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Preventing Home Equity Lending Fraud - Special Truth in Lending Protections Enacted

Gary Klein

Attorney, National Consumer Law Center, Boston, MA

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Special Truth in Lending protections enacted

by Gary Klein

Overview

In 1994, Congress passed consumer protections with respect to certain home equity mortgage loans made at high rates of interest.¹ The protections are designed to prevent some predatory lending practices targeted at vulnerable consumers.

The new law creates a special class of regulated, closed-end loans made at above market interest rates or with excessive costs and fees. Rather than cap interest rates for these loans entirely, the law contains a variety of regulatory approaches, including additional disclosures, new penalties, prohibitions of certain abusive loan terms, and an extension of potential liability for assignees. The new protections took effect October 1, 1995.²

These amendments to the Truth in Lending Act do not curb the problem of abusive home equity lending entirely. The amendments continue to allow home equity loans to be made at high rates, albeit with fewer terms designed to hide the true disadvantages and risks of such loans. Additionally, the new law does nothing to regulate abusive terms in transactions defined outside the class of covered loans including open-end credit transactions. This means that some lenders will undoubtedly continue abusive practices without triggering special defenses for homeowners.

Background and Legislative History

Abusive home equity lending is a longstanding problem that exploded in the 1980s.³ Vulnerable homeowners such as senior citizens, minorities and the poor, who could not access mainstream forms of credit, were the focus of these abusive practices.⁴ Many were forced to rely on equity loans with high rates of interest in order to finance home repairs, credit consolidation, or other crucial credit needs.⁵ A surprisingly diverse group of lending institutions, finance companies and outright usurers developed home equity loans designed to hide the true costs and disadvantages of secured credit at high rates. They targeted vulnerable consumers through a network of contractors, loan brokers, "bird-dogs," and scam artists. Because the loans were secured by home equity, lenders were protected from risk because they could either collect high rates from consumer payments or obtain repayment of the loans plus contract interest and costs, through foreclosures.

Gary Klein is an attorney at the National Consumer Law Center, 18 Tremont Street, Boston, MA, 02108. He is co-author of Truth in Lending (National Consumer Law Center, 1994 Supplement). The author wishes to thank Kathleen Keest and Judy O'Donnell for assistance in preparing this article.
During the 1980s, a number of factors coalesced to create an ongoing crisis:

- In 1986, the federal legislature changed the tax code to establish a tax preference for interest on second mortgages over interest on other consumer loans. This sent a pervasive message to homeowners that borrowing against home equity was sensible economic planning. This message meshed nicely with the overall “credit is good” theme of the 1980’s, and many people who never would have considered borrowing against the equity in their homes began to make this their first choice for borrowing.

- Mainstream banks nearly abandoned low-income neighborhoods across the country, especially minority low-income neighborhoods. This created a void to be filled by finance companies charging high rates of interest. Indeed, some mainstream banks helped fill the vacuum by setting up high rate finance companies or, alternatively, by funneling cash to unscrupulous lenders.

- Given appreciating real estate values throughout much of the country, finance companies were able to make loans at high rates with very little risk. Many finance companies targeted homeowners who had substantial equity in their homes in order to protect their investments if the borrowers did not pay. Elders were a common target because many had built significant equity in their properties over time. Based on equity, a lender was in an advantageous situation: either the borrower paid the loan back with high interest or foreclosure on the home permitted a recovery from the property directly. In fact, when foreclosure occurred and the borrower’s property was sold to the lender for less than fair market value (as it often is), the lender could resell the property after foreclosure and keep any additional profits. These anticipated windfalls encouraged some lenders to make loans designed to result in foreclosure to homeowners with substantial equity in their properties.

- A significant secondary market developed during the 1980s for finance companies marketing loans with high interest rates. This created substantial liquidity for high rate loans. Finance companies could defraud consumers, sell mortgages on the secondary market for cash, and then close up shop before consumers could discover and raise defenses. The assignees in the secondary market pled innocence, denying participation in the fraudulent process and asserting protection based on their claimed status as holders in due course. As a result, the assignees avoided liability for many of the consumer claims made against them.

Some banks and other institutional lenders actually created businesses to finance high rate lenders and to obtain assignment of the resulting high rate loans. By making these transactions appear to be purchases in the secondary market, these lenders purported to obtain the defenses of holders in due course.

- Deregulation allowed a wide range of marginal players into the lending and loan brokering business. Many of the historic protections against unfair lending practices, such as state ceilings on interest rates and licensing requirements, were removed or eviscerated during the 1980s. Even where licensing requirements remain, inadequate funding has lead to inadequate policing of abusive lenders.

- Finally, the Truth in Lending Act (“TILA”) itself became part of the problem. Many abusive lenders used the loopholes of TILA to pad loans, to hide complex terms, and to evade substantive regulation on the basis that the abusive loan terms were fully disclosed. Although TILA rescission rights have often been asserted to annul abusive loans, the disclosures proved inadequate both as a means of informing consumers about complicated loan terms and in overcoming oral fraud and other chicanery.

In 1993, after much publicity regarding abusive loans, particularly in Boston, Atlanta and Los Angeles, and at the urging of a variety of consumer groups, Congress held hearings on high rate lending. Many witnesses forcefully pointed out the hardship, dislocation and neighborhood destabilization that such loans caused. Homeowners from a number of communities travelled to the hearings by overnight bus and surprised legislators by singing spirituals and civil rights songs in the hearing room.

