K&L ALERT

Mortgage Banking Commentary

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Indiana High Cost Home Loan Law Imposes Enhanced Damages on Non-High Cost Home Loans

The enhanced damages that characterize state anti-predatory lending laws will apply to nonconforming residential mortgage loans in Indiana, without regard to a high cost test, under House Bill 1229 (H.B. 1229). H.B. 1229, which the Indiana legislature enacted in March 2004, contains, among other provisions, the Home Loan Practices Act (the Act), an anti-predatory lending law. The Home Loan Practices Act becomes effective for loans made on and after January 1, 2005[1] (although certain other provisions of H.B. 1229 became effective July 1, 2004). Based on the breadth and ambiguity of the Act, the rating agency of Standard & Poor's recently announced that it cannot rate structured finance transactions that include Indiana high cost home loans, and will require additional credit enhancement for transactions that include Indiana home loans.[2] Unless the Act is corrected, it is likely others will come to similar conclusions.

The Act imposes restrictions on home loans and high cost home loans and the lenders and brokers that originate such loans. In addition, the Act addresses certain practices that arise during the servicing of home loans, such as requiring each payment on a home loan to be posted on the same business day it is received. The Act imposes liability for violations upon the originating creditor of home loans and high cost home loans, as well as upon purchasers and assignees of such loans. Statutory damages equal to two times the finance charges agreed to in the mortgage loan documents are available against persons who violate the Act regarding home loans, without regard to a high cost test.

While the Act contains many of the prohibited practices with regard to high cost home loans that have become standard in such state laws, the Act contains several unique and deeply confusing provisions that may force lenders and others in the mortgage capital markets to retreat from the state until the dust settles. For instance, the Act contains unique exemptions for loans made by certain entities, but it is difficult (based upon the text of the exemptions) to tell which types of loans are subject to the exemptions. The Act also authorizes the borrower to rescind a home loan in accordance with TILA at any time by way of recoupment in a foreclosure action, but the scope of that provision is ambiguous. It appears, however, that if the provision is enforceable, it would extend the right of rescission under TILA from three years to the life of the loan in defensive claims by borrowers.

WHO MUST COMPLY WITH THE ACT?

In general, the Act applies to a "creditor," defined as a person who regularly extends consumer credit that is subject to a finance charge or that is payable by a written agreement in more than four installments, and to whom the debt arising from a home loan transaction is initially payable. The term "creditor" also is defined to include a person who brokers a home loan, including a person who directly or indirectly solicits, processes, places, or negotiates home loans for others; offers to solicit, process, place, or negotiate home loans for others; or closes home loans that may be in the person's own name with funds provided by others and that are thereafter assigned to the person providing funding for the loans. The definition of "creditor" expressly excludes a servicer. However, the Act contains a provision specifically applicable to servicers, requiring them to report both favorable and unfavorable payment history information to credit reporting agencies on a quarterly basis for high cost home loans. The Act also prohibits certain servicing practices by "creditors" with regard to home loans, such as requiring them to treat payments as posted on the same day they are received, and prohibiting them from charging a fee for pay-off information, as addressed in more detail below.

In a provision not common in other state anti-predatory loan laws, the Act provides a fairly broad exception for certain generally conforming mortgage loans, although the exception is critically ambiguous. The Act provides that except for one provision (prohibiting intentionally deceptive acts, as described below), the Act does not apply to the following types of loans:

- A loan made or acquired by a person organized or chartered under the laws of Indiana, any other state, or the United States relating to banks, trust companies, savings associations, savings banks, credit unions, or industrial loan and investment companies;
- A loan that can be purchased by Fannie Mae, Freddie Mac, or the Federal Home Loan Bank;
- A loan to be insured by the U.S. Department of Housing and Urban Development (HUD);
- A loan to be guaranteed by the U.S. Department of Veterans Affairs (VA);
- A loan to be made or guaranteed by the U.S. Department of Agriculture Rural Housing Service;
- A loan to be funded by the Indiana Housing Finance Authority; or
- A loan with a principal amount that exceeds the conforming loan size limit for a single family dwelling as established by Fannie Mae ($333,700 for one-family loans in 2004).

