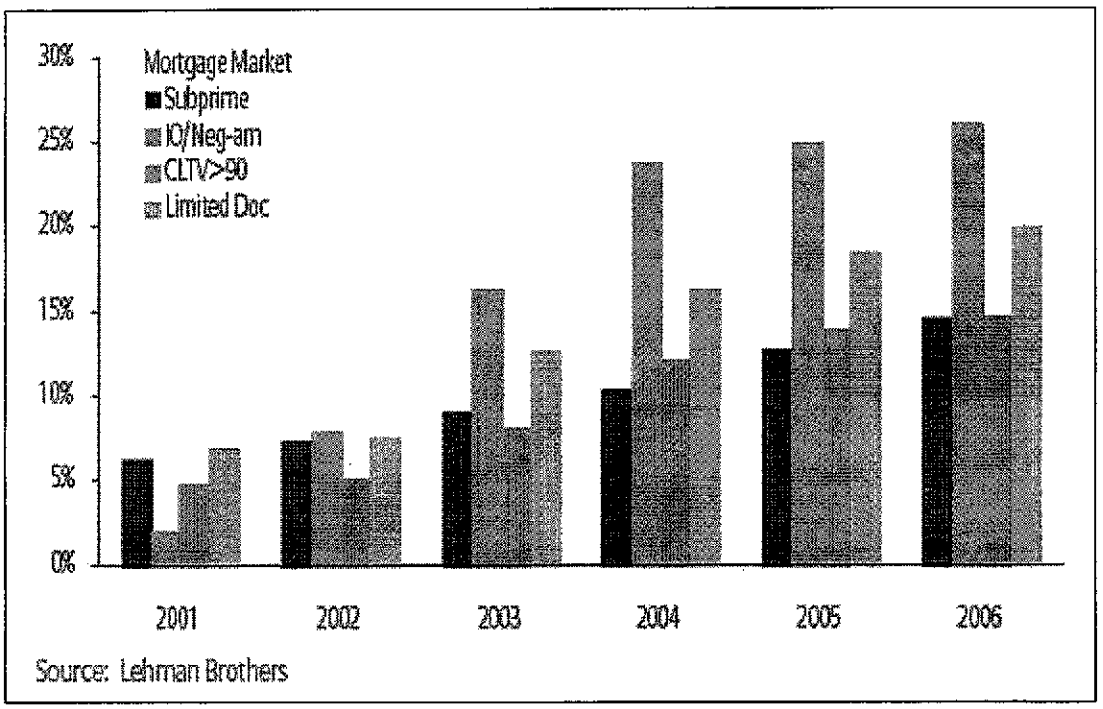
> Concerns like these haven't curbed Wall Street's hunger for option ARMS. "At a price, you can originate or sell anything," says Thomas F. Marano, global head of mortgage and asset-backed securities at Bear Stearns. Hedge funds have been particularly active, buying risky loans directly from banks and cutting out the bundlers in the middle. Kathleen C. Engel, an associate professor of law at Cleveland-Marshall College of Law at Cleveland State University, says Wall Street and hedge fund money has helped to finance widespread lending abuses, particularly among the most vulnerable borrowers . . . .
>
> Why are hedge funds willing to buy risky loans directly? Because they can demand terms that help insulate them from losses. And banks, knowing what the hedge funds want in advance, simply take it out of the hides of borrowers, many of whom qualify for lower rates based on their credit histories. "Even if the loan goes bad, [the hedge funds are] still making money hand over fist," says Engel.

Nightmare Mortgages, Mara Der Hovanesian, BusinessWeek, September 11, 2006.



