

Interest Rate Regulation Developments: High-Cost Mortgages, Rent-to-Own Transactions, and Unconscionability

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INTRODUCTION

The purpose of this Article is to review recent developments concerning federal and state usury law. It includes a discussion of one recently enacted federal statute¹ that relates to disclosures and substantive limitations on certain of the relatively more costly home equity loans.² The Article then discusses two important state cases concerning the treatment of rent-to-own transactions as consumer credit sales subject to usury laws.³ This Article concludes with a review of a California case holding that charges to depositors of someone else's dishonored check are not unconscionable under California law.⁴

NEW CURBS ON HIGH-COST MORTGAGES

The recent heightened attention to fair lending issues and the demographics of Main Street lending patterns produced allegations that neighborhoods and borrowers ignored by traditional lenders were left vulnerable to "predatory" lenders.⁵ "Reverse redlining" and "equity skimming" entered the lexicon, as Congress heard testimony alleging that some lenders targeted minority and elderly homeowners for high-cost loans and

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1. *See infra* note 7.

2. *See infra* text accompanying notes 5-41.

3. *See infra* text accompanying notes 42-56 and 57-65.

4. *See infra* text accompanying notes 66-79.

5. Mike Hudson, *Stealing Home: How the Government and Big Banks Help Second-Mortgage Companies Prey on the Poor*, 26 CLEARINGHOUSE REV. 1476 (Mar. 1993) (reprinted from WASHINGTON MONTHLY).

home improvement sales in order to cash in on the equity in these homes.⁶ Hearings on these practices were conducted as part of a series on fair lending and community development issues.

The outcome was the Home Ownership and Equity Protection Act of 1994 (HOEP).⁷ HOEP was narrowly drawn and specifically does not set a rate or fee cap.⁸ Rather, solely for a specially defined category of high-cost loans,⁹ it establishes additional "advance look" disclosure requirements and imposes limits on some potentially abusive substantive terms.¹⁰ These requirements reflect a view that such loans are "potentially dangerous when misused and warrant a heightened degree of consumer protection in order to ensure that borrowers are not victimized by abusive lending practices."¹¹ The legislation is important not only to those who originate "high-cost" mortgages, but also to those who purchase home improvement or home equity loans, as the legislation severely restricts the ability of assignees to assert holder in due course status as a defense to claims arising out of the transactions.¹²

COVERAGE OF HOEP

HOEP encompasses only closed-end, non-purchase money credit secured by the borrower's principal residence that meets one of two alter-

6. See *Hearing on H.R. 3153 Before the Subcomm. on Consumer Credit and Insurance of the House Comm. on Banking, Finance and Urban Affairs*, 103d Cong., 2d Sess. (1994); *Problems in Community Development Banking, Mortgage Lending Discrimination, Reverse Redlining, and Home Equity Lending: Hearings Before the Senate Banking Comm.*, 103d Cong., 1st Sess. (1993); *Home Ownership and Equity Protection Act: Hearing on S.924 Before the Senate Banking Comm.*, 103d Cong., 1st Sess. (1993); *The Home Equity Protection Act of 1993: Hearings on Community Development Institutions, 103-2: Hearing Before the Subcomm. on Financial Institutions Supervision, Regulation and Deposit Insurance of the House Comm. on Banking, Housing and Urban Affairs*, 103d Cong., 1st Sess. (1993).

7. Riegle Community Development and Regulatory Improvement Act of 1994, Pub. L. No. 103-325 tit. I, subtit. B, §§ 151-158 (to be codified in scattered sections of 15 U.S.C.) [hereinafter HOEP]. On March 24, 1995, the Federal Reserve Board of Governors (FRB) published final amendments to Regulation Z, 12 C.F.R. pt. 226 (1994), enacted pursuant to the Truth in Lending Act (TILA), 15 U.S.C. §§ 1601-1693 (1988 & Supp. V 1993), to implement the changes made under HOEP. 60 Fed. Reg. 15,463-77 (1995) (to be codified in scattered subsections and Appendices K and L of 12 C.F.R. pt. 226) [hereinafter *Final Amendments*].

8. HOEP, *supra* note 7, § 152(a) (to be codified at 15 U.S.C. § 1602); H.R. CONF. REP. No. 652, 103d Cong., 2d Sess. 147, 159 (1994) [hereinafter H.R. CONF. REP. NO. 652].