In addition, some portions of the lending community lobbied against the proposed legislation, arguing that...
regulation would shut off the flow of credit to low-income communities. The lending community claimed that home equity lending with high interest rates was justified by lending risks.

The legislative history of the bill explains the process by which legislators were convinced to regulate covered loans. Significantly, the conference report contains substantial explanations of potentially ambiguous language and will be a valuable resource for litigators pursuing claims under the new act. To the extent possible, the legislative history is referenced below in the discussion of substantive issues in this article.

Other Strategies for Litigating Problem Home Equity Loans

The remedies discussed in this article are not the exclusive means by which to attack abusive home equity loans. The legislative history suggests that the new law does not preempt more protective alternative laws and does not preclude attacks on loans that are not covered by the bill. Other provisions of the TILA, including rescission rights under 15 U.S.C. § 1635, will continue to be of primary importance in attacking abusive loans. In addition, claimants may challenge predatory mortgages by utilizing state controls on unfair trade practices, as well as warranty law, usury, unconscionability, fraud and general contract law.

As in the past, claimants will frequently litigate their claims in connection with foreclosure of abusive loans. Claimants may raise defenses in judicial foreclosure cases and may seek injunctive relief against non-judicial (“power of sale”) foreclosures. In addition, the automatic stay provided under the Bankruptcy Code and the objections-to-claim process can be used to forestall foreclosures and to invalidate mortgage claims.

Finally, some consumer attorneys are advocating creative remedies for unfair lending practices around the country. A number of suits directly attack “reverse redlining” practices at major banks. Reverse redlining is a practice by which banks make home equity loans at market rates in certain neighborhoods (typically white neighborhoods), while buying or making high rate loans by other means in central cities (usually in black neighborhoods). A Georgia suit against Fleet Bank, for example, was based on the racial disparity between Fleet Finance Company’s high interest customers, who were predominantly black, and Fleet Bank’s market rate customers, who were predominantly white.

Indeed, unfair lending cases can be very lucrative for plaintiffs. For example, in 1991 an Alabama jury awarded 45 million dollars to five families who had been victimized by a lender and a contractor. In a pattern of fraud and financial abuse, the contractor failed to complete work required in a high interest rate mortgage transaction.

Coverage

The home equity protection bill defines a special class of covered closed-end loans by setting up two triggers for the special protections of the law. Although initial versions of the bill would have called the protected class of loans “high rate loans,” Congress rejected this definition as unnecessarily pejorative. Consequently, throughout the law, covered loans are referred to as “a mortgage referred to in section 103(aa).”

The first of the two triggers is based on the annual percentage rate (“APR”) for the particular loan. The other is based on the total amount of points and fees the financial institution has charged. However, all covered loans must be “consumer credit” transactions and must be secured by the consumer’s principal dwelling. When the triggers are met, the protections of the bill are invoked. Of course, as with other coverage issues under TILA, the lender’s conclusion about whether the loan is covered will not necessarily control. An independent analysis of whether a particular loan is covered will have to be made.

1. Exempt Transactions

As in the case of the rescission provision of TILA, the law exempts “residential mortgage transactions.” This term is defined by TILA to include purchase money security interests to finance the acquisition or initial construction of the consumer’s dwelling. Consequently, all refinancing and other home equity loans are covered, but purchase and construction loans are generally not.

Loan products designed to deliberately evade the terms of the Act should be covered. However, the law contains an explicit exemption for reverse mortgages and for open-end credit.

Reverse mortgages are defined in 15 U.S.C. § 1602(bb) of the TILA. Generally, they are transactions in which payments are due only upon transfer of the dwelling in which the security interest is taken or when the con-
sumer dies or moves.\textsuperscript{38} Reverse mortgage loans have become widely available for elders who can use these loans to tap home equity in their properties without a repayment requirement while they are living in the home.

The exemption for open-end credit is more troubling. In general, open-end credit involves a loan which anticipates additional future advances. It seems likely that some creditors will seek to evade the loan protections discussed in this article by structuring abusive loans as open-end credit. When this occurs, the transaction should be carefully examined to ensure that it meets the definition in the statute and the regulations.\textsuperscript{39} Since the regulations require that in open-end credit transactions "the creditor reasonably contemplates repeated transactions," claimants may challenge some purportedly open-end credit based on the objective reasonableness of the creditor's intentions. This will be a question of fact that must be litigated as such on a case-by-case basis.\textsuperscript{40}

In addition, the Federal Reserve Board ("FRB") has discretionary authority under the Act to exempt specific mortgages, or categories of mortgages, from some of the prohibitions under the Act, but not from the disclosures.\textsuperscript{41} In order to create an exemption, the FRB must find that the exemption is in the interest of the borrowing public and that it is granted for the purchase of products that maintain and strengthen home ownership and equity protection. When the FRB designates an exemption, it will only apply to the prohibitions contained in 15 U.S.C. § 1639(c) through (i).\textsuperscript{42} The special disclosure requirements will remain applicable.\textsuperscript{43}

2. The Annual Percentage Rate Trigger

The first category of covered transactions under the Act are loans for which the annual percentage rate (at the time of consummation) exceeds, by more than 10 percentage points, the yield on treasury securities having comparable maturities at the time the lender makes the loan.\textsuperscript{44} The relevant date for evaluating the treasury bond rates will be the fifteenth day of the month immediately preceding the month in which the lender receives the application for an extension of credit.\textsuperscript{45}