Clearly the intent of these exemptions is to target the Act's protections to the "nonconforming" mortgage loan market; however, they create confusion as a practical matter. For example, it is unclear how the Act would apply to a loan that was made by an entity not mentioned above, but that is subsequently acquired by a bank or other entity enumerated in paragraph (1), above. The Act also is unclear as to a "loan that can be purchased" by Fannie Mae, Freddie Mac, or the Federal Home Loan Banks. Arguably that would mean more than simply a loan that comes within the conforming loan limits, as the last exemption clearly excludes loans that do not come within Fannie Mae's limits. Perhaps it means loans that conform to all of the underwriting criteria of one or more of the government-sponsored enterprises (GSEs), such as any loan that receives an "accept" or similar rating by the GSEs' automated underwriting systems. It could also refer to any loan that the GSEs are authorized by law or by their charter to purchase. Similar questions arise in trying to determine the parameters of a loan that is "to be insured" by HUD or "to be guaranteed" by VA. Until regulations are issued or amendments are enacted, the industry will be forced to guess which loans are subject to the bulk of the law, and which are largely exempt.

WHAT IS A "HOME LOAN" AND A "HIGH COST HOME LOAN"?

The Act applies to both "home loans" and "high cost home loans."

Home Loans. A "home loan" is a loan, <u>other than an open-end credit plan or a reverse mortgage transaction</u>, that is secured by a mortgage or deed of trust on real estate in Indiana, on which there is located or will be located a structure or structures designed primarily for occupancy by one to four families, and that is or will be occupied by a borrower as the borrower's principal dwelling.

High Cost Home Loans. A "high cost home loan" is a "home loan" (i.e., excluding open-end loans and reverse mortgage loans) that exceeds one or more high cost triggers.

Rate Threshold. First, a home loan is a high cost home loan if its "trigger rate"[3] exceeds the "benchmark rate," which is the interest rate[4] established under the Home Ownership Equity Protection Act (HOEPA) regulations for high cost home loans.

Points and Fees Threshold. Second, a home loan is a high cost home loan if it has total points and fees that exceed:

- For loans of $40,000 or more: 5% of the "loan principal" (which term is not defined; while the Act provides a definition for "total loan amount," a term often used in the context of high cost home loan laws to calculate the points and fees threshold, the Act does not use that term for that or any other purpose); or
- For loans less than $40,000: 6% of the loan principal.

Beginning July 1, 2006, the dollar amounts described above are subject to change at the times and according to the procedure set forth in under Section 24-4.5-1-106 of Indiana's Uniform Consumer Credit Code.

For purposes of this threshold, the Act defines "points and fees" to mean the total of the following:

- "Points and fees" as defined under the HOEPA regulations (12 C.F.R. § 226.32(B)(1)) on January 1, 2004;
- All compensation paid directly or indirectly to a mortgage broker, including a broker that originates a loan in the broker's own name, to the extent such compensation is not included in (1), above.

However, points and fees do not include the following:

- Bona fide discount points;
- Up to 1½ points in indirect broker compensation, if the loan terms do not include a prepayment penalty that exceeds 2% of the home loan principal;
- Reasonable fees paid to an affiliate of the creditor;
- Interest prepaid by the borrower for the month in which the home loan is closed.

WHAT PRACTICES ARE PROHIBITED OR RESTRICTED UNDER THE ACT FOR HOME LOANS?

Financing Credit Insurance. A creditor is prohibited from financing, directly or indirectly, any credit life insurance, credit disability insurance, credit unemployment insurance, credit property insurance, or payments directly or indirectly for any cancellation suspension agreement or contact, or payments directly or indirectly for any cancellation suspension agreement or contract. This prohibition does not apply to insurance premiums, debt cancellation fees, or suspension fees calculated and paid on a monthly basis.

Encouragement of Default. A creditor is prohibited from recommending or encouraging default on an existing loan or other debt before and in connection with the closing or planned closing of a home loan that refinances all or part of the existing loan or debt.

Posting Payments on Day Received. The Act requires a creditor to treat each payment made by a borrower in regard to a home loan as posted on the same business day as the payment was received by the creditor, servicer, or creditor's agent, or at the address provided to the borrower by the creditor, servicer, or creditor's agent for making payments.

Acceleration Without Cause. A home loan agreement may not contain a provision that permits the creditor, in the creditor's sole discretion, to accelerate the indebtedness without material cause (although acceleration in good faith upon failure to abide by material loan terms is not prohibited).

Fees for Pay-Off or Release. A creditor is prohibited from charging a fee for informing or transmitting to a person the balance due to pay off a home loan or to provide a written release upon prepayment. A creditor must provide a pay-off balance not later than 10 business days after the creditor receives the request. However, these requirements do not apply to actual charges that a creditor incurs for express or priority delivery that the borrower requests of home loan documents to the borrower.

