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Coalition of Firms Sues Mortgage Lenders

Lawyers Say Banks Hid Details to Lure Borrowers, Often Causing Foreclosures

By Robert Iafolla

Daily Journal Staff Writer

LOS ANGELES - As both a lawyer and a real estate agent, Jeffrey Berns was more than qualified to answer his father's questions about a loan offer from Countrywide to refinance his home. He soon smelled a trap.

In Berns' estimation, the agreement was deceptive, with real, punitive risks masked by confusing legalese, too obtuse for an average consumer to decipher. He began an investigation, interviewing borrowers and inspecting loans agreements from more than 100 other lenders, and found endemic problems.

While Berns was preparing to file lawsuits against lenders, a federal judge in Milwaukee ruled against a bank for similar loan practices, certifying class action status and rescinding the loans in question. Although the bank has appealed the judgment, the ruling further paved the way for Berns.

This week, Berns and lawyers from a coalition of firms will finish filing a raft of nearly identical class-action suits in California Federal Courts against 40 different lenders, including Countrywide, Bank of America and Washington Mutual, for fraudulent business practices. They represent some 9,000 borrowers so far, but if certified, the suits could cover hundreds of thousands of California borrowers, with the potential financial exposure measured in the billions.

Scott Silvestri, a spokesman for Bank of America Corp., said the bank intends to "vigorously defend" itself. Olivia Riley, a spokeswoman for Washington Mutual, said the company does not comment on pending litigation, except to say that it stands behind its business practices. A representative from Countrywide did not return calls seeking comment.

The barrage of federal lawsuits comes amid a blossoming crisis in the country's housing sector, with a slowdown in the housing market, an upturn in foreclosures, the cratering of the subprime mortgage credit and lending industries and politicians in Washington looking for remedies to prevent an economic implosion.

The suits focus on option adjustable-rate mortgage loans, known as option ARMs. These loans give borrowers a range of payment alternatives, the lowest covering a portion of the interest and none of the balance. In this case, the loan becomes negatively amortizing, meaning the unpaid interest is added to the balance of the loan.

The use of option ARM loans has exploded over the past few years. They are projected to make up 14.6 percent of all mortgages written this year, up from 0.4 percent in 2003, according to the industry tracker FirstAmerican LoanPerformance.



ROBERT LEVINS / Daily Journal

In California, the increase is even more dramatic, going from just under 1 percent to nearly 25 percent of mortgages written.

Experts say the increase in housing prices has driven option ARMs' popularity. Jack Williams, the immediate past president of the California Association of Mortgage Brokers, explained that years of bullish growth in the real estate market pushed median home prices in California in the \$500,000 range, more than the limit for government-secured loans. He said the high prices forced borrowers to find other vehicles for financing homes, and with the possibility of low payments, many chose option ARMs.

The mortgage securities market evolved to take advantage of the raging real estate sector, fueling the boom and eventual bust of the subprime industry. Yongheng Deng, an associate professor of policy, planning and development at USC, described a "food chain" where risky loans were bought, repackaged and resold to a variety of Wall Street players.

In this atmosphere, lenders created and marketed products whose "only purpose is to attract borrowers," said Deng, a former economist with the Office of Federal Housing Enterprise Oversight, the organization responsible for the health of two congressionally chartered, publicly-owned housing corporations, the Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation, known colloquially as Fannie Mae and Freddie Mac.

Option ARMs were developed in the 1980s and sold mainly to people with fluctuating incomes, like salesmen working on commission, who would take advantage of the range of payment options available in the loan according to their current cash flow. But lenders took them off the shelf in 2003 and sold them to people with fixed incomes, Deng said, by highlighting the low minimum payments and pairing them with temporarily low interest rates, called teaser rates.

Because of the equity-chewing effects of negative amortization that comes with making minimum payments, "people can get themselves in deep trouble pretty quickly," said Paul Leonard, the California director of the Center for Responsible Lending, a nonprofit, nonpartisan organization that combats predatory lending.

Critics call option ARMs the riskiest and most complicated home loan product on the market, a characterization an industry spokesman did not wholly refute.

"Option ARMs are certainly riskier than a traditional, fixed-rate mortgage, and like all products, is not the right fit for every borrower," said Dustin Hobbs, spokesman for California Mortgage Bankers Association. "Borrowers and lenders must make sure that all the features of the product are clearly described, and borrowers must be honest with themselves about their ability to comfortably repay the loan."

But the lawsuits filed by Berns and his colleagues allege the lenders purposefully mislead borrowers, seducing them with a classic bait-and-switch, and obscuring and omitting the risks involved.

They contend lenders lured borrowers in with their teaser rates of 1 to 3 percent for the first three to five years of the loan, but they were false promises. Instead, the borrowers benefited from the teaser rates for a month at the longest, and then the interest rate rocketed upwards. The lenders did not explain that minimum payments would trigger negative amortization, they allege.