By referencing "comparable maturities," the law requires the creditor to evaluate the rate for treasury bonds of the same duration as the loan. For example, coverage for a five-year loan will be evaluated by reference to the treasury's five year bond rates. An ambiguity may arise in a limited number of cases when the term is between two different bond maturities. The FRB has required that the security with the closest maturity date be used.\textsuperscript{46} Where a loan is exactly between two listed maturities, the lower of the two rates should be used.\textsuperscript{47}

The comparable yields used to determine whether a particular loan is covered are published in a variety of places, including the Federal Reserve Bulletin and the \textit{Wall Street Journal}. To get some idea of the coverage of the Act, at current treasury bond rates, loans starting in the range above 16.5\% (one year) to 18\% (ten year) APR would be covered depending on the loan term.\textsuperscript{48}

All of the applicable requirements for calculating the annual percentage rate will apply. It will be the accurate rate that controls, so the APR must be evaluated for errors. When an error is found, for example, because the creditor has misallocated a finance charge, the correct rate should be calculated and coverage should be evaluated based on this number. Thus, errors in calculating the APR can be the basis not only for civil liability and rescission, but for failure to comply with the requirements for high rate loans as well. As discussed below, enhanced penalties will then be triggered.\textsuperscript{49}

The FRB is empowered to change the margin for the coverage of annual percentage rates by regulation, but only every two years.\textsuperscript{50} The maximum permissible margin is 12\% and the minimum is 8\%.\textsuperscript{51} In evaluating whether to change the applicable rate, the Board must be sure the change is consistent with consumer protections against abusive lending and warranted by the need for credit.\textsuperscript{52}
3. The Points and Fees Trigger

The second trigger for coverage applies when the loan includes total points and fees in excess of 8 percent of the total amount of credit extended in the transaction. However, for coverage to apply under this section, the total points and fees must be at least $400. This floor will change each year on January 1 to adjust for inflation (as determined by the consumer price index on June 1 of the year prior to the adjustment).

There is an explicit three-part definition of points and fees under the Act. First, it includes all items contained in the finance charge for the loan other than interest and time-price differential. This captures all prepaid interest, points, origination fees, service charges and other lender’s charges for costs of doing business. Most often, these fees will be separately disclosed in the settlement statement, the itemization of amount financed or other disclosure of disbursements.

The second element of points and fees is “all compensation paid to mortgage brokers.” This provision recognizes that mortgage brokers who arrange high rate loans often contribute significantly to the lending abuses involved. The broker’s fees are often arranged between the broker and the creditor, rather than between the broker and the consumer. Even when the borrower does understand that a broker is involved, the broker’s fee is a significant ancillary cost of credit, which often significantly affects the total cost of the loan.

The third element of points and fees concerns real estate charges included under section 15 U.S.C. § 1605(e) other than escrow charges for future payment of taxes. An exception to inclusion of these charges as points and fees applies if the charge is reasonable, the creditor receives no direct or indirect compensation as a result of the charge, and the charge is paid to a third party unaffiliated with the creditor.

All three elements of this last test must be met for the exception to apply. For a charge to be reasonable, it must be actually charged and must be comparable with the standard, legitimate charge for that service in the applicable community. The term “reasonable” is to be interpreted consistently with the judicial interpretations of the “bona fide and reasonable” standard necessary to exclude such items from the TILA finance charge under Regulation Z, 226.4(c)(7).

Because the creditor may not receive any direct or indirect compensation from such charges, fees for document preparation, notarizations, appraisals, etc. (performed by employees of the creditor or related entities) cannot be excluded from the trigger. Moreover, to qualify for the exception, the charge must be paid to an entity that is unaffiliated with the lender. Fees paid to third parties that have interlocking boards, the same lending principals, or corporate affiliations cannot be excluded from the trigger.

This standard may lead to different results in some cases from the analysis applicable to calculation of the TILA finance charge. For example, a title examination charge may usually be included in the amount financed in calculating that amount for TILA purposes. However, if it does not meet the exception discussed here, it must be included as a fee for the purpose of determining coverage of high rate loan protections.

Finally, the FRB has power to add other charges to the definition of points and fees as it deems appropriate. In the Conference Report, Congress specifically pointed to credit insurance fees as an example of the type of fee the FRB might choose to include.

4. Expanded Definition of Creditor

One issue which has come up increasingly as a coverage issue under TILA is loans made by individuals or other entities which do not qualify under the definition of "creditor" because they do not make the requisite number of loans. In many cases, these loans are arranged by loan brokers who have individuals fund the loans in order to avoid the provisions of TILA.

This issue will be addressed in the new law by the creation of a special definition of "creditor" for high rate loans. Any person who makes two or more mortgages that qualify for coverage under the triggers or who makes one or more such mortgages through a mortgage broker is deemed a creditor.

Disclosure Requirements

1. Required Disclosures

New disclosure requirements applicable to covered loans may be found in 15 U.S.C. § 1639. The new disclosures do not replace the existing disclosure requirements under 15 U.S.C. § 1638, but rather are supplementary.

The new disclosures must be printed in type of a conspicuous size. Although the necessary size is not speci-
fied, to be conspicuous, they should be printed in type that is larger than normal. Additionally, the disclosures should be printed in type that is conspicuously larger than other type on the same page. Some guidance on this requirement may be found by reference to case law on the existing “clear and conspicuous” requirement under TILA, 15 U.S.C. § 1632(a). 6

For all loans, the creditor must make the following disclosures: 7

- You are not required to complete this agreement merely because you received these disclosures or have signed a loan application; and
- If you obtain this loan, the lender will have a mortgage on your home. You could lose your home and any money you have put into it if you do not meet your obligations under the loan.