9. The legislation initially used the term "high-cost mortgages," but that term was withdrawn. Unfortunately, no convenient term was substituted, as "a mortgage referred to in section 103(aa)" seems awkward for ordinary use. Hence it has continued to be referred to as "the high-cost mortgage" legislation. Under the Final Amendments, however, such mortgages are referred to as "certain closed-end home mortgages." *Final Amendments, supra* note 7, at 15,472 (to be codified at 12 C.F.R. § 226.32).

10. See *supra* note 7.

11. H.R. CONF. REP. No. 652, *supra* note 8, at 158. This Article will address only the substantive prohibitions, not the disclosure provisions, of HOEP.

12. HOEP, *supra* note 7, § 153(c) (to be codified at 15 U.S.C. § 1641(d)).

native cost triggers.¹³ If such credit has either an annual percentage rate (APR) that is more than ten percent above the yield on Treasury notes with comparable maturities,¹⁴ or provides for total fees and points that exceed the greater of eight percent of the total loan amount or \$400,¹⁵ it will be subject to HOEP.

The term "fees and points," as used in the trigger, is specifically defined. In addition to all non-interest components of the finance charge,¹⁶ it includes all compensation paid to mortgage brokers¹⁷ and, in some cases, the real estate closing fees given special Truth in Lending Act (TILA) treatment.¹⁸

Generally excluded from coverage are "residential mortgage transactions" (i.e., purchase money mortgages), open-end credit plans, and reverse mortgages.¹⁹ HOEP, however, does not completely exclude the latter two types of loans. The TILA is amended to require disclosures concerning reverse mortgages.²⁰ As to the open-end credit exclusion, Congress di-

13. *Id.* § 152(a) (to be codified at 15 U.S.C. § 1602(aa)). HOEP amends the TILA and where terms used in the TILA are not defined in the HOEP, the TILA definitions apply, except in one instance in which they do not, according to the Conference Report. *See infra* notes 29-31 and accompanying text.

14. For example, if the yield on 10-year Treasury securities is 6%, a 16% APR will trigger coverage. The FRB is given authority to float the margin by 2% in either direction biennially. HOEP, *supra* note 7, § 152(a) (to be codified at 15 U.S.C. 1602(aa)(2)).

15. The \$400 figure may be adjusted annually in tandem with the change in the CPI rate. *Id.* Under the FRB commentary to § 226.32(a)(1)(ii) of the Proposed Amendments, creditors must use the principal balance (excluding any additional costs incurred at closing) when determining whether the ratio of fees to the total loan amount exceeds 8. *Final Amendments, supra* note 7, at 15,465.

16. HOEP, *supra* note 7, § 152(a) (to be codified at 15 U.S.C. § 1602(aa)(4)(A)) ("all items included in the finance charge, except interest or the time-price differential").

17. *Id.* (to be codified at 15 U.S.C. § 1602(aa)(4)(B)).

18. *See id.* (to be codified at 15 U.S.C. § 1602(aa)(4)(C)). The fees under § 226.4(c)(7) of the FRB's Regulation Z will count toward the fees and points trigger unless the creditor can establish that they meet three criteria: (i) they are reasonable, (ii) the creditor receives no compensation from them, directly or indirectly, and (iii) they are paid to an unaffiliated third party. *Id.* (to be codified at 15 U.S.C. § 1602(aa)(4)(C)). The creditor has the burden to show they are excludable, as it is the one privy to the information. H.R. CONF. REP. NO. 652, *supra* note 8, at 159. The FRB has authority to add to the list any fees that are being abused to circumvent the HOEP. *See HOEP, supra* note 7, § 152(a) (to be codified at 15 U.S.C. § 1602(aa)(4)(C)).

19. *See HOEP, supra* note 7, §§ 152(a) (to be codified at 15 U.S.C. § 1602(aa)), 154(a) (to be codified at 15 U.S.C. § 1602(bb)).

20. *Id.* § 154(b) (to be codified at 15 U.S.C. § 1648) (adding § 138 to TILA). Under HOEP, a "reverse mortgage" means:

a nonrecourse transaction in which a mortgage, deed of trust, or equivalent consensual security interest is created against the consumer's principal dwelling— (1) securing one or more advances and (2) with respect to which the payment of any principal, interest, and shared appreciation or equity is due and payable (other than in the case of default) only after— (A) the transfer of the dwelling (B) the consumer ceases to occupy the dwelling as a principal dwelling or (C) the death of the consumer.

