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The impending storm: post-preemption state consumer protection enforcement

*By Andrew L. Sandler and Michelle L. Rogers**

In the past three years, litigation between states and national lenders has increased dramatically, resulting in high dollar settlements and unprecedented involvement by state officials in lenders' business operations. Responding to the public sentiment that lenders were to blame for subprime meltdown and the resulting foreclosure crisis, state attorneys general have used state consumer protection laws, commonly referred to as UDAP statutes (short for Unfair and Deceptive Acts or Practices), to challenge national banking practices with little regard to a lender's federal regulatory status.

The Consumer Financial Protection Act — formerly H.R. 3126, now title IV of the Wall Street Reform and Consumer Protection Act of 2009 — promises to increase this trend significantly by subjecting national banks and federal savings associations to both federal and state consumer protection laws while reducing their ability to claim federal preemption against enforcement efforts by state AGs.

One among the several ways that the CFPA weakens federal preemption protection is by codifying the Supreme Court's June 2009 decision in *Cuomo v. Clearing House Association LLC*, 557 U.S. __ (2009), which distinguished state oversight from enforcement actions, and held that federal preemption does not prohibit state AGs from enforcing substantive state laws against national banks. Indeed, the CFPA not only permits states to enforce substantive laws against national banks, but it also authorizes state AGs to enforce federal CFPA regulations and to seek both equitable and monetary relief in either federal or state court for CFPA violations. (*See* H.R. 4173 § 4402(a)(1).) With few limitations on their enforcement authority and a new arsenal of federal regulations at their disposal, the act promises to throw open the courthouse doors to a new wave of litigation by state AGs across the country.

Although the CFPA's end to federal preemption of state enforcement is new legislation, state AGs have increasingly used UDAP laws to target national lenders with allegations of predatory lending, unfair servicing and discrimination. The resulting cases demonstrate a progressive increase in the scope of enforcement activity by state AGs and provide a window into what national banks and federal savings associations can expect post-CFPA.

Foreclosure review processes

In early 2007, the Ohio AG sued New Century Financial Corp., alleging violations of Ohio's UDAP provision (the Consumer Sales Practices Act), based on New Century's failure to fund loans as promised and for alleged misconduct in servicing loans. (*See Ohio v. New Century Mortgage Corp.*, No. 07-618660 (Ct. Common Pleas 2007).) Following the entry of a temporary restraining order against New Century, the parties agreed to an injunction granting the AG authority to review all of New Century's pending foreclosures and delinquent loans prior to such loans advancing to foreclosure, and requiring New Century to modify consumer loans the AG believed may have violated Ohio law. In November 2008, a bankrupt New Century settled the case, agreeing to pay Ohio $250,000 and to submit to a permanent injunction preventing it and its subsidiaries from conducting business in Ohio and from continuing any foreclosure action without approval from the state.

'Structurally unfair' loans

Following in Ohio's footsteps, the Massachusetts AG filed suit against defunct lender Fremont Investment & Loan and its parent Fremont General Corp. in October 2007 and sought an injunction to stop Fremont from foreclosing on Massachusetts' borrowers. (*See Massachusetts v. Fremont Investment & Loan*, No. 07-4373-BLS1 (Mass. Super. Ct. 2007).) The suit alleged unfair and deceptive acts by Fremont in the making and servicing of loans, claiming that its products were "structurally unfair" — a term coined by the AG to describe loans the AG believed were "designed to fail." Fremont defended its products, which included adjustable rate mortgage and stated income loans, as both offered throughout the industry and regulated by state and federal guidelines.

The state court granted the AG a preliminary injunction requiring Fremont to engage in an onerous pre-foreclosure review process. Indeed, the Fremont process was much more complicated than Ohio's, requiring 30- and 45-day notice periods to the AG prior to any foreclosure and an analysis of each loan to determine whether it met a series of factors that, according to the court, made it "presumptively unfair." Where the AG objected to foreclosure and the parties could not resolve the dispute, Fremont was required to seek court approval to proceed with the foreclosure.

The injunction was affirmed on appeal by the Massachusetts Appeals Court and Supreme Judicial Court, both of which found that although the loans may have complied with the law at the time they were made, they could still be declared unfair under Massachusetts' UDAP law. (*See Massachusetts v. Fremont Investment & Loan*, 897 N.E.2d 548 (Mass. 2008).) The case settled in June 2009 for $10 million.

(See **POST-PREEMPTION** on page 4)

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Attack on 3rd-party servicers

Following *Fremont*, the Massachusetts AG filed a similar suit against Option One, parent company H&R Block, and loan servicer American Home Mortgage Servicing in June 2008. (*See Massachusetts v. Option One*, No. 08-11225-BLS1 (Mass. Super. Ct. 2008).) The AG alleged that the lender-defendants made structurally unfair loans and that they discriminated against African-American and Latino borrowers in originating loans by utilizing a discretionary pricing policy that considered subjective factors and resulted in those borrowers being charged more than similarly situated nonminority borrowers. It also alleged that American Home engaged in unfair and deceptive acts when servicing the loans.

