EVALUATING FORECLOSURE CASES INVOLVING RIP-OFF HOME EQUITY LOANS

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It used to be that when we in Legal Services talked about consumer credit, the big issue was access. If you were poor, you could not get credit. While it is often still difficult for low-income people to find decent mortgage financing to purchase a home, it is certainly not the case that poor people are excluded from the world of credit. Credit is available to the poor like never before, and an entire industry, known as "subprime" lenders, has arisen to meet the new demand. The overriding problem now is not the absence of credit, but, instead, an overabundance of poor quality, dangerous credit.

Rather than representing a revolution in the egalitarian motives of business, the explosion in accessible consumer credit during the 1990's had more to do with profits and with changes taking place in Wall Street. Indeed, it could be argued that this explosion has represented a diminution in business scruples regarding the exploitation of low-income consumers.

Reflecting these changes in the consumer economy, Legal Services foreclosure work has been undergoing substantial changes. Traditionally, the average mortgage foreclosure case has represented a post-transaction client crisis of some kind — e.g., lost job, injury or illness, emergency expenses — that has produced a default. Either the underlying transaction was the original purchase-money mortgage, or a small high-interest second mortgage from a finance company.

Occasionally, with the second mortgage cases, there might be a truth-in-lending issue or some other angle to attack the underlying obligation, but for the most part, our principal tool has been the Bankruptcy Code. The focus in the "regular" foreclosure case has been on the future and the client's ability to cure the default over time. In evaluating the routine case, the advocate's primary objective is to answer this question: Using litigation-induced delay or a chapter 13 will the client have the future means to get out of the hole and get payments back on track?

In the average subprime mortgage case, however, the loan transaction itself is assumed to be questionable from its inception. The client may never have had the means to pay the loan, the very purpose of the loan may be hard for the client to articulate, and lender over-reaching may have been immense. The focus is not primarily a prospective budget analysis, figuring out how to pay the obligation. Rather, it is a consumer fraud analysis, figuring out how the client was ripped off, and how you can turn the tables on the wrongdoer.

The work is exceptionally fun and satisfying. You can provide dramatically helpful relief to the client and the legal work is consistently interesting. There are diverse causes of action available, a choice of forums and legal strategies, and a rogue's gallery of adversaries to make for fascinating fact development. For unrestricted programs, subprime mortgage cases represent a constant flow of attorney's fee opportunities. Even for Legal Services attorneys who cannot themselves demand attorney fees, this area of practice should not be ignored. Several restricted programs have managed to remain active in defending their clients against the subprime industry without running afoul of LSC restrictions.

What follows below is a brief, step-by-step guide to interviewing a subprime mortgage client and to formulating a legal theory and strategy. It is intended to provide some organization and focus to those feeling insecure about doing this work or unsure how to get started, and, for those more experienced, something in the nature of an organized checklist of issues. For more detail regarding any of the issues discussed, readers should refer to the relevant National Consumer Law Center manuals, particularly Truth in Lending (4th ed.), Unfair and Deceptive Acts and Practices (4th ed.), The Cost of Credit (and 1999 Supplement) and Credit Discrimination (2d ed.). The bibles of all consumer advocates, the NCLC manuals should be regarded as absolutely essential components of a Legal Services library, no matter how small.

I. DEVELOP THE STORY BEHIND THE LOAN.

It is unlikely that a victim of predatory lending practices is going to be able to tell you the whole story. Indeed, it is often the case that, years after the loan, the low-income consumer is still in the dark concerning key details of the transaction. Developing the story behind the loan, then, will probably not materialize from a simple "What happened?" It ordinarily requires a review of the contract documents, some pointed questions, and, occasionally, some additional investigation.

A. Purchase-money Loan Or Subsequent In Time To The Home Purchase?

Mortgage foreclosure complaints are usually thin on facts, alleging little more than the existence of a mortgage, a default, and a right to foreclose. Therefore, unless you are already familiar with the subprime lenders active in your area, you will not know from the complaint itself whether this is a foreclosure by a subprime.

If someone comes in with foreclosure paperwork, the first thing you want to determine is whether the foreclosure involves the purchase-money mortgage or involves a subsequent transaction. While subprime lenders do some home purchase financing, we are generally talking about home improvement or consolidation loans when we talk about predatory mortgage lending by subprimes. In many regions of the country the subprime industry has become so dominant in home equity lending to low-income homeowners that, once you determine that the foreclosure does not involve a purchase-money mortgage, you are probably dealing with a subprime loan.

Note that simply questioning whether the foreclosing lender is the one who lent the money to purchase the house will not necessarily enable you to exclude this being a purchase-money transaction, since it is rare that any original mortgagee is still holding a purchase-money loan. The more productive question is to ask the client how long she has lived in the house and compare that to the date of this loan.