Id. § 154(a) (to be codified at 15 U.S.C. § 1602(bb)) (original paragraph structure omitted).

rected the Federal Reserve Board (FRB) to study and report on whether existing law adequately protects open-end credit borrowers.²¹

SUBSTANTIVE PROHIBITIONS

As to covered loans, this legislation marks a departure from the TILA's generally pure disclosure-oriented approach. Certain terms are limited or prohibited entirely.²² The limitations include the following: (i) only high-cost mortgages with terms of five years or more can include a balloon payment,²³ (ii) no negative amortization is permitted at any time on these loans,²⁴ (iii) the default interest rate cannot exceed the contract rate and, in cases of acceleration of these loans, unearned interest must be rebated by the actuarial method in all cases,²⁵ (iv) escrows for "prepaid payments" are limited to the equivalent of two periodic payments,²⁶ (v) payoffs for home improvement work must be made to the consumer or jointly to the consumer and the contractor,²⁷ (vi) prepayment penalties are generally prohibited, though there is a five-pronged exception,²⁸ (vii) high-cost mortgage lenders cannot engage in a pattern of "improvident lending,"²⁹ and

21. *Id.* § 157; *see also id.* § 158.

22. The substantive limitations are found at *id.* § 152(d) (to be codified at 15 U.S.C. § 1639) (adding new §§ 129(c)-(i) to the TILA). These provisions do not, however, preempt more protective state laws. *Id.* § 152(e)(2)(C)(ii) (Table of Sections of Chapter 2 of the TILA); *see also* H.R. CONF. REP. NO. 652, *supra* note 8, at 162.

23. HOEP, *supra* note 7, § 152(d) (to be codified at 15 U.S.C. § 1639(e)) (adding new § 129(e) to the TILA).

24. *Id.* (to be codified at 15 U.S.C. § 1639(f)) (adding new § 129(f) to the TILA). Some creditors use an accounting system that "accrues" interest according to the Rule of 78 rather than the actuarial method. Because this approach often results in negative amortization in the early stages of a loan, this section should generally preclude the use of the Rule of 78 even in that narrow category of cases where it might otherwise be allowed now.

25. *Id.* (to be codified at 15 U.S.C. § 1639(d)) (adding new § 129(d) to the TILA). Between this legislation and the 1992 Federal Interest Rebate Act, 15 U.S.C. § 1615 (Supp. V 1993), the circumstances under which the Rule of 78 can be used on a home equity loan are now extremely narrow. Only home equity loans with terms of 61 months or less that do not fall within the scope of HOEP are now free to use the Rule of 78 under federal law. *Id.* § 1615(b). State law may prohibit use of the Rule of 78 even in those cases.

26. HOEP, *supra* note 7, § 152(d) (to be codified at 15 U.S.C. § 1639(g)) (adding new § 129(g) to the TILA).

27. *Id.* (to be codified at 15 U.S.C. § 1639(i)) (adding new § 129(i) to the TILA). The consumer may elect to set up a third-party escrow. *Id.*

28. *Id.* (to be codified at 15 U.S.C. § 1639(c)) (adding new § 129(c) to the TILA). Prepayment penalties may be allowed if the borrower's debt-income ratio, counting the high-cost mortgage, does not exceed 50%, the borrower's income is verified, the loan is not a refinancing with the same or an affiliated creditor, prepayment occurs within five years of consummation and prepayment is not prohibited by other law. *Id.* Use of the Rule of 78 is, by definition, a prepayment penalty.

29. *Id.* (to be codified at 15 U.S.C. § 1639(h)) (adding new § 129(h) to the TILA). Some of these lenders considered only the value of the home, without paying attention to the consumer's ability to actually repay the loan. Now they must consider current and expected income, obligations, and employment.

