Subprime Lending Issues Reflect Industry Turmoil and Progress

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By Alvin C. Harrell

Mr. Varga also discussed Brunel v. Adams, a decision raising "dealing farmer" questions, and that the dealer charges the consumer a higher rate than the rate acceptable to the subsequent purchaser of the used car dealer as fiduciaries of their customers with a duty to tell the "entire" truth in response to every inquiry. Mr. Varga also noted: "The NCD v. GMC submission of the debate over the adequacy of the adequacy of credit has been largely resolved by the issuance of a new chapter 12 bankruptcy." Mr. Varga concluded by noting that a recent decision adverse to lenders was not a victory for non-filing insurance charges.}


2. "In the absence of any evidence of a new chapter 12 bankruptcy," Mr. Varga said, "the decision adverse to lenders was not a victory for non-filing insurance charges." Mr. Varga also noted: "The NCD v. GMC submission of the debate over the adequacy of the adequacy of credit has been largely resolved by the issuance of a new chapter 12 bankruptcy." Mr. Varga concluded by noting that a recent decision adverse to lenders was not a victory for non-filing insurance charges.
Mr. Hudson emphasized that loan discounting was not the source of the widely publicized financial and accounting problems at Mercury Finance and Mackay in early 1987, but nonetheless predicted that deep discounting is like waving a red flag at a public policy bull and may have consequences that affect not only the secondary market, and securitizations generally. He also noted that if these practices are held to violate state deceptive trade practices law, the result could be convictions of a corporate crime and possible license revocation at the state level.

Against this backdrop is the concept of hidden finance charges—the concern that a dealer may mark up the retail price in part as the financing. If not disclosed as part of the finance charge, such a mark-up violates the TILA and possibly state deceptive trade practices laws, not to mention possible RICO and state loan fraud laws.

Mr. Hudson emphasized that dealer training materials and marketing tools are often paid for by and gathering requirements, and annual report and press releases can be damaging. As noted earlier, a disinacted or bankrupt dealer may be eager to help a plaintiff, and dealer groups may be tempted to save themselves by doing likewise at a policy level. Instructions from the dealer to the dealer should be very carefully analyzed.

IV. RESPA Issues

Marsha Williams covered RESPA issues, noting that a continual series of changes and developments have created a maze of issues and requirements.

For solutions, Mr. Hudson noted that the safe course is to avoid loan discounts, and especially deep discounts. He suggested that discounts over 20% are dangerous, and he noted that when discounts are attacked the victims may include all discounters regardless of the size of the discount.

He recommended adjusting the RESPA as needed and living off of that income rather than a discount. If discounts are necessary, he suggested that they be disclosed to the consumer (in order to combat fraud claims) though this is clearly not a legal requirement. He also urged separate incorporation of state sanctions for a lack of a parent company liability.

Regarding dealer relations, Mr. Hudson again urged careful review of all dealer promotional, sales and training materials, and thorough education of dealer staff. There should be efforts to confirm that dealer representations and warranties are true, and these efforts should be documented and subject to periodic monitoring.

A more drastic solution is to require that dealers buy insurance to protect them from federal and state actions. This would subject the dealer to a policy level. Instructions from the dealer to the dealer should be very carefully analyzed.

The latest wave statutory changes are in EQUICRA, including a requirement that the Federal Reserve Board (FRB) and Department of Housing and Urban Development (HUD) issue regulations for TILA and RESPA, and provide a unified disclosure regime.

Mr. Williams also discussed the proposed HUD rules. HUD will now require that mortgage brokers for loan origination services.

She noted that in November 1992, HUD revised Regulation X to clarify that RESPA does not apply to secondary market transactions. She distributed a proposed HUD statement of principles for a new Fair Credit Reporting Act, which would further clarify that mortgage broker fees do not violate the RESPA, but noted that this was subsequently withdrawn in view of opposition by key Congressional Democrats.

Mr. Williams also noted the final rule streamlining the RESPA regulations to comply with the President's regulatory reform initiative, and the status of the Regulation X revisions covering consumer leases and computer operations (REGO and related issues). Her program materials include a form for disclosing an Affiliated Business Arrangement.

