How the Household Settlement Uncorked a Law Enforcement Bottleneck By Sally Peacock

Introduction

On October 11, 2002, twenty State Attorneys General announced a record-breaking settlement with Household International for its alleged predatory lending practices in the subprime mortgage lending market.¹ This settlement has been heralded by the press, the State Attorneys General and bank regulators as a "blueprint for national standards" in the mortgage lending industry.² The Household settlement, however, can do more than provide guidelines to lenders. It can act as a template for future multi-state, multi-agency Attorney General action against both predatory lenders and other law violators.

Part I defines the problem of predatory lending, including the business practices used by predatory lenders and the effect of those practices on both individual borrowers and the economy. Part II explains the three solutions that have been used in the past to stop predatory lending: federal legislation and enforcement, state legislation, and private lawsuits. This section concludes that these forms of law enforcement have failed to curb predatory lending sufficiently. Part III describes the formation of the unique multi-state team that investigated Household and examine the terms of the settlement, highlighting both its strengths and weaknesses. Part IV assesses the settlement's potential as a blueprint for future multi-state investigations.

Part I: The Problem

A. Defining Predatory Lending

Nationwide there exist three markets for mortgages: prime, subprime and predatory.³ In the prime market, borrowers with strong credit histories receive mortgages with "interest rates

¹ Press Release, States Settle with Household Finance: Up to \$484 Million for Consumers (October 11, 2002) (available at

www.state.ia.us/government/ag/latest_news/releases/oct_2002/Household_Chicago.html). Once states representing 80% of borrowers sign on to this agreement, the lender must pay \$484 million to injured borrowers and change many of its business practices. The subprime market is addressed in Part IA, *infra*.

² Erick Bergquist and Rob Blackwell, *Household Pact May Be National Blueprint; Aldinger: 50 states will sign; NY regulator says most on board*, THE AMERICAN BANKER, October 15, 2002, at 1.

³ Kathleen C. Engel and Patricia A. McCoy, *A Tale of Three Markets: The Law and Economics of Predatory Lending*, 80 Tex. L. Rev. 1255, 1257 (2002).

below the market-clearing rate" and often no prepayment penalties.⁴ Competition among lenders and regulation by both federal and state governments lead to overall similarity between loan terms.⁵ The borrowers in this market tend to have "greater familiarity with complex financial transactions" than those in the subprime market.⁶

The subprime mortgage market serves borrowers who lack the credit history required for a prime mortgage. Legitimate subprime lending thus "provides an important service, enabling such borrowers to buy new homes, improve their homes, or access the equity in their homes for other purposes." Subprime lenders compensate for these mortgages' comparatively higher risk by charging higher interest rates than their prime counterparts.

Professor Kurt Eggert states that the regulation of the subprime market is "rarely enough . . . to protect borrowers in an era when many homeowners are borrowing hundreds of thousands of dollars at a time." Not surprisingly, nearly all predatory lending takes place in the subprime market. Subprime borrowers are often less sophisticated, and many live in low-income neighborhoods which are served only by predatory lenders.

Predatory lending denotes the use of at least one of a host of business practices to gain an unfair advantage over a borrower. While HUD has asserted that defining predatory lending is a

⁵ Departments of the Treasury and Housing and Urban Development, Curbing Predatory Home Mortgage Lending, June 20, 2000, available at www.huduser.org/publications/pdf/treasrpt.pdf (hereinafter "HUD Study").

⁴ *Id.* at 1279.

⁶ *Id*. at 17.

⁷ Engel, *supra* note 3, at 1258.

⁸ HUD Study, *supra* note 5, at 3. HUD also reports that the subprime mortgage market was five times larger in 1999 than it was in only 5 years earlier, in 1994.

⁹ Kurt Eggert, *Held up in Due Course: Predatory Lending, Securitization, and the Holder in Due Course Doctrine*, 35 CREIGHTON L. REV. 503, 554 (2002).

¹⁰ Engel, *supra* note 3, at 1261.

¹¹ HUD Study, *supra* note 5, at 18. The HUD task force explains that many subprime borrowers who were unable to obtain credit in the past may not be aware of their credit options when applying for a mortgage. Subprime borrowers may also need to access supplemental funds for home repairs and other expenses in a relatively short timeframe due to their low income, which prevents such borrowers from comparison shopping for loans.

¹² Richard R. Daugherty, Will North Carolina's Predatory Home Lending Act Protect Borrowers From the Vulnerability Caused by the Inadequacy of Federal Law?, 4 N.C. Banking Inst. 569 (2000).

"problematic task," ¹³ Kathleen Engel and Patricia McCoy argue that such practices fall into one of five categories: "loans structured to result in seriously disproportionate net harm to borrowers, harmful rent seeking, loans involving fraud or deceptive practices, other forms of lack of transparency in loans that are not actionable as fraud, and loans that require borrowers to waive meaningful redress." ¹⁴ Specific practices include racial targeting in advertising, ¹⁵ steering of borrowers to high-cost lenders, loan payments which decrease a borrower's home equity with each payment ("equity stripping"), mortgages structured to result in foreclosure ("asset-based loans"), fraud on borrowers and secondary market buyers using falsified loan applications, high points, balloon payments, negative amortization, padded or duplicative closing costs and fees, insurance packing, excessive prepayment penalties, mandatory arbitration clauses, loan flipping/refinancing, loans in excess of 100% of loan-to-value ration of underlying collateral, and abusive collection practices. ¹⁶

As explained in Part II-C, *infra*, the securitization of mortgages plays an important role in predatory lending. During the 1980s, the mortgage industry witnessed a steep increase in securitization. Professor Kurt Eggert explains that

securitization is the process of aggregating a large number of notes secured by deeds of trust in what is called a mortgage pool, and then selling security interests in that pool of mortgages. Through securitization, the source of capital for mortgage funding has been transferred from the savings industry, which used deposits to fund loans, to the capital markets and the portfolios of institutional investors. ¹⁷

¹³ HUD Study, *supra* note 5, at 17.

¹⁴ Engel, *supra* note 3, at 1260.

¹⁵ McCoy and Engel report that some predatory lenders use census data to locate people of color to target with their marketing. *Id.* at 1281.

¹⁶ WILLIAM J. BRENNAN JR. AND PATRICIA STURDEVANT, A Catalogue of Predatory Lending Practices, 5 CONSUMER ADVOC. 4 (1999). The authors provide an even more exhaustive list of practices in their article.

¹⁷ *Id.* at 535-6.

As a result, over sixty percent of mortgages are originated with mortgage brokers, rather than traditional banks. A combination of federal and state regulations govern these mortgage brokers, leading to variation from state to state.

B. The Impact of Predatory Lending upon its Victims

Predatory lending has devastating effects on its victims. These borrowers tend to be unsophisticated about their loan options, and are predominantly low income and working class adults.¹⁹ Frequently, predatory lenders target minority and/or elderly individuals.

In gathering complaints about Household's lending practices, investigators found that borrowers "were varied, and included low income borrowers in the working class, and even middle income suburbanites," although the demographic data Household has filed with the federal government shows that its loans were concentrated in minority communities. ²⁰ In the southwest, complaints about Household came mostly from Hispanic borrowers. The State Attorney General of Arizona²¹ fielded numerous complaints mainly from Hispanics unable to read the English loan documents Household sent them. ²² Understanding why predatory lending so affects minority populations is thus crucial to analyzing the Household settlement.

Minorities

Much of the scholarly literature on the racial implications of predatory lending has focused on Afro-Americans. Predatory lenders target Afro-American communities for a variety of reasons. First, Afro-Americans often have lower credit ratings than whites, which places them

²⁰ Interview with Chris Saffert, ACORN representative, December 16, 2002 (hereinafter "Saffert Interview"). Mr. Saffert was one of the leaders in ACORN's lengthy campaign against Household.

²¹ Janet Napolitano was then the State Attorney General of Arizona. She has since been elected Governor of that state.

¹⁸ Eggert, *supra* note 9, at 553.

¹⁹ Engel, *supra* note 3, at 1280.

²² Interview with Sandra Kane, Civil Rights Attorney in the Arizona State Attorney General's Office, December 20, 2002 (hereinafter "Kane Interview"). Ms. Kane played a leading role in the Household settlement, and also heads up the mortgage lending task force, a coalition between NAAG and the United States Department of Justice.

in the subprime market for mortgages.²³ For instance, in 1989 45% of Afro-American households had checking accounts, while nearly 80% other households did.²⁴ Second, unemployment rates are higher in Afro-American communities, resulting in a lack wealth in either inheritance or savings.²⁵ A borrower is thus unlikely to find assistance in the form of loans or guarantors within her community, leading her to predatory lenders for assistance.²⁶

Finally, due to redlining, predatory lenders often stand as Afro-Americans' only choice for a loan.²⁷ While Congress has enacted laws to address redlining, evidence indicates that it continues to be a common practice.²⁸ According to William J. Brennan, Jr., director of the Atlanta Legal Aid Society's housing and consumer division, predatory lenders often fill the "credit-vacuum" created by redlining.²⁹ Once a prime lender has redlined a neighborhood, "high-cost finance companies target those same communities with overpriced loans, knowing that the residents are a captive market with no access to reasonably-priced credit." This practice is known as reverse redlining. Often the same institution both redlines and reverse redlines a neighborhood, creating a market for predatory lending through its own discriminatory practices.³¹

²³ HUD Study, *supra* note 5, at 22-23. HUD reports that Afro-American borrowers are more likely to refinance their mortgages with subprime lenders, making them statistically more likely to do business with predatory lenders. Another study by HUD shows that whereas only 9% of whites refinance their mortgages with subprime lenders, 51% of Afro-Americans do so.