(viii) the FRB is directed to prohibit other acts it finds to be unfair, deceptive, or designed to evade HOEP, including abusive refinancing practices.³⁰

REMEDIES

Violations of HOEP trigger the monetary damage provisions of the TILA—actual damages plus twice the finance charge to a maximum of \$1000.³¹ When the violations are “material,” the consumer also is entitled to an enhanced remedy of all finance charges and fees paid by the consumer.³² For rescission purposes, the violation of HOEP’s disclosure requirements and substantive limitations is deemed a failure to deliver the “material disclosures.”³³ Thus, violations trigger the TILA’s extended rescission right.³⁴

State attorneys general are also granted authority to enforce HOEP, although they must alert any relevant federal regulatory agency, which has the option of intervening.³⁵

LIMITATION ON HOLDER IN DUE COURSE STATUS

As one of the factors that Congress believed encouraged irresponsible and abusive lending was the secondary market and the holder in due course rule, HOEP limits an assignee’s right to assert holder in due course status.³⁶ Assignees are subject to all claims and defenses that could be asserted

30. *Id.* (to be codified at 15 U.S.C. § 1639(l)) (adding new § 129(l) to the TILA).

31. *Id.* § 153(a) (amending 15 U.S.C. § 1640(a)).

32. *Id.* Congress made it clear that “materiality” for purposes of enhanced damages under HOEP is not the same as “material” as defined in the TILA for rescission purposes. While HOEP’s disclosure and substantive requirements are all “material” for rescission purposes, Congress intended that “miscalculations, computer malfunctions, and printing mistakes” are not material if reasonable procedures to avoid them were used. H.R. CONF. REP. NO. 652, *supra* note 8, at 162. To make the materiality determination, case law under 15 U.S.C. § 1640(c) (1988 & Supp. V 1994) (bona fide error) and reasonable procedures may be used. H.R. CONF. REP. NO. 652, *supra* note 8, at 162.

33. HOEP, *supra* note 7, § 152(d) (codified at 15 U.S.C. § 1639(j)) (adding new § 129(j) to the TILA). Under the *Final Amendments*, the term “material disclosures” includes the disclosures in proposed § 226.32(c) and the limitations in proposed § 226.32(d), but would not include the prohibited acts and practices (*e.g.*, extending high-cost mortgages based on the consumer’s collateral to those consumers unable to pay, paying a contractor under a home improvement contract other than by certain specified methods, or selling or assigning a high-cost mortgage without delivering a specified note to the purchaser or assignee) in § 226.32(e). See *Final Amendments*, *supra* note 7, at 15,471 (to be codified at 12 C.F.R. § 226.23(a)(3) n.48).

34. 15 U.S.C. § 1635 (1988); 12 C.F.R. § 226.23 (1994). See generally NATIONAL CONSUMER LAW CENTER, TRUTH IN LENDING § 6.7.2 (1986 & Supp. 1991).

35. HOEP, *supra* note 7, § 153(b) (to be codified at 15 U.S.C. § 1640(e)).

36. See H.R. CONF. REP. NO. 652, *supra* note 7, at 163 (“With this provision, the Conferees intend to ensure that the market polices itself in order to eliminate abuses.”).

against the original creditor.³⁷ This vicarious liability can be avoided only if the assignee can establish that "a reasonable person exercising ordinary due diligence" could not determine, after reviewing the loan documentation (including that which shows all of the disbursements), that the transaction was one subject to HOEP.³⁸ Under ordinary circumstances, this determination will not present a problem, as high-cost mortgages are required to carry a notice warning purchasers of potential liability under HOEP.³⁹ Even if the loan documentation does not do so, however, if an understated APR, or fees and charges amounting to eight percent of the loan, would become apparent if the itemization of the financed amount, settlement, or disbursement record were examined, the due diligence standard would not be met.⁴⁰

If the assignee's liability arises solely as a result of HOEP, however, there are limitations on the liability. The non-TILA damages are limited to the total amount paid by the consumer and the amount of any remaining indebtedness, reduced by TILA damages.⁴¹

RENT-TO-OWN TRANSACTIONS AS CONSUMER CREDIT SALES

Rent-to-own agreements are typically entered into by customers who can neither afford to purchase the merchandise outright nor obtain credit. In these transactions, customers pay in advance to rent items for a weekly or monthly rental period. At the end of each term, customers may renew their rental for another term; if they renew for a specified number of terms, they can obtain ownership of the item rented. Some rent-to-own agreements allow a customer to acquire ownership merely by renting an item for a stated successive period of time, whereas others provide that after renting an item for a certain period, a customer will be granted an option to purchase the item for a small additional amount. The way the agreement is structured, however, consumers wishing to acquire ownership generally must pay a total price greatly exceeding fair market value.