Structuring a Transaction to Evade the Act. <u>All persons</u> (except those whose loans are exempt from most of the Act, as described above) are prohibited from dividing a loan transaction into separate parts with the intent of evading the Act, and from structuring a home loan transaction as an open-end loan with the intent of evading the provisions of the Act if the loan would be a high cost home loan had it been structured as a closed-end loan. As explained below, the Act contains another provision similar to this one, creating confusion as to the different intentions for the two provisions.

Deceptive Acts. <u>All persons, including persons whose loans are otherwise exempt from most of the Act</u> as described above, are prohibited from engaging in a "deceptive act" in connection with a home loan. A "deceptive act" is defined as an act or practice as part of a consumer credit mortgage transaction involving real property located in Indiana in which a person at the time of the transaction knowingly (i.e., having actual knowledge at the time of the transaction) or intentionally makes a material misrepresentation or conceals material information regarding the terms of conditions of the transaction. The Act applies this provision to all persons, including those who are otherwise exempt from the Act's provisions.

Before bringing an action regarding an alleged deceptive act, a person must notify the Indiana Homeowner Protection Unit (newly established by the attorney general to enforce the Act) of the alleged violation giving rise to the action, and allow the Unit at least 90 days to institute appropriate administrative and civil action to redress a violation.

WHAT PRACTICES ARE PROHIBITED OR RESTRICTED UNDER THE ACT FOR HIGH COST HOME LOANS?

Ability to Repay. A creditor may not make a high cost home loan without regard to repayment ability. If a creditor presents evidence that the creditor followed "commercially reasonable practices" in determining the borrower's debt-to-income ratio, there is a rebuttable presumption that the creditor made the high cost home loan with due regard to repayment ability. There is also a rebuttable presumption that the borrower's statement of income provided to the creditor is true and complete. "Commercially reasonable practices" include the use of the debt-to-income ratio (i.e., 41% or less) and the residual income guidelines established under the VA loan guaranty underwriting regulations (38 C.F.R. § 36.4337(c)(1), (d), (e); Form 26-6393).

Points and Fees on Refinancing (Anti-Flipping). Creditors are prohibited from knowingly or intentionally refinancing a high cost home loan by charging points and fees on the part of the proceeds of the new high cost home loan that is used to refinance the existing high cost home loan within four years of the origination of the existing high cost home loan.

Replacing Special Low Rate Loans. A creditor is prohibited from knowingly or intentionally replacing or consolidating a zero interest rate or other "subsidized low rate loan"[5] made by a governmental or nonprofit lender with a high cost home loan within the first 10 years of the subsidized low rate loan unless the current holder of the loan consents in writing to the refinancing. The Act requires that each mortgage securing a zero interest rate or other subsidized low rate loan executed after January 1, 2005 must prominently display a notice that it secures such a loan, and the Act provides that a creditor may reasonably rely on the presence or absence of the notice on the instrument's face as conclusive proof that the mortgage or deed of trust secures or does not secure such a loan.

Financing Points and Fees. A creditor making a high cost home loan may not directly or indirectly finance any points and fees.

Prepayment Fees. Prepayment fees or penalties may not be included in the loan documents for a high cost home loan or charged to the borrower if the fees or penalties exceed, in total, two percent of the high cost home loan amount prepaid during the first 24 months after the high cost home loan closing. The parties may not contract for a prepayment penalty that would be effective after the second year following the high cost home loan closing. Creditors are prohibited from including a prepayment fee in a high cost home loan unless the creditor offers the borrower the option of choosing a loan product without a prepayment fee. The terms of the offer must be in writing, clearly labeled, containing the language specified in the Act, and initialed by the borrower.[6]

Legend on the Mortgage. A mortgage or deed of trust that secures a high cost home loan must prominently display, at the time of recording, the following language on the instrument's face: "THIS INSTRUMENT SECURES A HIGH COST HOME LOAN AS DEFINED IN IC 24-9-2-8."

Notice to Assignees. Creditors are prohibited from selling or otherwise assigning a high cost home loan without furnishing a notice to the purchaser or assignee, in language specified under the Act, providing notification that the loan is subject to special rules and that purchasers and assignees may face liability for claims and defenses with regard to the loan that the borrower may assert against the lender.

Financing Life/Health Insurance. A creditor making a high cost home loan is prohibited from financing, directly or indirectly, any life or health insurance.

Structuring Loan Transaction to Evade the Act. Creditors are prohibited from dividing home loan transactions into multiple transactions with the effect of evading this article. Where multiple transactions are involved, the total points and fees charged in all transactions must be considered when determining whether the prohibition against charging points and fees on a refinancing apply.