²⁴ Peter P. Swire, *Equality of Opportunity and Investment in Creditworthiness*, 143 U. PA. L. REV. 1533, 1536 (1995).

²⁵ Keith N. Hylton, *Banks and Inner Cities: Market and Regulatory Obstacles to Development Lending*, 17 Yale J. on Reg. 197, 210 (2000).

²⁶ *Id.* at 210.

²⁷ Keith N. Hylton and Vincent D. Rougeau, *Lending Discrimination: Economic Theory, Econometric Evidence, and the Community Reinvestment Act*, 85 GEO. L.J. 237, 241 (1996). Financial institutions were known to outline geographic zones to indicate that no loans should be made in those areas. The Community Reinvestment Act, passed by Congress in 1977, aimed to prevent such racially discriminatory redlining practices. Find 123 Cong Record 17630 (1977).

²⁹ See Statement of William J. Brennan, Jr., Before the United States Senate Special Committee on Aging, March 16, 1998 (hereinafter "Brennan Testimony").

³⁰ *Id*. ³¹ *Id*.

The Elderly

Along with minorities, predatory lenders also target the elderly. Older people have characteristics that make them especially attractive to such lenders. First, older people tend to be "house rich but cash poor," because they have paid off their original mortgages and subsist on a small, fixed income. Seniors are often faced with medical or home improvement expenses which cannot be paid by this limited and fixed monthly income. In addition, many elderly people have little experience with complex financial transactions, suffer from medical infirmities, and live in relative isolation. The combination of all these characteristics make the elderly particularly susceptible to predatory lending schemes, and particularly attractive to predatory lenders. Indeed, housing advocates report that predatory lenders engage in a practice of searching the Registrar of Deeds to find homes in low-income neighborhoods without mortgages, searching other public records to find homeowners' ages, and touring those neighborhoods to find such homes in need of repair.

"Reverse mortgage loans...permit homeowners age sixty-two and older to turn their heretofore nonliquid house into an income-producing asset." Under most reverse mortgages, the senior does not have to repay the loan until she leaves her home or dies, without risk of foreclosure. However, elders continue to be at risk for "asset-based loans," which aim to foreclose on the borrower.

In his 1998 testimony before Congress, William Brennan revealed the scope of such abuse by telling the story of a seventy-year-old widow who had owned her house for twenty years took out a \$54,300 loan with 12.85% interest. Her monthly payments total nearly \$600, and at

³² HUD Study, *supra* note 5, at 72. *See also*, Institutional Investor, Inc., Lazio Pushes FHA-Insured Reverse Mortgage Program 5 (1995), which reports that in 1995, the median income of seniors was \$18,500, while the median value of their homes was \$70,000.

³³ See generally HUD Study, supra note 5, at 71-72.

³⁴ Jean Reilly, *Reverse Mortgages: Backing into the Future*, 5 ELDER L.J. 17 (1997).

³⁵ Brennan Testimony.

the age of 83 she will be liable for a balloon payment of \$47,599. She also paid a \$700 fee to her mortgage broker for helping her find this loan. ³⁷ Brennan's story illustrates the risk of assetbased loans which aim to foreclose on the borrower so that the lender can purchase the foreclosed home at auction. ³⁸

Reverse mortgages are not an inherently damaging financial instrument. The difference between beneficial and damaging reverse mortgages is suitability.³⁹ A reverse mortgage suitable to one senior may lead to the bankruptcy of another. Although a lender should recommend only those loans suitable for the particular customer, seniors like the aforementioned widow can fall prey to unsuitable reverse mortgages.

The loss imposed by predatory lenders is uniquely detrimental to its victims. As one advocate explains,

homeownership represents the best possible opportunity for families to build wealth and economic security and take their first steps into the middle class. Accumulating equity in their homes is the primary way most families earn the wealth to send children to college, pay for emergencies and pass wealth on to future generations, as well as develop a real stake in society.⁴⁰

Thus just as the working poor achieves the goal of homeownership, the aforementioned business practices take it away. Predatory lending both displays and exacerbates society's inequality, by bankrupting and foreclosing on its victims.⁴¹

° Id.

³⁶ Ms. Reilly describes three lawsuits filed against Providential, a reverse mortgage provider, alleging that the company fraudulently convinced the plaintiffs to take out the loans by misrepresenting the interest rates, leading to equity stripping. Reilly, *supra* note 34, at 20-26.

³⁷ See generally Brennan Testimony.

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³⁹ Engel, supra note 3 at 1318.

⁴⁰ Eric Stein, Quantifying the Economic Cost of Predatory Lending: A Report from the Coalition for Responsible Lending, July 25, 2001, at n.4 (revised October 30, 2001), (available at http://www.responsiblelending.org/research/Quant10-01.PDF).

⁴¹ See generally Brennan Testimony.

C. The Economic Costs of Predatory Lending

Predatory lending imposes enormous costs upon society. The Coalition for Responsible Lending, ⁴² a North Carolina organization, estimates that nationally, borrowers lose \$9.1 billion per year to predatory lenders. ⁴³ Of this figure, Responsible Lending attributes \$1.8 million to exorbitant fees built into predatory loans, \$2.3 billion to prepayment penalties, \$2.1 billion to credit finance insurance, and \$2.9 billion to rate-risk disparities.

Because predatory lenders target low income minority and elderly borrowers, foreclosures concentrate in the minority neighborhoods. A foreclosure effects more than the holder of the mortgage. It can devastate a family, especially because the home is often the family's most valuable asset. A foreclosed home often remains uninhabited for a period, resulting in a deterioration of surrounding property values. Crime rates are higher in uninhabited areas, imposing added costs of law enforcement. This syndrome can eventually lead to the loss of neighborhood cohesiveness and added crime, harming an entire community. As Chicago mayor Richard Daley explains,

We are seeing a pattern in the city and in the suburbs . . . It's the same story: A family has suddenly abandoned their home. In many cases, it is elderly people who have lived there for many years . . . Once abandoned, these homes have been taken over by gangs and drug people, and they become breeding places for crime. ⁴⁹

⁴² Responsible Lending is a collaboration of organizations dedicated to fighting predatory lending. Members include AARP-North Carolina, North Carolina NAACP, North Carolina Equity, North Carolina Consumers Council, North Carolina Association of Realtors, North Carolina Credit Union League, and 21 local Habitat for Humanity affiliates. More information about this group can be found at www.responsiblelending.org.

⁴³ Eric Stein, Quantifying the Economic Cost of Predatory Lending at 2.

⁴⁴ HUD report, *supra* note 5, at 49.

⁴⁵ *Id.* at 51.

⁴⁶ *Id*. at 51.

⁴⁷ Stein, *supra* note 39, at 12.

⁴⁸ ACORN, A Foreclosure Epidemic: The Explosion in Foreclosures from Predatory Lending in Albuquerque, January 28, 2002 (available at http://www.acorn.org/acorn10/predatorylending/reports.htm). ACORN explains that with this increased foreclosure rate comes "abandoned properties, reduced homeownership rates, capital flight from the state, increased crime, and a financially stressed population."

⁴⁹ James T. Berger, Subprime Lending Produces Dangerous Side-Effects, CHICAGO SUN-TIMES, June 9, 2000.

In addition to injuring its victims, homelessness imposes welfare and public housing costs on society.

Part II: The Solutions of the Past

Both legislators and law enforcement officials have tried to address predatory lending. While the federal government has used both *ex ante* legislation and *ex post* law enforcement, state governments have largely been stymied by the complex and partially preemptive regulatory framework that governs lending institutions. Finally, the victims of predatory lenders have tried to use litigation to redress their injuries. Yet none of these solutions has proven sufficient. One group estimates that the city of Albuquerque witnessed a 223% increase in mortgage foreclosures between 1996 and 2000.⁵⁰ This phenomenon is likely linked to predatory lending, since subprime lender foreclosures increased 640% over the same time period.⁵¹ The solutions of the past thus affirm the need to use the Household settlement as a blueprint.

A. Federal Legislation and Enforcement

AMPTA

Enacted by Congress in 1983, the Alternative Mortgage Transaction Parity Act ("AMPTA")⁵² is administered by the Office of Thrift Supervision ("OTS"). The stated purpose of AMPTA is to

eliminate the discriminatory impact that those regulations [adopted by the Comptroller of the Currency, the National Credit Union Administration and the OTS] have upon nonfederally chartered housing creditors and provide them with parity with federally chartered institutions by authorizing all housing creditors to make, purchase, and enforce alternative mortgage transactions so long as the transactions are in conformity with the regulations issued by the Federal agencies.⁵³

⁵² 12 U.S.C. § 3801 et. seq.

⁵⁰ ACORN report, *supra* note 48.

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⁵³ 12 U.S.C. § 3801(b).

AMTPA "was created to provide a level playing field for all types of lenders, so that a state could not discriminate against any one type of lender in light of the high inflationary environment."⁵⁴ If a housing creditor qualifies for AMTPA, it must follow federal regulations designated by OTS.

