RECENT CASES

CONSTITUTIONAL LAW — PERSONAL JURISDICTION — NORTH CAROLINA SUPREME COURT FINDS NO JURISDICTION OVER NEW YORK TRUST. — *Skinner v. Preferred Credit*, 638 S.E.2d 203 (N.C. 2006), *reh'g denied*, 643 S.E.2d 591 (N.C. 2007).

In early March 2007, the Dow Jones Industrial Average plunged nearly 250 points when missed payments by subprime mortgage holders hit a four-year high.[1] Later that month, when the Senate Committee on Banking, Housing, and Urban Affairs held hearings on what analysts were already calling a mortgage market crisis, the issue of subprime lending was firmly thrust into the national spotlight.[2] By the time Congress began this effort to "protect[] hard-working Americans from unscrupulous financial actors,"[3] however, subprime mortgages — offered to borrowers whose flawed credit history prevents them from obtaining prime rates — were thriving as alternative lending vehicles.[4] Not surprisingly, this burgeoning market, and the sophisticated financial infrastructure that has grown around it, poses important questions for legislators and courts. Recently, in *Skinner v. Preferred Credit*,[5] the North Carolina Supreme Court refused to extend personal jurisdiction to a nonresident trust that held a subprime mortgage on in-state realty, allegedly in violation of the state's usury statutes.[6] By examining the financial infrastructure that legally insulated the trust but ignoring the trust's functional reach, the court failed to recognize the trust's purposeful contacts with North Carolina and denied an important legal protection to potentially vulnerable borrowers.

In January 1997, Garry and Judy Skinner closed on a second mortgage loan from Preferred Credit Corporation.[7] The interest rate on the loan was 14.75%, and the costs charged at closing included a $3600 origination fee.[8] Preferred Credit subsequently entered into a Pooling and Servicing Agreement (PSA) with Credit Suisse First Boston Mort-

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[1] Edward M. Gramlich, *It's Not Your Parents' Mortgage Market Anymore*, WASH. EXAMINER, Apr. 6, 2007, at 17.

[2] *See generally Mortgage Market Turmoil: Causes and Consequences: Hearing Before the S. Comm. on Banking, Housing, & Urban Affairs*, 110th Cong. (2007) (opening statement of Sen. Chris Dodd, Chairman, S. Comm. on Banking, Housing, & Urban Affairs), *available at* http://banking.senate.gov/index.cfm?Fuseaction=Articles.Detail&Article_id=125&Month=3&Year=2007.

[3] *Id.*

[4] Gramlich, *supra* note 1.

[5] 638 S.E.2d 203 (N.C. 2006), *reh'g denied*, 643 S.E.2d 591 (N.C. 2007).

[6] *Id.* at 206.

[7] *Id.* at 207.

[8] *Id.*

gage Securities Corporation as depositor, Advanta Mortgage Corporation USA as servicer, and Deutsche Bank Trust Company Americas (DB Trust Co.) as trustee.[9] By means of the PSA, the 1997-1 Trust was formed under New York law.[10] The primary purpose of the Trust was to hold and receive income from mortgage loans, distribute payments, and issue certificates.[11] Under a separate agreement, Credit Suisse purchased mortgage loans, including the Skinners' loan, from Preferred Credit.[12] Credit Suisse subsequently assigned all rights under this agreement to the 1997-1 Trust, an assignment that included mortgage loans from multiple borrowers in North Carolina.[13]

Amidst this horde of financial actors, the Skinners filed suit, alleging that Preferred Credit charged excessive loan origination fees and usurious interest rates.[14] The Skinners' case went to trial with eighteen named defendants, all of whom were later dismissed either voluntarily or by the trial court on jurisdictional grounds.[15] The Skinners appealed the court's dismissal. By the time the case reached the court of appeals, the Skinners had voluntarily dismissed all but two defendants — the 1997-1 Trust and DB Trust Co.[16]

The North Carolina Court of Appeals, in a divided opinion, affirmed the trial court's holding. The Skinners asserted that three subsections of North Carolina's long-arm statute authorized jurisdiction, but the court rejected each in turn, emphasizing that the Trust was only a passive holder of assigned mortgage notes — a fatally "tenuous" connection.[17] Because it found no statutory basis for jurisdiction, the court did not address the due process question in its personal jurisdiction analysis.[18]

