ReedSmith

December 2003
Bulletin 03-81

New Jersey's Anti-Predatory Lending Law Takes Effect: Are You Ready?

If you have questions or would like additional information on the material covered in this Bulletin, please contact one of the authors:

Robert M. Jaworski
(Princeton)
609.520.6003
rjaworski@reedsmith.com

Leonard A. Bernstein
(Princeton)
609.520.6005
lbernstein@reedsmith.com

Patricia E. Obara
(Princeton)
609.514.5988
pobara@reedsmith.com

...or the Reed Smith attorney with whom you regularly work.

New Jersey's anti-predatory lending law, officially known as the "New Jersey Home Ownership Security Act of 2002," c.64, P.L. 2003, (the "NJ Act") was effective on November 27, 2003. Briefly, the NJ Act places restrictions on "home loans," "covered home loans" and "high-cost home loans," with the latter two categories including loans which exceed either an APR or a "points and fees" threshold. Because the NJ Act is in many respects vague and ambiguous, imposes severe penalties, and in some situations can extend potentially unlimited or at least unquantifiable liability upon loan purchasers, it could significantly damage the New Jersey market for non-prime lending.

Key Definitions

"Home Loans" are defined in the NJ Act as closed- or open-end, purchase-money or refinance, first- or subordinate-lien loans (other than reverse mortgage loans), that are secured by real estate on which is located or is to be located a 1-6 family dwelling or a manufactured home that the borrower occupies or will occupy as his/her principal dwelling, the proceeds of which are used for personal, family or household purposes. Business purpose loans, reverse mortgage loans and loans secured by a vacation home are not covered by the NJ Act.

"High-cost home loans" are defined as "home loans" not in excess of $350,000 (adjusted annually) meeting *either* of the two prescribed thresholds described below:

- *Rate threshold*—equivalent to the APR Threshold under HOEPA, currently 8 percentage points above the comparable Treasury yield for first-lien loans, and 10 percentage points above the comparable Treasury yield for subordinate-lien loans;
- *Total points and fees threshold*—triggered when "points and fees" (defined to exclude a "conventional prepayment penalty" or up to two "bona fide discount points" as discussed below) exceed 5 percent of the total loan amount for loans equal to or more than $40,000 in amount; 6 percent of the total loan amount for loans equal to or more than $20,000 but less than $40,000 in amount; or the lesser of 6 percent of the total loan amount or $1,000 for other loans.

"Covered home loans" are home loans in which the total points and fees, excluding a "conventional prepayment penalty" or up to two "bona fide discount points," exceed 4 percent of the total loan amount for loans in excess of $40,000, or 4.5 percent for loans less than $40,000 or FHA-VA loans. In addition, all "high-cost home loans" are "covered home loans."

LONDON
NEW YORK
LOS ANGELES
SAN FRANCISCO
WASHINGTON, D.C.
PHILADELPHIA
PITTSBURGH
OAKLAND
PRINCETON
NORTHERN VA
WILMINGTON
NEWARK
MIDLANDS, U.K.
CENTURY CITY
RICHMOND
HARRISBURG
WESTLAKE VILLAGE

This bulletin is presented for informational purposes and is not intended to constitute legal advice.
© Reed Smith LLP 2003. All Rights Reserved.
"Reed Smith" refers to Reed Smith LLP, a limited liability partnership formed in the state of Delaware.

"Points and fees" include: (1) all items (except interest) listed as "finance charges" in 15 U.S.C. § 1605(a)(1) through (4) of the Truth-in-Lending Act ("TILA")—points, service or carrying charges, loan fees, finder's fee, or similar charges, and fees for an investigation or credit report; (2) all charges listed in 15 U.S.C. § 1605(e) even though these items are excluded by TILA from the computation of the finance charge—title insurance premiums, fees for preparation of loan-related documents, escrows for future payments of taxes and insurance, fees for notarizing deeds and other documents, appraisal fees, including fees related to any pest infestation or flood hazard inspections conducted prior to closing, and credit reports; (3) all direct and indirect mortgage broker compensation; (4) all premiums for credit life, credit disability, credit unemployment or credit property insurance, or any other life or health insurance, or any payments for debt cancellation, which are paid out of the loan proceeds, *i.e.*, financed single premium insurance; (5) the maximum prepayment fee that may be charged to the borrower if the loan is prepaid; and (6) any prepayment fee the borrower has to pay on a prior loan being refinanced with the proceeds of a high-cost home loan made by the same creditor or an affiliate.