For fixed rate loans, the creditor also must disclose the annual percentage rate and the amount of the regular monthly payment. 7 For adjustable rate loans, additional disclosures include the annual percentage rate, the amount of the regular monthly payment, a statement that the interest rate and the monthly payment may increase and the amount of the highest potential monthly payment based on the maximum allowable interest rate. 7

2. Timing of Disclosures

The disclosures required for covered loans must be given not less than three business days prior to consummation of the transaction. 7 The disclosures made are inaccurate, the terms of the loan may not be changed, unless the creditor makes new disclosures. 7 When new disclosures are required, they may, in some circumstances, be made by telephone at least three days before consummation. For the telephone provision to apply, three conditions must be met: 7

- The change must be initiated by the consumer;
- The creditor must provide the new disclosures in writing at the time of consummation; and
- The creditor and consumer must certify in writing, at the time of consummation, that the creditor provided the new disclosures by telephone no later than 3 days prior to the date of consummation of the transaction.

For the first time, home equity protections for high rate loans prohibit certain terms for covered loans.

Although the timing requirements appear straightforward, it is a common practice for predatory lenders to rush the consumer to complete a loan transaction before the consumer understands the nature of the loan or can obtain advice from a lawyer, friend, or relative. It seems likely that unscrupulous lenders will seek to evade the new disclosure requirements by misdating documents and/or by abusing the telephone provision. 7

3. Consequences of Failure to Disclose

Failure to make the necessary disclosures properly will give rise to civil liability under 15 U.S.C. § 1640(a) and enhanced damages pursuant to 15 U.S.C. § 1640(a)(4). 7 In addition, failure to make the new disclosures will constitute a failure to make “material disclosures” under the amended Act. 7 Thus, failure to properly make the new disclosures will give rise to an extended right (on behalf of the consumer) to rescind the transaction for up to three years from the date of the consummation. 7 This should apply equally to creditors who fail entirely to make the necessary disclosures, as well as to those who fail to make accurate disclosures or who fail to follow the proper disclosure procedures required under section 1639(a). This will be a powerful new weapon for consumers who wish to challenge high rate loans because rescission requires, at a minimum, that the creditor or an assignee cancel the mortgage plus any finance charges or other loan costs. 8

Limitations on Terms

For the first time, home equity protections for high rate loans prohibit certain terms for covered loans. In addition to triggering civil liability and special damage remedies, 81 inclusion of a prohibited term constitutes a failure to deliver required disclosures for the purposes of rescission under TILA. 82

Most of the prohibitions are not absolute. Care should be taken to ensure that when an exception is invoked, the creditor meets the preconditions to the exception.
1. Limitations on Prepayment Penalties

All prepayment penalties are prohibited for covered loans with a five part exception. Prepayment penalties are defined to include any method of calculating a rebate less favorable than the actuarial method. This will eliminate use of the "Rule of 78s" in covered loans unless an exception applies. The "Rule of 78s" is a shorthand formula for approximating the rebate of unearned charges upon the early termination of credit. Creditors have used this rule widely because it has an inherent bias in the creditors' favor. The rebate to the consumer will always be smaller under the "Rule of 78s" than under the technically precise actuarial method. The distortion is so great in long-term loans (a disparity that can exceed thousands of dollars) that Congress previously prohibited its use in all consumer credit transactions with terms longer than 61 months. With these new amendments, high cost mortgages, those with terms of 5 years or less, now will be spared the "78 penalty" unless the loans fall within the exception.

To invoke the exception, the creditor must meet all five preconditions contained in the statute. First, the loan must not require the consumer to pay more than 50% of his or her monthly gross income toward "monthly indebtedness payments." This is measured as of the consummation date of the loan. The term "monthly indebtedness payments" is not defined, except that it clearly includes, at a minimum, the debtor's obligation on the amount of credit extended in the transaction. The legislative history provides that the "consumer's total monthly debt service under all obligations" must be considered. This includes not only payments on all mortgages, but also credit card payments, rent-to-own charges, installment payments on other loans, current utility bills, agreements to pay back charges on utility bills, current tax payments, payments on back taxes, student loans, medical bills, agreements to pay tort judgments, and insurance bills. One question which may arise is whether monthly credit card payments should be treated as if the consumer will pay the minimum allowed. The better position is that the amount to be included should be the portion of the total balance owed at the time of consummation which is required to amortize the bill over a reasonable period of time. Similarly, a consumer's obligation to pay a joint debt may be called into question. Because the relevant issue is whether the consumer is "liable," it should not matter whether it is actually the consumer who is paying the debt.

The second prerequisite to the exception provides that the income and expenses of the consumer be verified by a financial statement signed by the consumer, as well as by a credit report. In the case of employment, income verification must include payment records or an employer verification. A pay stub or other payment record supplied by the consumer will suffice. The verification requirement will not be met if the lender's verification procedures are inadequate. For example, if the lender uses a financial statement that does not inquire about all the consumer's potential "debt service," the lender will not meet the verification requirement. When the debtor has multiple sources of employment income, the verification requirement applies separately to each source.

The third condition to the exception requires that the penalty not apply to repayments by refinancing with the creditor who made the initial mortgage or with an affiliate of the same creditor. This will prevent creditors from invoking the exception when they are refinancing loans themselves or through a related company. Additionally, the language of the statute prohibits a prepayment penalty when the initial creditor refinances the loan, even after assignment.