B. Identify The Original Lender.

You should be able to determine who made the original loan from the client's paperwork, and compare that to who is foreclosing and whom the client has been paying. Some subprime lenders, past and present, have maintained their own retail operations for making new loans (e.g. United Companies Lending, Aames, Associates), while others purchased loans from their own subsidiary companies (e.g. IMC). Still other companies maintain largely wholesale operations, making loans on referrals from mortgage brokers (e.g. Ameriquest, Equicredit), while other companies tend to be more removed from the origination of loans, relying instead on the purchase or servicing of loans originated by other lenders (e.g. EMC, Ocwen).

Sometimes the foreclosing mortgagee may be a named trustee or a numbered trust. Don't let this throw you. Much of what has fueled the subprime explosion during the 90's is a Wall Street device called "securitization." Companies originate large pools of loans that are then sold to a trust of their own creation. They continue servicing the loans in the pool, for a fee, and keep the difference between what the borrowers are paying and what the company is obligated to pay the trust.

C. The "HUD-1" Settlement Sheet: Follow The Money.

While it is, of course, important to question the client on the purpose of the loan, it is very likely that her recollections will provide a very incomplete picture of what happened. The place I like to start in finding the story behind the loan is the settlement sheet, also known as the "HUD1." This document, either one or two pages, is the road map concerning all the money, showing how much was borrowed, and, more importantly, where all the money went.

The HUD-1 contains an itemization of all payments to third parties, including payments to pre-existing creditors, escrows for home improvements, cash to the borrower and settlement charges. Each category of disbursements should be reviewed with the client.

1. What benefit did the client get from the loan?

The HUD-1 is going to tell you very quickly what the client got out of the loan. If you already know that there were home improvements financed, figure out who got the home improvement money and how much. If this was a consolidation loan, figure out who got paid, something the client will often not be able to tell you. There are a few places you might find these items on the HUD-1, depending on what form the closing agent used and on whether it was filled out properly. There is a version of the HUD-1 designed for refinancings (HUD-1A) that actually has a section for Disbursement to Others (lines 1500), but sometimes disbursements to creditors appear under Additional Settlement Charges (lines 1300) and sometimes there is a typed Addendum which separately lists the payments made.

You should be particularly interested in large pay-offs, usually involving an old mortgage, and, if you see one there, ask questions about that pre-existing obligation. Eventually, you are going to want to figure out, from the client's standpoint, whether the refinancing made any sense. (They rarely do.) Whose idea was it to pay off the old mortgage? Was it delinquent at the time? What were the monthly payments and the rate? Was the old mortgage recent? Be alert for cases where the client has refinanced frequently. (Note that you may want to see the paperwork from the old mortgage; the client is unlikely to have brought it with her to the initial interview.)

See what other obligations were paid off, as well. What about unsecured utility bills or credit card balances? Did the client realize that she was converting unsecured debt into mortgage debt and whose idea was it to do that? Were there debts paid that should not have been paid at all, such as debts that the client did not owe or that did not require current payments? Remember the simple idea that a person with little income should be borrowing as little as possible, and know that a subprime lender (or, at least, the broker arranging the loan and probably earning a percentage fee) is, on the other hand, looking to lend out as much as possible. Was the client involved in deciding what bills to consolidate? Did she know, prior to the closing, which bills were going to be paid?

If there were home improvements financed with the loan, where does this money show up? Perhaps there was a designated escrow for home improvements, or perhaps the home improvement money appears as "cash to borrower." Were the home improvements actually done? Did the client actually receive that much money? (Cash to the borrower would be either at line 303 or 1604.)

2. What did it cost the client to get this loan?

Look carefully also at the itemized settlement charges which could make up 10-20 % of the total loan, or more. Points are generally itemized at lines 801 or 802 of the HUD-1, but there may be additional lender fees other than the ones designated as points, for example, "loan fee," application fee, or tax service fee. All of these fees represent lender profits, over and above what they may earn over time in loan interest.

Be particularly alert for credit insurance premiums appearing on the HUD-1. Lenders make a lot of money selling credit insurance, which tends to be very costly and of minimum benefit to the borrower. See NCLC, The Cost of Credit, Chapter 8. The client's awareness and understanding about this charge should be probed.

Another key determination is whether broker fees were paid from the loan. If so, they will probably appear within the 800 lines on the HUD-1. The role of the broker, the work performed, and the relationship of the borrower and the lender to the broker are extremely fruitful subjects for your investigation. It is not unusual for the client to be completely in the dark about the existence of a broker and the costs attributable to the broker's "services."

Add up the various fees charged by the lender. This sum, together with the broker fees, will enable you to determine whether the loan is a HOEPA (or "Section 32") loan, i.e. whether it is a loan subject to the special protections and disclosures required by the Home Owners Equity Protection Act, 15 U.S.C. §§1602(aa), 1639; Reg. Z, 12 C.F.R. §§226.32. See NCLC, Truth in Lending, Chapter 10.