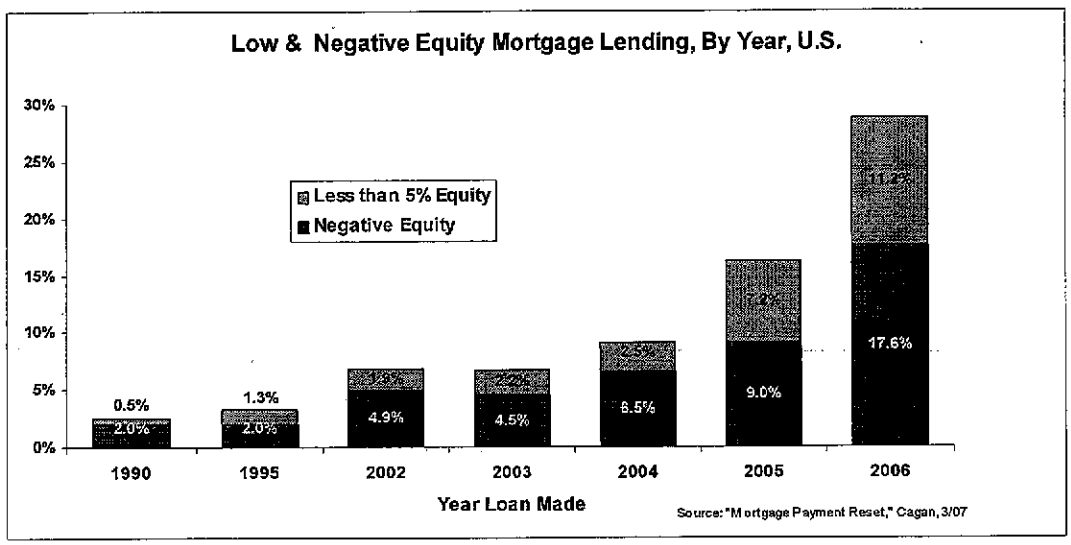
Aggravating the problem that has come to be called the "Subprime Meltdown" or "Subprime Crisis" were newly developed, too creative, mortgage loan products grown so recently notorious: Low and No Documentation loans ("liar loans"), Interest Only Loans, Option ARMS (also known as "negative amortization" loans), Teaser Rate 2-28 "exploding" Subprime ARM loans, and Alt-A "near prime" loans. These new "exotic" products were ceaselessly flogged across the industry and grabbed more and more market share even as the real estate boom was showing signs of an imminent demise.[5]

[5] From *Still Renting*, Mark Kiesel, U.S. Credit Perspectives, PIMCO, May, 2007. available at: http://www.allianzinvestors.com/documentLibrary/mutualFunds/supportingLiterature/generalLitature/US_credit_perspectives_aa020.pdf



Adding insult to injury, the land-rush mentality that fueled the mortgage lending excesses of the late 1990's and early 2000's encouraged the widespread phenomenon of inflated home appraisals. Too often mortgage brokers and loan officers (who were paid on commission) controlled the home valuation process. They would put pressure on real estate appraisers to hit "target values" on homes so that the collateral for a loan package would "make the numbers work." While many appraisers resisted their importuning, it was a losing game for appraisers with integrity. If an appraiser didn't meet the "expected" valuation the brokers and loan officers could retaliate by not paying the appraiser for their work, or worse, by refusing to make future referrals to the uncooperative appraisers. Honest appraisers learned that if they would not compromise, there was always a competitor in the market who was not so inflexible. Too often the

most accommodating appraisers in a market prospered, while the appraisers with integrity either left the business or found themselves competing for an ever shrinking pool of assignments. The upshot of these widespread practices is captured by the graph below.[6]



Back before the advent of subprime, exotic mortgages, and the voraciously expanding private MBS market, the high loan to value mortgage (where the loan amount is at or near 100% of the value of the home) was the rare exception in mortgage lending. But by 2006 loans for *more* than value of the underlying home comprised nearly 17.6% of all the mortgages originated in that year, while loans between 95% and 100% of value comprised 11.2%. Thus, according to the data from a respected real estate economist and researcher, nearly 20% of the mortgage borrowers in the United States in 2006 left the closing table "underwater." And then the cooling real estate market added to their woes.