Notwithstanding the above, specifically *excluded* from "points and fees" are: taxes, filing fees, and recording fees paid to public officials to determine the existence of or to perfect, release or satisfy a security interest; title insurance and title examination fees paid to a licensed title insurance producer. Also excluded, but only if reasonable in amount and paid to someone other than the creditor or mortgage broker or an affiliate of either, are tax service fees, flood certification fees, pest inspection fees, appraisal fees, pre-closing inspection fees, credit report fees, survey fees, attorneys' fees, notary fees, escrow charges, and fire and flood insurance premiums (provided TILA requirements for exclusion from the finance charge are met).

"Bona fide discount points" are points knowingly paid by the borrower to buy down the interest rate on a home loan and which in fact reduce the interest rate (the "Start Rate") such that the amount of the bona fide discount points will be recouped over at most five years of scheduled monthly payments. Bona fide discount points may be excluded from "points and fees" only if the Start Rate is less than or equal to the "conventional mortgage rate" for a first-lien home loan published in FRB Statistical Release H.15 plus 2 percent for a first-lien loan or 3.5 percent for a junior lien loan.

"Conventional prepayment penalty" means a prepayment fee that may not exceed 2 percent of the amount prepaid and is otherwise permitted by law. A prepayment penalty only qualifies as a "conventional prepayment penalty" if the interest rate on the mortgage itself does not exceed the published "conventional mortgage rate" (as referenced above) by more than two percentage points. *(Note: Prepayment penalties are prohibited under New Jersey law. Only institutions entitled to federal preemption may charge them and only to the extent permitted under the applicable federal law.)*

The definition of "points and fees" is obviously of critical importance in determining whether or not a loan is a "high-cost home loan" or a "covered home loan." Yet the definition is extremely complex, and raises serious questions as to what is included or excluded. For example, should tax escrows—an item listed in 15 U.S.C. § 1605(e)—be counted as "points and fees"? How about closing agent fees paid to a title insurance agent?

Prohibited Practices: All Home Loans

The NJ Act impacts all home loans, not just non-prime loans. Consequently, stiff penalties could result even from a violation of the NJ Act which relates only to a home loan.

The NJ Act prohibits, as to *all home* loans:

- *Credit Insurance:* the financing of single premium credit insurance or debt cancellation agreements.
- *Encouraging Defaults:* recommending or encouraging default on an existing loan.
- *Late Charges:* charging late fees in excess of 5 percent of the payment in default or for a payment that is past due less than 15 days, or where the creditor does not send the borrower written notification of the imposition of the late fee within 45 days.

- *Posting of Payments:* posting a payment other than on the same date that it was received (arguably, even if the lender receives the payment after the close of its business day), provided it was sent to the address identified by the creditor.
- *Acceleration:* accelerating the indebtedness at the creditor's sole discretion.
- *Payoff Requests—Fees & Timing:* charging a fee for information concerning a borrower's payoff balance or to provide a release upon prepayment, or providing a requested payoff quote more than seven business days after the request is received. (Business days are not defined.)

Prohibited Practices: Covered Home Loans

The NJ Act prohibits "flipping." "Flipping" occurs upon the refinancing of an existing home loan within five years by a "covered home loan" under circumstances where there is no "reasonable tangible net benefit" to the borrower. The NJ Act includes no definition of reasonable tangible net benefit, but merely directs that various circumstances be considered, including the terms of the new and the old loan, the "economic and noneconomic circumstances," the loan purpose, the cost of the new loan, and the borrower's circumstances. Worse, the NJ Act does not delegate rulemaking power to the New Jersey Department of Banking and Insurance ("NJDOBI") to further define this vague test, which will leave lenders wondering whether or not they can safely make or purchase covered home loans that are refinance loans.