As noted above, the Act imposes a similar restriction upon home loans that is applicable to all nonexempt persons (and is not, like this provision, limited to "creditors"). However, that previously-mentioned provision requires proof of intent to evade the Act, whereas this provision relies upon the effect of evasion of the Act. It is unclear, however, if the two provisions were intended to apply to different types of loans. Both provisions use the terms "loan transaction" or "home loan transaction," and although this latter provision appears in the chapter of the Act targeted toward high cost home loans, it does not expressly limit its applicability to such loans. Thus, it is not clear what type of distinction the Act is attempting to make with these somewhat duplicative provisions.

Balloon Payments. A high cost home loan must not require a scheduled payment that is more than twice as large as the average of earlier scheduled monthly payments under the high cost home loan agreement, unless the payment becomes due and payable at last 120 months after the date of the high cost home loan. This prohibition does not apply if the payment schedule is adjusted to account for the borrower's seasonal or irregular income, if necessary.[7]

Negative Amortization. A high cost home loan must not include payment terms under which the outstanding principal balance will increase at any time over the course of the high cost home loan because the regular periodic payments do not cover the full amount of interest due, other than a temporary forbearance requested by the borrower.

Increased Interest Rate After Default. A high cost home loan may not contain a provision that increases the interest rate after default, except for any interest rate changes in a variable rate loan otherwise consistent with the provisions of the high cost home loan documents, if the change in the interest rate is not triggered by the event of default or the acceleration of the indebtedness.

Consolidated Advance Payments. A high cost home loan may not include terms under which more than two periodic payments required under the loan are consolidated and paid in advance from the loan proceeds provided to the borrower.

Information Regarding Counseling. A creditor may not make a high cost home loan without first providing the borrower information to facilitate contact with a nonprofit counseling agency certified by HUD or the Indiana Department of Commerce at the same time as the good faith estimates are provided to the borrower in accordance with the requirements of the federal Real Estate Settlement Procedures Act.

Home Improvement Contracts. A creditor is prohibited from paying a contractor under a home improvement contract from the proceeds of a high cost home loan unless the creditor is presented with a signed and dated completion certification showing that the home improvements have been completed; and the instrument is payable to the borrower or jointly to the borrower and the contractor, or, at the borrower's election, through a third party escrow agent under a written agreement signed by the borrower, the creditor, and the contractor before the disbursement.

Modification or Deferral Fees. A creditor is prohibited from charging a borrower any fees or other charges to modify, renew, extend, or amend a high cost home loan or to defer a payment due under the terms of a high cost home loan.

Disclosure Requirement. A creditor is prohibited from making a high cost home loan unless the creditor has given the following notice in writing to the borrower at least three days prior to consummation (i.e., "not later than the time that notice is required under 12 C.F.R. § 226.31(c)"):

> Notice to Borrower
>
> You should be aware that you might be able to obtain a loan at a lower cost. You should compare loan rates, costs, and fees. Mortgage loan rates and closing costs and fees vary based on many factors, including your particular credit and financial circumstances, your employment history, the loan-to-value requested, and the type of property that will secure your loan. The loan rate, costs, and fees could also vary based on which creditor or broker you select.
>
> If you accept the terms of this loan, the creditor will have a mortgage lien on your home. You could lose your home and any money you have paid if you do not meet your payment obligations under the loan.
>
> You should consult an attorney and a qualified independent credit counselor or other experienced financial adviser regarding the rate, fees, and provision of this mortgage loan before you proceed. A list of qualified counselors is available from the Indiana Department of Commerce.
>
> You are not required to complete this loan agreement merely because you have received this disclosure or have signed a loan application. Remember, property taxes and homeowner's insurance are your responsibility. Not all creditors provide escrow services for these payments. You should ask your creditor about these services.

Also, your payments on existing debts contribute to your credit ratings. You should not accept any advice to ignore your regular payments to your existing creditors.

Mandatory Arbitration. Without regard to whether a borrower is acting individually or on behalf of others similarly situated, a provision of a high cost home loan agreement is unconscionable and void if it: (1) requires arbitration of a claim or defense; (2) allows a party to require a borrower to assert a claim or defense in a forum that is less convenient, more costly, or more dilatory for the resolution of the dispute than an Indiana court in which the borrower may otherwise bring a claim or defense; or (3) limits in any way any claim or defense the borrower may have.