A divided North Carolina Supreme Court affirmed. The court's four-judge majority chose to resolve the case only on the basis of personal jurisdiction over the 1997-1 Trust.[19] Like the court of appeals,

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[9] *Id.*
[10] *Id.*
[11] *Id.*
[12] *Id.*
[13] *Id.*
[14] *Id.* at 208.
[15] Skinner v. Preferred Credit, 616 S.E.2d 676, 678 (N.C. Ct. App. 2005).
[16] *Skinner*, 638 S.E.2d at 208.
[17] *Skinner*, 616 S.E.2d at 679–80.
[18] *See id.* at 680. A strong dissent *did* reach the due process question, finding that the Trust had sufficient contacts with North Carolina to subject it to personal jurisdiction in the state. *Id.* at 685–87 (Bryant, J., dissenting). The dissent also contended that the majority's holding would work against North Carolina's public policy of protecting its citizens against predatory lending practices. *Id.* at 688.
[19] *Skinner*, 638 S.E.2d at 207–08. The court refrained from addressing DB Trust Co.'s involvement because there was no evidence in the record regarding the company's contacts with North Carolina. *Id.* at 208.

the supreme court began by considering the three subsections of the long-arm statute that the Skinners raised as bases for personal jurisdiction. While noting that the statute's "substantial activity" clause[20] gave "North Carolina courts the full jurisdictional powers permissible under federal due process,"[21] the court concluded that none of the 1997-1 Trust's activities fell within the statute's grasp.[22]

The court dedicated the balance of the opinion to its due process analysis, inquiring whether the defendant had "minimum contacts" with North Carolina "such that the maintenance of the suit [would] not offend 'traditional notions of fair play and substantial justice.'"[23] The Skinners based their argument on three contacts: Preferred Credit's origination of the loan in North Carolina, the deeds of trust on North Carolina property that secured the loans held by the 1997-1 Trust, and the loan payments sent from North Carolina that were eventually received by the Trust.[24] The court addressed each contact independently.[25] Reasoning that the Trust was "at least two steps removed from the North Carolina origins of this loan," the court concluded that a jurisdictionally sufficient contact could not exist on the basis of the loan's place of origination.[26] Nor did the deeds of trust on North Carolina property that secured the loans suffice; the majority emphasized that the Trust simply held a beneficial interest in the properties, a far-too-feeble contact.[27] Even weaker, the court observed, was the Trust's relationship with the North Carolina loan payments. Because the Trust only "serve[d] as the depository for income derived, in part, from North Carolina loans" and did not receive payments directly from North Carolina citizens, the Trust was too passive a defendant to have availed itself of the forum state.[28]

A forceful three-judge dissent condemned the majority's opinion as "aid[ing] in the exploitation of our state's most vulnerable citizens" by denying the victims of predatory lending the right to sue in North Carolina courts.[29] The dissent rejected the majority's application of the long-arm statute before turning to its own due process analysis, maintaining that the 1997-1 Trust had "every reason to expect that it

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[20] N.C. GEN. STAT. ANN. § 1-75.4(1)(d) (West 2005).

[21] *Skinner*, 638 S.E.2d at 208 (quoting Dillon v. Numismatic Funding Corp., 231 S.E.2d 629, 630 (N.C. 1977)).

[22] *Id.* at 208–10.

[23] *Id.* at 210 (quoting Int'l Shoe Co. v. Washington, 326 U.S. 310, 316 (1945)) (internal quotation marks omitted).

[24] *Id.* at 211.

[25] *Id.*

[26] *Id.*

[27] *Id.*

[28] *Id.*

[29] *Id.* at 213 (Timmons-Goodson, J., dissenting).

might be subjected to litigation in North Carolina."[30] The fact that the day-to-day operations of the Trust, its trustee, and its servicer were not physically in North Carolina was not dispositive; because the Trust's commercial efforts were consciously directed toward North Carolina borrowers, its actions "constitute[d] a purposeful invocation of the benefits and protection of North Carolina's laws."[31] Coupled with the state's strong public policy interest in the case, the dissent concluded, this purposeful availment answered the majority's due process concerns and made the exercise of personal jurisdiction over the Trust not only permissible, but also necessary for the protection of North Carolina citizens.[32]

The disagreement between the majority and the dissent turned on the Trust's role in the Skinners' mortgage transaction. The securitization of subprime mortgages involves a series of complex financial transactions that serves to prevent vehicles like the Trust from having direct contact with — and therefore legal liability in — the states in which they effectively operate. By failing to fully examine this financial structure, the majority ignored the Trust's functional reach and erroneously considered its contacts in isolation. This approach not only disregards personal jurisdiction precedent, but also prevents North Carolina courts from providing an important supply-side disincentive for predatory lenders and a potentially significant measure of legal protection for subprime borrowers.

