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Subprime Practice Group Advisory: Another Subprime Lender Enjoined from Foreclosing on Mortgage Collateral

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The Massachusetts Attorney General is two for two. In a decision rendered on November 10, 2008, a Massachusetts Superior Court judge enjoined subprime lenders H&R Block Mortgage Corp. and Option One Mortgage Corp. (collectively the "Defendants") from foreclosing on any of their mortgage loans with Massachusetts subprime borrowers without the express prior approval of the Attorney General (*Commonwealth of Massachusetts v. H&R Block, Inc., Block Financial Corp., Option One Mortgage Corp., H&R Block Mortgage Corp., AH Mortgage Acquisition Co., d/b/a American Home Mortgage Servicing Inc.* ("*H&R Mortgage*")[1]).

Relying substantially on its findings in the 2007 *Fremont* case,[2] the court found that the Defendants, through their issuance of subprime loans to Massachusetts borrowers, violated:

M.G.L. c. 93A, § 2 by engaging in "unfair and deceptive acts and practices"; and

M.G.L. c. 151B, § 4(3B) by discriminating against black and Latino borrowers.

The Defendants have been enjoined from foreclosing on *any* property secured by a Massachusetts loan whether or not it is considered presumptively unfair (discussed below) without first giving the Attorney General at least 30 days advanced written notice to examine the loan documentation. If the mortgages are deemed "presumptively unfair," the Defendants may not foreclose without giving the Attorney General at least 45 days advanced written notice. If the Attorney General's office objects, the parties have 15 additional days to resolve their differences regarding the proposed foreclosure. If they cannot reach a mutually agreeable resolution in that time period, then the Defendants may only proceed with a foreclosure if they receive court approval.

A defendant, American Home Mortgage Servicing, Inc. ("American Home"), purchased the servicing rights of the mortgage loans in early 2008. The court found that American Home was not subject to civil penalties, the payment of the costs of investigation, or attorneys' fees, but did require that it remain subject to the injunction for the "limited purpose, if needed, of providing the alleged victims of the mortgage loan fraud with an equitable remedy."

The Fremont Four Factors … Modified

As described in *Fremont*, four factors (the "Four Factors"), when taken together, make a loan "presumptively unfair" and in violation of Chapter 93A. *H&R Mortgage* retains a slightly modified version of the Four Factors:

- the loan is an adjustable-rate mortgage with an introductory period of three years or less;
- the loan has an introductory or "teaser" rate for the initial period that is at least **2%** (3% in *Fremont*) lower than the fully indexed rate (*i.e.*, the adjusted rate at the end of the introductory period);
- the borrower has a debt-to-income (DTI) ratio that would exceed 50% if the lender's underwriters measure the debt not by the debt due under the teaser rate, but by the debt due under the fully indexed rate (if the borrower has a DTI ratio greater than 55%, then the loan may be presumptively unfair whether or not the loan included a teaser rate); and
- the loan-to-value ratio is **97%** (100% in *Fremont*) or the loan carries a substantial prepayment penalty or a prepayment penalty that extends beyond the introductory period.

An exception was also made in Factor 3 above where a borrower has a student loan in which payment has been deferred at least six months from the date of submission of the loan application. In such cases, the DTI ratio in Factor 3 above drops from 50% to 45%.

Predatory Loans

In rejecting the Defendants' argument that M.G.L. c. 93A, § 2 is unconstitutionally void for vagueness, the court reiterated its *Fremont* finding: it is an unfair act in violation of M.G.L. c. 93A, § 2 for a lender to issue an adjustable-rate mortgage that the lender reasonably should expect the borrower would be unable to afford to pay or be able to refinance once the introductory period ends, unless the fair market value of the home has increased at the close of the introductory period. In *H&R Mortgage*, the court characterized the Defendants' action as exhibiting a "reckless disregard of the risk of foreclosure" and that contrary to the Defendants' assertion that the claim asserted is void for vagueness, the Defendants had fair notice of the prohibited conduct. In support of its finding, the court noted, *inter alia*, that a December 10, 1997 advisory by the Massachusetts Commissioner of Banks was sent to each executive officer of each state-charted financial institution and each licensed mortgage lender in Massachusetts describing the growing practice of subprime lending. In the advisory, the Commissioner defined predatory lending as "extending credit to a consumer based on the consumer's collateral if, considering the consumer's current and expected income, the consumer will be unable to make the scheduled payments to repay the obligation" (quoting 209 CMR 32.32(5)(a)(1996)). The Commissioner observed that such predatory lending was a "prohibited illegal act [that] will not be tolerated by the Division [of Banks]." In light of the Commissioner's advisory, and similar advisory letters issued by the United States Office of the Comptroller of the Currency, the court rejected the Defendants' assertions that they failed to receive fair notice of the prohibited conduct.

Discrimination Claim

The Attorney General alleged in her complaint that the Defendants' pricing policy ("Pricing Policy") was based, in part, on subjective factors under which black and Latino borrowers were charged higher points and fees than similarly situated non-minority borrowers, even when objective factors other than race and national origin were equal. The Pricing Policy considered two elements:

- an *objective element*, referred to as the "Par Rate," which calculated rates, points, and fees for mortgage loans based on such risk-related characteristics of the borrower as the FICO score, the loan-to-value ratio, and the debt-to-income ratio; and
- a *subjective element*, which gave loan officers both the discretion and incentive to charge higher points and fees to borrowers, and which resulted in disproportionately higher points and fees being charged to black and Latino borrowers.

The court rejected the Defendants' argument that the Attorney General failed to show any causal connection between the Pricing Policy and the disparate impact. The court found that the plaintiffs identified a sufficiently specific policy where "subjective criteria, unrelated to creditworthiness, should play *no* part in determining a potential borrower's eligibility for credit" (emphasis in the original). Consequently, the Defendants' motion to dismiss the discrimination claim was denied and any future proceedings on the discrimination claim will have to consider the issue of the causal connection between the Defendants' Pricing Policy and the disparate impact on black and Latino borrowers.

Conclusion

On December 9, 2008, the Massachusetts Supreme Judicial Court (SJC) affirmed the granting of the preliminary injunction in the *Fremont* case. One might rightly assume that any appeal of the *H&R Mortgage* case will result in a similar finding, given the judge's almost wholesale reliance on the reasoning in *Fremont*. Subprime lenders are now on notice that foreclosing on their Massachusetts collateral may not be a simple matter of executing their rights under their mortgages. If the Four Factors were present at the time of loan origination, a foreclosing lender will almost certainly have to provide written notice to the Attorney General of its intention to foreclose and presumably enter meaningful discussions with the Attorney General as how to best balance the interest of subprime borrowers who face foreclosure and loss of their homes on the one hand, and the interest of the lender in recovering the value of its loan to such borrowers on the other hand. Alternatives to foreclosure must be considered and explored in the first instance when the Four Factors were present at the origination of the loan, and if the Attorney General does not agree to allow foreclosure, the permission of the court will be necessary prior to executing foreclosure proceedings.

Endnotes

[1] Mass. Sup. Ct. Civil Action No. 08-2474-BLS1.

[2] *Commonwealth of Massachusetts v. Fremont Investment & Loan and Fremont General Corporation*, Mass. Sup. Ct. Civil Action No. 07-4373-BLS1.

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