Reporting to Credit Reporting Agencies. A "servicer" (which term the Act does not define) of a high cost home loan must report at least once each calendar quarter to a nationally recognized consumer credit reporting agency both the favorable and unfavorable payment history information of the borrower on payments due to the creditor on a high cost home loan. However, this requirement does not prohibit a servicer from agreeing with the borrower not to report specified payment history information in the event of an resolved or an unresolved dispute with a borrower, and does not apply to high cost home loans held or serviced by a lender for fewer than 90 days.

Right to Reinstate. If a creditor asserts that grounds for acceleration under the terms of a high cost home loan exist and requires the payment in full of all sums secured by the security instrument, the borrower may, at any time before the title is transferred by means of foreclosure, judicial proceeding and sale, or otherwise, cure the default and reinstate the high cost home loan by tendering the amount or performance as specified in the security instrument. If the borrower cures the default on a high cost home loan, the original loan terms must be reinstated, and any acceleration of any obligation under the security instrument or note arising from the default is nullified as of the date of the cure.

Judicial Foreclosure. A creditor making a high cost home loan that has the right to foreclose must use the judicial foreclosure procedures of the state in which the property securing the high cost home loan is located (which presumably would be Indiana, since the definition of high cost home loan refers only to loans secured by a mortgage or deed of trust on real estate in Indiana). The borrower has the right to assert in the proceeding the nonexistence of a default and any other claim or defense to acceleration and foreclosure, including any claim or defense based on any violations of the Act, subject to any applicable statutes of limitation or repose.

WHAT ARE THE PENALTIES AND LIABILITY UNDER THE ACT?

Penalties. With regard to **all home loans**, the Act provides that a person who violates the Act is liable to a borrower for the following:

- Actual damages, including consequential damages. (A borrower is not required to demonstrate reliance in order to receive actual damages.)
- Statutory damages equal to two times the finance charges agreed to in the home loan agreement.
- Costs and reasonable attorney's fees.

A borrower may be granted injunctive, declaratory, and other equitable relief as the court determines appropriate in an action to enforce compliance with the Act. So, for example, a single failure by a servicer to post a payment on the day received could lead to statutory damages equal to two times the finance charge; unlike most state high cost home loan laws, lenders cannot avoid these draconian penalties that bear no relationship to actual harm merely by staying below the high cost triggers.

The Act has a unique rescission provision that appears to respond to a limitation of a borrower's right of rescission under TILA, although the scope of the Act's provision is not clear. The Act provides that "the right of rescission granted under 15 U.S.C. 1601 et seq. [TILA] for a violation of law is available to a person acting only in an individual capacity by way of recoupment as a defense against a party foreclosing on a home loan at any time during the term of the loan." The Act then appears to attempt to clarify the scope of that right of rescission by providing that "any recoupment claim asserted under this provision is limited to the amount required to reduce or extinguish the person's liability under the home loan plus amounts required to recover costs, including reasonable attorney's fees."

TILA limits rescission rights, providing that the right of rescission expires three years after the date of consummation. That limitation applies even under circumstances of foreclosure. See 15 U.S.C. § 1635(f), (i). Some states have sought to provide a borrower an extended right to rescind a loan for a TILA violation as a defense to a foreclosure action, regardless of when the foreclosure action occurs. See, e.g., the Arkansas Home Loan Protection Act, Ark. Stat. Ann. § 23-53-106(c). **The Indiana Act also may be an attempt to extend, for all home loans, the TILA right of rescission for the life of the loan, by allowing a borrower to assert a TILA violation in foreclosure (even if the foreclosure occurs outside TILA's three-year limit on the borrower's rescission right).** However, the Act provides that the right is available for a violation "of law," making the scope of that right is ambiguous. Amendments to clarify this provision are currently being drafted.

An action under the Act must be brought within five years after the date that the person knew, or by the exercise of reasonable diligence should have known, of the violation. An award of damages as described above has priority over a civil penalty imposed under the Act (see below)

A person who knowingly or intentionally violates the Act commits a Class A misdemeanor, and an act that is actionable by the Indiana Attorney General and subject to penalties. Beginning July 1, 2005, the attorney general and the attorney general's Homeowner Protection Unit has the authority and mandate to enforce the Act for any violation occurring within five years after the making of a home loan. The attorney general may refer a matter to a prosecuting attorney for enforcement. The attorney general also may bring an action to enjoin a violation of the Act. A court in which the action is brought may issue an injunction, order a person to make restitution, order a person to reimburse the state for reasonable costs of the attorney general's investigation and prosecution of the violation of the Act, and impose a civil penalty of not more than $10,000 per violation.