Now Ohio, and more recently the nation, is awash in mortgage defaults and home foreclosures, the wages of this heedless and incessant push to sell more and shakier loans to marginal borrowers so as to feed more and more fodder to the insatiable subprime

[6] *Mortgage Payment Reset: The Issue and the Impact*, Stephen L. Cagan, First American

securitizers and MBS investors. One result of this excess on the part of the mortgage industry is belated acknowledgment of the role these new-fangled products have played in undermining economic stability from local neighborhoods on up and through international credit markets. Former optimistic assurances of the "containment of the subprime contagion" have given way to begrudging acknowledgement of the virulent subprime "pathogen." Witness the Federal Reserve's recent about face on interest rates; depositor bank runs in England (Northern Rock); the near collapse of Countywide Financial (the nation's largest mortgage lender); and the most recent evidence panic gripping international financial markets, a proposed bail out of the world's largest bank, Citigroup. Encouraged by federal regulators, a consortium of lenders is hoping to artificially support the hundreds of billions of dollars worth of swooning subprime-collateralized securities Citigroup now holds both on and off its balance sheet.[7]

Amici submit that radically changed circumstance require that this court reconsider the latest permutation of the *Miller* rule and adjust the "shifting fee shifting" back to the traditional American rule: absent statutory or bad faith considerations, each party should pay its own counsel.

This fee shifting rule change is required by sound public policy and is best explained by reference to Governor Strickland's recent proposed "Compact to Help Ohioans Preserve Homeownership" with the 20 largest subprime mortgage servicers in Ohio. This Compact is the latest state effort to take the emerging consensus around the

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Core Logic, March 2007.

[7] *Big Banks Push $100 Billion Plan To Avert Crunch*, Carrick Mollenkamp, Ian McDonald and Deborah Solomon, Wall Street Journal, October 13, 2007.

causes, nature and extent of the subprime foreclosure crisis and pressure[8] cooperation from mortgage loan servicers. Servicers are in the business of administering mortgage loans, collecting payments, allocating fees, and paying investors and are responsible to work with defaulting borrowers either to modify loans or to reinstate loans with forbearance agreements or to foreclose loans. The Compact begins with a recitation concerning the scope and nature of the challenges facing Ohio:

> In the last three (3) years, Ohio has consistently had one of the highest rates of foreclosure and percentage of "seriously delinquent" loans. The number and rate of home foreclosures in Ohio threatens the stability of families and communities.
>
> Foreclosures, evictions, and sales of foreclosed properties are expensive and time-consuming processes for the Servicers and the noteholders to whom the Servicers report. Recent data suggest that foreclosure of a mortgage loan translates into a 40-50% loss of expected return to the holder of a mortgage note.
>
> The primary source of Ohio foreclosures and delinquencies today are subprime residential mortgage loans. Approximately 33% of Ohio's subprime Adjustable Rate Mortgage ("ARM") loans were already in foreclosure or at risk of foreclosure by the end of 2006 and accounted for 63% of the foreclosure starts within Ohio in 2005.
>
> Delinquencies and foreclosures are expected to increase further in Ohio beginning the fall of 2007 as an estimated 150,000 to 200,000 subprime ARM loans valued at approximately $14 billion are scheduled to reset at higher rates through 2008. The Parties anticipate that many Ohioans will neither be able to

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[8] The term "pressure" is used advisedly. Notwithstanding the best public relations efforts of the servicing industry to convince policy makers and legislators of their commitment to ameliorating the damages to borrowers and communities from these defaulting loans, the hard evidence is that they have refused to initiate efforts of scale to keep these loans as "performing" assets:

> Specifically, the (Moody's) survey showed that most servicers had only modified approximately 1% of their serviced loans that experienced a reset in the months of January, April and July 2007. . . Based on the survey results, Moody's is concerned that the number of modifications that will be performed in the future by subprime servicers on loans facing reset may be lower than what will be needed to significantly mitigate losses in subprime pools backing rated securitizations.

Moody's Subprime Mortgage Servicer Survey on Loan Modifications, Special Report, September 21, 2007.

afford the higher monthly mortgage payments resulting from these resets, nor be able to extinguish their debts by refinancing or selling their homes.