The NJ Act also provides: "In addition, the following home loan refinancings shall be presumed to be flipping if [either one of two sets of circumstances exists]." These circumstances are where: (1) the "primary tangible benefit" of the new loan as compared to the refinanced loan is a lower interest rate, and "it will take more than four years for the borrower to recoup the costs of the points and fees and other closing costs through savings resulting from the lower interest rate"; and (2) the new home loan refinances an existing home loan that is a "special mortgage" (subsidized or guaranteed by a government agency or a non-profit that bears a below-market interest rate or beneficial non-standard payment term) such that the borrower loses the below market interest rate or one or more of the beneficial non-standard payment terms of the special mortgage.

Although the NJDOBI has issued interpretive "guidance," discussed further below, that the above presumptions only apply where the new loan is a "covered home loan," the fact that this paragraph begins with the phrase "[i]n addition," and nowhere references the term "covered home loan," raises an issue as to whether or not these presumptions can be read to apply even where the new loan is not a covered home loan. We would argue strongly to the contrary, but do not presume to predict how a court might decide the issue in the context of an actual case.

Prohibited Practices: All High-Cost Home Loans

The NJ Act prohibits in connection with *all high-cost home loans:* (1) the financing of points or fees in excess of 2 percent of the total loan amount; (2) balloon payments; (3) negative amortization; (4) default interest rates; (5) requiring more than two advance payments at closing; (6) mandatory arbitration clauses if the result will be "less convenient, more costly, or more dilatory" for the resolution of a dispute than suing in court. *(Note that this prohibition applies whether a borrower plans to act "individually or on behalf of others similarly situated," an ominous phrase for those fearful that class actions may be permitted under the NJ Act.)*

The NJ Act also prohibits the making of any *high-cost home loan:* (7) without giving the borrower, at least three business days before closing, a prescribed form of cautionary notice that must be acknowledged by the borrower; and (8) in cases where the borrower is financing points or fees, without receiving from the borrower a certification that the borrower has received advice from an approved nonprofit credit counselor.

Finally, the NJ Act prohibits in connection with all *high-cost home loans:* (9) paying home improvement contractors out of the loan proceeds by means of a one-party check; (10) charging modification or deferral fees; (11) charging points and fees in connection with the refinancing of an existing high-cost home loan with a new

high-cost home loan "held by the same creditor or note holder"; and (12) using a non-judicial foreclosure procedure when the creditor has a legal right to foreclose.

Assignee Liability

The NJ Act applies to a "creditor," which is defined to include those who extend consumer credit and "to whom the obligation is payable at any time." Although assignees are expressly excluded from the definition of "creditor," that does not mean that they take high-cost home loans free and clear of claims the borrower may have against the creditor.

Section 6(a) of the NJ Act applies to *home loans* made or referred by a manufactured home seller or a home improvement contractor, and gives borrowers of such loans the right to assert against the creditor to whom the borrower was referred, and any assignee or holder of the home loan, "all affirmative claims and defenses" that the borrower may have against the seller or contractor. Liability under this provision is limited to amounts required to reduce or extinguish the borrower's liability under the home loan, plus the total amount paid by the borrower in connection with the loan, plus costs and reasonable attorney's fees. (Although the language in Section 6(a) is similar to the FTC's Trade Regulation Rule regarding the Preservation of Consumer's Claims and Defenses, the omission of any reference in the NJ Act to this FTC rule has caused some concern about cash-out refinance loans and subordinate-lien loans, the proceeds of which may be used for home improvement purposes, as discussed below.)

Section 6(b) of the NJ Act makes purchasers or assignees of *high-cost home loans* subject to "all affirmative claims and any defenses" with respect to the loan that the borrower could assert against the original creditor or broker of the loan, unless the purchaser or assignee can demonstrate by a preponderance of the evidence that a reasonable person exercising reasonable due diligence could not have determined the loan was a high-cost home loan. This section also establishes a presumption that a purchaser or assignee has exercised such due diligence if: it has a policy in place at the time of purchase or assignment that expressly prohibits the purchase or acceptance of assignment of a high-cost loan; it requires the persons from whom it acquires loans to represent and warrant in their purchase contracts that they will not sell or assign high-cost home loans; and it exercises reasonable due diligence to make sure that the loans it acquires or has acquired are not high-cost home loans. *(Note that, per Section 6(e), this limitation on assignee liability only applies to claims made by a borrower acting under Section 6(b).)*