Cure Provision. If the creditor or an assignee establishes by a preponderance of evidence that a violation of the Act is unintentional or the result of a bona fide error of law or fact notwithstanding the maintenance of procedures reasonably adopted to avoid any such violation or error, the validity of the transaction is not affected, and no liability is imposed "under section 4 of this chapter,"[8] except in the case of a refusal to make a refund. A creditor in a high cost home loan who in good faith fails to comply with the Act is not considered to have violated the Act if the creditor does the following before receiving notice of the failure from the borrower: (1) not later than 90 days after the date of the loan closing, makes appropriate restitution to the borrower of any amounts collected in error, and takes necessary action to make all appropriate adjustments to the loan to correct the error; (2) not later than 120 days after the date of the loan closing, notifies the borrower of the error, and the amount of the required restitution or adjustment. However, the creditor must establish that the compliance failure was not intentional and resulted from a bona fide error of fact or law, notwithstanding the maintenance of procedures reasonably adopted to avoid the errors.

Assignee Liability With Regard to High Cost Home Loans. The Act contains two subsections that address the extent of assignee liability. While the second subsection seems at first glance to qualify or further define the extent of assignee liability established in the first subsection, the Act curiously provides that the rights conferred on borrowers by each of the subsections are "independent of each other and do not limit each other."

First, the Act provides that a person who purchases or is otherwise assigned a high cost home loan is subject to all affirmative claims and any defenses with respect to the high cost home loan that the borrower could assert against a creditor or broker of the high cost home loan. However, the assignee liability provision mentioned above does not apply if the purchaser or assignee demonstrates by a preponderance of the evidence that a reasonable person exercising ordinary due diligence could not determine that the loan was a high cost home loan. A purchaser or assignee is presumed to have exercised reasonable due diligence if the purchaser or assignee:

- Has in place at the time of the purchase or assignment policies that expressly prohibit the purchase or acceptance of the assignment of any high cost home loans;
- Requires by contract that a seller or an assignor of home loans to the purchaser or assignee represents and warrants to the purchaser or assignee that either:
    - The seller or assignor will not sell or reassign any high cost home loans to the purchaser or assignee; or
    - The seller or assignor is a beneficiary of a representation and warranty from a previous seller or assignor to that effect;
- Exercises reasonable due diligence at the time of purchase or assignment of home loans, or within a reasonable period after the purchase or assignment of home loans, intended by the purchaser or assignee to prevent the purchase or assignment of any high cost home loans; or
- Satisfies the requirements of (1) and (2), above, and establishes that a reasonable person exercising ordinary due diligence could not determine that the loan was a high cost home loan based on the documentation required by TILA and itemization of the amount financed and other disbursement disclosures.

Thus, under this first assignee liability subsection, liability appears to extend to any claim or defense with respect to the loan (not limited to a violation of the Act), but an assignee may avoid liability if a reasonable person exercising ordinary due diligence could not determine that the loan was a high cost home loan, as described above.

Under the second assignee liability subsection, the Act provides that a borrower <u>acting only in an individual capacity</u> may assert the following types of claims against the creditor <u>or any subsequent holder or assignee</u> of a high cost home loan. In such an action, a claim, or a counterclaim described below, the borrower may recover <u>only amounts required to reduce or extinguish the borrower's liability under the home loan, plus amounts required to recover costs, including reasonable attorney's fees</u>.

- <u>Within three years</u> after the closing of a home loan, <u>a violation of the flipping prohibition</u> (prohibiting charging points and fees on a refinancing of a high cost home loan within four years) as a defense, claim, or counterclaim, after:
    - An action to enjoin foreclosure or to preserve or obtain possession of the dwelling that secures the loan is initiated.
    - An action to collect on the loan or foreclose on the collateral securing the loan is initiated; or
    - The loan is more than 60 days in default;
- <u>Within five years</u> after the closing of a high cost home loan, <u>a violation of the Act</u> in connection to the high cost home loan as a defense, claim, or counterclaim <u>in an original action</u>; and

- At any time during the term of a high cost home loan, after an action to collect on the loan or foreclose on the collateral securing the loan is initiated, the debt arising from the loan is accelerated, or the loan is more than 60 days in default, any defense, claim, counterclaim, or action to enjoin foreclosure or preserve or obtain possession of the home that secures the loan, "including [but apparently not limited to] a violation of the Act."

