

Preventative Measures: Avoiding Predatory and Discriminatory Lending Litigation

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Overview

- Reviewing the regulatory structure from the point of view of the Consumer Financial Protection Bureau.
- Understanding the future of discriminatory and predatory lending litigation.
- Considering non-legal issues that revolve around the lending process and how they can affect a financial institution's litigation risk.



The Legal Perspective

- Identifying problem areas in the loan process and analyzing whether there exists a basis for disparate impact claims.
- Consult the Consumer Financial Protection Bureau’s (“CFPB”) Supervision and Examination Manual – Version 1.0 (the “Manual”). It provides examination guidance on the following (among other laws and activities):
 - Unfair, Deceptive, or Abusive Acts or Practices
 - Equal Credit Opportunity Act
 - Real Estate Settlement Procedures Act
- The Manual provides Interagency Fair Lending Examination Procedures.
- The Manual includes checklists and appendices that provide guidance on how CFPB will examine financial institutions with consumer-protection laws.
- Disparate Treatment vs. Disparate Impact:
 - Disparate Treatment – Understanding predatory lending laws to ensure that bank and employees comply with legal obligations.
 - Disparate Impact – This does not require intent. Need to understand how to prevent, or identify quickly, activities that are *not* intended to discriminate against minorities or other protected classes, but nonetheless have that effect.



Consumer Financial Protection Bureau

- Created by the Dodd-Frank Wall Street Reform and Consumer Protection Act.
- Regulatory power became effective July 21, 2011.
- Oversee consumer-protection issues that had been handled by a wide range of federal regulators.
- Actions taken by CFPB to date:
 - Simplifying disclosures
 - Launching *Know Before You Owe* program
- CFPB will adopt either a rules-based approach or enforcement-based approach to regulation.
- What will be the future impact of CFPB?



Equal Credit Opportunity Act

- Prohibits discrimination based on:
 1. Race, color, religion, national origin, sex, marital status, or age (assuming capacity to contract).
 2. A person receiving all or part of income from any public assistance programs.
 3. A person exercising his or her rights under the Consumer Credit Protection Act.
- Statue of Limitations: 2 years (private right of action may be brought within 1 year of commencement of enforcement action or civil action by the Attorney General).

15 U.S.C. §§ 1691 *et seq.*



Preventive Measures for ECOA

- Review manuals, credit underwriting guidelines, loan documents, and advertising.
- Understand the level of discretion employees have in granting loans and whether there is an opportunity to base decisions on discriminatory reasons.
- Perform self-audit using the Regulation B Examination Checklist.



ECOA– Self-Tests and Self-Evaluations

- Use of self-tests and self-evaluations can identify violations of ECOA, but they are not the same.
 - Self-tests – Create new data that is not available in loan files. This information is privileged, unless the report is disclosed, which forfeits privilege (12 C.F.R § 202.15(b)(2) and 24 C.F.R. § 100.142(a)).
 - Self-Evaluations – Performing tests based on information already available in the loan files. This information is NOT privileged.



Establishing Remedial Procedures Before There is a Problem

- The Manual indicates that financial institutions should have systems for remedying violations quickly.
 - Internal Remediation:
 - Talking to employees
 - Changing advertising
 - Fixing loan procedures
 - External Remediation:
 - Working with borrowers to fix specific instances
 - Educating local stakeholders about specific efforts to eliminate discriminatory practices
- CFPB will examine whether there are remediation procedures in place to fix discriminatory practices and will assess their strength.



Real Estate Settlement Procedures Act

- Imposes requirements on financial institutions regarding disclosures about real estate settlement process.
- Protects consumers from abusive practices (example: kickbacks).
- Governed by Regulation X (24 CFR Part 3500)
- Statute of Limitations:
 - Servicing mortgage loans and administration of escrow accounts – 3 years (all claimants)
 - Receiving kickbacks and unearned fees – 1 year (private right of action); 3 years (when brought by the Secretary of HUD, the Attorney General of any state, or the insurance commissioner for any state)

12 U.S.C. §§ 2601 *et seq.*



Compliance with RESPA

- RESPA includes primarily objective enumerated obligations.
- Must have audits to confirm consistent compliance with RESPA requirements.
- Key focal points:
 - Mortgage referral sources and other Affiliates Business Arrangements
 - Escrow accounts for mortgage



Fair Housing Act

- May not discriminate based on race, color, national origin, religion, sex, familial status or disability, including taking the following actions:
 - Refusal to make a mortgage loan
 - Refusal to provide information regarding loans
 - Imposing different terms on a loan (interest rates, fees, etc.)
 - Discrimination in appraising property
 - Refusal to purchase a loan
- Statute of Limitation: 2 Years for private right of action (tolls as provided by statute); 18 months for civil actions commenced by the Attorney General.

42 U.S.C. §§ 3601 *et seq.*



Future Trends in Litigation

1. Rise in claims under the Fair Housing Act:
 - *Gallagher v. Magner*, 619 F.3d 823 (8th Cir. 2010) *cert. granted* – The U.S. Supreme Court will decide whether disparate impact claims can be brought under FHA.
 - Proposed HUD Rule adoption test about discriminatory impact similar to approaches adopted in *Gallagher* and in other circuit courts.
2. Claims based on loss mitigation programs provided by the bank and the government.