AMTPA has "pre-empted state prohibitions"⁵⁵ on predatory lending practices such as balloon payments, negative amortizing loans and adjustable rate mortgages, "notwithstanding any State constitution, law or regulation."⁵⁶ AMTPA provides borrowers with new loan opportunities, but it also "fuel[s] a significant increase in predatory lending practices," since it provides predatory lenders with a federal preemption defense against claims based on state lending laws.⁵⁷

For many years, housing advocates, the AARP, NAACP and State Attorneys General lobbied the OTS to amend its regulations to restore the states' ability to regulate these lenders. Finally, in April 2002 the agency announced a proposed rulemaking which would limit the applicability of the AMTPA by "no longer identify[ing] its regulations on prepayment and late charges for housing creditors." OTS noted that "[c]onsumer groups and states generally urged OTS to limit the applicability of the Parity Act [AMPTA] regulations to enable the states to better regulate non-depository state housing creditors." On September 26, 2002 (only five days after the FTC announced its settlement with First Associates, discussed *infra*) OTS promulgated this

⁵⁴ Daugherty, *supra* note 12, at 582.

⁵⁵ Donna S. Harkness, *Predatory Lending Prevention Project: Prescribing a Cure for the Home Equity Loss Ailing the Elderly*, 10 B.U. Pub. Int. L.J. 1, 27 (2000).

⁵⁶ 12 U.S.C. § 3803.

⁵⁷ Daugherty, *supra* note 12, at 583.

⁵⁸ See, e.g., Responsible Lending, Pending Bush Rule Change Would Boost State Efforts To Fight Predatory Lending Abuses (available at www.predatorylending.org/other/media.cfm) ("As a law enforcement officer of a state with a strong predatory lending law, I welcome the OTS proposal," said North Carolina Attorney General Roy Cooper, co-chair of the Predatory Lending Working Group of the National Association of Attorneys General. "Under the new rules, predatory lenders would no longer be able to avoid North Carolina law restricting prepayment penalties by claiming our law does not apply to them.")

⁵⁹ 67 Fed. Reg. 80 (April 25, 2002).

⁶⁰ 67 Fed. Reg. 80 (September 26, 2002) (to be codified at 12 C.F.R. pt. 560, 590, 591).

final rule, which now allows the states to regulate prepayments and late charges for housing creditors.61

While the OTS has rulemaking power under AMPTA, the Federal Trade Commission ("FTC") is the primary federal prosecutor against predatory lending. In addition to the federal Unfair and Deceptive Acts and Practices Act ("UDAP"), 62 the FTC has enforcement authority under the Fair Housing Act ("FHA"), 63 the Truth in Lending Act ("TILA"), 64 and the Real Estate Settlement Procedures Act ("RESPA"). 65 Like the OTS, however, the FTC has largely failed to focus its energies on predatory lending. Engel and McCoy explain that "shifting political winds, and constraints on the FTC's enforcement resources make private relief under the Federal Trade Commission Act highly unlikely for the vast majority of victimized borrowers."66

The FTC has negotiated settlements with predatory lenders in the past, ⁶⁷ but most have been for relatively small sums of money. For example, the FTC charged Fleet Finance with violations of UDAP and TILA,⁶⁸ settling the case for \$1.3 million.⁶⁹ Divided among over 30,000 Fleet borrowers, the average victim – many of whom had lost their homes – received only \$43.30.⁷⁰ In September 2002, the FTC settled with Associates First Capital Corporation,⁷¹ for

⁶¹ *Id*.

⁶² 15 U.S.C. 45 (a) § 5(a).

^{63 42} U.S.C. §§ 3601-3619 (1994)

⁶⁴ 15 U.S.C. §§ 1601-1693 (c) (2000). The Home Ownership Equity Protection Act ("HOEPA") amended TILA in 1994 to prohibit most predatory lending practices. HOEPA places limitations on the terms of loans with an APR of more than 10% above the yield on Treasury securities with a maturity date comparable to the term of the loan, or points and fees greater than either 8% of the loan amount or \$400. See generally Anne-Marie Motto, Note & Comment: Skirting the Law: How Predatory Mortgage Lenders are Destroying the American Dream, 18 GA. St. U.L. Rev. 859, 873-875 (2002).

^{65 12} U.S.C. §§ 2601-2617 (2000).

⁶⁶ Engel, *supra* note 3, at 1304.

⁶⁷ The FTC worked with six State Attorneys General (Arizona, California, Florida, Illinois, Massachusetts and New York) the AARP and individual borrowers to reach a \$60 million settlement with First Alliance Mortgage Company ("FAMCO") in April 2002.

⁶⁸ See FTC complaint Docket No. C-3899 (available at www.ftc.gov/oc/1999/9910/fleetfinancecmp.htm.), which charged Fleet Bank with violations of both UDAP and TILA.

⁶⁹ The FTC's press release on the Fleet consent agreement is available at www.ftc.gov/opa/1999/9910/fvi991018.htm

⁷¹ Four months before these charges were filed, the company had been purchased by Citigroup for \$27 million.

its largest monetary victory in a consumer protection case.⁷² The agency charged First Associates violations of the federal UDAP, TILA, the Equal Credit Opportunity Act ("ECOA"),⁷³ and the Fair Credit Reporting Act ("FCRA").^{74,75} The agency alleged that First Associates engaged in "loan packing," by inducing borrowers to purchase optional credit insurance products.⁷⁶

Under the settlement, First Associates will pay \$215 million, which the agency will distribute to members of class action filed and certified by a California court.⁷⁷ The class consists of borrowers who purchased single premium credit insurance in connection with a real estate-secured or personal loan from First Associates between December 1, 1995 and November 30, 2000.⁷⁸

The settlement also imposes reporting and record keeping requirements on First Associates. The lender must provide the FTC with an annual written report on its sales and marketing of credit insurance and "the progress and status of any and all steps taken to enhance and improve those practices." The settlement requires that the lender "maintain documents approved for use, and exercise its best efforts to maintain communications from supervisory

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⁷² Statement of FTC Commissioner Mozelle W. Thompson, File No. X 010026, available at http://www.ftc.gov/os/2002/09/thompsonstatementcitigroup.htm. Mozelle further explained that "[t]he alleged conduct of Citigroup's subsidiary would be serious if directed at the most knowledgeable and least needy in our society. The fact that the alleged conduct targeted people who were at the other end of the spectrum is especially troubling."

⁷³ 15 U.S.C. § 1607(c).

⁷⁴ 15 U.S.C. § 1681s (a).

⁷⁵ Five similar class action suits were filed by private plaintiffs in California; on February 21, 2002, a California state court combined those suits. This class action sought the same relief as the FTC, and thus joined with the agency's proceeding as plaintiffs against Citigroup.

Press Release, Federal Trade Commission, Citigroup Settles FTC Charges Against the Associates Record-Setting \$215 Million for Subprime Lending Victims (September 19, 2002) (available at http://www.ftc.gov/opa/2002/09/associates.htm).
 Order Preliminarily Approving Stipulated Final Judgment and Order, Civil No. 1:01-CV-00606 JTC

⁷⁷ Order Preliminarily Approving Stipulated Final Judgment and Order, Civil No. 1:01-CV-00606 JTC (hereinafter referred to as "Order"). The Superior Court of San Francisco County, California, certified the consolidated class action complaint filed against Citigroup.

⁷⁸ *Id.* at 6. On the same day, First Associates also settled a separate class action suit in which plaintiff borrowers alleged that the company engaged in fraudulent loan refinancing practices, or what is colloquially known as "loan flipping." *See* Brennan Congressional Testimony, supra note 15. Under that settlement, the company will pay \$25 million to the members of the class of plaintiffs who were injured by these practices. Stipulation of Settlement, Judicial Council Coordination Proceeding No. 4197. All class members who receive money from this settlement must "release any claim, known or unknown," against

personnel, relevant to the sale and marketing of real-estate secured and personal loans, credit insurance, and other add-on products."80

Housing advocates have criticized the First Associates settlement. Matthew Lee, executive director of Fair Finance Watch, explained that "the lack of any reforms to CitiFinancial's [First Associates] current and future practices is a massive flaw in this settlement." The reporting and record keeping requirements imposed by the settlement fail to guarantee any change in First Associates' practice of bundling unwanted and unnecessary insurance into mortgage-backed loans. Instead, they shift the onus to the FTC to perform more stringent monitoring of the lender's practices.

Advocates have been equally critical of the settlement's monetary relief. Under it most borrowers will receive about \$1,000 to cover approximately 60% of their losses. But Lisa Donner, director of the financial justice center for the Association of Community Organizations for Reform Now ("ACORN"), a grassroots organization dedicated to stopping predatory lending, said the previously reported \$200 million settlement was "very low compared to the damage that was done." Donner claimed that First Associates' practices in fact cost class member "thousands or tens of thousands of dollars each."

The First Associates settlement could be the FTC's trial run, rather than its "blueprint." Nevertheless, this "record-setting" agreement provided for less than half the monetary relief of the Household settlement. Combined with the agency's history of enforcement, First Associates

First Associates. Order at 24. Attorneys' fees and other expenses from the California class action will not come out of the \$215 million consumer redress sum. Order at 16.

⁷⁹ *Id*. at 24.