Section 6(c) of the NJ Act enables a borrower "acting only in an individual capacity" to assert against any creditor "or any subsequent holder or assignee" any defense, claim or counterclaim based on a violation of the NJ Act subject to the following limitation periods:

- if in connection with a *covered home loan,* as an original action brought by the borrower, or in an action brought by the assignee to collect on the loan or foreclose on the property, within six years of the loan closing, or
- if in connection with a *high-cost home loan,* at any time during the loan term after a foreclosure action has been undertaken or the loan has been accelerated or become more than 60 days in default.

Such individual actions under Section 6(c) are limited to amounts required to reduce or extinguish the borrower's liability under the home loan, plus costs and reasonable attorney's fees.

The uncertainty evident in the combination of these provisions concerning potential assignee liability will likely create problems in the secondary market, perhaps leading to a contraction of that market, as happened in Georgia. Standard & Poors has indicated that it will not allow New Jersey "high-cost home loans" to be included in their rated structured finance transactions and will allow "covered home loans," "manufactured home loans" and "home improvement loans" only if accompanied by a Compliance Representation (by a creditworthy entity with sufficient financial strength to repurchase loans that are in breach of this representation

at a price that will make the securitization issuer whole, including any costs and damages incurred by the issuer in connection therewith). Other rating agencies have announced similar positions.

Fannie Mae and Freddie Mac have declared that they will not purchase New Jersey high-cost home loans and may impose special documentation requirements with respect to manufactured home loans, home improvement loans and certain refinance loans. The Federal Home Loan Bank of New York has gone even further, indicating, on November 25, 2003 (similar to a position previously taken by Standard & Poors, which it subsequently modified as stated above)m that it will not make advances based on collateral that includes New Jersey high-cost home loans, covered home loans, manufactured home loans and home improvement loans (including cash-out refinance loans and subordinate-lien loans).

Some New Jersey lenders have indicated that they will not make any cash-out refinance loans or subordinate lien loans after November 27, 2003. Lenders wishing to make such loans may be prudent by having the borrower document either that the loan proceeds are not going to be used for home improvement purposes or that the loan was not arranged or referred by a home improvement contractor or manufactured home seller.

Remedies, Penalties: Class Actions?

The remedies and penalties provided for in the NJ Act are as follows:

- Section 8(a) says that violations of any of the provisions of the NJ Act are also violations of the New Jersey Consumer Fraud Act (CFA), for which substantial fines may be assessed by the Attorney General and a private right of action may be brought. The CFA allows for recovery of treble damages, attorney's fees and court costs. While the CFA does not prohibit class actions as further discussed below, Section 6(c) of the NJ Act speaks to a private right of action by borrowers in their individual capacity only. We would vigorously argue that class actions were not intended under the NJ Act; however, Section 8(a) does not address the issue.
- Section 8(b) provides that, as an alternative to the CFA remedies, borrowers can recover statutory damages for "material violations" equal to the amount of all finance charges plus 10 percent of the amount financed. For malicious or reckless violations, the borrower can also recover punitive damages plus attorney's fees and court costs. Again, while the limits on assignee liability in Section 6 are incorporated, there is no mention of class action liability.
- Violations of the NJ Act can also lead the NJDOBI to impose: (i) fines up to $10,000 per violation; (ii) license suspensions or revocations; (iii) cease and desist orders; and (iv) in extraordinary situations, emergency restraints.
- Brokers can incur liability under the NJ Act only for violations committed by the broker in the course of providing mortgage brokering services in connection with a home loan, or for acts that are related to the purchasing or making of a home loan and are otherwise prohibited under the NJ Act.

Good Faith Errors, Corrective Actions

The NJ Act allows a creditor who commits a violation when acting in good faith to avoid liability if restitution and appropriate adjustments are made within 45 days after closing. The NJ Act also establishes a "bona fide error" defense for a creditor who, within 90 days after closing and before receipt of any notice from the borrower of a compliance failure, makes restitution and appropriate adjustments, so long as the failure was unintentional and occurred despite reasonable procedures to prevent it. This "bona-fide error" defense is not available to cure an error of legal judgment.