Relying on *Fremont*, the same Superior Court judge issued a similar, though more restrictive injunction, limiting the defendants' ability to foreclose on Massachusetts borrowers under an even more stringent set of criteria. However, unlike the *Fremont* injunction, which applied only to those loans actively owned and serviced by Fremont, the *Option One* injunction explicitly applied to third-party servicer American Home. That injunction was also affirmed on appeal. American Home settled with the Massachusetts AG in November 2009, agreeing to modify approximately 8,200 Massachusetts mortgages, as the state's suit against H&R Block and Option One continued.

Other states are also looking beyond loan originators to third-party servicers. The Ohio AG has filed three lawsuits against third-party servicers alleging unfair and deceptive servicing practices. And, in May 2009, Goldman Sachs, a subprime loan purchaser and the owner of Litton Loan Servicing, agreed to settle an investigation with the Massachusetts AG for up to $50 million in loan modifications and a $10 million payment to Massachusetts.

Additionally, states are also exploring discretionary pricing claims against national lenders similar to those raised in *Option One*. For example, in July 2008, GreenPoint Mortgage, a subsidiary of Capital One Financial, agreed to pay approximately $1 million to settle similar discretionary policy pricing claims levied by the New York AG. Illinois also filed a discretionary pricing suit against another national lender, Wells Fargo, in July 2009 (*see below*).

High-dollar settlements and mortgage relief

In perhaps the most costly of the settlements to date, four months after California and Illinois simultaneously sued Countrywide Financial Corp., its new owner, Bank of America, settled claims on its behalf with those and nine other states by agreeing to provide up to $8.68 billion in mortgage relief to distressed borrowers. (*See California v. Countrywide Financial Corp.*, No. LC081846 (Cal. Super. Ct. 2008) (alleging violations of California UDAP statute), and *Illinois v. Countrywide Financial Corp.*, No. 08ch22994 (Ill. Super. Ct. 2008) (alleging violations of Illinois UDAP statute).) The suits against Countrywide alleged unfair conduct and false advertising in originating, marketing and servicing mortgage loans, claiming specifically that Countrywide unfairly made risky loans to borrowers without concern for their ability to repay the loans and that it misrepresented the terms of the loans.

The real value of the *Countrywide* settlement is unclear since it is dependent upon, among other things, the ultimate amount of mortgage relief provided. Nevertheless, the case not only set a record in its total potential settlement value, but also continued the trend of settlements designed to help troubled homeowners modify loans in an attempt to assist those borrowers avoid foreclosure. Indeed, the $10 million Fremont and $60 million Goldman Sachs settlements, discussed above, both were reached after the *Countrywide* settlement and shared similar promises to assist homeowners with loan modifications.

Next wave of litigation

Less than a month after the Supreme Court's *Cuomo* decision to definitively allow state enforcement actions against national banks, notwithstanding the preemption provided in the National Bank Act for such entities, Illinois sued a major lender and national bank alleging that its discretionary pricing policy resulted in African-American and Latino borrowers being charged more for their loans than similarly-situated white borrowers (like the *Option One* and *GreenPoint* cases before it). (*See Illinois v. Wells Fargo and Co.*, No. 09CH2643 (Ill. Super. Ct. 2009).)

Although the theory of the case is not new, even the Illinois AG acknowledged that the case "would have been much more difficult to bring" prior to *Cuomo*. The case thus typifies what lenders can expect to see with the CFPA's passage: AG actions that advance claims seen before to new defendants previously beyond state reach. This will be further complicated once states are able to add new claims to suits by attempting to enforce the act's regulations once they take effect.

Unintended consequences

While the obvious impact of the CFPA will be to increase state litigation against national lenders, the unintended consequences will have significant implications in the form of fewer products and increased costs to consumers. For example, as certain states become more aggressive than others in challenging loan products and lender conduct, banks may limit lending or restrict product offerings in those states. Thus, what is available in one state may be unavailable in another as state enforcement initiatives result in disparate outcomes nationwide.

Moreover, the cost of borrowing will likely rise. Lenders will face increased administrative costs while they work to keep up with lending criteria that differ among states, along with rising costs associated with increased litigation, both of which will likely be passed on to consumers.

In short, the CFPA's state-level enforcement provisions will not only impact national banks and federal savings associations, but they will affect consumers too by increasing the cost borrowers pay to obtain loans and reducing the choices available to them as lenders wrestle with the transformation of a national lending market to one that operates differently in states across the country. ❑

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