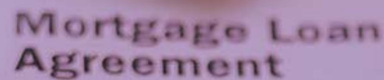
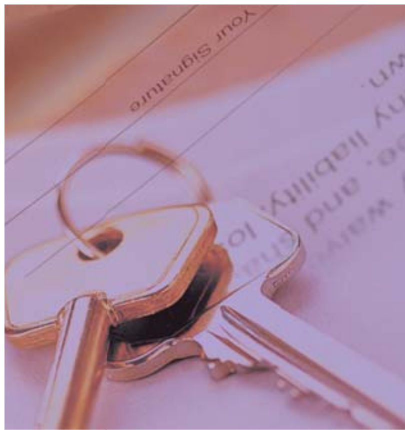
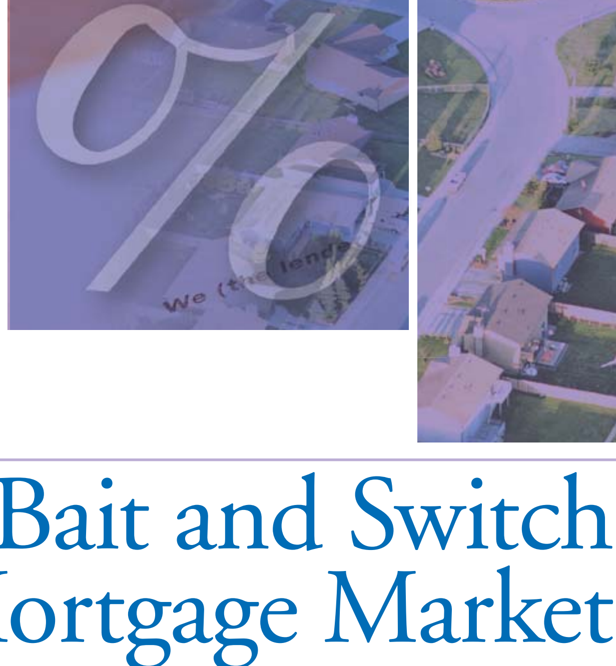
Consumer Law







Bait and Switch in the Mortgage Market

By Frederick L. Miller

COPING WITH HIGH-RATE SLEIGHT OF HAND

Abbe Hays could be a poster child for the mortgage refinance bait and switch. She sought a small loan to cover siding for a home addition only partially completed when her husband left her and her three children.[1] When closing came in August 1994, the loan papers said she was borrowing much more: $45,500, at an interest rate of 13.75 percent, and large fees. She signed, but went back to the lender (the since-bankrupt United Companies Lending Corporation) to use her rescission rights within the three-day period in the notice given at closing.

The lender's agent said that was not necessary; he would refinance her at a favorable low rate after she made one year of payments. She didn't rescind, made the payments, but was later denied refinancing.

Not to worry. Another lender, Vanguard Mortgage, sent her a letter saying they could refinance her at a low rate. The "Initial Financing Agreement" was for a conventional 30-year mortgage at 9.7 percent. Another document, labeled "Financing Agreement," apparently delivered at closing, "locked in" a 30-year loan at 10.65 percent. But the actual mortgage note, now at $57,000 with high fees for the new loan, was for 15 years, with a balloon payment of over $48,000. Ms. Hays asked what a "balloon loan" was and was told, "Don't worry, they all have that now." Ms. Hays ended up in foreclosure.

Despite federal and state laws aimed at making mortgage lending transactions transparent, bait-and-switch sales are alive and well in the housing loan marketplace. In 2000, a Department of Housing and Urban Development—Treasury Department Task Force on Predatory Lending listed bait and switch among aggressive tactics used by some lenders, brokers, and home improvement contractors arranging financing.[2] The report recommended action by the Federal Reserve Board to curb these practices.

Bait-and-switch abuses were cited by attorneys general and other officials from 49 states in a settlement with mortgage giant Ameriquest earlier this year.[3] Bait-and-switch tactics are alleged in class actions, including one against Wells Fargo, which advocates say has prompted changes in company policy.[4]

Federal and state laws have long recognized the importance of clear and timely disclosure of consumer credit terms. However, gaps in disclosure requirements and the aggressive ingenuity of mortgage lenders and brokers have left borrowers with loan terms they had no reason to expect, and their attorneys (when they have them) grasping for remedies.