V. Alabama Developments

Litigation in Alabama and resulting legislative reform efforts have received national attention in the aftermath of the controversial decision in Johnson v. Mercury Finance Company of Alabama.

Professor Gene Markon commented on the Johnson case and subsequent Alabama developments. 

Professor Markon opined that Johnson was not a yield spread premium or loan discount case, arguing that other factors were paramount. He argued that some dealers list a cash price on the vehicle, then raise that price as part of the financing arrangement. He indicated that some dealers even give the consumer the original price sticker together with TILA disclosures showing a higher cash price, noting that this is an invitation to a law suit.

Professor Markon then described the recent changes in the Alabama Supreme Court, and recent litigation. He noted a current proposal to cap punitive damages but that it faces an uncertain future.
Mark Draper then spoke on the issues facing those who purchase subprime auto paper in the secondary market. He noted that a secondary market purchaser has no way to know how much an auto loan is currently worth and what the cost of the collateral, any more than the consumer buying the goods has such knowledge. Efforts to reveal or disclose the cost of goods or services sold to either the buyer of the goods or the buyer of the contract represent an attempt by the law to ensure that the buyer does not lack information about the relationship between the two businesses in a sale of a used car, the value of the car (and sales price) is negotiated by the parties and can be influenced by a wide variety of factors (including, of course, personal taste). The sale of the contract in the secondary market is not affected by these different factors affecting the price. The Fairman court distinguished Parkside because there were no such allegations. As noted supra, cases like Fairman and Briefe appear to be premised on the unlikely notion that the public interest is served by the press raising the status of the purchaser to an entity the fair market value of subprime auto dealer TILA violations as a basis for fraud and/or RICO claims. The dealer may then file bankruptcy. The consumer then argues that the dealer should have disclosed his knowledge to the consumer and that the dealer violated TILA. The consumer may seek recovery for the cost of the collateral, any more than the consumer buying the goods has such knowledge. Efforts to reveal or disclose the cost of goods or services sold to either the buyer of the goods or the buyer of the contract represent an attempt by the law to ensure that the buyer does not lack information about the relationship between the two businesses in a sale of a used car, the value of the car (and sales price) is negotiated by the parties and can be influenced by a wide variety of factors (including, of course, personal taste). The sale of the contract in the secondary market is not affected by these different factors affecting the price. The Fairman court distinguished Parkside because there were no such allegations. As noted supra, cases like Fairman and Briefe appear to be premised on the unlikely notion that the public interest is served by the press raising the status of the purchaser to an entity the fair market value of subprime auto dealer TILA violations as a basis for fraud and/or RICO claims. The dealer may then file bankruptcy. The consumer then argues that the dealer should have disclosed his knowledge to the consumer and that the dealer violated TILA. The consumer may seek recovery for the...
being financed each year, at an average sales price of $36,000 or more. Fifty-two percent are "multi-wide" homes, with an average sales price of $45,000. Over 30% of all new homes sold last year were manufactured homes, a market share that has remained consistent for a number of years after a significant decline that followed implementation of strict federal construction standards (implemented by HUD). As could be expected the federal standards covered many smaller manufacturers out of business, temporarily reducing volume in the industry and simultaneously driving up prices.

Manufactured housing finance includes both pre- and post-standard homes and modular units; resale value may be affected by this distinction and lenders should be aware of this issue when financing used units. Lenders can ascertain whether a manufactured home meets the federal (HUD) standards by examining the unit for a HUD seal next to the electrical box.

Manufactured housing finance can be further categorized into: (1) sales of the manufactured unit alone (average sales price $33,700, financed for 245 months); and (2) sales of a home and land (average price $69,000, financed for 354 months). Mr. Lefet noted that 15% of all Florida residents live in manufactured homes. The manufactured home purchase and finance market is influenced by the loan volume of around $13 billion, $22 billion including nonpurchase and refinancing activity.