The fourth prerequisite requires that the penalty not apply after a five year period, beginning on the date the mortgage is consummated. Because this limitation is measured from the date of consummation, if there is an irregular first period that exceeds 30 days, a penalty is not available even before the 60th payment comes due. Thus, a five year loan with an irregular first period, which contains an unlimited prepayment penalty provision, will violate the limits in the exception.

The final prerequisite requires that the penalty must be legal under other applicable law. This preserves state
law limits on prepayment penalties.

Since inclusion of a prohibited term is grounds for rescission based on 15 U.S.C. § 1635(j), rescission is available even if a prohibited penalty is never invoked. This means that if the penalty provision, as drafted, does not strictly and accurately incorporate the limits on the exception contained in the statute, the consumer may rescind the entire loan.

2. Prohibition of Interest Rate Increases on Default

A covered loan may not include a term that increases the interest rate in the event of a default. In addition, if the loan is accelerated due to default, and the consumer is entitled to a rebate of interest, that rebate must be calculated by a method at least as favorable to the consumer as the actuarial method. This will prevent creditors in covered loans from including provisions in loans that make it impossible, or nearly impossible, for a homeowner to cure a default. Similarly, creditors will not be permitted to artificially inflate the amount due after default to obtain excessive repayment through the foreclosure process.

3. Limitation on Balloon Payments

Balloon payments are large monthly payments that become due during a loan term, usually at the end of the loan. They pose a problem for consumers who do not have the means to make such payments from their income or assets. When coupled with a prepayment penalty term, even if the consumer is able to refinance, there may be a significant financial disadvantage. Balloon loans have caused special hardship for many consumers because they are often coupled with a fraudulent oral promise to refinance. These refinancing promises are seldom met and foreclosure is a frequent consequence.

Balloon payments are prohibited in covered loans that have a term of less than five years. Thus, for loans of less than five years, the payments must fully amortize the outstanding principal balance. Because negative amortization is completely prohibited, even in loans of more than five years, the largest potential balloon will be the initial principal balance.

Additionally, since prepayment penalties are generally prohibited after the first five-year period of the loan, a consumer will be able to refinance a balloon payment loan without incurring a penalty. This will bring an end to one of the most flagrant abuses in high rate loans.

4. Prohibition of Negative Amortization

Negative amortization is a loan term under which the payments due each period are insufficient to cover the interest on the loan as it becomes due. Therefore, the balance due increases as the additional interest is added to the principal. Because such interest can compound, the ultimate balance can quickly and easily exceed the consumer's ability to repay.

Negative amortization is entirely prohibited in covered loans. Because the law prohibits negative amortization at any time during the course of the loan, even a loan that has a limited period of negative amortization is prohibited. Presumably, this will catch some covered loans with large irregular first periods so that they give rise to remedies under the act. Similarly, covered loans that require incremental or variable payments will be prohibited if any of the payments do not cover at least the amount of periodic interest.

5. Limitation on Prepaid Payments

Prepaid payments are amounts that are withheld from the proceeds of the loan to cover one or more payments that would otherwise be paid over the course of the loan. They have been used by some unscrupulous creditors to disguise the true amount of credit granted and to increase the consumer's obligation to pay interest. In addition, because the lender retains use of this money, the lender frequently earns interest on the prepaid payments without crediting the interest to the borrower's account.

The amendments preclude taking more than two prepaid payments in covered loans. This provision, as drafted, should apply equally to lenders who place more than two payments in escrow at the consummation of the loan, and to those who disburse such payments to the consumer only to immediately recollect them as a payment.

6. Extending Credit Without Regard to Ability to Pay

Another problem that has plagued the home equity lending industry involves lenders who make loans which they know or should know the consumer is not able to repay. As discussed above, lenders make these loans based on the value of the property involved and the advantages they expect to reap upon foreclosure.

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The amendments contain a compromise provision on this issue that prohibits a lender from engaging in "a pattern or practice of extending credit to consumers in covered loans based on the consumers' collateral without regard to the consumers' repayment ability, including the consumers' current and expected income, current obligations, and employment."  

This is a curious provision because it requires an individual consumer to establish a "pattern or practice." Presumably, such cases will be difficult and expensive because the lender's entire loan portfolio may need to be examined.

There are a number of factors that might contribute to establishing such a case, including a pattern of making loans in low-income neighborhoods with relatively high property values. A significant portion of a lender's portfolio may be examined to review loan-to-value ratios. A lender may violate the provision if it has a pattern of making small loans to consumers with substantial home equity.

Similarly, the lender's practice in evaluating a consumer's income and ability to pay should be examined. Through discovery efforts, litigants suing in different areas of the country have established that certain lenders do not evaluate or verify consumer incomes, expenses or credit histories to determine if the loans can be repaid. Their only concern appears to be that the consumer has sufficient equity in his or her property. These lenders' underwriting procedures begin and end with an appraisal that reveals a level of sufficient equity to assure repayment through the foreclosure process.

When a consumer alleges fraud under this provision due to an abusive loan or series of loans to particular consumers, discovery should be allowed to determine the lender's general underwriting policies and its specific portfolio of existing loans. Because many lenders are reluctant to reveal such information publicly, aggressive discovery should create some incentive to settle.

7. Special Requirements for Payments to Home Improvement Contractors

When a lender finances a home improvement contract, disbursements for a covered loan may not be payable directly to the contractor alone. Disbursements must be payable to either the consumer or jointly to the consumer and the contractor. At the election of the consumer, the lender may disburse the funds through a third party escrow agent provided the consumer, lender, and contractor sign an agreement to do so prior to the disbursement date.