D. How Did The Client Get To The Lender?

If this part of the story hasn't already come out, ask the client how she got connected to this particular lender and use the HUD-1 to probe the client's memory about the cast of characters involved in the loan. Was it a home improvement contractor that started the whole thing? Or was it a television ad or telemarketing call? By whom? Does she have a business card of the person who gathered her personal information for the loan and convinced her to do this?

E. Was There A Balloon Payment Or A Variable Rate?

Loan salespeople tend to focus almost entirely on what the monthly payment will be, as opposed to the amount of the loan, points and fees, and other aspects of the transaction. Among the tricks commonly used by subprimes to keep the payment down, at least temporarily, are balloons and variable rates. In loans containing a balloon, the loan is amortized over a long term, but then the entire balance of the loan comes due in one "balloon" payment long before the term expires. In variable rate loans, the contractual rate rises in accordance with some published rate index. One typical version of this in subprime loans is for the borrower to pay an artificially low "teaser" rate for three years to be followed by frequent increases in accordance with an index called LIBOR. Both balloons and variable rates will appear in the Note or in a supplement to the Note.

F. What Were The Client's Income And Expenses At The Time Of The Loan?

While traditional mortgage lenders are extremely unlikely to make loans to people who lack the income to repay the loan, subprimes are prone to minimizing the importance of repayment ability. Develop a budget for the client as she was at the time of the loan. Did the loan provide the client with any noticeable improvements to her monthly cash flow, and, even if it did, did the contractual payment leave her enough to pay for essential, recurring monthly expenses? If there is a codebtor in the loan, was the codebtor actually a part of her household and a realistic contributor to future payments?

G. What Else Smells Bad About This Loan?

In any consumer case, it is always a good idea to follow your instincts when confronted with transactions that fail the "smell test." Sometimes the client's lack of understanding of the nature of the transaction can set off alarm bells fairly early in your interview. Clients confused about the original transaction today were likely to be confused at the loan closing. Sometimes the loan documents themselves can suggest fruitful areas of inquiry, as for example, when you see a forged signature on a broker agreement, a loan application signed at the loan closing or a preprinted date on a form acknowledging receipt of disclosures on a specific date.

II. DEVELOPING A LEGAL THEORY.

A. Remember The Key Statutes Of Limitation.

If the date of the loan transaction is within the last year, you should be acting quickly. Several statutes of limitations, particular under Truth in Lending (including affirmative HOEPA claims) and the Real Estate Settlement Procedures Act (RESPA) are one-year. If you are within three years, you should be looking for a way to rescind the loan.

B. Is It A HOEPA Loan?

See NCLC, Truth in Lending, 4th ed., Chapter 10. If the lender treated it as a HOEPA loan, look for the advance HOEPA disclosure and question the client about the signing. Don't assume that the date appearing on the form is the date it was actually presented to the client. See Newton v. United Companies Financial Corp., 24 F.Supp. 2d 444 (E.D.Pa. 1998). And look at the disclosure itself for possible violations. Some lenders fail to disclose a balloon and others disclose a "contract rate" in addition to the APR.

If the lender did not regard the loan as being a HOEPA loan, you may still be able to argue that it was. Particularly if the points and fees calculation is just under 8%, you may be able to make a case that a settlement charge was wrongly excluded from the calculation. See Truth in Lending, §10.2.4.

Remember that, if you are within a year of the transaction, a HOEPA violation gets you statutory penalties in addition to the basic TILA penalty of $2,000. See 15 U.S.C. §1640(a)(4); Newton v. United Companies. It also gets you rescission within three years of the transaction. 15 U.S.C. §1639(j); Reg. Z §226.23, n. 48. A lesser known, but extremely important, consequence of a transaction being a HOEPA loan is that all claims and defenses, up the amount of the indebtedness, that exist against the original lender can be asserted against subsequent holders of the mortgage. 15 U.S.C. §1639(d).

C. TILA Rescission.

Even if you have no claims under HOEPA, there still may be traditional TILA violations that can get you rescission. Some recent violations we have spotted include the following:

- a charge designated "attorney fee" that was excluded from finance charge where there was no attorney that attended the closing and there was a separate "doc prep" fee;
- charges for appraisal and for title insurance on a refinancing by the same lender one year after the same charges were collected (i.e., a challenge to them being bona fide and reasonable and thus, excluded from finance charge);
- mistakes regarding the itemization of mortgage filing fees;
- improper disclosures of the payment schedule in balloon or variable rate transactions.

D. Claims Related To Brokers.

If the client paid a broker fee and if you are within one year, you should immediately assume you have a RESPA claim against both the broker and the lender. See NCLC, The Cost of Credit, 1999 Cumulative Supplement, §11.3.1; The Consumer Advocate, Volume 4, Issue 6 (November/December 1998, special issue on RESPA). Even if you are outside the year, you may have some broker-related claims worth exploring.