The financial infrastructure surrounding the management and assignment of the Skinners' loan is a common example of a financial technology called securitization. Securitization integrates mortgage markets with capital markets by allowing investment banks to create pools of loans, carve up the cash flows from those loans, and convert the cash flows into bonds secured by the mortgages.[33] Through a two-tiered structured transaction, usually involving assignment to an independent trust, the loan pool is effectively isolated from the original lender. By merging mortgage markets and capital markets, securitization increases capital flow, making a larger pool of credit available to a

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[30] *Id.* at 218.

[31] *Id.* at 217.

[32] *See id.* at 219. In April 2007, the dissent's arguments found a receptive audience in the North Carolina House of Representatives, which introduced a bill extending the state's long-arm statute to include defendants like the 1997-1 Trust. The bill was signed into law on August 16, 2007, and explicitly abrogated the *Skinner* court's long-arm analysis. *See* 2007-351 N.C. Adv. Legis. Serv. (LexisNexis). The majority's and dissent's conflicting due process analyses, however, remain unaffected.

[33] *See* Kathleen C. Engel & Patricia A. McCoy, *Turning a Blind Eye: Wall Street Finance of Predatory Lending*, 75 FORDHAM L. REV. 2039, 2045 (2007); *see also* Deanne Loonin & Elizabeth Renuart, *The Life and Debt Cycle: The Growing Debt Burdens of Older Consumers and Related Policy Recommendations*, 44 HARV. J. ON LEGIS. 167, 178 (2007).

larger portion of the population.[34] The core problem with securitization, however, is reflected in the merits issue that the *Skinner* court avoided: the quality of the loans in the loan pool. Since the advent of securitization, lenders have had incentives to unload their worst loans onto investors and thus to underwrite their loans more carelessly.[35] And, because securitization "unbundl[es] the tasks in lending and parcel[s] them out among a string of market actors,"[36] lenders are able to conceal the credit flaws that would ordinarily scare investors away.[37]

Such "unbundling" of the mortgage industry not only insulates subprime lenders from the credit risks that they would otherwise bear, but provides them with legal insulation as well.[38] The *Skinner* majority opinion illustrates this point. By the third paragraph of its opinion, the court had introduced six distinct financial actors.[39] These geographically diverse parties formed only very tenuous connections with each other — in fact, they were structurally *designed* to do so, in order to push risk onto investors and reap the maximum financial gain from the Skinners' loan. The majority took this complex financial infrastructure at face value, finding no personal jurisdiction because the Trust was "at least two steps removed from the North Carolina origins" of the Skinners' loan.[40]

The majority's superficial look at this fragmented financial situation failed to capture the true position of the Trust, resulting in a shallow due process analysis that does not accord with settled jurisdictional precedent. As prescribed by the Supreme Court, jurisdictionally sufficient minimum contacts require that the defendant "purposefully avail[] itself of the privilege of conducting activities within the forum State, thus invoking the benefits and protections of its laws."[41] The majority's analysis deviated from precedent in two ways.

First, the majority focused only on the legal structures that were designed to insulate the 1997-1 Trust, rather than conducting the purposive and functional inquiry required by precedent. By divorcing the Trust from the financial parties that insulated its operations, the court overlooked the Trust's true role as assignee of North Carolina loans on North Carolina property. The majority preferred instead to rely on the

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[34] *See* Christopher L. Peterson, *Predatory Structured Finance*, 28 CARDOZO L. REV. 2185, 2213 (2007).

[35] *See* Kurt Eggert, *Held Up in Due Course: Predatory Lending, Securitization, and the Holder in Due Course Doctrine*, 35 CREIGHTON L. REV 503, 550 (2002).

[36] Engel & McCoy, *supra* note 33, at 2049.

[37] *Id.* at 2049–50.

[38] This segmented structure is not always in place to avoid personal jurisdiction per se; securitization can be used to both avoid litigation risk and price it efficiently. *Id.* at 2052.

[39] *See Skinner*, 638 S.E.2d at 207.

[40] *Id.* at 211.