This provision will end a common practice of collaboration between lenders and contractors who arrange for funds to be disbursed directly to contractors without the knowledge of consumers. Often, lenders have disbursed funds to contractors even though the contractors have not completed the work the contracts require. Unfortunately, the protections can do little to stop contractors from pressuring vulnerable consumers to endorse checks prematurely.

8. Remedies for Including a Prohibited Term

Inclusion of a prohibited term will give rise to civil liability under 15 U.S.C. § 1640(a) and enhanced damages pursuant to 15 U.S.C. § 1640(a)(4). In addition, inclusion of a prohibited term gives rise to the extended right to rescind the loan under 15 U.S.C. § 1635. Because the language of the statute makes the remedy available whenever a prohibited term is "contained" in a mortgage, the rescission remedy is available even if the term is never invoked.

When a creditor includes a term that is available in a covered loan only by virtue of an exception to a prohibition, the term should accurately track the language of the applicable exception. Otherwise, the mortgage will contain the prohibited term and the rescission right will apply.
Remedies

1. Civil Liability and Enhanced Damages

The violation of any provision of the new law gives rise to civil liability for actual damages, statutory damages, attorney’s fees and costs.\(^1\) In addition, there are special enhanced damages for violations of 15 U.S.C. § 1639 available under 15 U.S.C. § 1640(a)(4) unless the lender demonstrates that its failure to comply is not material. These include all finance charges and fees paid by the consumer. By using the conjunction “and” in 1640(a), it is clear Congress intended for the enhanced damages to supplement existing civil liability provisions.

All violations of 1639 will give rise to civil liability. Unlike other TILA requirements, there is no provision limiting civil liability under 1640 to certain types of violations for these special protections concerning high rate loans.\(^2\) More specifically, all violations, whether material or not, will give rise to claims for actual damages, statutory damages, attorney’s fees and costs. The “material” violation requirement is contained in 1640(a)(4) only.

Also, the amendments supplement existing TILA requirements. Therefore, if there is a basis for civil liability under other provisions of TILA, liability will apply to a covered loan as well.

2. Material Violation Standard for Enhanced Damages

Undoubtedly, the meaning of the term “material,” as used in § 1640(a)(4), will be a substantial issue when a consumer seeks the enhanced damages available under the new law. Based on the statutory language, the creditor has the burden of establishing that the violation is not material.

According to the conference report:

The conferees employ the word “material” to reference prior judicial interpretation of materiality, not to reference “material disclosures” under TILA. Case law under 130(c) may be used to evaluate materiality and the reasonableness of the prevention procedures for errors under this section. Miscalculations, computer malfunctions and printing mistakes shall not be deemed material if the creditor maintained reasonable procedures to prevent such mistakes.\(^3\)

Presumably, the tolerances contained in the statute apply to disclosures of the annual percentage rate.\(^4\) The conference report suggests that the primary concern was to exclude the penalty for some inadvertent violations. For instance, when the lender’s error is due to a simple miscalculation or other mistake, and it maintains procedures to catch such errors, the penalty will be unavailable.\(^5\) Certainly, the principle that a violation must be material does not mean the law incorporates a reliance standard. Nothing is contained in the amendments or the legislative history of § 1639 that suggests these provisions provide any less than a strict liability standard than do the balance of the provisions of TILA.\(^6\) Without question, all the prohibited terms and the disclosures required for high rate loans would be material in making an informed decision about the use of credit. If, as a prerequisite to suit, the consumer was required to read, understand and rely on the prohibited provision or inaccurate disclosures, then the remedial purpose of the Act would be entirely frustrated.

3. Requirement That Finance Charges and Fees Be Paid

The enhanced damages provision requires finance charges and fees be paid by the consumer.\(^7\) Given the applicable one year limitation period, this may be a small amount in affirmative cases. When damages are available by way of recoupment, however, as they are in many jurisdictions,\(^8\) a much greater offset will be possible. Additionally, it is possible to argue that prepaid finance charges are paid by the consumer at the time of consummation so that they can be recovered as damages.\(^9\)

One additional question is whether the enhanced damages, in the form of finance charges and fees paid, will be available in conjunction with rescission remedies and/or an award of actual damages. In either case, it appears the legislature contemplated the use of compound damages for the same financial harm. This is true for rescission, because rescission cancels the finance charges and fees. It appears Congress intended to allow multiple damages when it made multiple remedies available under the same statute.

4. Rescission

As discussed above, a covered loan that includes prohibited terms will be subject to the extended right to rescind under 15 U.S.C. § 1635.\(^10\) Also, it is important to note that the amendments supplement, rather than replace,
existing TILA requirements. If there are grounds for rescission of a covered loan under other provisions of TILA, the right to rescind will continue to apply. Thus, failure of a lender to make material disclosures at consummation, or to provide a proper notice of right to rescind, will provide grounds for a consumer to rescind a covered loan at any time during the lending process.

**Attorney General Enforcement**

In addition to the existing administrative provision, states' attorneys general may bring actions to enforce the new amendments. There is a limitations period of three years for such actions, and action may be brought in federal or state court. The state attorney general is required to provide prior written notice and a copy of the complaint to the federal agency responsible for administrative enforcement unless prior notice is not feasible. That federal agency may then intervene if it so chooses.