Furthermore, they say hidden, stiff prepayment penalties trapped borrowers. And they allege another feature of the loan, which restructures the payments to a high, fixed figure far higher than what they were first offered if the principal of the loan increases to a certain amount, usually 110 percent of the original balance, puts the borrowers on the road to foreclosure.

"These are the worst possible loans for people with a fixed income, and lenders knew this," Berns said.

He said not a day goes by that he does not get a call from borrower asking for help. The plaintiffs he represents, mainly people who refinanced existing loans, encompass a wide spectrum of education levels, from high-school dropouts to lawyers and doctors. The variety of plaintiffs who "didn't have a clue what was going on" shows how deceptive the loans were, Berns claimed.

Shirley Boschma, a 75-year-old retiree, is one of the plaintiffs. She and her husband receive \$2,200 in Social Security each month, and had a 30-year, 5 percent fixed-rate mortgage on their Whittier home. Boschma said a broker from

LendingTree called her and offered her a way to drastically reduce her \$1,300 monthly payments.

Boschma said she was told her credit was so good that she qualified for a loan with a 1.25 percent interest rate for the first five years, and at the end of the five years, she could refinance again and get a similar low rate. She accepted over the phone, and eventually signed the papers for a \$250,000 option ARM loan, which dropped her monthly payments to \$833 per month.

First, Boschma said her interest rate was readjusted to 7.25 percent after one month. Then, after several months of making the \$833 payment, she saw her balance had increased by \$4,000. At this rate, she would soon trigger the recash provision, which would increase her monthly payments to \$1,900.

She said her only option was to refinance out of the loan - and that's when she discovered her prepayment penalty, to the tune of \$28,000. She got out of the option ARM loan, but she said it wiped out her life savings.

"I don't have a dime," she said. "I have a reverse mortgage and a credit card."

Alison Vail, spokeswoman for LendingTree, said that "until further investigation, we're unable to comment" on Boschma's story or the lawsuit against the company.

Anthony Pennington-Cross, an associate professor of finance at Marquette University, said lenders commonly use direct-to-consumer marketing, like cold calls, mailings and personal visits, to sell subprime home loan products. This is problematic, he said, because of the complexity of the loans and the enormity of the obligation a borrower undertakes with a loan.

"Even the most educated people need a representative at the table to take care of them" before committing to a loan, Pennington-Cross said.

When Berns, a solo practitioner in Tarzana, decided to go after as many lenders as possible on behalf of people like Boschma, he knew he'd need some help. First he contacted Paul Kiesel of Kiesel, Boucher & Larson, the firm that acted as liaison counsel for the plaintiffs in the Catholic Church abuse suits in Southern California.

Berns and Kiesel assembled a team of 40 lawyers from firms including Kiesel Boucher, Brown Woods & George, Spiro Moss, and Philadelphia-based Donovan Searles. The coalition filed the first of 40 suits in May.

They allege the lenders violated the Truth in Lending Act and the California Unfair Competition Law, and for used deceptive contracts. Their primary claim is that the lenders failed to provide the required disclosures in the Federal Truth in Lending Disclosure statement.

Boschma's statement, for example, does not make direct reference to negative amortization. The payment schedule reflects the 1.25 percent teaser rate, not the rate she was actually charged, Berns pointed out. Moreover, he said the passive language in the statement is misleading, and fooled Boschma into thinking some features to the loan were a possibility when they were really a certainty.

On a summary judgment this January, U.S. District Judge Lynn Adelman ruled Chevy Chase Bank violated the Truth in Lending Act by failing to disclose the terms and features of the plaintiff's home loans, which included a teaser rate and negative amortization. Adelman attached the plaintiff's Federal Truth in Lending Disclosure statement as an exhibit.

Adelman certified the class and ordered rescission, such that any borrower who took out a loan like the plaintiff between April 2004 and January 2007 can have their loans canceled and any money paid in interest or closing costs returned.

Kevin Demet of Demet & Demet, one of the plaintiffs' attorneys in the case, said the exact details of the judgment, including how the remedy will play out and the amount of attorneys fees, have not been determined. The case is scheduled for a hearing at 7th U.S. Circuit Court of Appeals later this month, he said.

While Demet litigated a single case against a single lender, Berns and his coalition are angling for something broader, possibly through negotiations.

"My hope is to find a global solution that would provide stability to the financial markets, a way for individuals to remain in their houses, and modifications to the way the loans are marketed and sold in the future," Kiesel said.

Just as Berns and his coalition finish filing their barrage of lawsuits, they will face their first test in front of a judge on one of their suits. On Monday, U.S. District Judge Andrew J. Guilford will hear a motion to dismiss by defendant Downey Savings and Loans Association.

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