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Introduction to Part II of the Annual Survey of Consumer Financial Services Law

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This will conclude the 1990 Annual Survey of Consumer Financial Services Law.[1] Part II of the Survey will focus on three important areas where recent developments are having an impact on consumer financial services. In the area of Truth in Lending the March 29, 1990 release by the Federal Reserve Board of its new Official Staff Commentary provides guidance concerning the Fair Credit and Charge Card Disclosure Act of 1988 and the Home Equity Loan Consumer Protection Act of 1988.[2] The Fair Housing Amendments Act of 1988, in conjunction with recent changes to the Community Reinvestment Act and the Home Mortgage Disclosure Act, significantly changes the legal environment for home mortgage finance in ways that are just now becoming apparent.[3] And recent developments relating to the securities and investment powers of banks have led to a new focus on bank powers in the aftermath of the problems in the thrift industry.[4]

While these three areas are the focus of this segment of the Annual Survey, as always there are other developments that do not fit directly into the customary Survey topics but nonetheless affect consumer financial services, and therefore deserve brief note. For example, in the area of consumer bankruptcy several

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1. The Annual Survey of Consumer Financial Services Law is a project of the Committee on Consumer Financial Services. This is the eleventh Annual Survey of developments in this area. The first part of this year's Annual Survey appears in the June 1990 issue of *The Business Lawyer*.

2. *See* Chamness & Meredith, *Truth in Lending Developments in 1990: The Interstitial Activity Continues*, 46 Bus. Law. 347 (1990).

3. *See* Ulrich, *The Fair Housing Amendments Act of 1988: New Litigation Tools for Housing Advocates*, 46 Bus. Law. 333 (1990).

4. *See* Kurucza, Ballen, & Diana, *Securities and Investment Activities of Banks—Recent Developments*, 46 Bus. Law. 325 (1990). *See also* Avilés, *Expansion of Bank Powers in the Aftermath of the Thrift Crisis: The Age of "Darwinian" Banking*, 44 Consumer Fin. L.Q. Rep. 115 (1990); Horn & Keehan, *Cooperative Marketing Arrangements: Where Banks Turn Rivals Into Allies*, 44 Consumer Fin. L.Q. Rep. 126 (1990).

recent cases serve to highlight a recent trend with significant implications for home mortgage lending.

The most important of these cases is *In re Hougland*,[5] in which the U.S. Court of Appeals for the Ninth Circuit confirmed a growing trend that allows a Chapter 13 debtor to bifurcate his or her home mortgage loan into secured and unsecured portions before applying the protections granted mortgagees under Bankruptcy Code paragraph 1322(b)(2).[6] Paragraph 1322(b)(2) apparently was intended to protect home mortgage loans from modification in Chapter 13; however, *Hougland* and similar cases have applied Bankruptcy Code subsection 506(a)[7] to limit the protection of paragraph 1322(b)(2) to the secured portion of the mortgagee's claim, permitting the unsecured portion to be treated separately and modified or discharged like any other unsecured claim in bankruptcy.[8] In effect, this permits a Chapter 13 debtor to keep his or her home while unilaterally reducing the home mortgage debt to an amount equal to the current value of the property, treating the balance as unsecured debt. Clearly this represents a significant realignment of the legal relationship between home mortgagors and their lenders. Another line of cases has further restricted the applicability of paragraph 1322(b)(2), by declining to extend its protection to lenders whose mortgages cover any collateral other than the debtor's home, on grounds that by its terms paragraph 1322(b)(2) is limited to "a claim secured *only* by a security interest in real property that is the debtor's principal residence. . . ."[9]

Still another U.S. Court of Appeals decision from the Third Circuit considered related issues in the context of a Chapter 7 bankruptcy. In *Gaglia v. First Federal Savings & Loan Association*,[10] the court allowed the Chapter 7 debtor to bifurcate the home mortgage loan into secured and unsecured claims, pursuant to Bankruptcy Code subsection 506(a), and then permitted the debtor to

5. 886 F.2d 1182 (9th Cir. 1989). *See also* Wilson v. Commonwealth Mortg. Corp., 895 F.2d 123 (3d Cir. 1990).

6. 11 U.S.C.A. § 1322(b)(2) (West 1979), interpreted in *Hougland*, 886 F.2d at 1183.

7. 11 U.S.C.A. § 506(a) (West 1986).

8. *See Hougland*, 886 F.2d at 1182; *Wilson*, 895 F.2d 123; *In re* Caster, 77 Bankr. 8 (Bankr. E.D. Pa. 1987); Bentley, *Treatment of Undersecured Home Mortgage Claims in Bankruptcy*, 61 Okla. Bar Ass'n. J. 1415 (1990).

9. 11 U.S.C.A. § 1322(b)(2) (West 1979) (emphasis added). *See Wilson*, 895 F.2d 123 at 124 (mortgagee was not protected by § 1322(b)(2) because the home mortgage also covered appliances, machinery, furniture and equipment); *In re* Stiles, 74 Bankr. 708 (Bankr. N.D. Ala. 1987) (beneficiary of credit life insurance policy could not be protected by § 1322(b)(2)); *Caster*, 77 Bankr. 8 (standard rents, royalties, and profits clause in home mortgagee disqualified mortgage under § 1322(b)(2)); *Matter of* Foster, 61 Bankr. 492 (Bankr. N.D. Ind. 1986) (mortgage on farm homestead not protected under § 1322(b)(2)).