Without systematic and expeditious modification to existing subprime loans in Ohio, an unprecedented number of Ohioans will lose their homes to foreclosure within the next twelve months. An unprecedented number of foreclosures in Ohio would also mean unprecedented losses for the Servicers and the noteholders to whom the Servicers report.[9]

The proposed Compact specifically focuses on three types of loans that will require extraordinary efforts to resolve in favor of borrowers keeping their homes: "low and no doc" loans where there was little or no effort to verify and underwrite the loan at the time of origination; "exploding" subprime Adjustable Rate Mortgage loans where the loan was granted based upon a temporary "teaser" interest rate set to explode upward after a two or three year fixed period; and loans based upon inflated appraisals leaving few options for borrowers who are struggling to pay down on loans that exceed the value of their underlying homes. In all instances the Compact requires cooperating servicers to waive accumulated, post-default fees where they would impede a successful and sustainable loan workout. Attorney fees are specifically included in the list of potential impediments to transforming a defaulting loan into a "performing asset":

3.1 Servicers pledge to modify loan terms to the greatest extent possible so as to provide permanent, affordable relief to Ohio borrowers, doing so in accordance with their fiduciary, legal and contractual obligations and in accordance with prudent mortgage lending and servicing practices. Where necessary to keep or make a loan a performing asset, and in accordance with existing contractual obligations, Servicers pledge to waive late fees, pre-payment penalties, refinancing or modification fees, inspection fees, security fees, *and attorney fees*, and to include Servicers escrows for taxes and insurance if not already present. When possible, Servicers also pledge to avoid the submission of adverse credit information to any credit reporting agency where borrower's

[9] Available at:
http://governor.ohio.gov/News/October2007/News10907/tabid/365/Default.aspx

> acceptance of any of the following modifications keeps or makes the subject loan a performing asset.[10]

As the Governor's proposed compact makes clear, efforts to expeditiously resolve as many of these loans as possible serves the interests all the parties (and sub-parties) to the loan agreement, and the aggregated fees, including attorney fees *whether justifiable or not, under ordinary conditions* are now simply a needless and punitive impediment to dealing with the foreclosure crisis and the extensive damage that crisis is causing to Ohio and its people.

If ever there was a propitious time to return to the traditional American Rule concerning attorney fees in debt instruments, this is it. Culpability for a looming economic disaster rests with all the parties to these loans, including borrowers. But unlike borrowers, the industry from brokers, on up to lenders, banks, investment banks, rating agencies, investors and servicers has contributed to vast private fortunes creating, marketing, securitizing and speculating in these irresponsible, sub-par loan products. It is well past time the industry was forced by sound public policy considerations to accept some of the costs incident to their reckless commercial conduct, including, at a minimum, accepting responsibility for payment of their own counsel's fees.

II. THE COURT SHOULD AS A MATTER OF LAW DECLINE TO WIDEN THE EXCEPTIONS TO THE AMERICAN RULE.

For well over a century, the American Rule reigned supreme in Ohio and contract clauses requiring defendants to bear the burden of plaintiffs' attorney fees in the absence of bad faith were deemed contrary to public policy and therefore void and unenforceable. *Miller v. Kyle* (1911), 85 Ohio St. 186; *Leavens v. Ohio Natl. Bank* (1893), 50 Ohio St.

[10] *Id.* Article III, Utilize Preferred Workout Methods (emphasis added).

591. Although this Court has carved exceptions to Miller's holding, those exceptions should not be applied to debt instruments executed in today's mortgage market. In *Worth v. Aetna Cas & Ins. Co.* (1987), 32 Ohio St.3d 238, this Court wrote.

> When a stipulation to pay attorney fees is incorporated into an ordinary contract, lease, note or other debt instrument, it is ordinarily included by the creditor or similar party to whom the debt is owed and is in the sole interests of such party. In the event of a breach or other default on the underlying obligation, the stipulation to pay attorney fees operates as a penalty to the defaulting party and encourages litigation to establish either a breach or a default on the obligation. In those circumstances, the promise to pay counsel fees is not arrived at through free and understanding negotiation.

Id. at 242 - 43. In *Nottingdale Homeowners' Association v. Darby* (1987), 33 Ohio St.3d 32, a condominium instrument's provision requiring a defaulting party to pay the attorney fees incurred in either a collection or a foreclosure action was deemed "enforceable and not void as against public policy *so long as the fees awarded are fair, just and reasonable as determined by the trial court upon full consideration of all of the circumstances of the case.*" *Id.* at syllabus (emphasis added).