⁸⁰ *Id*. at 25.

⁸¹ Ieva W. Ausustums, FTC Settles Predatory Lending Suit Against Citigroup: \$215 million Agreement Would Be the Largest in the Agency's History, DALLAS MORNING NEWS, September 20, 2002.

⁸² David Ho, *Debtors due \$215 million from Citigroup*, THE TIMES UNION, September 19, 2002, at E1 (quoting FTC Chairman Timothy Muris).

Anitha Reddy, Citigroup, FTC to Settle Suit Over Lending Practices, Washington Post, September 19, 2002.

⁸⁴ *Id*.

⁸⁵ See Bergquist, supra note 2.

indicates that injured borrowers cannot look with confidence to the federal government to stop predatory lending.

B. State Legislation

In July 1999, North Carolina was the first state to enact a statute specifically prohibiting predatory lending practices. Predatory lending had thrived in the United States since the securitization of mortgage lending in the late 1970s. Two decades would seem to be an unacceptable delay, even by legislative standards. Federalism explains the holdup. The states "have been hamstrung by DIDMCA and AMTPA," discussed in Part IIA, *supra*, which preempt state regulation of most mortgage lending. 88

The 1999 North Carolina law was drafted by Roy Cooper, who was then a North Carolina State Senator (and is now State Attorney General of North Carolina). The Act "represents a compromise between the consumer advocacy interests, banking interests, and the Attorney General's office." Many housing advocates have praised the Act as "a critical step in encouraging more responsible lending practices [because] it addresses several gaps in the federal law," while the banking community – after some dispute – supported the bill.

⁸⁶ N.C. Gen. Stat. § 24-1.1E(a)(4), (a)(6), (b) (1999).

⁸⁷ Cathy Lesser Manfield, *THE USURY LAW DEBATE: The Road to Subprime "HEL"* Was Paved with Good Congressional Intentions: Usury Deregulation and the Subprime Home Equity Market,* 51 S.C. L. REV. 473, 561 (2000) (noting that DIDMCA and AMPTA forces states to "carefully draft state proposals addressing a significant local problem so as not to run afoul of these acts").

⁸⁸ The Depository Institutions Deregulation and Monetary Control Act, or "DIDMCA," was passed by Congress in 1980. DIDMCA allows savings and loan institutions, or thrifts, to compete with commercial lenders by overriding state usury ceilings and other regulatory restrictions. *See* 12 U.S.C. § 1735(f)-7(a). Although DIDMCA has an effect on predatory lending, for the purposes of this paper I focus on AMPTA. ⁸⁹ The North Carolina Act contains specific provisions for "high-cost home loans." The high-cost loan must be secured by a security interest in a manufactured home or a mortgage or deed of trust of real estate which is the borrower's principle dwelling. In addition, the terms of the loan must exceed the thresholds defined by the law. Once these requirements have been met, section B of the NC Act prohibits most of the characteristic elements of predatory lending: balloon payments, negative amortization, increased interest rate after default, advance payments, and modifications or deferral fees for changes to a high-cost home loan. Section C requires that high-cost lenders guarantee that borrowers receive home-ownership counseling from a state-approved counselor. It also prohibits "lending without due regard to repayment ability," or equity stripping.

⁹⁰ Daugherty, *supra* note 12 at 592.

⁹¹ *Id*. at 604.

Other legislatures have followed North Carolina's example. California passed a state predatory lending law in July 2002. Just months later, the Los Angeles City Council preliminarily approved an ordinance that would provide even more protection to borrowers. Georgia has amended its Fair Lending Act ("GAFLA") to prohibit abusive home loan practices. The New York state legislature passed a predatory lending bill in October 2002 which "follows much the same footprints as legislation passed ... by North Carolina." County Supervisors in Pima County, Arizona plan to "explore the possibility of enacting new laws aimed at curbing predatory lending practices that target the elderly, the poor and Hispanics," and the Detroit City Council announced hearings on two proposed predatory lending ordinances in November 2002.

The strength of mortgage lending and banking institutions' political ties creates an uphill battle for housing advocates in the state legislatures. In October 2002, New York Mayor Michael Bloomberg vetoed a predatory lending bill passed by the New York City Council that "would bar the city from doing business with financial institutions that engage in practices or have ties with companies that exploit low-income borrowers." The Mayor's action was attributed to the political power of financial institutions. Citigroup (owner of First Associates), J.P. Morgan Chase & Co., the Bond Market Association and the New York City Chamber of Commerce all opposed the bill, arguing "it would impose costly obligations to make sure neither lenders nor their partners were engaged in such practices." The City Council overrode the Mayor's veto in November. However, this incident serves as a small example of the obstacles to legislating

⁹² See Crackdown on Lenders Ok'd, Los Angeles Times, November 23, 2002.

⁹³ See 2001 Bill Text GA H.B. 1361

⁹⁴ N.Y. ALS 626 (2002). *See also* Dennis Hevesi, *New Curbs on Predatory Loans*, THE NEW YORK TIMES, November 10, 2002, at 1.

⁹⁵ (Arizona) County Wants to Curb Predatory Lending, ASSOCIATED PRESS, December 4, 2002.

⁹⁶ Gregg Krupa, *Detroit Aims at Predatory Home Lending; Companies Target Low-income Families with Poor Credit*, THE DETROIT NEWS, November 26, 2002, at 1C.

⁹⁷ Bloomberg Vetoes New York "Predatory Lending" Bill, BLOOMBERG NEWS, October 23, 2002.

⁹⁸ Id.

⁹⁹ See Metro Briefing: New York, NEW YORK TIMES, November 21, 2002.

against predatory lending. Forging political compromises between housing advocates and lenders is a difficult task. Unlike an injunction, legislation is susceptible to changing political tides.

C. Private Suits

Subprime lenders provide important funding to borrowers who might not otherwise be able to purchase a home. Some lenders argue that borrowers are at fault for their impulsive borrowing, and hence should be forced to speak for themselves through the private bar. Indeed, borrowers can file suit for lenders' violations of unconscionability and fraud, along with a spate of federal statutes. But due to the considerable obstacles plaintiffs face, the private bar is an unrealistic solution to predatory lending.

Mandatory Arbitration Clauses

A borrower's first obstacle is often the mandatory arbitration clause buried in the lending contract. Such clauses have two common effects: limiting the procedural rights of the victim during arbitration, and determining the fee structure arising out of the proceeding. Courts will enforce a mandatory arbitration clause even if its terms are ambiguous. In *Green Tree Financial Corp.-Alabama v. Randolph*, 531 U.S. 79 (2000), the Supreme Court overturned the Eleventh Circuit's invalidation of a mandatory arbitration clause which was silent as to fees and procedures. The Eleventh Circuit had reasoned that such an ambiguous clause risked the plaintiff-borrower's statutory rights under TILA since she could face steep arbitration costs. The Supreme Court held that where "a party [such as the plaintiff] seeks to invalidate an arbitration agreement on the ground that arbitration would be prohibitively expensive, that party bears the burden of showing the likelihood of incurring such costs." While this decision rested in part on the "liberal federal policy favoring arbitration agreements," that also indicates that ambiguous mandatory arbitration clauses will likely withstand challenge.

¹⁰⁰ HUD Study, *supra* note 5, at 98.

Green Tree Financial Corp.-Alabama v. Randolph, 531 U.S. 79, 92 (2000).

¹⁰² Id. at 91, quoting Moses H. Cone Memorial Hospital v. Mercury Constr. Corp, 460 U.S. 1 (1983).

The ramifications of mandatory arbitration clauses are threefold. First, these clauses prevent borrowers from choosing a forum in which to make their claim, which can lead to added expense and inconvenience for the borrower. Even if the arbitration is relatively inexpensive, it prevents individual borrowers from joining in class action suits against predatory lenders. As to more permanent remedies, arbitration cannot provide the injunctive relief needed to change lenders' business practices.

Unconscionability

Even if a lending contract does not include a mandatory arbitration clause, a borrower faces an uphill battle in court. Many predatory lending contracts could be challenged based on the doctrine of unconscionability, codified by U.C.C. § 2-302. ¹⁰⁶ E. Allan Farnsworth explains that although this provision technically only applies to the sale of goods, it has been extended to include all contracts subject to the U.C.C. ¹⁰⁷ In *Williams v. Walker-Thomas Furniture Co.*, the D.C. Circuit defined unconscionability as "an absence of meaningful choice on the part of one of the parties together with contract terms which are unreasonably favorable to the other party... In many cases, the meaningfulness of the choice is negated by a gross inequality of bargaining power." Although *Williams* was decided over three decades ago, this description has remained the most "durable answer" of what unconscionability means. ¹⁰⁹

At first glance, the standard of unconscionability would seem to provide borrowers with legal relief, since one of the hallmarks of predatory lending is that the borrower misunderstands

¹⁰³ HUD Study, *supra* note 5, at 98.

¹⁰⁴ *Id*. at 99.

¹⁰⁵ *Id.* at 99.

¹⁰⁶ U.C.C. § 2-302(1) states that "If the court as a matter of law finds the contract or any clause of the contract to have been unconscionable at the time it was made the court may refuse to enforce the contract, or it may enforce the remainder of the contract without the unconscionable clause, or it may so limit the application of any unconscionable clause as to avoid any unconscionable result."

