DOJ SETTLEMENT WITH AIG SUBSIDIARIES MAY SIGNAL EXPANDED LENDER LIABILITY AND AGGRESSIVE ENFORCEMENT OF FAIR LENDING LAWS

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Introduction

On March 19, 2010, the United States District Court, District of Delaware approved a settlement between the United States Department of Justice ("DOJ") and two subsidiaries of American International Group Inc.—AIG Federal Savings Bank ("AIG FSB") and Wilmington Finance, Inc. ("WFI" and, together with AIG FSB, "AIG"), an affiliated mortgage lending company—resolving allegations that the companies engaged in a pattern or practice of discrimination against African-American borrowers. The settlement reflects the DOJ's increasingly aggressive enforcement of fair lending laws and, to the extent it broadens lender liability for the actions of third parties, is especially significant. This note overviews the DOJ's initial allegations as well as the settlement's terms and conditions, characterizing their potential impact on the mortgage lending industry. The note also describes some pro-active risk mitigation strategies that, in light of the settlement, lenders should consider.

Allegations in the Complaint

The DOJ's complaint, brought under the Fair Housing Act ("FHA") and Equal Credit Opportunity Act ("ECOA"), alleges that from approximately July 2003 to May 2006, African-American borrowers nationwide were charged broker fees on wholesale mortgage loans[1] that were, on average, 20 basis points higher than similarly-situated non-Hispanic white borrowers. The matter was referred to the DOJ after an October 2007 examination of AIG FSB by its regulator, the Office of Thrift Supervision ("OTS"), which led the agency to believe that AIG FSB and WFI had engaged in a pattern or practice of discrimination on the basis of race after an analysis of their 2005 Home Mortgage Disclosure Act ("HMDA") data.

During the relevant time period, AIG FSB funded mortgage loans that were originated by WFI pursuant to a Mortgage Loan Services Agreement. According to the DOJ's complaint,

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[1] "Wholesale mortgage loans" are loans originated by independent third-party mortgage brokers to be funded by a lender, usually pursuant to a broker agreement. Such loans are differentiated from loans made directly to borrowers by a lender through, e.g., a retail branch.

approximately 94% of the loans that WFI originated for AIG FSB were wholesale loans supplied by third-party mortgage brokers. These wholesale brokers were compensated through direct or "up-front" fees and/or yield-spread premiums.[2] The direct fees were set by the brokers in their full, independent discretion and paid by borrowers. The yield-spread premiums were subject to an upper limit and paid by WFI and AIG FSB to the brokers. The complaint includes allegations that WFI and AIG FSB did not (i) establish objective criteria for brokers to use in setting direct fees; (ii) oversee or supervise brokers in setting the amounts of direct fees; or (iii) monitor the amounts of direct fees for "racially discriminatory disparities." The complaint alleges that the higher broker fees charged to African-American borrowers were based on at least some race-related factors as a result of WFI and AIG FSB's policy and practice of granting "unsupervised and subjective discretion" to brokers, which was "not justified by business necessity or legitimate business interests."

Terms of Settlement

Under the settlement, AIG FSB and WFI deny all allegations and will pay up to $6.1 million to African-American borrowers who were charged higher broker fees than similarly-situated, non-minority borrowers, and will invest at least $1 million in consumer financial education efforts. The settlement also requires the entities to develop and implement direct broker-fee monitoring programs and to provide employee training. In addition, although neither AIG FSB nor WFI are currently engaged in lending activities, should either company choose to re-enter the wholesale mortgage business, it will also be prohibited from discriminating on the basis of race or color.

Expanded Lender Liability

Notably, the settlement underscores the persistence of the DOJ's efforts to hold lenders accountable for the conduct of third-party, independent mortgage brokers, who are neither employed by nor controlled by such lenders. This action against AIG FSB and WFI is the latest in the line of cases brought by the DOJ that alleges that lenders are liable for the actions of wholesale brokers, following the DOJ's actions against Long Beach Mortgage Company ("Long Beach") in 1996 and Delta Funding Corporation ("Delta") in 2000.