**Extension of Assignee Liability**

1. **Overview**

As discussed above, one of the contributing causes to abusive loan schemes is transfer of fraudulently obtained mortgages to assignees who assert the protections of a holder in due course. The assignees claim this defense to defeat claims which would be available against the originator of the loan. The homeowner is left to pay the mortgage without a defensive strategy against the assignee. Particular problems arise because many of the most unscrupulous, "fly-by-night" mortgage originators are insolvent or they disappear at the first hint of litigation.

In the case of some home improvement loans, this problem is addressed by the Federal Trade Commission's Holder Rule that abrogates the traditional protections of a holder in due course for certain loans. In other instances, it may be possible for a consumer to avoid application of assignee protections by establishing that the assignee is not a holder in due course. Also, assignees have some potential liability for TILA violations under existing law, including liability for rescission when such a remedy is available. All of these remedies will continue to be available for assignees of loans covered by the new home equity protections. In addition, there is a special provision creating extended liability for assignees of covered loans. This new provision is likely to cause investors in the secondary market for home equity loans to be more careful about where they buy loans. They no longer will be able to purchase mortgages from companies committing fraud, or other consumer credit violations against homeowners, without any risk of liability for the originator's fraudulent actions.

2. **Availability of Extended Liability**

The protections for high rate loans provide that assignees of covered mortgages are liable for all claims and defenses with respect to the assigned mortgage that the consumer could assert against the originator, except to the extent of certain limitations on damages discussed below.

However, an assignee will still be entitled to protection from liability if it legitimately could not have known the assigned mortgage was a covered loan. Protection from assignee liability arises when the assignee demonstrates, by a preponderance of the evidence, that a reasonable person exercising ordinary due diligence could not have determined the loan was covered. "Due diligence" requires that the assignee examine all documentation required by TILA, the itemization of the amount financed and other disclosures of disbursements. In addition, the assignee is responsible for any other information it has knowledge of at the time of assignment.

In most cases, whether the loan is covered or not will be apparent on the face of the documents. In fact, the maker of a covered transaction is required to place notice of the fact that assignees are potentially liable in the loan documents. This notice must be prominent. Alterna-
tively, review of the APR and the points and fees charged should reveal whether or not the loan is covered.

Problems will arise when a loan does not contain the notice of assignee liability or when coverage is based on misdisclosure, misallocation of points and fees or other error. In such instances, an assignee may assert freedom from liability based on its inability to discover that the loan was covered. The assignee will have the burden of establishing that it met the statutory standard.

Under the statute, due diligence extends to the TILA documentation, the itemization of amount financed and other disclosure of disbursements. This means that if upon a careful reading these documents establish that the loan was covered, then the assignee is liable. For example, the assignee must review the APR disclosures and the disclosed points and fees. If the assignee made errors in calculation, and the errors were discoverable based on due diligence, the assignee should be liable. The due diligence standard also requires that an assignee reconcile documents that are internally inconsistent to determine if the loan is covered. A reasonable person would not ignore errors on the face of the documents. Similarly, obvious misdisclosures should be discovered upon exercise of due diligence.

3. Damages Available Against Assignees

When assignees are liable, they will be subject to the full range of claims that could have been asserted against the maker of the loan. This includes liability for the originator's unfair trade practices, fraud, consumer credit abuses, RICO violations and any other claims within the imagination of litigators and the limits of Rule 11.

However, there are two substantive limits on damages against assignees. For actions brought under TILA, liability is available to the extent of the "amount specified in 1640." The use of the term "amount" in the legislative history suggests that Congress intended to reference the entire relief available under § 1640, including actual, statutory, and enhanced damages for covered loans as well as attorney's fees and costs. This limitation will rarely come into play because most TILA cases brought against assignees will continue to be brought under § 1631(a) or (c).

For actions based on any other claim, damages are limited to the amount of all remaining indebtedness and the total amount already paid by the consumer. When damages are awarded based on TILA and on other claims, the TILA damages must be offset against the damages awarded on the other claims. By using the term "amount of any damages" in the provision governing this offset, Congress suggested that attorney's fees and costs should not be offset.

Read together, it is clear that the maximum damages available against an assignee under § 1631(d) is the amount of the loan due at the time of suit, plus the amount already paid on the loan. Under the statute, it does not matter whether the payments were made to the original creditor or to the assignee. In many instances, especially when the loan can be rescinded, a substantial damage award will result.

ENDNOTES

1 Home Ownership and Equity Protection Act of 1994, Subtitle B of Title I of the Riegel Community Development and Regulatory Improvement Act, Pub. L. No. 103-325 (Sept. 23, 1994) hereinafter "HOEP." Final regulations implementing the new law are at 60 Fed. Reg. 15,463 (March 24, 1995).


5 Dozens of examples were raised in the variety of Congressional hearing held on these issues. Problems in Community Development Banking, Mortgage Lending Discrimination, Reverse Redlining, and Home Equity Lending: Hearings Before the Senate Comm. on Banking, Housing, and Urban Affairs, 103d Cong., 1st Sess. 258, 260 (Feb. 17, 1993) (statement of Terry Drent, Ann Arbor Community Development Dept., Ann Arbor, MI); Hearing on S.924 Home Ownership and Equity Protection Act, Before the Senate Banking Committee, 103d Cong., 1st Sess. (May 19, 1993); The Home Equity Protection Act of 1993, Hearings on H.R. 3153 Before the Subcommittee on Consumer Credit and Insurance of the House Committee on Banking, Finance and Urban Affairs, 103d Cong., 2d Sess. (March 22, 1994); Hearing on Community Development Institutions, 103-2, Before the House Committee on Banking, Finance, and Urban Affairs.
In one notable incident, the reporter Sam Donaldson caught a purported home improvement contractor on camera telling an 80 year old homeowner: "20% APR, that's about 10% interest." The reporter, for example, in re Celona, 98 B.R. 705 (E.D. Pa. 1989). See also In re Porter, 961 F.2d 1066 (3rd Cir. 1992).