While grounded on principles of the fundamental right to contract, the *Nottingdale* decision tempered this right against considerations of the parties' respective bargaining positions and whether the provision was the result of free and understanding negotiations. In *RB-3 Assoc. v. M.A. Bruder & Sons, Inc.*, 1996 U.S. Dist. LEXIS 22516, 1996 WL 1609231 (S.D. Ohio Aug. 26, 1996), the court found that Nottingdale emphasized the importance of equality of bargaining power in determining whether contract provisions should be enforced.

> This Court will interpret Nottingdale as standing for the proposition that, although the important principle of freedom of contract generally weighs in favor of enforcing provisions which provide for the payment of attorneys fees, public policy requires that such provisions be unenforceable where there is a lack of

> equal bargaining power. Accordingly, attorney fees provisions in commercial transactions, which are negotiated in a fair manner by parties with equal bargaining power, are enforceable under Ohio law.

Id. at *7.

Compare such commercial transactions, entered into between parties of equal bargaining power and the freedom to negotiate, with that of a homeowner entering into a residential mortgage transaction with a lender. "[T]he mortgage and note are the ultimate contracts of adhesion. The consumer needs the mortgage and note to buy or keep housing . . . . The mortgage and note are rarely presented before the scheduled closing date. Therefore, the consumer has no real opportunity to negotiate the costs and terms associated with the mortgage and note." Dudley, Kelli, "Behavioral Economics in the Mortgage Lending and Mortgage Foreclosure Contexts," *The John Marshall Law School Fair & Affordable Housing Commentary*, 2006. In this context, the exception to the American Rule created in the holdings of *Washington Mutual Bank v. Mahaffey* (2003), 154 Ohio App.3d 44, 2003 Ohio 4422, *Davidson v. Weltman, Weinberg & Reis*, 285 F.Supp.2d 1093 (S.D. Ohio 2003), and affirmed in *Wilborn v. Bank One*, 7th App. No. 04-MA-182, 2007 Ohio 596, 2007 LEXIS 565, is clearly unsound, and weakens contract principles.

In 2003, the Second District Court of Appeals carved out an exception to the American Rule and held that it is not against public policy to enforce a fee-shifting provision of a promissory note or mortgage against a defaulting borrower as a condition of allowing the borrower to reinstate.

> We see nothing against public policy in imposing the requirement of the payment of attorney fees expended in foreclosure proceedings as a condition of reinstatement of a mortgage loan. If the loan were not reinstated, the borrower would be entitled to its remedies in foreclosure, and it has expended attorney fees toward that end. It is reasonable that the mortgagee should require, as a condition of abandoning the foreclosure action and reinstating the loan, that it recover its attorney fees expended in the foreclosure that it is abandoning.

Washington Mutual Bank v. Mahaffey, 154 Ohio App.3d at 52, 2003 Ohio 4422 at ¶39. Payment of attorney fees was permitted because they arose "merely [as] a condition of reinstatement, not [as] an obligation that arises in connection with the enforcement of the contract." *Id.* In *Davidson*, the court rested its decision on the rationale of *Mahaffey* stating:

> Miller and its progeny were concerned with attorney's fees constituting a penalty against the debtor upon default or breach of the contract. Due to the decision in Nottingdale, the continued viability of that holding is in doubt. The Court need not resolve that question, however, because, as indicated in Mahaffey, the requirement of the payment of attorney's fees as a condition of reinstatement does not arise in connection with the enforcement of the mortgage contract, i.e., the default itself.

Davidson v. Weltman, Weinberg & Reis, 285 F.Supp.2d at 1102 (footnote omitted). In doing so, the *Davidson* court furthered the legal fiction that a fee-shifting provision, contained in a contract of adhesion in which one party has little or no bargaining power and has no realistic choice as to terms, may be rehabilitated by limiting its application to mortgage reinstatement after default.