In the Long Beach action, the DOJ alleged that the lender was responsible for discrimination in the "entirety of its lending operations," including discretionary amounts charged by its wholesale brokers, because the lender ultimately "retained the right to determine whether to grant the loan." As part of that settlement, the DOJ required that Long Beach (i) offer fair lending training to its wholesale brokers and (ii) obtain expanded documentation for loans that included price exceptions. However, the settlement only required the "periodic review" of wholesale brokerage operations for compliance with fair lending laws, in contrast to the more stringent requirement that Long Beach implement a monitoring system for its retail mortgage loans.

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[2] "Yield-spread premium" refers to the fee a lender pays a broker for an interest rate on a loan to a borrower that is higher than the wholesale interest rate offered to the broker by the lender.

Similarly, the Delta action alleged that the lender discriminated in "acceding to the discretionary prices that were charged by mortgage brokers for the loans made by Delta." However, the settlement went further than the Long Beach agreement, affirmatively requiring that with respect to wholesale lending operations, the lender "reject the broker's proposal or make a counteroffer when it believes the broker's proposed compensation and costs are not permitted under the fair lending laws." In a step closer to implicating a duty to monitor wholesale brokers, the Delta settlement then also required the lender to implement a "detailed periodic monitoring" system of mortgage origination pricing practices "to ensure that flexible pricing does not result in discrimination."

Now, in the case against AIG FSB and WFI, the DOJ has demonstrated a willingness to impose such a duty to monitor wholesale brokers by proceeding under a theory of liability that implicates the lender for failing to "supervise" third-party wholesale brokers and "monitor" the amount of direct fees charged by them to borrowers. Although the settlement is not binding precedent, this continued expansion of liability to lenders for the actions of third parties could herald a significant trend by government enforcement authorities to go after more visible, deep-pocketed entities where it may be impractical, if not impossible, to pursue the actual wrongdoer. Such secondary liability raises important compliance and due diligence[3] concerns for mortgage lenders offering wholesale loans.

The continued expansion of liability could also trigger similar private litigation against lenders to seek redress for third-party acts. Because mortgage brokers are relatively unattractive defendants given the difficulty in obtaining nationwide class certification in suits against them[4] and their limited ability to satisfy large judgments, lenders may prove to be more appealing targets for private litigants. For example, in the 2006 case *In re First Alliance Mortgage Company*,[5] the United States Court of Appeals for the Ninth Circuit held that a participant in the secondary mortgage market was liable for the predatory lending practices of a mortgage lender under an aiding and abetting theory.[6] It is possible that we may see future aiding and abetting allegations, possibly under state law theories, against secondary market loan purchasers.

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[3] The DOJ settlement in its 2002 action against Fidelity Federal Bank ("Fidelity Federal") may provide insight into the agency's stance regarding a lender's due diligence burden with respect to third-party service providers, including possibly wholesale brokers. In this case, the DOJ brought an action against Fidelity Federal alleging discrimination in the bank's subprime credit card programs marketed by third-party service providers. The complaint further alleged that Fidelity Federal "failed to perform adequate due diligence on the service providers" prior to executing the marketing agreements and "failed to ensure that the service providers had policies in place which would ensure compliance with fair lending laws." The settlement required the bank to implement a compliance and risk management program that included due diligence review. It is possible that the government may make similar allegations regarding adequate due diligence of third parties against lenders in future actions.

[4] Several characteristics of the mortgage origination industry that pose difficulties to class certification include differing regulatory schemes and applicable law across the states; the diverse nature of brokerage operations, ranging from unaffiliated individuals to large corporate divisions; and the highly individualized facts and circumstances surrounding the origination of each loan to a borrower.

[5] 471 F.3d 977 (9th Cir. 2006).

[6] *Id.* In this case, Lehman Brothers ("Lehman") was sued under California law by a class of mortgagors for the fraudulent conduct of subprime lender First Alliance Mortgage Company ("First Alliance"). During the relevant time period, Lehman eventually became First Alliance's sole source of warehouse funding and underwriting. The court found that Lehman had direct knowledge of First Alliance's fraudulent lending practices and substantially

Disparate Impact and Discretionary Pricing

The action against AIG FSB and WFI also shows the DOJ's more aggressive use of disparate impact theory,[7] which may reveal statistical patterns that implicate race-based disparities, even where brokers may not have engaged in discriminatory conduct. Such "disparate impact" statistics have commonly been used in attempts to prove fair lending discrimination claims by applicants who are members of a protected class. Several of these cases are currently being litigated nationwide and similar allegations that rely on statistical analysis to make a claim can be expected in future actions by the DOJ and private litigants.