[41] Hanson v. Denckla, 357 U.S. 235, 253 (1958).

location of the Trust's day-to-day operations and its lack of North Carolina offices or employees — the type of argument that the Supreme Court rejected in *International Shoe Co. v. Washington*.[42] The court also leaned heavily on the fact that the Trust was not involved in the origination of the loan and did not directly receive loan payments. Again, its analysis ignored the Trust's role as assignee. Moreover, unlike the indirect connections through the "stream of commerce" that the Supreme Court has deemed insufficient to create jurisdiction,[43] the Trust's contacts were indirect due to the purposeful segmentation that accompanies securitization. Such conscious unbundling — the result of financial innovations designed to spread risk — should not be used to confer the secondary benefit of liability insulation. Personal jurisdiction doctrine, through its focus on purposeful availment and fundamental fairness, adapts to "transformation[s] of our national economy"[44] in order to get at the heart of new, evolving commercial transactions. By focusing only on the relatively novel financial infrastructure that barricaded the Trust, the majority insisted on a narrow interpretation of "contact" that neither followed relevant precedent nor reflected commercial reality.

Second, when the majority did consider purposeful availment, it looked at each of the Trust's connections to North Carolina *independently* rather than in the aggregate.[45] This analytic fragmentation further disregards existing precedent. The Supreme Court has made clear that a defendant's contacts should be evaluated holistically. For example, the Court in *Burger King v. Rudzewicz*[46] employed a "highly realistic"[47] approach that included collective consideration of all facts relevant to the question of whether the defendant had purposefully invoked the benefits of the forum state's laws.[48] The *Skinner* court,

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[42] 326 U.S. 310 (1945). The Court in *International Shoe* upheld personal jurisdiction in spite of a similar absence of day-to-day operations and offices and employees in the forum state, reasoning that so far as a defendant's duties "arise out of or are connected with [its] activities within the state, a procedure which requires the corporation to respond to a suit brought to enforce them can, in most instances, hardly be said to be undue." *Id.* at 319.

[43] *See, e.g.*, Asahi Metal Indus. Co. v. Superior Court, 480 U.S. 102 (1987).

[44] McGee v. Int'l Life Ins. Co., 355 U.S. 220, 222 (1957). More recently, internet jurisdiction cases have reemphasized the adaptive nature of personal jurisdiction doctrine. *See, e.g.*, Zippo Mfg. Co. v. Zippo Dot Com, Inc., 952 F. Supp. 1119, 1123 (W.D. Pa. 1997) (reviewing precedents that highlight the need for personal jurisdiction doctrine to respond to technological and commercial innovations).

[45] *Skinner*, 638 S.E.2d at 211 ("We address each of these 'contacts' in turn.").

[46] 471 U.S. 462 (1985).

[47] *Id.* at 479 (quoting Hoopeston Canning Co. v. Cullen, 318 U.S. 313, 316 (1943)) (internal quotation marks omitted).

[48] *Id.* at 482 ("Although [a choice of forum clause] standing alone would be insufficient[,] . . . when combined with the 20-year interdependent relationship Rudzewicz established with Burger King's Miami headquarters, it reinforced his deliberate affiliation with the forum State and the reasonable foreseeability of possible litigation there.").

however, dispensed with the three contacts that the Skinners highlighted — the loan's origination in North Carolina, the Trust's possession of loans secured by deeds of trust on North Carolina property, and the Trust's acceptance of loan payments originating in North Carolina — without discussing whether all of these contacts, analyzed in the aggregate, made jurisdiction proper.[49]

When viewed through the lens of the Supreme Court's "purposeful availment" inquiry, the Trust's contacts with North Carolina clearly appear to have been jurisdictionally sufficient. As in *Burger King*, the Trust's jurisdictional fate should have depended not only on the isolated mechanics of its formation, but also on the sum total of its myriad business contacts with North Carolina. By accepting North Carolina loans, the Trust incurred "continuing obligations" to North Carolina residents under North Carolina laws. Despite the barricade of transactions that surrounded the Trust, by "assum[ing] all of the rights, benefits, obligations, and liabilities" of the Skinners' loan, the Trust also accepted the jurisdictional consequences that such an assumption might entail.[50]

Furthermore, by failing to allow jurisdiction over investment vehicles like the Trust, the majority's due process analysis could significantly hinder efforts to harness the benefits of subprime markets while protecting consumers against predatory lenders. It is important to keep in mind that, by allowing legitimate subprime lenders to capitalize on their existing subprime loans, securitization aids in the expansion of credit — and thus homeownership — to previously excluded groups.[51] Requiring subprime loan assignees like the Trust to defend against out-of-state lawsuits could limit the benefits of securitization by making loan pools less attractive to investors.[52] At the same time, this "quick churning of loan principal"[53] is an ideal situation for predatory lenders, who thrive on the rapid securitization of their worst loans.[54] By offering particularly abusive loan terms to borrowers with

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[49] *Skinner*, 638 S.E.2d at 211.