¹⁰⁷ E. ALLAN FARNSWORTH, CONTRACTS 308 (1999).

¹⁰⁸ Williams v. Walker-Thomas Furniture Co., 350 F.2d 445 (D.C. Cir. 1965).

¹⁰⁹ Farnsworth, *supra* note 105, at 311.

the terms of the contract, which weigh heavily in favor of the lender. Yet suits based on unconscionability are prohibitively expensive. One writer estimates that had plaintiff Williams paid for her attorney at a rate of \$25 per hour (the market rate in 1965), 110 her legal fees would have totaled \$5,250, nearly five times what she owed to Walker-Thomas Furniture. 111 Because predatory lenders target low-income people, few borrowers have the resources or sophistication needed to mount a successful unconscionability suit.

The securitization of mortgages further insulates predatory lenders from unconscionability claims. The "holder in due course" doctrine protects the bona fide purchasers of mortgaged-backed securities from claims based on the underlying mortgage. Once a mortgage is assigned to a holder who does not have notice of unconscionability and duress, the borrower is barred from asserting such defenses to the enforcement of the lending contract. The result is that predatory lenders can sell unconscionable loans to borrowers, securitize those loans, sell those securities, and protect themselves from most common law contract claims. The borrower takes on all of the risk associated with the predatory loan, and is precluded from asserting a claim of unconscionability under U.C.C. § 2-302.

Private Suits under State UDAPs

Borrowers can also file suit under their state's Unfair and Deceptive Acts and Practices law, which provide for private causes of action against violators. There are a number of states whose UDAPs can be used against predatory lenders. Those states include Arizona, Illinois, Kansas, Michigan, New Hampshire and Pennsylvania. Richard Daugherty explains that North Carolina's UDAP has a limited effect on predatory lending, because it uses language written in general terms." Yet it is precisely the definitional ambiguities of deceptive and unfair that may

¹¹⁰ Williams was represented by an attorney from the Legal Assistance Office of the Bar Association of the District of Columbia, who provided her with legal representation *pro bono*.

¹¹¹ STEWART MACAULAY, ET. AL, CONTRACTS: LAW IN ACTION 779 (1995).

¹¹² Eggert, *supra* note 9, at 508.

¹¹³ *Id.* at 508.

¹¹⁴ Engel, *supra* note 3, at 1304.

allow injured borrowers – or attorneys general acting on their behalf – to utilize their states' UDAPs. "UDAP statutes are written in a broad fashion," because their drafters recognized that "the meanings of unfairness and deception are to be developed over time, so that UDAP law can adapt to future business practices." ¹¹⁵ Indeed, the State Attorneys General have used these statutes aggressively and to great effect in many areas that the UDAPs' original drafters may not have foreseen.

However, as with unconscionability, some borrowers may face obstacles when suing based on UDAP violations. A handful of states' UDAPs, including Ohio, Texas, ¹¹⁶ Georgia, ¹¹⁷ and Alabama, ¹¹⁸ are limited to "goods and services," and thus do not cover predatory lending. ¹¹⁹ In addition, a borrower's state UDAP may limit recoverable damages, which can make the suit unattractive to plaintiffs' attorneys.

Private Suits under Federal Statutes

Finally, borrowers can assert claims based on numerous federal statutes, including the FHA, TILA and the RESPA, but private suits under these statutes cannot stave off the predatory lending. First, "the Fair Housing Act is not an effective tool for combating mortgage lending discrimination" since borrowers rarely know they have been illegally denied a loan based on their race, color, religion, sex, familial status or national origin. Furthermore, in order to state a claim under the FHA, a borrower must show that the lender made mortgage loans to similarly

¹¹⁵ Glenn Kaplan and Barry Smith, *Patching the Holes in the Consumer Safety Net: Using State Unfair Practices Laws to Make Handguns and Other Consumer Goods Safer*, 17 YALE J. ON REG. 253, 276-77 (2000).

See Trevino v. Sample, 565 S.W.2d 93, 95-97 (Tex. App. 1978) (holding that mortgage loan applicants did not have supportable claim under state deceptive trade practices act against mortgage loan company that refused to make loan, since act applied only to transactions involving goods or services, loan was not "service," and mortgage company's alleged banking services, such as assisting in closing of house sale, were merely incidental to primary purpose of transaction, which was making of loan.)

¹¹⁷ Credithrift of America, Inc. v. Whitley, 380 S.E.2d 489 (Ga. App. 1989).

¹¹⁸ Deerman v. Federal Home Loan Mortg. Corp., 955 F. Supp. 1393 (N.D. Ala. 1997), aff'd, 140 F.3d 1043 (11th Cir. 1998), reh'g and suggestion for reh'g in banc denied, 145 F.3d 364 (11th Cir. 1998) (finding that Alabama UDAP does not extend to mortgage lending).

¹¹⁹ Daugherty, *supra* note 12, at 585-6.

¹²⁰ 42 U.S.C. § 3604. See also Stephen M. Dane, Eliminating the Labyrinth: A Proposal to Simplify Federal Mortgage Lending Discrimination Laws, 26 U. MICH. J.L. REF. 527, 543-544 (1993).

situated borrowers of other races. But because the FHA does not include a reporting requirement, from which a plaintiff might gather such data, a borrower has little chance of proving such discrimination. 121 Finally, although some victims of predatory lending are minorities, the FHA cannot address predatory lending in non-minority communities.

TILA requires lenders to disclose the finance charge and annual percentage rate to borrowers. TILA does not, however, require disclosure of charges for credit reports, title searches, document preparation, and government taxes, all of which are frequent features of predatory loans. 122 RESPA requires lenders to disclose the good faith estimate of closing costs. 123 but RESPA gives lenders three days from the time of the loan application for disclosure. By that time, many borrowers have already paid the significant application fees imposed by predatory lenders. 124

Part III: The Household Settlement

The settlement with Household marks the "largest direct restitution amount ever in a state or federal consumer case." 125 Most early commentators have praised the settlement as a step in the right direction. 126 Because the settlement did not result from charges filed against Household, few public records document the agreement.

This landmark raises a number of questions. First, how was the team formed to combat these formidable practices? How did that team assert jurisdiction over Household? As explained in Part II-C, supra, many state UDAPs do not cover predatory lending. What role did housing

¹²¹ *Id.* at 544.

¹²² See generally Engel, supra note 3, at 1269.

¹²³ *Id.* at 1269.

¹²⁴ *Id*. at 1269.

¹²⁵ Press Release, States Settle with Household Finance: Up to \$484 Million for Consumers (October 11, 2002) (quoting Iowa Attorney General Tom Miller) (available at www.state.ia.us/government/ag/latest_news/ releases/oct 2002/Household Chicago.html).

¹²⁶ "Hooray for the state lawyers, who include Illinois Attorney General Jim Ryan. The best way to reform sleazy business practices is to drain the sleaze's bottom line, and the attorneys general did a nice job of that. The payments were a big reason for the 55 percent drop in Household's third quarter profits." A Predator's Comeuppance, St. Louis Post-Dispatch, October 23, 2002, at C18.

advocate groups like ACORN play in pressuring the State Attorneys General to investigate Household? Have these groups been satisfied with the results of that pressure? Finally, and most importantly, how did State Attorneys General leverage their past experience in multi-state litigation against Household?

A. The Multi-state, Multi-agency Team

The Household settlement more than doubled the FTC's then-record-breaking settlement with First Associates. More revolutionary, however, was the fact that the negotiating team was composed of attorneys from the consumer protection and civil rights divisions of State Attorneys' General offices and state banking regulators. 127

Attorneys from the civil rights and consumer protection divisions of State Attorneys' General offices had worked together in the past. In 1993, NAAG created a joint initiative with the U.S. Department of Justice to address mortgage lending. Sandra Kane, Assistant State Attorney General of Arizona, co-chaired the group with Sandy Ross of the DOJ. This task force included attorneys from both civil rights and consumer protection divisions of State Attorneys' General offices. Moreover, the mortgage lending task force already had experience with predatory lenders after its investigation of and settlement with FAMCO.

The cross-agency barriers began to fall at the 1999 conference of the National

Association of Consumer Advocates ("NACA"), 130 in Des Moines, Iowa. Kathleen Keest,

Assistant Attorney General of Iowa, helped organize the conference. There, public enforcement

¹²⁹ See generally FTC reaches 60 million settlement in mortgage lending fraud suit, CONSUMER FINANCIAL SERVICES LAW REPORT, April 10, 2002. The FAMCO settlement was reached in 2002 after over 6 years of negotiations and the company's eventual bankruptcy.

¹²⁷ E-mail interview with Kathleen Keest, Assistant Attorney General of Iowa and Deputy Administrator of the Iowa Consumer Code (November 14, 2002) (hereinafter "Keest Interview"). Ms. Keest was one of the leaders of the multi-state, multi-agency team. She has worked for many years to combat predatory lending, and has written many articles on the subject, including *The Two-Tiered Consumer Financial Services Marketplace: The Fringe Banking System and its Challenge to Current Thinking About the Role of Usury Laws in Today's Society*, 51 S.C. L. REV. 589 (2000).

¹²⁸ Kane Interview.