The Good Faith Estimate

The Truth in Lending Act (TILA)[5] sets out detailed disclosure requirements that govern virtually all consumer credit transactions, with the goal of promoting informed consumer choice. The Real Estate Settlement Practices Act (RESPA)[6] dictates procedures and forms for residential real estate closings to make clear to borrowers the true costs of buying and refinancing.

Complementary provisions of TILA and RESPA require lenders to provide "good faith estimates" of both loan terms and costs early in the mortgage process. Clearly, Congress had the bait-and-switch problem on its mind. However, neither law has prevented problems or provided much relief for unsuspecting and unsophisticated consumers.

RESPA requires written estimates of closing costs within three days of submission of a mortgage loan application.[7] However, the large majority of high-rate, high-fee mortgages now go through mortgage brokers. The ultimate lender may not get a written "application" until closing, when this document appears as part of the vast sheaf of papers the borrower is to sign. Thus, the good faith estimate is often first shown at the same time as the closing figures it is designed to forecast. Further, RESPA omits any private right of action for violations of its good faith estimate requirements, so there is little incentive for unscrupulous brokers or lenders to change their practices.

TILA requires a good faith estimate of its required disclosures, including annual percentage rate, finance charges, payments schedule, and more, also within three business days of submission of a mortgage loan application.[8] However, the requirement applies only to purchase-money mortgages. Refinances, where many of the worst practices appear, are not covered. Further, court decisions give lenders great leeway in their "good faith" estimating and have not applied TILA to prohibit abuses.[9] One analyst has concluded that, far from protecting consumers, the loose requirement for good faith estimates "creates a federally structured opportunity for lenders to use bait-and-switch consummation tactics."[10]

Home Ownership and Equity Protection Act (HOEPA)

In 1994, the Home Ownership and Equity Protection Act (HOEPA)[11] was added to TILA, with the goal of addressing predatory tactics in the selling of high-rate and high-fee mortgage loans. HOEPA added a new layer of disclosures to make bait and switch more difficult. The correct annual percentage rate of the loan, the size of any balloon payments, and the cost of any credit insurance must be provided at least three days before closing, along with a notice that the borrower does not have to go through with the loan and a warning that the consumer could lose his or her house upon default.

HOEPA also has teeth: failure to follow its disclosure requirements extends the three-day TILA cancellation rights for up to three years. Actual damages, normal TILA statutory damages up to $1000, plus enhanced statutory damages for material violations are also available.[12]

In enacting HOEPA, Congress recognized that the federal structure of mandated disclosures at closing and some "estimates" before closing were inadequate to protect vulnerable homeowners. However, the extra disclosures are limited, and the triggering threshold for loans covered by HOEPA is high. By limiting coverage to the highest tier of mortgage loans in terms of interest rates or closing fees and exempting open-ended loans such as home equity lines of credit, relatively few loans are covered, and lenders are given incentive to structure loans so they fall just outside the parameters of HOEPA.

Equal Credit Opportunity Act (ECOA)

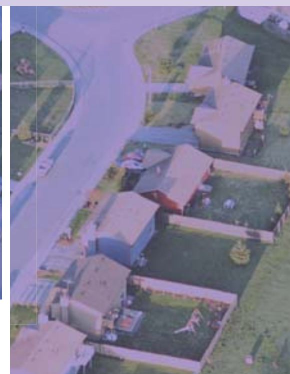
The Equal Credit Opportunity Act[13] is primarily an anti-discrimination law. However, Congress added notice requirements to the act in 1976 that apply to all consumer credit transactions, and can be enforced whether or not there is an allegation of discrimination. ECOA notices are required whenever there is an "adverse action," i.e., "a denial or revocation of credit, a change in the terms of an existing credit arrangement, or a refusal to grant credit in substantially the amount or on substantially the terms requested."[14] Since bait and switch always involves "a change in the terms of an existing credit arrangement," the ECOA notice requirement should be a bulwark against lender and broker sleight of hand.[15]

The act creates a private right of action for actual and punitive

FAST FACTS

Legal Protections Against Mortgage Bait and Switch:

- Federal statutes require pre-closing disclosure of estimated loan terms, pre-closing disclosure of actual loan terms for high-rate and high-fee mortgage loans, and notice when changes are made from the terms applied for by the borrower.
- State statutes and common law prohibit fraud, deceit, and misrepresentation in loan transactions.