Moreover, the action highlights the DOJ's continued scrutiny of discretionary pricing models. In the complaint, the DOJ alleges that the discretion granted to brokers by WFI and AIG FSB in pricing direct fees resulted in discrimination on the basis of race or color, citing as evidence allegedly statistically significant disparities between the fees charged to African-American borrowers versus white borrowers. Although no findings were made, the complaint alleges that there was no legitimate business justification for the discretionary pricing by brokers from whom the companies purchased wholesale loans.

Although not perfectly analogous, in the automobile lending context, the DOJ implicitly recognized that competition can be an appropriate business justification for discretion in pricing. In 2007, the DOJ settled actions against Springfield Ford and Pacifico Ford, two automobile dealerships that allegedly discriminated against African-American customers by charging them higher interest rates on car loans. The DOJ settlement provided for a disclosure form to document any exceptions to base rates, which allowed for interest rate mark-ups by dealers at their discretion. If the dealer varied from the pre-established interest rate, he or she had to select from the reasons set forth on the disclosure form, which included grounds such as competing offers or promotional financing campaigns. By now alleging that there is no legitimate business justification for discretion in pricing by wholesale brokers, the DOJ's complaint against AIG FSB and WFI seems to depart from its earlier position permitting pricing discretion on the basis of competition. Further scrutiny of the use of discretionary pricing models can be expected in future government examinations and enforcement actions.

Risk Mitigation Strategies

The government's focus on limiting discretionary pricing in broker fees for residential mortgage loans is evident from the undertakings outlined in the settlement's Consent Order. The measures that AIG FSB and WFI must implement should either choose to re-enter the wholesale home lending business suggest best practices that lenders should consider making part of their compliance efforts: (i) establishing a loan-pricing policy with limits on the amounts of fees that

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assisted those practices through its financing of First Alliance's operations, and was therefore liable on aiding and abetting. The plaintiffs were awarded over $5 million in damages.

[7] Debate exists over the validity of claims brought under the FHA and ECOA that are premised upon disparate impact theory because neither statute contains language that expressly authorizes such claims or includes "effects" language, as found in Title VII of the Civil Rights Act of 1964 and discussed by the Supreme Court in *Smith v. City of Jackson*, 544 U.S. 228 (2005). *See* Peter N. Cubita & Michelle Hartmann, *The ECOA Discrimination Proscription and Disparate Impact – Interpreting the Meaning of the Words that Actually Are There*, 61 BUS. LAW 829 (2006).

may be charged; (ii) disclosures regarding broker fees and compensation and notice of non-discrimination; (iii) improved documentation in loan files; (iv) enhanced compliance review, including implementing a monitoring program, equal credit opportunity training for employees and brokers, and robust borrower complaint resolution programs; and (v) consumer education, including credit counseling and financial literacy. Adoption of the above practices, in conjunction with other risk mitigation strategies such as managing discretion exercised by employees and third parties and tracking exceptions to underwriting policies, should limit violations of fair lending laws and potential lender liability for third-party actions.

Conclusion

The AIG FSB and WFI action and settlement sends a strong message that the DOJ intends to continue to enforce fair lending laws aggressively. In the DOJ's press release, both the Assistant Attorney General in charge of the DOJ Civil Rights Division and the Financial Fraud Enforcement Task Force Executive Director used emphatic language to signal their intent to bring future actions, characterizing this case as a "warning shot," attributing discriminatory practices as partially causing the subprime mortgage crisis, and calling for accountability by lenders, brokers, and other parties. Thus, lenders should take pro-active steps now to mitigate such litigation and enforcement risks.

For a copy of the press release, please see http://www.justice.gov/opa/pr/2010/March/10-crt-226.html. For a copy of the Consent Order, please see http://www.justice.gov/crt/housing/documents/aigsettle.pdf.