¹³⁰ Information about NACA can be found at www.naca.net. As Ms. Keest explains, NACA's acts as an "umbrella organization that tries to bring together legal advocates representing consumers from all aspects

officials discussed predatory lending. More importantly, "people from the FTC, Attorneys' General offices, and financial regulators got to know one another." As a result, an "informal communications network" was formed that linked State Attorneys General and financial regulators. 132

The state of Washington also played an important role creating ties between the State Attorney General's office and the state's Department of Financial Institutions. David Huey, Assistant State Attorney General of Washington (consumer protection division), explains that his state's Consumer Loan Act provides that violations of its terms are also per se violations of the Consumer Protection Act. The DFI enforces the former and the State Attorney General enforces the latter. This provision caused the two agencies to work together closely. 133

Yet working together was not without its challenges. Mr. Huey described a culture gap between the two groups. "Agencies, being bureaucracies, tend to...focus on paper. It is harder to mobilize an agency to take a license away, since they don't see that as their function. But in the [State Attorney General's office], we go after people; I like to call myself a plaintiff's attorney in the largest defense firm in the state of Washington." ¹³⁴ Mr. Huey speculates that the "more aggressive enforcement elements of DFI were attracted to a relationship with [the State Attorney General's office because they knew we could bring both an aggressive tone and resources to the battle."135

To strengthen the enforcement of the state's Consumer Loan and Consumer Protection Acts, an "interoffice task force was created between the Attorney General's office and the DFI in

⁻ legal services, private attorneys who specialize in representing consumers, public enforcement." Keest Interview.

¹³¹ Keest Interview.

¹³³ Interview with David Huey, Assistant Attorney General of Washington, December 19, 2002 (hereinafter "Huey Interview"). Mr. Huey has worked in consumer protection for many years, having started his career in the office of the State Attorney General of North Dakota. Mr. Huey played an important leadership role in the Household settlement, especially in planting the seeds for interagency cooperation between banking regulators and state attorneys. 134 Id.

July 2001."¹³⁶ The task force "identified targets" for an investigation.¹³⁷ Since "Household was high on both [agencies'] lists…it ended up being the lender we decided to look into."¹³⁸ DFI spent the summer of 2001 gathering complaints from Household borrowers in that state. From the very start, banking regulators were heavily involved in the investigation.

The inclusion of state banking regulators in the multi-state team was crucial to the State Attorneys' General case against Household. In the states whose UDAPs do not cover financial instruments, legislators had reasoned that lending institutions are already regulated – through licensing – by state banking agencies. Indeed, the deterrent power of the regulator is significant: in many states, the revocation of a license in one state is grounds for revocation in another state. "Consequently, there was a lot more leverage in this multi-state than in an Attorney General-only multi-state."

The state of Ohio is paradigmatic of the regulators' importance. Because Ohio's UDAP does not extend to financial instruments, ¹⁴⁰ Betty Montgomery, then State Attorney General of Ohio, would not have had direct jurisdiction to sue Household. ¹⁴¹ The Ohio Division of Financial Institutions, however, has the authority to revoke a lender's license based on unfair practices, ¹⁴² and hence was part of the multi-state team. This cooperation enabled the team to maneuver around jurisdictional issues that had stymied enforcement for decades. Household now faced a real threat of litigation, or worse yet, loss of its license. ¹⁴³

¹³⁵ *Id*.

¹⁴³ Keest Interview.

¹³⁶ *Id*.

¹³⁷ *Id*.

¹³⁸ *Id*.

¹³⁹ Keest Interview.

¹⁴⁰ See generally Anna Beth Ferguson, *Predatory Lending: Practices, Remedies and Lack of Adequate Protection for Ohio Consumers*, 48 CLEV. St. L. Rev. 607, 625-28 (2000).

¹⁴¹ Ohio Attorney General Montgomery was one of the first State Attorneys General to express interest in investigating predatory lending at the June 2001 NAAG conference.

¹⁴² See ORC Ann. § 1121.32, § 1111.32, providing the Ohio Division of Financial Institutions with the authority to revoke banks' and trusts' licenses for violations of the law.

B. The Role of the Outside Agitator

ACORN ran its own campaign against Household. Chris Saffert, an ACORN representative in Brooklyn, New York, explained that his organization's predatory lending campaign "focused on Household as a violator" starting in late 2000. He by summer 2001, while the Washington DFI was gathering complaints about the company, ACORN's 53 offices "started a concerted effort," holding "direct actions at many Household offices, when [they] handed out flyers warning borrowers about Household's practices." In addition, ACORN's "organizers were out in the field, knocking on doors, interviewing people who had problems with Household." The group "also gathered lists of the borrowers and did mailings asking for their complaints," about the company. He

ACORN recognized that State Attorneys General would be critical to their national campaign against the lender, so the organization began filing as many complaints as it could gather with many State Attorneys General. Mr. Saffert explained that his organization wanted "to show that borrowers were worse off in every respect, and that Household had sold them loan terms that were different from the actual loan they received."

ACORN's efforts were met with mixed responses from the State Attorneys General. While some offices simply forwarded the complaints to Household, others were very receptive. In Washington, for instance, ACORN brought David Huey's team complaints from the Seattle area, which may have "spurred them to do a larger investigation." Saffert identified Minnesota, Massachussetts, New York, Arizona, California, and Iowa as the states most interested in pursuing Household.

¹⁴⁴ Saffert Interview.

¹⁴⁵ Id

¹⁴⁶ *Id*.

¹⁴⁷ *Id*.

¹⁴⁸ *Id*.

¹⁴⁹ *Id*.

Ms. Keest and Ms. Kane confirm ACORN's role in Household. In Arizona, ACORN filed complaints with State Attorney General Janet Napolitano's office about mortgage loans made to Hispanic borrowers who could not read their English loan documents. Ms. Keest explained that ACORN 2001 campaign was "absolutely key" to Iowa's investigation because victims of predatory lending often fail to file complaints with their State Attorney General. "They usually do not know the law, and so don't know that a lender may have violated [it]; they may not feel comfortable talking about financial troubles (especially the elderly); they may just feel they have made a bad decision and will have to live with it." ACORN acknowledged that it is "difficult to get people to feel comfortable about talking about their problems with money." However, as an organization, "ACORN has experience helping people overcome their doubts and fears that they were alone or were at fault. We helped people see the problem on a broader scale, by getting them involved in the campaign and taking leadership roles." 153

While ACORN had considerable institutional experience in gathering consumer complaints, its aggressive practices were not universally well received by the members of the multi-state team. David Huey stated that half the team, including himself, viewed ACORN as "an ally, with a corresponding interest in the investigation." Another set of public attorneys viewed ACORN as "less rational…on the fringes, prone to do things like show up at offices, chanting with signs." Indeed, in April 2002, ACORN led 20 customers in a protest at Mr. Huey's office in Washington. Mr. Huey recognized that this protest was not directed at his office, but his more conservative colleagues, who "don't want to see their picture in the paper or be quoted," felt anxious about being linked to ACORN. 155

¹⁵⁰ Kane Interview.

¹⁵¹ Keest Interview.

¹⁵² Saffert Interview.

¹⁵³ *Id*.

¹⁵⁴ Huey Interview.

¹⁵⁵ *Id*.

Although not all of ACORN's complaints were met with prosecutorial vigor, Ms. Keest explained that they continued to play an important role within the State Attorney General world. In response to ACORN's campaign, "e-mail communications went through three separate channels – the banking regulatory channel, the AG CPD [Consumer Protection Division] channel, and the informal predatory lending and NAAG mortgage lending channel."¹⁵⁶

C. The Rogue Office Defense

In May 2002, the Washington DFI announced that "in a routine examination" of Household offices the previous summer, "it uncovered violations of the state's Consumer Loan Act," by refinancing existing loans and charging points on the balances of both loans, in violation of the Act. 157 Although Household attributed this violation to a computer error, 158 the DFI's investigation led to increased media attention on Household.

The DFI planned to release a report of 179 complaints from borrowers about Household later that same month. Mark Thomson, then acting director of the Washington DFI, distinguished these complaints from the aforementioned overcharges as "about sales and origination practices and people not understanding the terms of the loans they entered into." ¹⁵⁹

The Washington DFI's report contained information about Household's lending practices that could potentially damage the company's already falling stock price. David Huev told the press that the report contained "some serious allegations about misrepresentations that [Household] made to people and potentially unfair practices that they engaged in. We're looking

¹⁵⁶ Keest Interview.

¹⁵⁷ Erick Bergquist, Household Required to Pay More Refunds for Overcharging, AMERICAN BANKER, May 28, 2002.

Household later confessed, "We did screw up. We know mistakes were made in California [and Washington]." The company explained that the "screw up" was due "computer glitches and employee errors caused fees to be charged erroneously." Melissa Allison, Household Fighting Image of Predator: Suits, Politicians Put Pressure on Stock Price, CHICAGO TRIBUNE, June 2, 2002.

¹⁵⁹ *Id.* quoting Mark Thomson, acting director of Washington DFI.