For a further discussion of reverse redlining see NATIONAL CONSUMER LAW CENTER, THE COST OF CREDIT: REGULATION AND LEGAL CHALLENGES, ch. 11 (1995).


See the definition of open end credit is contained in 15 U.S.C. § 1602(l) and is amplified by Regulation Z, 12 C.F.R. 226.2(a)(20).

See NATIONAL CONSUMER LAW CENTER, TRUTH IN LENDING, ch. 5 (2d ed. 1989 & Supp.).

For a further discussion explaining the meaning of the term "residential mortgage transactions," see NATIONAL CONSUMER LAW CENTER, TRUTH IN LENDING, 6.2.1 and 6.2.2 (2d ed. 1989 & Supp.). Case law on the coverage of this term for the purposes of rescission should be equally applicable to coverage for home equity loan protections.

HOEP § 154(a). Though reverse mortgages are excluded from the special consumer protections for high cost mortgages, the bill did amend TIL, adding 138 15 U.S.C. § 1648, to provide more meaningful disclosures for this type of credit. HOEP § 154(b). These disclosure requirements are not discussed in this article.

The definition of open end credit is contained in 15 U.S.C. § 1602(l) and is amplified by Regulation Z, 12 C.F.R. 226.2(a)(20).

See NATIONAL CONSUMER LAW CENTER, TRUTH IN LENDING, ch. 5 (2d ed. 1989 & Supp.).
In explanatory material accompanying amendments to Regulation Z, the Board expressed the view that an application is received when it reaches the creditor in any one of the ways applications are normally transmitted, even if the application is incomplete. 60 Fed. Reg. 15465 (March 24, 1995) (explanation of 226.32(a)). The application date will then be determinative of which treasury rates to evaluate for determining coverage. In some situations involving rapidly rising or falling rates, or where there are small changes which affect coverage, some creditors may seek to manipulate the application date. Factual disputes may arise and discovery may be necessary on this issue.

See infra, at pp. 134-35 "Civil Liability and Enhanced Damages."

56 Official Staff Commentary 226.4(c)(7).
57 The FRB has chosen not to do so at this time but rather has expressly stated that it will hold hearings on this issue among others. 60 Fed. Reg. 15466 (March 24, 1995) (explanation of 226.32(b)(1)).
58 Conference Report, supra, note 17, at 159.
61 Official Staff Commentary 226.4(c)(7).
68 15 U.S.C. § 1639(a)(2)(A). All adjustable-rate mortgage loans made since Dec. 9, 1987 must specify a maximum interest rate. Absent any applicable usury ceiling, the rate can be as high as the creditor wishes, but a cap must be included in the contract. 12 U.S.C. § 3800(a); Reg. Z 226.30.
72 See generally Rodash v. AIB Mortgage Co., 16 F.3rd 1142 (11th Cir. 1994) (scheme to predate notice that loan is not rescinded violates the rescission requirements of TILA).
75 15 U.S.C. § 1635; Regulation Z, 12 C.F.R. 226.23 (d). For a broader discussion of rescission remedies under the Truth in Lending Act, readers are encouraged to see National Consumer Law Center, Truth in Lending, ch. 6 (2d ed. 1989 and Supp.).
76 See infra, pp. 134-35 "Prohibition of Negative Amortization."
82 See infra, pp. 134-35 "Civil Liability and Enhanced Damages."
84 15 U.S.C. § 1640(a)(3) (limiting damage remedies to certain disclosure requirements that Congress considered especially crucial at the time of TILA simplification).
85 Conference Report, supra, note 17, at 162.
87 For case law on the bona fide error defense, see National Consumer Law Center, Truth in Lending 7.1.2 (2d ed. 1989 & Supp. 1989).
88 Conference Report, supra, note 17, at 161.
91 15 U.S.C. § 1639(c)(2)(B). The term "affiliate" is defined for these purposes as it is in section 2(k) of the Bank Holding Company Act of 1956, 12 U.S.C. § 1841(k). 15 U.S.C. § 1639(k). The definition is "any company that controls, is controlled by, or is under common control with another company.
96 See infra, p. 133 "Prohibition of Negative Amortization."
102 See infra, pp. 134-35 "Civil Liability and Enhanced Damages."
105 Compare 15 U.S.C. § 1640(a)(3) (limiting damage remedies to certain disclosure requirements that Congress considered especially crucial at the time of TILA simplification).
112 See National Consumer Law Center, The Cost of Credit: Regulation and Legal Challenges 4.7, 5.5.2.2 (1994).
113 See infra, p. 134 "Remedies for Including a Prohibited Term."
119 15 U.S.C. § 1641(d)(1). See also Conference Report, supra, note 17, at 163. (assignee liability provisions for covered loans are 'not intended to limit assignee liability under other portions of the Truth in Lending Act ... or other causes of action."
122 Id.
123 Conference Report, supra, note 17, at 163.
126 Note that these limitations apply only to the extent that the action is made permissible by 15 U.S.C. § 1641(d)(1). They are inapplicable if the action against an assignee is made available under another provision of 1641 or by any other means of establishing assignee liability.
128 Conference Report, supra, note 17, at 163. ("Truth in Lending violations, damages are limited to relief available under Section 130").