Case Study: Facts Giving Rise to Causes of Action Under FHA and Predatory Lending Laws

- *NAACP v. HSBC*, 2:09-CV-01759 (C.D. Ca.)
- Facts:
 - Class consists of African Americans who either:
 - Were eligible for less expensive loans; or
 - Only qualified for loans based on lower initial interest rate, not the scheduled higher interest rates.
 - Relied on statistical evidence from studies that demonstrated discrepancies between treatment of African-Americans and Caucasians that were similarly situated.
 - Allegedly no review of loan application process to determine whether borrowers qualified for better loans.
 - Claims were brought under:
 - Fair Housing Act
 - Equal Credit Opportunity Act
 - Civil Rights Act
 - HSBC settled these claims.



Predatory Lending and Bank M&A

- Part of the due diligence process of a bank acquiring a target bank should be the target bank's risk profile for predatory lending.
- Lending weaknesses in both institutions magnify the problem and may invite litigation.
- Case study: *U.S. v. Citizens Republic Bancorp, Inc.*, 2:11-cv-11976 (E.D. Mich.) - On May 5, 2011, Citizens Republic Bancorp, Inc. ("CRBI") settled a redlining lawsuit brought by Department of Justice for \$3.6 million.
 - CRBI acquired Republic Bank. Republic Bank and Citizens Bank, the wholly-owned subsidiary of CRBI, had substantial presences in Michigan.
 - DOJ asserted claims under FHA and ECOA that the combined bank had catered to majority-white areas, while ignoring and failing to services majority-black areas.
 - Almost all of the bank's post-merger branches were located in majority-white census tracts. None of the branches were located in the City of Detroit.



Addressing Predatory Lending Issues During the M&A Process

- Communicate with bank M&A team early to understand the liabilities a bank is acquiring.
- Designate a person from the target bank to compile information and identify important documents and practices about the target bank that could be helpful for defending future litigation stemming from the target bank's lending practices.
- Without proper preparation, a bank may be forced to settle cases solely because of its inability to obtain facts necessary to defend cases.
- Consider the profile of potential targets. If a target bank does not have a strong history of servicing minorities, consider the profile of the post-acquisition bank. Take steps early to improve relationships with under-served areas to reduce the post-acquisition risk.



Best Practices Tips in the Loan Process

1. Document all interactions with borrowers.
2. Limit oral communications on deal terms and approval.
3. Document the basis for accepting or rejecting loans and for choosing one loan product over another.
 - This is especially important for borrowers on the margins of being approved for loans or specific products. Need to be able to explain a year (or multiple years) after the loan was made why two borrowers with similar profiles received different treatment.
4. Enumerate specific conditions required to trigger bank's obligation to lend – avoid adding material conditions later in the loan process.
5. Developing an anti-discrimination policy:
 - Consider all aspects of banking and customer contacts
 - Different methods of educating employees (internal seminars, handbooks, social media)
 - Strengthen defense under *Wal-Mart*
6. Strive and test for consistency.
7. Protect bank from sales channels
 - Perform due diligence on mortgage brokers
 - Carefully draft agreements with mortgage brokers so that it is clear they are independent contractors, not agents or employees. One page agreements may be best.
8. Review procedures for maintaining REO properties.
9. Maintain robust workout and foreclosure procedures.



Documentation May Not Be Enough

- *Marr v. Bank of America, N.A.*, 662 F.3d 963 (7th Cir. 2011) – Holding that a borrower could withstand summary judgment on failure to receive two copies of notice of three-day right to rescind, as required by TILA, despite written acknowledgment by borrower of receipt of such notices.
- Borrower's assertions:
 - File with loan documents was untouched after closing (except for *addition* of documents)
 - Closing agent failed to follow procedures during the closing
- Written acknowledgment of receipt of the notices created a rebuttable presumption, but the court found the borrower's testimony was sufficient to rebut the presumption.
- “[U]ncorroborated, self-serving testimony, if based on personal knowledge or firsthand experience, may prevent summary judgment against the non-moving party, as such testimony can be evidence of disputed material facts.” (Internal citation omitted)



Protecting the Bank at the Closing Table

Fair lending and TILA claims can arise from similar facts related to failures at the closing table:

- Need to prepare comprehensive escrow instructions for the escrow agent related to the closing.
- Need to obtain closing protection letter from title company that certifies that a transaction closed properly.
- These measures will protect a bank from liability, but will not prevent litigation.



The Practical Perspective

- Understand reputation risk and the practical implications of the loan process:
 - Who is the borrower?
 - Members of CFPB have identified the impact loan transactions on military personnel
 - How are you marketing your consumer loans?
 - What is your reputation in the community?
 - What is the best way to balance the need to service communities and customers and to provide profitable services?



Taking Affirmative Steps to Solidify Your Reputation

- How does your bank interact with underserved communities (branches, volunteering, educational seminars)?
- Take a role as a community leader.



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