Thus, under the second subsection (which, again, is independent of and does not limit the first subsection, described above), assignee liability is addressed with regard to individual actions, which are limited to amounts required to reduce or extinguish the borrower's debt plus costs and attorney's fees, and are limited in time and circumstance as described above. It is unclear whether an assignee can avoid liability if "a reasonable person exercising ordinary due diligence could not determine that the loan was a high cost home loan," as that provision is contained in the first subsection (as described above), but expressly applies to "this section," which arguably would encompass the second subsection, as well.

Assignee Liability With Regard to Home Loans. As mentioned above, the Act provides that a right of rescission granted under TILA "for a violation of law" is available to a person acting only in an individual capacity by way of recoupment as a defense against a party foreclosing on a home loan at any time during the term of the loan. The Act then appears to attempt to clarify the scope of that right of rescission by providing that "any recoupment claim asserted under this provision is limited to the amount required to reduce or extinguish the person's liability under the home loan plus amounts required to recover costs, including reasonable attorney's fees."

STATE LAW PREEMPTION

The Act provides that the State of Indiana is the sole regulator of the business of originating, granting, servicing, and collecting loans and other forms of credit in the state and the manner in which the business is conducted. The Act and other such forms of regulation preempt all other regulation of those activities by any political subdivision. Political subdivisions may not: (1) enact, issue, or enforce ordinances, resolutions, regulations, orders, requests for proposals, or requests for bids pertaining to financial or lending activities, including ordinances, resolutions, and rules that disqualify persons from doing business with a municipality and that are based upon lending terms or practices; or (2) impose reporting requirements or any other obligations upon persons regarding financial services or lending practices or upon subsidiaries or affiliates that are subject to the jurisdiction of the Indiana Department of Financial Institutions; are subject to the jurisdiction or regulatory supervision of the Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency, the Office of Thrift Supervision, the National Credit Union Administration, the Federal Deposit Insurance Corporation, the Federal Trade Commission, or HUD; are chartered by Congress to engage in secondary market mortgage transactions; are created by the Indiana Housing Finance Authority; or originate, purchase, sell, assign, securitize, or service property interests or obligations created by financial transactions or loans made, executed, originated, or purchased by persons referred to above.

OTHER AMENDMENTS

Federal Preemption/Parity. H.B. 1229, which includes the Home Loan Practices Act as described above, also amended other portions of the Indiana Code, including (but not limited to) Indiana's Financial Institutions Code. H.B. 1229 added a provision to that Code providing that if the Department of Financial Institutions determines that federal law has preempted a provision of Indiana's Trade Regulations Code (which will include the Home Loan Practices Act upon its effectiveness), its Commercial Law, its Financial Institutions Law, its Probate Law, or its Trusts and Fiduciaries Law, then those provisions apply to a state chartered entity only to the same extent that the Department determines the provision is applicable to the same or a functionally equivalent type of federally chartered entity. A state chartered entity seeking an exemption from those provisions, based on the preemption of the provision as applied to a federally chartered entity, must submit a letter to the Department, describing in detail and documenting the federal preemption. The Department is required to notify the requesting entity of its determination within ten business days after its receipt of such a letter. The requesting entity may generally, upon receipt of the notification, operate as if it is exempt from the provision for 90 days after the Department receives the letter, unless otherwise notified by the Department. The Department must take action (i.e., by approving or denying the requested exemption, or by convening a hearing) not later than 90 days after the Department receives the letter. If the Department denies the request of a financial institution for exemption from preempted provisions, the requesting institution may appeal the Department's decision to the circuit court.

Loan Brokers Act. H.B. 1229 also amended Indiana's Loan Brokers Act, effective July 1, 2004. The Loan Brokers Act is generally applicable to persons seeking to engage in the loan brokerage business in the state. The amendments in H.B. 1229 include effectively subjecting the following types of persons to certain limited provisions of the Loan Brokers Act, including its set of prohibited acts and its authorization of the Securities Commissioner to investigate and enforce violations of applicable provisions: any person authorized to sell and service loans for Fannie Mae or Freddie Mac, issue securities backed by Ginnie Mae, make loans insured by HUD, act as a supervised lender or nonsupervised automatic lender of the VA, or act as a correspondent of loans insured by HUD.

Hazard Insurance. H.B. 1229 adds a new section under Indiana's Mortgages Law addressing hazard insurance. That new section becomes effective on July 1, 2004, and states that a mortgagee or a mortgagee's assignee or representative may not require a mortgagor, as a condition of receiving or maintaining a mortgage, to obtain hazard insurance coverage against risks to improvements on the mortgaged property in an amount exceeding the replacement value of the improvements.