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damages, plus attorney fees and costs. However, vague rules make the ECOA notice requirements difficult to enforce.[16]

Fair Credit Reporting Act (FCRA)

The Fair Credit Reporting Act[17] has a separate notice requirement, which applies whenever a credit grantor takes adverse action based in whole or in part on information from a credit report.[18] The notice gives the consumer the information needed to fix credit reporting errors and triggers the right to a free report from the consumer reporting agency.

However, the definition of "adverse action" is tied to the ECOA provision, and thus the confusion surrounding it. The FCRA both incorporates the ECOA definition and has its own additional definition.[19] If the subsection incorporating ECOA definitions means that the ECOA regulations apply, no FCRA notice is required when a credit report results in a counteroffer that is accepted and signed, since the ECOA regulations put counteroffers in a separate category, dropping them from "adverse actions."[20] In addition, several courts have held that 2003 amendments to the FCRA eliminated a private right of action for failure to provide adverse action notices.[21]

State Law

In 2002, Michigan adopted the Consumer Mortgage Protection Act,[22] designed in part to preempt local ordinances seeking to rein in predatory lending. The act has no requirements for disclosure of loan terms or changes in loan terms, beyond incorporating the requirements of other state and federal laws. The act has a general prohibition on deceptive or misleading statements in connection with a mortgage loan, but no private right of action. Michigan's statute is among the weakest state responses to predatory lending abuses in recent years[23] and has little to offer to combat bait-and-switch practices.

The Michigan Mortgage Brokers and Lenders Act also has a general prohibition on "fraud, deceit and material misrepresentation" in mortgage transactions,[24] and this licensing statute does have a private right of action.[25] Likewise, common law fraud may be used by misled consumers. However, the standard of proof is high for fraud. In addition, the statute of frauds and the broad Michigan application of the parol evidence rule in fraud cases[26] create serious barriers to common law and statutory fraud cases based on mortgage loan transactions.

Practitioners responding to aggressive mortgage sales practices have some tools to work with, but current law has yet to ward off the classic bait and switch. ◆

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Footnotes

1. *Hays v Bankers Trust of California,* 46 F Supp 2d 490 (SD WV 1999).
2. http://www.huduser.org/Publications/pdf/treasrpt.pdf, p 79.
3. See Michigan Attorney General press release, "Cox Announces Ameriquest to Pay $325 Million Nationwide and Reform its Lending Practices," available at http://www.michigan.gov/ag/0,1607,7-164—134830—,00.html.
4. "Wells Fargo Implements Borrower Protections," *LA Times,* August 31, 2005.
5. 15 USC 1601 et seq.
6. 12 USC 2601 et seq.
7. 12 USC 2604(c).
8. 15 USC 1638(b)(2).
9. *Clark v Troy & Nichols, Inc,* 864 F2d 1261 (CA 5, 1989) (discussed in the full version of this article, available online at http://www.michbar.org/consumer/articles.cfm).
10. Peterson, Christopher, *Federalism and predatory lending: Unmasking the deregulatory agenda,* 78 Temple L R 1, 18 (Spring 2005).
11. 15 USC 1639.
12. 15 USC 1640(a)(4).
13. 15 USC 1691 et seq.
14. 15 USC 1691(d)(6).
15. See, e.g., *Newton v United Companies Financial,* 24 F Supp 2d 444 (ED PA 1998).
16. See further discussion in full version of this article, available online at http://www.michbar.org/consumer/articles.cfm.
17. 15 USC 1681 et seq.
18. 15 USC 1681m(a).
19. 15 USC 1681a(k)(1)(A) and (B).
20. See *Harper v Lindsay Chevrolet Oldsmobile,* 212 F Supp 2d 582 (ED Va 2002).
21. *Murray v GMAC Mortgage Corp,* 434 F3d 948, 951 (CA 7, 2006) (dicta stating that sec 1681m(h)(8) eliminated private right of action); contra, *Barnette v Brook Road, Inc,* 429 F Supp 2d 741 (ED Va 2006) (bar on private actions only applies to that subsection).
22. MCL 445.1630.
23. Peterson, supra, fn 11, at 67, n 488.
24. MCL 445.1672(b).
25. MCL 445.1681.
26. See *UAW-GM Human Resources Center v KSL Recreation Corp,* 228 Mich App 486 (1998).