At common law, rent-to-own agreements were treated as leases, rather than as sales, because the consumer was not obligated to pay the full purchase price, but instead could terminate the transaction by returning

37. *Id.*

38. HOEP, *supra* note 7, § 153(c) (to be codified at 15 U.S.C. § 1641(d)(1)) (adding new § 131(d)(1) to the TILA). This does not apply to assignee liability under 15 U.S.C. § 1640(a) or (c), which remains unaffected; nor does it apply to liability that may arise from other theories, such as agency, conspiracy, etc. H.R. CONF. REP. NO. 652, *supra* note 8, at 163.

39. HOEP, *supra* note 7, § 153(c) (to be codified at 15 U.S.C. § 1641(d)(4)) (adding new § 131(d)(4) to the TILA).

40. *Id.* § 153(c) (to be codified at 15 U.S.C. § 1641(d)(1)) (adding new § 131(d)(1) to the TILA); H.R. CONF. REP. NO. 652, *supra* note 8, at 163.

41. HOEP, *supra* note 7, § 153(c) (to be codified at 15 U.S.C. § 1641(d)(2)-(3)) (adding new § 131(d)(2)-(3) to the TILA); H.R. CONF. REP. NO. 652, *supra* note 8, at 163. This applies only to TILA liability.

the merchandise.⁴² Many states, however, have enacted consumer credit sales statutes that define certain terminable leases as sales of goods.⁴³ Such statutes generally attempt to extend to consumers engaging in rent-to-own transactions the same protections traditionally afforded to consumers engaging in conventional credit sales, including protection under general usury statutes. Recently, courts in at least two states have held that rent-to-own transactions constitute consumer credit sales, and are therefore subject to the interest rate limitations of state usury laws.⁴⁴

MINNESOTA

In *Miller v. Colortyme, Inc.*,⁴⁵ the Minnesota Supreme Court ruled that the rent-to-own agreements that the plaintiffs had entered into with various dealerships violated state usury provisions.⁴⁶ The court held that under the definitions found in the Minnesota Consumer Credit Sales Act (CCSA),⁴⁷ rent-to-own transactions constituted "consumer credit sales."⁴⁸ The court noted that rent-to-own contracts, though technically leases, fell within the statutory definition of a sale of goods because consumers had the option to renew the contract by making specified rental payments, could acquire ownership by renewing for a specified number of periods, and could assume ownership only by paying an amount exceeding the value of the property and services provided.⁴⁹ The court concluded that

42. See 2 SAMUEL WILLISTON, THE LAW GOVERNING SALES OF GOODS AT COMMON LAW AND UNDER THE UNIFORM SALES ACT § 336 (rev. ed. 1948).

43. See, e.g., Minnesota Consumer Credit Sales Act, MINN. STAT. §§ 325G.15-.16 (West 1981 & Supp. 1995); Wisconsin Consumer Act, WIS. STAT. §§ 421-427 (West 1988 & Supp. 1994).

44. See *infra* notes 45-65 and accompanying text.

45. 518 N.W.2d 544 (Minn. 1994).

46. *Id.* at 550.

47. MINN. STAT. §§ 325G.15-.16.

48. *Miller*, 518 N.W.2d at 547-48. Under the CCSA, a consumer credit sale is defined in the following manner:

a sale of goods or services in which (a) credit is granted by a seller who regularly engages as a seller in credit transactions of the same kind; (b) the buyer is a natural person; and (c) the goods or services are primarily purchased for a personal, family, or household purpose, and not for commercial, agricultural, or business purpose.

MINN. STAT. § 325G.15, subd. 2.

49. *Miller*, 518 N.W.2d at 547. Under the CCSA, a sale of goods

includes a contract in the form of a terminable bailment or lease of goods if: (a) the bailee or lessee has the option to renew the contract by making the payments specified in the contract; (b) the contract obligates the bailor or lessor to transfer ownership of the property to the bailee or lessee for no other or a nominal consideration upon full compliance by the bailee or lessee with [the bailee's or lessee's] obligations under the contract including any obligation incurred by reason of the exercise of an option by the bailee or lessee to renew the contract; and (c) the payments contracted for by the bailee or lessee, including those payments pursuant to the exercise of an option by the bailee