In *Wilborn v. Bank One*, 7th App. No. 04-MA-182, 2007 Ohio 596, 2007 Ohio App. LEXIS 565, the appellate court upheld the theory that a contract term that could not be enforced through a foreclosure judgment is properly applied as a condition of reinstatement. The trial court held, and the appellate court affirmed, "that Ohio common law did not prevent the parties from agreeing to pay reasonable attorney fees in

connection with a mortgage reinstatement provision or alternate workout agreement. . . . [T]he trial court reasoned that the 'payment of attorney's fees in the context of a reinstatement of a mortgage is not synonymous with the payment of attorney's fees in the context of default on a note or mortgage." *Id.* at *¶7. The Seventh District Court of Appeals concluded:

> First, here, the attorney fee provision was incorporated into the mortgage by the lender. However, like the situation in *Worth*, such a provision is not in the sole interest of the lender. The provision allows the borrower to work out an agreement with the lender and retain their home. Additionally, it is unlike the situation in *Miller* where it was clear that the attorney fee provision was one-sided in favor of the lender and acted as a penalty upon the borrower.
>
> Second, the distinction highlighted in *Mahaffey* is persuasive. The payment of attorney fees is only a condition for reinstatement, not an obligation that arises in connection with the enforcement of the loan contract.

Id. at *¶43-¶44. There is no justification for the conclusion that a demand for attorney fees that would be a penalty if sought in connection with a foreclosure judgment should be deemed permissible in the context of reinstatement.

The reinstatement exception to the American Rule is based on tortured logic and should be overturned. First, it is based upon the false premise that homeowners facing the loss of their homes through the foreclosure process have equal bargaining power to lenders offering reinstatement because the fee-shifting provision "allows the borrower to work out an agreement with the lender and retain their home." *Id.* at *¶43. Second, the contention that the fee-shifting provision is not in the sole interest of the lender ignores the fact that it is one-sided and that reinstating a mortgage after default generates substantially more profit for the lender and investor than obtaining a judgment in foreclosure – provided that the homeowner is able to afford the monthly mortgage

payment. Third, because today's mortgage loans are priced according to the credit risk present by an individual borrower, the potential costs of enforcing the mortgage have been factored into the interest rate and fees charged at loan origination; therefore, the attorney fees demanded as a condition of reinstatement are much more akin to an illegal penalty than a payment to make the lender whole.

A. *Attorney Fee Provisions Are Illegal Penalties.*

Ohio law disfavors terms that exact a penalty for the breach of a contract. "The complete freedom to contract, however, is not permitted in certain circumstances for public policy, such as when stipulated damages constitute a penalty. 'Punishment of a promisor for having broken his promise has no justification on either economic or other grounds and a term providing such a penalty is unenforceable on the grounds of public policy.'" *DeCastro v. Wellston City School District Board of Education* (2002), 94 Ohio St.3d 197, 201, citing to 3 Restatement of the Law 2d, Contracts (1981) 154, § 356, comment a.

To the extent that the costs of default have been factored into the pricing of mortgage loans, enforcing a fee-shifting provision as a condition of reinstatement penalizes homeowners who can least afford it.[11] "Subprime borrowers have lower

[11] Economists once theorized that residential mortgage borrowers would choose to default on their mortgages if the value of their homes fell below the outstanding loan amount, thus requiring lenders to purchase their home in exchange for mortgage elimination. Quercia, McCarthy, and Stegman, "Mortgage Default among Rural, Low-Income Borrowers," *Journal of Housing Research*, Vol. 3, Issue 3, © Fannie Mae 1995; Elmer and Seelig, "Insolvency, Trigger Events, and Consumer Risk Posture in the Theory of Single-Family Mortgage Default," FDIC Working Paper 98-3. Research has invalidated this theory and insolvency is recognized as the primary reason for default. "Overall, cash flow changes and crisis events were found to have significant effects on default. In contrast, the level of equity was found to have not effect on default." Quercia, et al.

incomes and inconsistent credit histories, forcing them to pay high interest rates, sometimes double-digit interest rates, to get their loans." Gramlich, Edward M., "America's Second Housing Boom," The Urban Institute, No. 7, February 2007. The higher costs of subprime loans are based upon the theory of risk-based pricing in which a borrower who "presents a greater measurable risk of loss to the lender pays higher interest rates and fees that directly reflect the marginal cost of the additional risk." White, Alan M., "Risk-Based Mortgage Pricing: Present and Future Research," Housing Policy Debate, Vol. 15, Issue 3, © Fannie Made Foundation 2004.