¹⁶⁰ On May 1, 2002, Household's stock traded at \$57.70. By the first week in June, its price had fallen to \$50.94.

into their activities and we may be doing something about it."¹⁶¹ In reality, of course, Mr. Huey's office had been working with the DFI for some time. During the last week of May 2002, Household raced to court to stop the release of the report. Thurston County Superior Court Judge Daniel Berschauer issued a temporary restraining order against the DFI's release of "any information or documents obtained in connection with any investigation of Household's lending practices."¹⁶² But the damage Household feared became a reality when the DFI's report leaked to the press soon after the injunction. ¹⁶³

In response to this growing list of allegations, Household lowered the interest rates of its Bellingham, Washington customers who had joined a lawsuit against the company. The spokeswoman of Household stated that "[Household] took full and prompt responsibility...[and was] satisfied that this situation was localized to the Bellingham branch." In essence, Household was arguing that a "rogue office" had "gone bad," resulting in the evidence of predatory lending. Moshe Orenbuch, a consumer finance equity analyst at Credit Suisse First Boston, echoed this line of defense when he told reporters "no doubt you find instances where an individual was disadvantaged, but I don't think it's a systematic approach." This defense tactic was a potential setback for enforcement officials in the various states.

The defense failed. By June 2002, sixteen states were involved in the Household investigation, represented by either a banking regulator, a State Attorney General's civil rights division, a State Attorney General's consumer protection division, or by both a regulator and

¹⁶¹ Erick Bergquist, For Household, New Fight and Small Victory, THE AMERICAN BANKER, May 31, 2002 at 1.

¹⁶² John Stark, *Lending Company Blocks Release of Report*, THE BELLINGHAM HERALD, May 30, 2002, at 1A (quoting the text of the restraining order).

¹⁶³ The DFI's report, dated April 30, 2002, was first leaked to the Bellingham Herald in early May 2002. The full text of the report is available at http://news.bellinghamherald.com/downloads/hfc-document.pdf.

¹⁶⁴ Bergquist, *supra* note 161.

¹⁶⁵ Keest Interview.

¹⁶⁶ Allison, *supra* note 153.

State Attorney General.¹⁶⁷ Household's rogue office story clearly could not survive the continued scrutiny of ACORN and the multi-state, multi-agency team. Ms. Kane said that the team realized they "were all seeing the same thing," in their respective jurisdictions.¹⁶⁸ A "rogue office...story can only go so far when the same practices are found from Massachusetts to Washington, and from Minnesota to Florida." As a national organization, ACORN helped to discredit Household's defense by filing complaints with Attorneys General in numerous states.¹⁷⁰

D. The Settlement Negotiations

Many observers have questioned Household's willingness to settle so quickly with the multi-state team. In the prior major predatory lending case, First Associates had spent years negotiating with the FTC. The stock market seems to provide the most salient explanation for the rapidity of the settlement.

Although "the existence of the multi-state [investigation] was supposed to be confidential, rumors were flying," ¹⁷¹ in addition to the news of the Washington DFI's investigation and suits filed by borrowers and ACORN in California, Washington, Illinois. ¹⁷² When the DFI's report leaked in late spring, Household's stock price began slipping, from a high of \$62 per share in May to less than \$50 in June. By the third week in July, Household stock was trading at \$36 per share.

By fall 2002, Household's stock price had been falling for many months, to reach \$22. Equity research analysts at Sanford Bernstein issued reports that lowered their earnings estimates

¹⁶⁷ Washington and New York were represented by both banking regulators and State Attorneys General. Keest Interview.

¹⁶⁸ Kane Interview.

¹⁶⁹ Keest Interview.

¹⁷⁰ *Id*.

¹⁷¹ *Id*.

¹⁷² In May 2002, New York State Comptroller Carl McCall said that Household needed to "to take drastic steps to reform its predatory lending practices," which seemed to be a veiled threat to sell off New York's Common Retirement Fund's 2.5 million shares of Household stock worth roughly \$140 million. Bergquist, *supra* note 157. As Comptroller, McCall was the sole trustee of that fund. In the same week, the Boston City Council passed a resolution requesting that the city's retirement board consider its \$1 million investment in Household due to complaints from Massachusetts residents about the company's practices.

for Household, based in part on the threat of litigation. 173 With each state added to the multi-state team and each new article discussing its lending practices, Household witnessed yet another drop in its market capitalization. Rather than face this continued financial disaster, the company "wanted universal peace," rather than brokering piecemeal settlements with different states. 174 By requiring states representing 80% of its borrowers to sign on to the agreement, Household no longer "faces the possibility that six months or a year later the same issues [might] come up from a non-settling state."¹⁷⁵

On November 14, 2002, HSBC announced its plans to acquire Household for \$14 billion.¹⁷⁶ Negotiators for the states have universally denied knowing about the deal prior to its public announcement. 177 One can conjecture that Household's management wanted to settle its potentially messy lawsuits with the states to facilitate the acquisition, but kept its plan under wraps to avoid giving its opponents a bargaining tool. Other commentators have hypothesized that the settlement itself forced Household to the auction block. In fact, few individuals know what role, if any, HSBC played in the settlement negotiations with the multi-state team.

E. The Settlement Terms

The final negotiations team combined State Attorneys General and financial regulators. It was lead by Tom Miller, Iowa State Attorney General, Christine Gregoire, Washington State Attorney General, Roy Cooper, North Carolina State Attorney General, and Elizabeth McCaul, New York State Superintendent of Banks. Household has agreed to the following terms:

Limit up-front points and origination fees to 5%

¹⁷³ Howard K. Mayson, analyst with Sanford Bernstein, said "If indeed they [Household's violations] are more widespread, there is a material risk to Household's earnings as the firm moves to ensure compliance with its best-practices policy." Bergquist, *supra* note 161.

¹⁷⁴ Keest Interview.
175 *Id*.

¹⁷⁶ Under the purchase agreement, Household shareholders will receive 2.675 HSBC shares per Household share, at a 47% premium over Household's stock price of \$22 per share, for a total price of \$14 billion. See HSBC Buys Household for \$14B, CNN MONEY, November 14, 2002 (available at www.money.cnn.com/2002/11/14/news/ deals/hsbc household.ap/index.htm).

¹⁷⁷ Keest Interview.

- Limit prepayment penalties on current and future home loans to the first two years of a loan
- Reform and improve disclosures to consumers
- Eliminate "piggyback" second mortgages
- Ensure that new home loans actually provide a benefit to consumers prior to making the loans
- Reimburse states to cover the costs of the investigations into Household's practices
- \$484 million in relief to Household borrowers

Those involved with the Household settlement are almost universally pleased with its terms. Many observers, including ACORN, identify the two-year prepayment penalty limit as the most important feature of the settlement, since it permits borrowers to take advantage of lower interest rates. Some states (such as New York) had already legislated against prepayment penalties. When the OTS promulgated its new rule in September 2002, 179 allowing the states to regulate prepayment penalties, those laws will finally ban the practice. Furthermore, "for those states which do still allow [prepayment penalties], there are good provisions in the injunction," to protect borrowers. Ms. Keest explains that "TILA [the federal statute] only requires a vague statement that 'you may have to pay a prepayment penalty' if there is one...I defy anyone to look at the note language in Household [loans] and figure out how this clause translates to dollars. I can do it – so long as I can run an amortization chart." So in addition to limiting the penalty period to two years instead of five years, under the Household settlement "consumers have to be told in dollars what the maximum [penalty] amount could be."

The monetary relief of \$484 million is the largest recovery from a predatory lender in history. Ms. Keest acknowledged that "no affected consumers will be made 100% whole. But then neither would any other process." David Huey agreed when he stated that

settlements have advantages and disadvantages. People criticize the settlement for failing to get 100% relief for borrowers...but we were not choosing between 100% relief and

¹⁸² *Id*.

¹⁷⁸ See note 92, supra. New York State passed its predatory lending bill in early October.

¹⁷⁹ See Part IIA, supra.

¹⁸⁰ Keest Interview.

¹⁸¹ *Id*.

50% relief; no one would write me a check for 100%. If we were willing to compromise, we could get more injunctive relief. 183

The reimbursement of investigation costs is a boon to the states. Ms. Kane said that she has witnessed greater interest among her colleagues to pursue predatory lending cases, in part because of the recovery of attorneys fees.

ACORN has also expressed its approval of the settlement terms. Chris Saffert said that "the terms are very similar to the 'best practices' Household had announced," in Spring 2002 in response to the leak of Washington's investigation. But whereas "the best practices are not binding on Household, a consent decree with the State Attorneys General is binding. If Household violates the decree, we can pursue that violation and get punitive damages." ¹⁸⁵

Part IV: Household as a Blueprint

Household and Other Lenders

The Household settlement can be a powerful tool against other lenders. The settlement terms themselves may act as *de facto* regulations of other mortgage lenders. David Huey reports that representatives of other financial institutions have told Christine Gregoire, State Attorney General of Washington, that they have met or exceeded all of the provisions of the Household settlement. "They already perceive, as we do, that this is a new day, and there are standards they [the lenders] need to meet." Ms. Kane explained that on a broader scale, "consciousness has been raised" by the Household case. "A few years ago, people denied there was any predatory lending in [Arizona]. Now the industry is admitting there is a problem." 188

Perhaps more importantly, the unique multi-state, multi-agency team may be used against other predatory lenders. The replication of that group will not, however, be without its hurdles.

¹⁸³ Huey Interview

¹⁸⁴ Saffert Interview.

 $^{^{185}}$ Id

¹⁸⁶ Huey Interview.

¹⁸⁷ Kane Interview.

¹⁸⁸ *Id*.