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If you have any questions about the Act or this newsletter, please contact Kris D. Kully (202-778-9301 / kkully@kl.com), Nanci L. Weissgold (202-778-9314 / nweissgold@kl.com), or any other member of our Mortgage Banking Consumer Finance Group.

ENDNOTES

1 H.B. 1229 provides that "a person is not subject to a prohibition or requirement of IC 24-9-3 [Chapter 3 of the Act, under the heading "Prohibited Lending Practices Generally"] and IC 24-9-4 [Chapter 4 of the Act, under the heading "Additional Prohibitions for High Cost Home Loans"], both as added by this act, with respect to a loan made before January 1, 2005." H.B. 1229 does not define when a loan is considered "made" for purposes of that effective date.

2 See "Standard & Poor's Addresses Indiana Anti-Predatory Lending Law" (Oct. 18, 2004), available at www.standardandpoors.com, under Credit Ratings, Structured Finance Legal Criteria.

3 The Act defines "trigger rate" as follows: (1) for fixed rate home, the rate as of the date of closing; (2) for home loans in which the interest varies according to an index, the sum of the index rate as of the date of closing plus the maximum margin permitted at any time under the loan agreement; or (3) for all other home loans in which the rate may vary at any time during the term of the loan, the maximum rate that may be charged during the term of the home loan.

4 The applicability of the special high cost loan provisions of the federal Home Ownership Equity Protection Act (HOEPA) relies upon a loan's annual percentage rate (APR), rather than the loan's interest rate, as provided under the Act. However, state regulators have indicated, in informal conversations, that the "benchmark rate" will be interpreted to mean HOEPA's APR thresholds.

5 The Act defines a "subsidized low rate loan" as a loan that carries a current interest rate of at least two percentage points below the current yield on Treasury securities with a comparable maturity. If the loan's current interest rate is either a discounted introductory rate or a rate that automatically steps up over time, the fully indexed rate or the fully stepped up rate, as appropriate, should be used instead of the current rate to determine whether a loan is a subsidized low rate loan.

6 Besides this new prepayment fee restriction for high cost home loans under the Act, Indiana law restricts prepayment fees only with regard to loans subject to its Consumer Credit Code, which applies to subordinate-lien mortgage loans, but does not apply to first-lien mortgage loans (unless the parties agree to make the loan subject to the Code).

7 This prohibition against balloon payments also does not apply if the loan is a bridge loan connected with or related to the acquisition or construction of a dwelling intended to become the borrower's principal dwelling.

8 "Section 4 of this chapter" refers to the section of the Act that: (a) subjects a person who violates the Act with regard to a home loan to actual damages, statutory damages of twice the finance charges, costs and attorney's fees; (b) authorizes injunctive, declaratory, and other equitable relief in the enforcement of compliance with the Act; and (c) provides for an extended right of rescission under TILA for a violation of law by way of recoupment as a defense against foreclosure on a home loan at any time during the term of the loan.

MORTGAGE BANKING/CONSUMER FINANCE GROUP

Kirkpatrick & Lockhart LLP was founded in 1946, and, with more than 700 lawyers, is one of the 50 largest law firms in the United States. K&L attorneys are based in ten offices in key U.S. cities—Boston, Dallas, Harrisburg, Los Angeles, Miami, Newark, New York, Pittsburgh, San Francisco, and Washington. Our firm represents a broad range of clients in a wide variety of matters, including corporate and securities, e-commerce, investment management, insurance coverage, financial institutions, mortgage banking and consumer finance, creditors' rights, intellectual property, tax, labor, environmental, antitrust, health care, and government contracts. More than half our attorneys are litigators. We litigate class actions on a range of financial issues, generally defending financial institutions, broker-dealers, public companies, and investment companies and their officers and directors against claims of violations of securities laws, consumer credit laws, and common law tort and contract claims. You can learn more about our firm by visiting our Internet website at www.kl.com.

The Mortgage Banking/Consumer Finance Group provides legal advice and licensing services to the consumer lending industry. We counsel clients engaged in the full range of mortgage banking activities, including the origination, processing, underwriting, closing, funding, insuring, selling, and servicing of residential mortgage loans and consumer loans, from both a transactional and regulatory compliance perspective. Our focus includes both first- and subordinate-lien residential mortgage loans, as well as open-end home equity, property improvement loans and other forms of consumer loans. We also have experience in multi-family and commercial mortgage loans. Our clients include mortgage companies, depository institutions, consumer finance companies, investment bankers, insurance companies, real estate agencies, homebuilders, and venture capital funds. Members of the Mortgage Banking/Consumer Finance Group and their telephone numbers and e-mail addresses are listed below:

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