B. *Reinstatement Benefits Lenders.*

In *Wilborn*, the appellate court contends that fee-shifting provisions are not one-sided in the sole interest of the lender, as if such fees could be viewed as reasonable consideration for granting to the borrower an opportunity to "re-contract." However, reinstatement provides substantial financial benefits to lenders that are not available through foreclosure judgment, primarily the continuation of interest income. The profit realized from interest is the reason that prepayment penalties are so prevalent in subprime loans. Gramlich, Edward M., "Booms and Busts: The Case of Subprime Mortgages," Senior Fellow, Urban Institute, Presented in Jackson Hole, Wyoming, August 31, 2007. While the "prime mortgage market consists largely of long-term fixed-rate mortgages . . . the subprime market contains all kids of exotic instruments—interest-only loans, negative amortization mortgages, and the real menace, 2/28 loans. Under these, the interest rate is fixed for two years and then becomes adjustable for 28 years. Often lenders offer teaser rates in the first two years, and borrowers suffer what are known as serious payment

shocks after that. But these loans also contain prepayment penalties that last longer than two years." *Id.*

C. *There is No Determination of the Reasonableness of the Fee.*

Homeowners are at a substantial disadvantage in their dealings with lenders. "After a loan is closed, consumers may be subject to loan servicing practices that extract monies not owed under the loan terms or that inhibit refinancing options with another lender. A lender may provide inaccurate monthly-payment demands, adding fees and charges that are not owed. Because of the complexities of loan terms, it is difficult for the borrower to know whether the lender's payment demands are accurate. A lender also may fail to provide the consumer with full or accurate pay-off information, and at the same time aggressively solicit the borrower to refinance with the lender. Consequently, the borrower becomes tied to a lender without a means of escape." Prepared Statement of the Federal Trade Commission before the House Committee on Banking and Financial Services on Predatory Lending Practices in the Subprime Industry, May 24, 2000.

When lenders file foreclosure complaints, homeowners wishing to reinstate are not able to negotiate a mortgage "workout" with the lender as suggested below in *Wilborn*. Lenders submit reinstatement demands that homeowners may accept or decline—there is no negotiation. Therefore, assessing attorney fees as condition of reinstatement presents a particularly insidious problem for homeowners. Reinstatement occurs outside of the judicial process, courts do not review reinstatements to ensure that the fees and costs charged to the homeowner are reasonable and fair. In *Nottingdale*, this Court held that fee-shifting provisions are "enforceable and not void as against public policy *so long as the fees awarded are fair, just and reasonable as determined by the*

trial court upon full consideration of all of the circumstances of the case." *Nottingdale*, at syllabus (emphasis added). No mechanism exists by which homeowners can seek court review of the fees and costs assessed for a determination of whether they are fair, just and reasonable. As homeowners are generally not legally entitled to reinstatements, they are not able to seek judicial review of the fees and costs imposed by the lender.

While state courts do not review mortgage workout or reinstatement agreements to ensure that homeowners' interests are protected, lenders must provide bankruptcy courts with evidence in support of the claim for attorney fees. Such evidence may include the terms of the attorney fee contract between the lender and its attorney, including hourly or flat rate and method of compensation, time records showing the amount of time expended by each attorney or paralegal, a description of each service performed, and the customary hourly rate charged by that attorney or paralegal. If a judgment of foreclosure was entered by the state court, a complete file-stamped copy of the judgment must be attached so the bankruptcy court may take into account any award of fees or costs contained in the judgment. The lender must also provide copies of invoices or receipts for all expenses incurred. If reimbursement of charges for property inspections or appraisals is sought, some additional evidence demonstrating the necessity for activities must be submitted, and if title insurance is purchased, a copy of the commitment and the invoice should be attached. *In re Coates*, 292 BR 894, 906 (Bankr. C.D. Ill. 2003).

CONCLUSION

For the foregoing reasons, the *Amici* respectfully urge the Court to reverse the Seventh District Court of Appeals.

Respectfully submitted,

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CERTIFICATE OF SERVICE

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