Financing the purchase of a manufactured unit only (not including land) generally will be covered by Uniform Commercial Code (UCC) finance charges, retail installment/lease finance laws. Financing the purchase of a home and land will additionally involve real property law and possibly the UCC Article 9 rules on fixtures. This is an attractive option in many areas as the prices of conventional homes in some areas have escalated beyond the means of many consumers. Other transactions may involve the financing of or sales of homes from one consumer to another, financing of repossession sales, loan assumptions, financing dealer inventory, direct loans from lenders (as opposed to consumer sales), and home equity or home improvement lending. Purchase money loans may involve the separate or combined acquisition of the land, the improvements and manufactured unit.

Unique issues confronted in this business include: the relationship between real estate law, the UCC, and state certificate of title laws; lender-dealer relationships; the relationship between the home and the dealer as contractor (e.g., in obtaining permits, licenses, transportation and hook-up, land preparation, and making warranties regarding goods under the UCC and services under other law); RESPA treatment of manufactured housing; and the transition from personal property to real property law if the home is permanently affixed to real estate (involving the scope of certificate of title laws, the UCC, and real property law).

A resulting question is: What happens to the scope and requirements of personal property and certificate of title laws when the unit is affixed to real property? Some states require notice to the Motor Vehicle Department and/or cancellation of the certificate of title, others require a fixture filing, while others provide special priority rules. Issues also arise with regard to taxation of the unit as either personal or real property and the impact this has on characterization of the collateral.

Credit terms and loan underwriting standards in manufactured housing finance differ dramatically from those in the real estate industry, including the age, condition, model and quality of the home; the amount of downpayment; loan-to-value ratio; employment stability; home and debt level; and credit history of the borrower; diversification and loan concentration needs of the lender; the lender's costs of funds and other business expenses; the term to maturity of the loan; the yield; permissible loan terms, fees and charges; loan loss provisions; loan discounts; real estate law issues and potential conflicts; and whether the loan is secured by a purchase money security interest.

In addition, secondary market lenders must face various dealer-related issues, including the appropriate dealer representation and warranties (and their effectiveness); the FTC Holder in Due Course notice; the problem of the "close connection" doctrine; the appropriate use of forms; the overall level of oversight of the dealer; discounts, overages and acquisition fees; and the need for a mobile home park agreement (to allow repossession and removal). Mr. Lefet noted that the cost to relocate a manufactured home can be very high, and a park agreement may enable the easier or allow the lender to keep the home in the park for resale. This may significantly reduce repossession expenses. In any event, the consumer can negotiate for a resale home (typically more than ten percent) and the rapid depreciation from the price of a new home means that such loans are seldom fully secured.

Mr. Lefet also discussed charging and licensing issues. The federal thrift charter has only had statutory authority to regulate state pure personal property law (e.g., those parked temporarily on a rented slab at a mobile home park). But what about a state that is permanently affixed to real estate so as to become part of the real estate estate (e.g., an appurtenance to the real estate or a fixture)? In addition, in some states manufactured homes are considered and/or taxed realty. In these circumstances it seems that section 1322(b)(2) could apply.

VI. Designing a Compliance Program

Chris Jones describes the challenges that current consumer credit law creates for corporate (or outside) counsel seeking to assess legal compliance. He noted that it takes three to five years experience for a new legal associate to understand the maze of interconnected and sometimes contradictory requirements affecting consumer credit transactions. Mr. Jones' remarks served as a sequel to his previous presentation at the Consumer Credit 1990 Institute and were built on the foundation of that earlier seminar. He recommended the use of separate forms for each state, tailored to meet the requirements of each state, using state law terms. He also recommended the chartering of a separate subsidiary for each state. This permits forms and practices to be tailored to permitted practices and changes in state. It does not use nation-wide forms providing that are "outlawed" in each state. Collection attorneys should be able to consult the text of the specific state laws in taking judgment. The lender should also get a license in each state, e.g., before undertaking mail promotions and/or operations. States requiring an in-state office are problems and should be changed but in the meantime a state license is cheap insurance. States that have added to the CCEB principal residence (theoretically, already properly excluding from coverage are those that have primarily personal property card (e.g., the new Alabama Code) are helpful and should be enacted in every state. But state administrators in a number of states examine for RUSPA and other federal law violations.