[50] *Id.* at 216.

[51] Moreover, although recent media attention has been focused primarily on subprime foreclosures, it is worthwhile to note that a majority of subprime borrowers — up to eighty-seven percent — are making their payments. *See* Austan Goolsbee, *'Irresponsible' Mortgages Have Opened Doors to Many of the Excluded*, N.Y. TIMES, Mar. 29, 2007, at C3.

[52] *See* David J. Weiner, Comment, *Assignee Liability in State Predatory Lending Laws: How Uncapped Punitive Damages Threaten the Secondary Mortgage Market*, 55 EMORY L.J. 535, 559–60 (2006) (detailing how Standard & Poor's excluded from its rated securitizations all loans covered by a Georgia law that provided for uncapped punitive damages for assignees).

[53] Eggert, *supra* note 35, at 546.

[54] *See* Peterson, *supra* note 34, at 2213–21 (discussing the "nexus between home mortgage-backed securities and predatory lending," which attracts "aggressive investors and businesses looking to maximize their profits by any possible means").

poor credit, predatory lenders tend to target and exploit more economically vulnerable populations.[55]

The complexity of the financial structures surrounding subprime securitization makes it difficult to craft mechanisms that punish predatory lenders without limiting legitimate subprime loans. Basic consumer protections typically available in the prime market are not extended to subprime borrowers.[56] As a result, the ability of these borrowers — many of whom have limited financial resources — to sue the eventual assignees of their debt in their home state becomes a significant legal protection. Many existing subprime lending regulations, such as laws that cap interest rates or provide additional credit regulations in certain neighborhoods, focus only on restricting the *borrower's* ability to access credit. Such laws, while potentially effective, have the unfortunate side effect of alienating certain groups from the credit market.[57] Extending the reach of personal jurisdiction to financial actors such as the 1997-1 Trust is important because it is a legal protection that works the opposite way: the threat of legal liability targets predatory lending on the *lender's* side. The potential for legal action would make both investors and financial institutions wary of securities backed by questionable loans, limiting the ability of predatory lenders to profit from quick and easy securitization. Extending personal jurisdiction to nonresident trusts would decrease the incentive for such lenders to offer exploitative loans, without imposing regulations that restrict *all* subprime lenders.[58]

By refusing to recognize the Trust's sufficient contacts with the forum, the North Carolina Supreme Court foreclosed this remedy. By focusing on financial parties and transactions in isolation, the majority's due process analysis failed to peel back the protective layers surrounding the Trust's activities. By not extending personal jurisdiction to nonresident holders of securitized in-state debt, the court's decision exacerbated the perverse incentives in the predatory lending market and failed to provide an important legal protection to potentially vulnerable homeowners.

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[55] "Predatory lending" has been notoriously difficult to define. For an analysis of the term, see Kathleen C. Engel & Patricia A. McCoy, *A Tale of Three Markets: The Law and Economics of Predatory Lending*, 80 TEX. L. REV. 1255, 1259–70 (2002).

[56] *See* WILLIAM APGAR ET AL., HARVARD UNIV. JOINT CTR. FOR HOUS. STUDIES, MORTGAGE MARKET CHANNELS & FAIR LENDING 43 (2007).

[57] *See, e.g.*, Amy Merrick, *Borrowing Trouble: Illinois Tries New Tack Against Predatory Loans*, WALL ST. J., Aug. 21, 2007, at A10 (discussing the "vitriolic" response to an Illinois bill that prevented low-income borrowers within ten zip codes from getting loans without additional credit counseling).

[58] Although the issue is beyond the scope of this piece, scholars have suggested that the monitoring of predatory behaviors would not be prohibitively expensive for the secondary market. *See* Kathleen C. Engel & Patricia A. McCoy, *Predatory Lending: What Does Wall Street Have to Do with It?*, 15 HOUSING POL'Y DEBATE 715 (2004).