Consumer Education

As stated above, the NJ Act requires counseling in the context of a high-cost home loan where points or fees are financed. It also directs the NJDOBI, the New Jersey Division of Consumer Affairs and the New Jersey

Division on Civil Rights to develop and implement a program of consumer counseling and awareness to protect vulnerable consumers against predatory lending practices. A proposed regulation to accomplish this was published in the *New Jersey Register* on September 15, 2003.

Preemption Issues

Local Laws Preempted—Perhaps the only good news in the NJ Act for lenders is that it preempts local governmental authorities from enacting laws or regulations related to the NJ Act or to abusive home loan lending practices generally.

Preemption as to Loans Made by Federally Chartered Depositories—On July 23, 2003, the General Counsel of the Office of Thrift Supervision ("OTS") issued an opinion concluding that portions of the NJ Act are preempted as to federal thrifts and their operating subsidiaries. (OTS Op. Chief Counsel, P-2003-4) In addition, the Office of the Comptroller of the Currency ("OCC") has declared that portions of Georgia's original predatory lending law (which has since been substantially amended but which before amendment was similar in many respects to the NJ Act) are preempted with respect to national banks and their operating subsidiaries, making OCC preemption of the NJ Act likely.

NJDOBI Guidance

Pursuant to its enforcement authority under the NJ Act, the NJDOBI has issued written guidance to industry members concerning some of the NJ Act's provisions. This guidance is in the form of two departmental Bulletins, Bulletins 03-15 (July 24, 2003) and 03-30 (November 18, 2003).

Unfortunately, since the NJDOBI was given extremely limited rulemaking authority under the NJ Act, courts are under no obligation to defer to the NJDOBI's interpretations, thus leaving brokers, lenders and loan purchasers at risk of conflicting judicial interpretations.

Conclusion

All residential mortgage lenders, purchasers and servicers operating in New Jersey need to review the portions of the NJ Act that are applicable to all home loans. These provisions may sneak up on the conforming residential mortgage loan industry and bite with harsh penalties.

Those making "high-cost loans" should proceed with extreme caution. Where "covered home loans" are made and, perhaps all refinances, procedures should be put in place to determine that "flipping" is not occurring.

Where loans are being purchased, potential assignee liability should be analyzed and procedures established to prohibit the purchase of "high-cost home loans" (if that is the policy decision); representations, warranties and buy-back requirements should be obtained from the seller of such loans to protect against assignee liability; and due diligence reviews of loans to be purchased should be conducted to prevent the inadvertent purchase of "high-cost home loans" (unless a program to purchase such loans is knowingly entered into with adequate safeguards to insure all the requirements relating to "high-cost home loans" have been met).

Finally, those seeking to obtain clarification on the myriad ambiguous and/or vague provisions included in the NJ Act, including provisions covering both class action and assignee liability, should work with us or other firms with government affairs units to secure necessary amendments to the NJ Act as soon as possible. We understand that at least three bills to amend the NJ Act have already been or are about to be introduced.

* * * * * * *

Reed Smith's Consumer Financial Services Group ("CFSG"), the largest multi-office practice group of its kind in the nation, offers our clients sophisticated retail finance compliance advice. We help our clients interpret and implement new federal and state laws and regulations impacting credit cards, mortgage loans, deposit and

insurance products, automobile finance, and related retail products. The CFSG has considerable litigation experience defending lenders in individual and consumer class actions. Recent cases involved credit card fees, mortgage broker fees, mortgage fraud, Fair Credit Reporting Act issues, debt collection procedures, collateral protection insurance, Truth in Lending Disclosure Act errors, and fair housing discrimination complaints.

* * * * * * *

Reed Smith, a leading global law firm with nearly 1,000 lawyers located in 16 U.S. and two U.K. cities, represents Fortune 100 as well as mid-market and emerging companies. Clients include technology companies and entrepreneurs, financial services firms, life sciences companies and health care providers and insurers, communications companies, manufacturers, universities, non-profit organizations, real estate developers, and municipalities throughout the United States and in 40 countries. For more information, please visit *reedsmith.com*.