Multi-state litigation brings with it multi-state goals and "frustration."¹⁸⁹ It often "proved more difficult to get a consensus among the fifty states than to deal with Household."¹⁹⁰ For example, New York law prohibits prepayment penalties after the first year of a loan. The New York representatives did not wish to compromise monetary relief in exchange for a two-year prepayment penalty limit that would not provide additional protection to its constituents. Yet states without predatory lending laws needed the Household settlement to fill that legislative gap.

In addition, ACORN's somewhat radical techniques caused discomfort among some in the multi-state team. If members of the multi-state team do not wish to "see their picture in the paper or be quoted," working with ACORN may prove challenging.¹⁹¹

The cultural differences between regulators and state attorneys may also stymie future multi-state multi-agency litigation. "Banking superintendents are very reluctant to take on the industry," explained Ms. Kane. "They don't think there is predatory lending; they . . . see that the documents have been signed and conclude it was not a predatory loan." This description sharply contrasts with Mr. Huey's view of his role as Assistant Attorney General as that of a "plaintiff's attorney."

These barriers are, however, surmountable. First, Mr. Huey explained that while the Household multi-state was "not an uncommon arrangement for [attorneys] in consumer protection," combining attorneys from both civil rights and consumer protection divisions proved to be an important factor in the settlement. As explained in Part I-B, *supra*, predatory lending disproportionately affects minorities. Attorneys like Sandra Kane, who have experience dealing with civil rights issues, can bring important perspective to the table. Moreover, attorneys from civil rights divisions can rarely charge predatory lenders with civil rights violations since statutes

¹⁸⁹ Huey Interview.

¹⁹⁰ Kane Interview.

¹⁹¹ Huey Interview.

¹⁹² Kane Interview.

¹⁹³ *Id*.

¹⁹⁴ Huey Interview.

require evidence of purposeful targeting, which is often difficult to prove. Hence it is often "much easier to prove consumer fraud than it is to prove a civil rights violation," making the combination of civil rights and consumer protection attorneys critical to an investigation's success. ¹⁹⁵

Secondly, while ACORN's radical tactics may not sit well with the risk-averse members of the multi-state team, their ability to arouse public interest in the Household case could also be used in the future. Attorney General Miller agreed that "Household was under a lot of pressure from the public and the investment community and the press. That was an intangible at play, and ACORN had some effect, and may have indirectly added to our bargaining position." Moreover, ACORN's ability to gather complaints was critical to proving that Household's predatory practices existed beyond the state of Washington. Because of those complaints, the multi-state team "started to contact each other and compare notes, to affirm that [it] was not an isolated case."

Finally, the collaboration between State Attorneys General and banking regulators can be replicated in future cases. In many states, including Washington, California and New York, attorneys from the State Attorney General office and banking regulators worked on Household. The contacts made during the six month investigation can be used against other predatory lenders in the future.

Attorney General Tom Miller acknowledged that "getting all of the Attorneys General to come to a consensus is hard enough, but we are a family. To go outside the family to get consensus [with banking regulators] would be even more challenging." Yet the new recipe

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¹⁹⁵ Kane Interview.

¹⁹⁶ See note 172, supra. ACORN's rabble rousing likely contributed to Comptroller McCall's decision to to divest New York's Common Retirement Fund of its Household stock.

¹⁹⁷ Miller Interview.

¹⁹⁸ Kane Interview.

¹⁹⁹ Interview with Tom Miller, State Attorney General of Iowa, December 27, 2002 (hereinafter "Miller Interview"). General Miller has been at the forefront of many of the major multi-state actions for the past

worked. General Miller said "for the two months I was involved, the working relationships with the financial regulators exceeded all of my hopes."²⁰⁰ Unlike the stereotype of bureaucrats as risk averse conservatives, Attorney General Miller described the regulators, especially those from Washington, Minnesota and New York, as "the hardliners, the toughest negotiators in the group."²⁰¹ This description ratifies Mr. Huey's sense that the "more aggressive enforcement elements" of the banking regulators were attracted to the Household case. 202 Nothing should stop that unit from working together again – "it is just a natural success if you can get over petty jealousies."203

Without the critical mass of information from ACORN, the states might be tempted to adopt a parochial, rather than national, perspective. But due to the "shifting political winds . . . and constraints on the FTC's enforcement resources,"204 the states should not cede to the federal government for a national solution to predatory lending. The under-regulation of the mortgage lending market is analogous to the Reagan era, when federal agencies lacked the resources to enforce antitrust laws. The State Attorneys General responded by filing highly coordinated multi-state antitrust cases to protect consumers. ²⁰⁵ Using the Household model, the State Attorneys General could perform the same role for borrowers injured by predatory lenders. In addition, attorneys from NAAG and the DOJ already work together on the mortgage lending task force lead by Ms. Kane. Leveraging that relationship could overcome political obstacles and provide considerable bargaining power to state and federal law enforcement officials.

Bargaining as a team provides greater leverage against lenders and relief for borrowers. For example, before the multi-state team had formed, the state of Minnesota negotiated a

²⁰⁰ Id.

two decades, including tobacco, Microsoft, and Firestone. Along with three fellow Attorneys General, General Miller was the lead negotiator on the final settlement with Household.

²⁰¹ *Id*.

²⁰² Huey Interview.

²⁰³ Miller Interview.

²⁰⁴ Engel, *supra* note 3, at 1304.

\$200,000 consent order with Household. In comparison, Minnesota borrowers received \$5.5 million under the multi-state settlement. 206 The multi-state team thus brought both law enforcement success and private financial relief. For this reason, Attorney General Miller said that he "expects this group to work together again in the future," and that he and his colleagues will "return to the Household terms as the starting point for defining a remedy." 207

B. Household and Other Entities

The Household multi-state team broke a law enforcement logiam. Legislation has largely failed to stop lenders from using predatory practices, and is subject to amendment. Private suits against predatory lenders have proven to be nearly impossible to win. By thinking creatively about jurisdictional gaps and leveraging the strength of its many members, the Household team won permanent injunctive relief that will help thousands of borrowers reach their goal of homeownership.

The Household settlement may also presage the future of law enforcement. Attorney General Miller explained that combining regulators and Attorneys General has already met with success in law enforcement outside the lending industry. Like the Household settlement, the investigation of investment banks exemplifies this new model. State Attorney General of New York Eliot Spitzer has led the investigation of financial institutions. Only Spitzer and three other Attorneys General have jurisdiction to pursue securities violations under their states' laws. In the forty-six remaining states, another official has jurisdiction. "The Attorneys General are a small minority, even though Eliot [Spitzer] is their leader."²⁰⁸

²⁰⁵ See Michael F. Brockmeyer, Federal and State Enforcement Agencies: Current Activities and Priorities: State Antitrust Enforcement, 57 ANTITRUST L.J. 169 (1988).

²⁰⁶ Press Release, Minnesota, 34 Other States Reach Settlement with Household Finance (October 11, 2002) (available at

http://www.commerce.state.mn.us/pages/NewsReleases/Releases2002/News021011.htm). The originally proposed \$200,000 settlement represents 3.6% of what Minnesotan borrowers received through the multi-

²⁰⁷ Miller Interview.

²⁰⁸ Id.

Law enforcement attorneys can extend the Household paradigm beyond banking and lending. Consider a hypothetical retailer with stores in all fifty states. A State Attorney General receives labor complaints about the retailer, and decides to look into the matter. ²⁰⁹ According to the status quo, the state's department of labor investigates the retailer's wage and hour violations at stores within state borders. With sufficient data, the State Attorney General negotiates a settlement agreement for the company's state violations.

But what if this breach is not due to one rogue manager, but instead indicates a systemic, nationwide practice of wage and hour violations? Under the new model, a task force composed of State Attorneys General and labor department officials from multiple states compares the violations witnessed within each state – perhaps employing the help of a grassroots organization like ACORN to gather complaints – to determine whether this national company has a national problem. Negotiating with the retailer as a unit, the team uses both licensing and litigation as leverage, extracting far greater injunctive and monetary relief than would be possible under the status quo.

In light of the consolidation of the nation's retail, manufacturing and service industries, many violations which appear isolated likely represent systemic problems. By combining licensing officials with State Attorneys General, the new model can aid the enforcement of labor, civil rights, disability and even environmental laws. To replicate the success of Household, the State Attorneys General must reach beyond both state borders and their own offices, to fellow attorneys, licensing officials and administrative agencies. With creative thinking and cooperation, the Household model can continue to uncork law enforcement bottlenecks.

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²⁰⁹ This hypothetical is partially based upon complaints about Wal-Mart's labor practices. In 2000, the state of Maine fined Wal-Mart \$205,650 for violations of child labor laws in every one of its Maine stores. Subsequent lawsuits, however, have alleged that the company violates labor laws in all fifty states. *See generally* Joshua L. Weinstein, *Wal-Mart Fined \$205,650 in Child Labor Case*, PORTLAND PRESS HERALD, March 2, 2000, at 1A (describing the results of Maine's Bureau of Labor Standards' investigation of Wal-Mart's labor practices); Steven Greenhouse, *Suit Says Wal-Mart Forces Workers to Toil Off the Clock*, THE NEW YORK TIMES, June 25, 2002, at A1 (discussing a suit filed by Wal-Mart employees in 28 states alleging that the retail giant routinely and nationally commits wage and hour violations).