

# Consumer Financial Services

## LAW REPORT

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### Credit crisis drives coordinated state enforcement activities

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The level of enforcement activity by state regulators in the mortgage lending arena has predictably increased since the credit crisis began in the summer of 2007. So has the degree of cooperation among state officials via coordinated attacks on lenders and other participants in the mortgage origination/securitization channel.

Attorneys general from four states have recently filed lawsuits that provide evidence of this trend. The battles are still in the early stages and the end results remain uncertain. Let's consider the specifics of three of these cases and try to draw some conclusions about what we can expect to see over the balance of 2008 and beyond in terms of state enforcement activities.

#### Attorneys general attack Countrywide using UDAP

During the last week of June, Countrywide Financial was sued by the AGs of California and Illinois in civil lawsuits seeking restitution and civil penalties under the states' unfair and deceptive acts or practices statutes, and for injunctive and equitable relief.

The timing of the complaints, both filed on the day that Bank of America received shareholder approval to take over Countrywide, together with the similar pleading allegations, suggest a high-level of harmony in the preparation of the lawsuits. Less than two weeks later, the Attorney General of Florida filed a similar civil action seeking damages for Countrywide's alleged deceptive marketing and sales practices.

All three suits argue that Countrywide's marketing, origination, underwriting, securitization and servicing practices were unfair and/or deceptive to consumers. The allegations focus on the concept of "structural unfairness" (loans designed to fail) as the predatory-act hook for the asserted UDAP violation, premised on the impropriety of lending against the value of the collateral — instead of the borrower's ability to repay.

#### California v. Countrywide Financial

The California complaint alleged that Countrywide violated the state's "Little FTC Act" by using an unfair business model to implement a deceptive scheme through misleading marketing practices designed to sell

risky and costly loans to homeowners who did not understand the terms and dangers. The alleged scheme included:

- Advertising that it was the nation's largest lender and could be trusted.

- Encouraging borrowers to refinance or obtain purchase money financing with complicated mortgage instruments like hybrid or payment option ARMs that were difficult to understand.

- Marketing these complex loan products to consumers by emphasizing very low initial 'teaser' or 'fixed' rates, while obfuscating or misrepresenting the later steep monthly payments and interest rate increases or risk of negative amortization.

- Routinely soliciting borrowers to refinance only a few months after Countrywide or the loan brokers with whom it had 'business partnerships' had sold them loans.

The California AG requested a \$2,500 civil penalty for each violation of the state's business and professional code, and an order enjoining Countrywide from any further such acts.

#### Illinois v. Countrywide Financial

The Illinois AG made very similar allegations against Countrywide under the Illinois Consumer Fraud and Deceptive Business Practices Act. The Illinois complaint alleged that Countrywide engaged in unfair and/or deceptive acts or practices by originating mortgage loans to borrowers who did not have the ability to repay their loans through practices such as, but not limited to:

- Promoting the use of reduced-documentation underwriting guidelines to qualify borrowers who did not have sufficient income or assets to afford the Countrywide loans they were sold.

- Inflating borrowers' income on loan applications.

- Qualifying subprime borrowers for hybrid ARM mortgage loans using less than the full-indexed rate.

- Qualifying borrowers for mortgage loans with an interest-only payment option using less than the full-amortizing payment.

- Originating loans not designed for long-term viability, but for short-term refinancing.

- Promoting serial refinancing without regard to the increased cost to the borrower or the affordability of the loan, and without disclosing that the ability to refinance relied on a perpetual increase in home valuation.

- Loosening underwriting guidelines over time, originating loans with multiple layers of risk and allowing exceptions to underwriting guidelines, all of which resulted in the sale of unaffordable loans.

### **Florida v. Countrywide Financial**

In an action for damages and injunctive relief under Florida's UDAP statute, the Florida AG relied upon many of Countrywide's statements made in SEC filings and attacked its business model with allegations very similar to those made by the Illinois and California AGs. The Florida action alleged that Countrywide originated subprime loans to borrowers who did not have the ability to repay, and originated higher-interest loans to borrowers who otherwise qualified for prime loans "in furtherance of its policy to place the generation of consumer loans (and maximization of its profits) above concerns about the consumers' ability to meet their loan obligations.