However, some courts have held that the home mortgage is not ["tainted"] by the other collateral for purposes of § 1322(b)(2) unless that other collateral has actual value. *See Foster*, 61 Bankr. at 495 (mortgage on worthless Land Bank stock was "illusory"); *In re* Hart, No. CIV89-797-T (W.D. Okla. Aug. 28, 1989) (order on appeal) (nonresidential collateral described in the mortgage did not exist and hence there was no security interest except in home).

10. 889 F.2d 1304 (3d Cir. 1989).

reaffirm the secured claim (in order to retain the residence) while discharging liability for the unsecured portion. Together, these cases introduce significant new risks into the home mortgage transaction.

Secured lenders of all types need to be aware of the increasing impact of government drug enforcement actions against the collateral for their loans. *United States v. One Single Family Residence Located at 6960 Miraflores Ave.*[11] is an illustrative case. In that case, a suspected drug dealer used a Panamanian "shell corporation" to purchase a Florida residence, apparently with the proceeds of drug-related transactions. When the drug dealer learned that federal authorities were investigating his affairs, his associates went to a local bank and obtained an $800,000 mortgage loan on behalf of the corporation, secured by the $1.2 million residence and guaranteed by various other parties (one of whom was considered a good customer of the bank). The loan proceeds were forwarded to the drug dealer's Swiss bank account, and the loan transaction enabled the drug dealer to transfer the funds out of the United States before the authorities could take any action.

The U.S. government sought forfeiture of the bank's collateral under 12 U.S.C.A. section 881,[12] which calls for forfeiture of drug-related property subject only to an "innocent owner" exception. The court held that the bank did not qualify under the "innocent owner" exception because it had ignored numerous "red flags" which should have alerted it to the drug connection. Among the "suspicious circumstances" cited by the court was the fact that the principal borrower was a Panamanian corporation with no apparent ability to repay the loan; the fact that the debt was evidenced by a one-year balloon note; the fact that one of the guarantors (who was known to the bank as a good customer) had no apparent relationship to the principal borrower; and the fact that the bank president was personally involved in the transaction and expedited the transaction.[13]

While the trial court undoubtedly has a better perspective on the issues involved in such cases, and the issues are usually fact-intensive, it appears that many of the factors cited by the court as evidence of "suspicious circumstances" may be present in ordinary secured transactions. As a result, this decision does not leave secured lenders with much in the way of guidance regarding the avoidance of forfeiture under section 881. Until these issues are better clarified, secured lenders should be advised to thoroughly investigate any potentially suspicious borrowers, with an awareness that the lender may not be able to rely on the collateral in those circumstances.

In *In matter of Hamilton,* a case that has significance for purchase-money secured parties, the Fifth Circuit held that the 10-day grace period at Bankruptcy Code subsection 547(c)(3)(B)[14] supersedes the nonuniform 20-day grace period that some states have incorporated into their Uniform Commercial Codes

11. 731 F. Supp. 1563 (S.D. Fla. 1990).
12. Hereinafter cited as section 881.
13. 731 F. Supp. at 1571.
14. 11 U.S.C.A. § 547(c)(3) (West 1986).

("U.C.C.") at subsection 9-312(4).[15] As a result a purchase money security interest perfected outside the Bankruptcy Code 10-day grace period, but within an applicable 20-day state law grace period, can be set aside as a preferential transfer under Bankruptcy Code subsection 547(b).[16] For consumer lenders, the relevance of this development is largely limited to security interests in motor vehicles and fixtures, since these are excluded from automatic perfection of purchase money security interests pursuant to U.C.C. subsection 9-302(1)(d). Other purchase money security interests in consumer goods will be automatically perfected and this should suffice for purposes of Bankruptcy Code subsection 547(c)(3)(B). *Hamilton* indicates, however, that motor vehicle and fixture lenders rely on extended state law grace periods at their peril.

In *Hamilton,* the Fifth Circuit rejected the reasoning of *In re Burnette,*[17] which adopted a more analytical approach regarding the relationship between state and federal law. Instead, *Hamilton* characterized the issue as a simple conflict between state and federal law, in which the latter must prevail. While *Hamilton* provides a bright-line answer to the questions raised in these cases, it does not resolve them in a way that clarifies the basic relationship between the U.C.C. and the Bankruptcy Code. It is unfortunate that the Fifth Circuit did not more fully explore some of the issues raised in *Burnette.*

As in past years, the Committee on Consumer Financial Services will continue to monitor and report on these and other developments that affect the delivery of consumer financial services. As we enter the decade of the 1990s, consumer expenditures have become the driving force behind the continuing expansion of the national economy. In these circumstances, legal developments that affect consumer financial services have taken on an increased importance. The Committee on Consumer Financial Services is pleased to present the conclusion of the 1990 Annual Survey, and wishes to give special thanks to the authors of this year's Survey articles and to the editors of *The Business Lawyer* for making this Survey possible.

15. *Matter of* Hamilton, 892 F.2d 1230 (5th Cir. 1990).
16. *Id.*
17. 14 Bankr. 795 (Bankr. E.D. Tenn.) (1981).