Broker fees paid outside of closing (identified as "POC" on the HUD-1) by the lender were probably excluded from the lender's HOEPA points and fee calculation. Putting them into the calculation may put you over the top for HOEPA coverage. See Truth in Lending, §10.2.4.2.3. Look to state law for possible claims that the broker violated a fiduciary duty to the borrower, or committed unfair or deceptive practices.

E. Bait And Switch Lending.

Where you can argue that the client agreed to one loan and ended up being presented with another, you may be able to make out a case of bait-and-switch. Take for example the typical case of a homeowner who agrees to home improvement financing and ends up also paying off numerous bills that she was not looking to consolidate, you could argue that the switch was unfair and deceptive. You might also argue that it was effectively a "counteroffer" within the meaning of the Equal Credit Opportunity Act and Reg. B, requiring a counteroffer notice which was undoubtedly not provided, yielding an ECOA claim of punitive damages up to $10,000 and attorney fees. See Newton v. United Companies. (Note that the ECOA statute of limitations is two years, rather than one year as in most other federal consumer protection statutes.)

F. Attacking The Fairness Of The Entire Loan Or Of Particular Components Of The Loan.

If the transaction smells bad, you should be thinking UDAP and fraud. And remember that if it is HOEPA loan, your fraud claims can also be asserted against the ultimate holder of the loan.

III. STRATEGY AND TACTICS.

A. Where To File And Who To Sue.

From my experience, litigating defensively in a mortgage foreclosure proceeding is not where you want to be. If you are within a year of the transaction, or if you have a TILA rescission claim, you should be thinking about filing your own case in federal court. Depending on your state law regarding the recoupment doctrine, you may even be able to pursue time-barred claims in bankruptcy court as a way to reduce the lender's proof of claim. You may want to be in bankruptcy court anyway if you are on the eve of a sheriff sale or if the client has lots of unsecured debt. We tend to prefer bankruptcy court as a forum for trying these kind of issues, but this depends a lot on the character of your particular courts.

As for who to sue, my thinking has evolved on this. When I first started filing HOEPA cases, my strategy was to sue only the lender, thinking that HOEPA makes the lender responsible for fraud by a prior holder of the loan and that suing only the deep-pocket bad guy keeps the case simple. I am now convinced of the opposite, that you sue everyone involved, including the broker, the originating lender, the attorney who took a fee out of the settlement, the contractor and anyone else whose fingerprints are on the loan. Multiple defendants are more likely to point their fingers at each other rather than cooperate in fighting against you and are almost always going to produce more money for your client.

B. Settlement Goals.

At a minimum, particularly early on in litigation, a rescission is an excellent result for the client. What I mean by rescission is a deal where the lender agrees to a loan modification under which the client is responsible only for money she actually got (i.e., you exclude all points and settlement charges), she gets credit for all payments made, and then you get a rate and/or contract term for the remaining balance that translates into an affordable payment. You may be able to negotiate some statutory penalties, as well, and, of course, attorney's fees.

Especially where you bring in other parties, however, you are likely to be able to get a settlement even better than that. Think seriously about taking the position that the loan should be wiped out and the client should receive damages in addition. I have been in cases where the lender is more willing to consider forgiving the loan where there are other parties who can fund damages and fees.

As with all settlement negotiations, the key to getting a good result is to project confidence and a willingness to go to trial. A little substantive knowledge in this area will very likely make you more knowledgeable than the average foreclosure lawyer. And seriously consider taking a case to trial if the opportunity presents itself. These are cases that are extremely satisfying to try, especially where you have strong facts underlying any technical statutory claims.

C. Special Considerations For Restricted Legal Services Programs.

The inability to assert attorney's fees claims makes consumer practice very difficult for LSC-funded legal services lawyers. Having said that, however, there is still a critical role in this area that needs to be filled by legal services programs. The clients losing their homes will continue to seek representation from legal services and it is there where the solutions must begin.

Many consumer specialists in restricted programs have managed to remain leaders in the effort to combat predatory lending without running afoul of the LSC restrictions. Just to name a few, NACA members Bill Brennan in Atlanta and Lynn Drysdale in Jacksonville, and the consumer specialists at our sister organization, Philadelphia Legal Assistance, have continued to save houses and to combat the subprimes through a variety of approaches. One is to maintain close connections to private attorneys willing to take these cases, and to invest time in educating the private bar concerning the enormous potential of predatory lending litigation. Another is to file the suit yourself but with a co-counsel who is able to make the attorney's fee claim. Finally, while the big money in federal consumer litigation is often in the statutory fees, there is nothing to prevent a restricted legal services lawyer from filing a state court fraud case, which, in the end, may produce more for the client than anything else.