The Florida AG alleged that the marketing of Countrywide's ARMs included the following "material misrepresentations":

- The amount of time the initial 'fixed' interest rates would be in effect.

- That the interest rates on the loans were 'fixed' when that was not the case.

- The manner and degree in which payments would increase subsequent to the termination of the initial fixed rate period.

- Employing and advertising extremely low 'teaser' rates while not properly disclosing that these rates would dramatically increase, resulting in monthly payments which were beyond the capacity for consumers to meet.

The misrepresentations were direct, said the complaint, or were the result of hiding, or not sufficiently disclosing, these material terms prior to closing.

These legal challenges to Countrywide's business model by the AGs of California, Illinois and Florida could easily be repeated by other states — witness Connecticut, which filed a similar suit just as this article was going to press. Other subprime lenders with a history of lending practices similar to Countrywide's could be challenged under state UDAP statutes. Expect to see that happen. The concepts of an unsuitable loan and "structural unfairness" are legal theories which the states are primed to push through the courts. Stay tuned for many more battles on that turf.

### **Foreclosure process intervention**

The Massachusetts AG has taken a lead role in exercising state authority over the foreclosure activities of certain lenders that are not owned by national banks and which do not have federal preemption arguments

to avoid state regulatory enforcement. The AG sought and obtained a restraining order and a preliminary injunction against Fremont General prohibiting any foreclosures against Massachusetts consumers without advance notice to the state AG's office.

In a repeat performance in June, the Massachusetts AG obtained a similar injunction against all foreclosure activities of H&R Block/Option One Mortgage Corp. So far, other states have not pursued this path, but given the success of Massachusetts with the claim theory, it is likely that other AGs will follow.

### **NAAG and AARMR coordination**

Associations of attorneys general and of regulators in the residential mortgage market provide the opportunity and the means for such coordinated activities in the credit markets and otherwise. The level of concerted action should grow as a result of these organizations. The National Association of Attorneys General has a standing committee on consumer protection which promotes multi-state protection enforcement efforts, as well as information exchange concerning investigations and litigation.

This NAAG committee is cochaired by North Carolina Attorney General Roy Cooper and North Dakota Attorney General Wayne Stenehjem. The working group includes Florida Attorney General Bill McCollum and Louisiana Attorney General Charles Foti. At the Consumer Protection Conferences as well as the annual summer meeting held in mid-June, interested attorneys general and staffers gather to exchange ideas about a variety of enforcement initiatives.

State financial institution regulators, for example, who regularly coordinate with attorneys in their respective state attorney general offices, are meeting in Minneapolis this year at the American Association of Residential Mortgage Regulators annual conference. Among the hot topics of interest at this year's meeting will be the Joint Statement on Subprime Mortgage Lending, issued last year. The Joint Statement substantially mirrors the federal statement released in June.

### **More to come**

In addition to the types of parallel enforcement activities described above, there are other areas where the lending industry can expect to see more common action by state regulators:

- Enforcement of the new state laws imposing various forms of fiduciary duties on brokers/lenders, whether by consideration of a borrower's ability to repay at the fully indexed rate, or agency principles, or breach of good faith/fair dealing, or a duty by other name.

- The use of state licensing power to ban mortgage brokers and servicers identified as having engaged in the sharpest of dealings over the past several years.

■ Consultation and cooperation in the process by which AGs are entitled to notice of intended settlement of class action litigation under the Class Action Fairness Act and are given an opportunity to object to or tweak settlement terms.

■ Preemption turf battles asserting parallel state rights to FTC-type enforcement activities, as states seek to take back some territory even over national bank subsidiaries as carve outs to the Supreme Court decision in *Watters v. Wachovia Bank, et al.*, 127 S. Ct. 1559 (2007).

State AGs, banking regulators and legislatures have proven to be on the front lines in response to the mar-

ket failure and foreclosure stress in the residential mortgage industry. They have significantly increased investigations and enforcement actions throughout the first half of 2008. They are poised to continue the fight for underwriting risk reform and consumer redress.

Players in the subprime mortgage lending market may be forced to consider the endgame forced upon big tobacco when it faced a similar multifaceted front. The surviving lenders may have to consider an armistice based upon changed rules and best practices in order to avoid the costs and casualties of a prolonged siege. □