If third parties (e.g., dealers) are involved, the lawyer should ensure their compliance even at the risk of being considered the dealer's agent. "Affinity" programs are an example. Methods include: reports, periodic exams; and compliance checklists. Review not only the dealer's forms but its execution of those forms. Management and the marketing department may want to push the limits of antiquated laws, but bad facts may then create legal problems. Mr. Jones also pointed to several cases. Management should be urged to consider the possibility liability if losses. On difficult issues the lender should consider getting multiple legal opinions (a belt and suspenders approach). The in-house lawyer must then articulate, separate and distinguish the business and legal risks, putting the business decisions and risks on management. Also consider the regulatory and litigation risks, and seek regulatory approval if possible. Other suggestions included: Keep the Compliance Manual simple and short as possible, so the staff can understand the manual, and avoid the problems big loose leaf manuals that are not kept up to date and are not read by the staff. Conduct regular training meetings and compliance audits. Use industry's data banks and check lists and review forms and transactions. Use plain English forms. Beware
with different terms, or the consumer was told the lease was a sale (How could the prominent "lease disclosures be ignored?"

The Department of Justice (DOJ) and Federal Trade Commission (FTC) are prosecuting advertising disclosure violations. Some leases are "stacked" to assure high occupancy and high revenue. Leases that have such disclosures are generally ignored. The clear evidence that these companies have been engaged in such practices is clearly significant. The FTC has been investigating these companies for several years and has received many complaints about their advertising practices.

In conclusion, the report does not provide sufficient evidence to support the claim that such lease disclosures are being ignored. Further investigation is needed to determine the extent of these practices.

(X) IX. Is Leading Fleecing?

Tom Hudson described a perception by some that "leasing is fleecing." He noted that in most states the only governing consumer leasing is the federal statute and Regulation M. (Some states have similar laws, but they are not as stringent as the federal legislation.)

Leasing is a complex and sometimes confusing process for consumers. The Federal Trade Commission (FTC) has received numerous complaints about leasing practices, and the FTC has initiated several investigations into these practices.

In conclusion, leasing is a complex and difficult process for consumers. There is a need for greater transparency and regulation to protect consumers from being fleeced.
QUARTERLY REPORT

Yield Premiums in the auto finance market are growing, as indicated by the recent rise in car loan rates. This is due to several factors, including a tightening of credit standards and increased demand for loans. The auto finance market is expected to continue to strengthen in the coming quarters, with increased demand for new and used vehicles.

Overages

Robert Jaworski spoke on the subject of "overages" in the yield premium market. He discussed how overages can lead to increased costs for consumers and the potential for regulatory scrutiny. He recommended that lenders take steps to mitigate overages and ensure fair practices.

Other Topics

Other topics discussed included the impact of interest rate changes on the yield premium market, the role of credit bureaus in assessing creditworthiness, and the emerging trend of peer-to-peer lending in the auto finance sector. The panel concluded that the yield premium market is poised for continued growth, with opportunities for both lenders and consumers to benefit from increased transparency and fair practices.
sweat of $150,000 for mental anguish and $3,000,000 in punitive damages; this was upheld by the Supreme Court of Alabama.

In a recent Missouri decision reviewing the issues in April, the U.S. District Court for the Northern District of Illinois decided Balentsev v. Union Mortgage Co.25 In Balentsev the plaintiff secured Union Mortgage for fraud under the Illinois Consumer Fraud and Deceptive Business Practices Act (ICFDBP) on a federally insured home equity loan. The court ruled that the plaintiff's cause of action was "extraordinary" and that the Bankruptcy Court had jurisdiction to hear the case. The court also noted that the plaintiff's claim was based on a conspiracy to defraud the lender.

In 1993, a federal court in Illinois held a lawsuit on the same facts in Balentsev v. Union Mortgage Co. The court ruled that the plaintiff's cause of action was "extraordinary" and that the Bankruptcy Court had jurisdiction to hear the case. The court also noted that the plaintiff's claim was based on a conspiracy to defraud the lender.

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