

JULY 2, 2001

New Wave of Usury Class Actions Are Filed

Lawyers purporting to act on behalf of subprime borrowers have recently filed several new class action lawsuits in Pennsylvania and the State of Washington, alleging that lenders violated usury laws and licensing laws in making high loan-to-value subordinate lien closed end residential mortgage loans. The complaints also generally alleged violations of consumer protection laws. The new lawsuits follow similar suits that have been filed in Illinois, Michigan and Missouri.

Plaintiffs' counsel brought the lawsuits ostensibly on behalf of all borrowers who obtained similar second mortgage loans from each lender, generally over a period of time beginning in 1995 or 1996. In some of the class action lawsuits, plaintiffs have sued the lender and various entities they believe are current assignees of the mortgage notes. In the leading Pennsylvania lawsuit, plaintiffs have not sued the lender, but instead have sued twelve Delaware business trusts and seven other entities which they contend are holders of mortgage notes. In the Washington class action lawsuits, plaintiffs have sued the lenders and numerous business trusts and other entities which are current or former holders of the mortgage notes.

The following discussion provides a general overview of a typical complaint in both Pennsylvania and Washington. The complaints selected highlight the allegations which are typical of numerous other cases. K&L represents several defendants in each of the cases. Of course, there are numerous strong defenses to assert, a description of which goes beyond the scope of this client alert.

I. PENNSYLVANIA CLASS ACTION: *KOEBLER, ET AL. v. FIRSTPLUS HOME LOAN TRUST 1996-2, ET AL.*

Lawyers acting for borrowers filed this class action in early April 2001, on behalf of a putative class of all persons who received secondary mortgage loans from FirstPlus Bank secured by real property in Pennsylvania and who were allegedly damaged by the predatory lending practices alleged in the complaint. The complaint was filed in the Court of Common Pleas of Allegheny County (Pittsburgh). The defendants include twelve Delaware business trusts and seven other entities that plaintiffs assert are "holder(s) of mortgage notes related to mortgage loans made by FirstPlus Bank." Plaintiffs' counsel did not sue FirstPlus Bank, an FDIC insured California chartered industrial loan company which apparently originated the secondary mortgage loans to the defendants.

In an amended complaint filed on June 25, 2001 (following the filing of defendants' preliminary objections arguing that the case must be dismissed), plaintiffs contend that FirstPlus Bank issued second mortgage loans to numerous borrowers in Pennsylvania without a license from the Pennsylvania Department of Banking under the Secondary Mortgage Loan Act ("SMLA") (7 P.S. §§ 6601, *et seq.*). The SMLA regulates the making of secondary mortgage loans in Pennsylvania and includes license requirements and exemptions as well as interest rate and fee restrictions. *See id.* §§ 6603, 6609. While the SMLA provides penalties for violations of its provisions (*see id.* § 6622), it does not specifically provide rights for a private individual

to bring a cause of action. By its terms, the SMLA (including its licensing requirements and interest and fee restrictions) does not apply to state or national banks, state or federal savings and loan associations, savings banks, or insurance companies. *Id.* § 6623.

In the *Koebler* amended complaint, plaintiffs allege that FirstPlus Bank engaged in a “fraudulent shell game calculated to conceal the true originator” of the loans at issue. Plaintiffs allege that FirstPlus Financial, Inc., which they allege is not exempt from the SMLA, was the true originator and engaged in a scam by which it caused FirstPlus Bank to be identified as the originator on borrowers’ HUD-1 settlement statements, mortgage notes and second mortgages. Further, the amended complaint alleges that, even if FirstPlus Bank were the “true” originator, it is not a legitimate state chartered FDIC insured depository institution.

The amended complaint asserts that FirstPlus Bank (or its affiliate) made second mortgage loans in Pennsylvania without being licensed under the SMLA. Plaintiffs further contend that the purpose of the licensing provision in the SMLA is to protect consumers and serve as a deterrent to those inclined to make second mortgage loans in Pennsylvania without a license and therefore the loan agreements between FirstPlus Bank and the plaintiffs are either void or voidable as an illegal contract against public policy. Consequently, among other things, the amended complaint seeks relief that borrowers need not repay the loans and that they are entitled to damages of at least three times the excess interest charged to date. The amended complaint also asserts that FirstPlus Bank charged interest and fees in excess of the SMLA’s fee restrictions and that the loan agreement should be either voided or reformed.

The *Koebler* amended complaint also asserts that since FirstPlus Bank was not licensed under the SMLA, FirstPlus Bank’s loans were therefore required to comply with Pennsylvania’s interest rate statute (“Act 6”). See 41 P.S. §§ 101 *et seq.* Act 6 contains an index setting the maximum lawful rate of interest that may be charged by applicable institutions for residential mortgages. *Id.* § 301(b). By its terms, Act 6 does not apply to the extent that another statute establishes, permits or removes a

maximum interest rate, or prohibits the use of usury as a defense. *Id.* § 604. Act 6 provides that a person who has paid a rate of interest in excess of the maximum lawful rate or charges and fees in excess of those allowed by law may recover triple the amount of such excess through a private lawsuit. *Id.* § 502. The amended complaint asserts that FirstPlus Bank violated Act 6 by charging interest rates in excess of Act 6’s maximum permissible interest rate. The plaintiffs argue again that the loan agreements are void or voidable and ask the court to award them triple the amount of the alleged excess interest and fees paid.

Finally, the plaintiffs allege that the FirstPlus Bank practices in making the second mortgage loans constituted violations of the Pennsylvania Unfair Trade Practices and Consumer Protection Law (“UTPCPL”). See 73 P.S. §§ 201-1 *et seq.* In particular, the *Koebler* amended complaint contends that FirstPlus Bank failed to disclose that it was not licensed to make second mortgage loans in Pennsylvania and that its lending practices violated the SMLA and Act 6. Plaintiffs also claim that FirstPlus Bank deceptively charged an illegal rate of interest, illegal costs and illegal fees in connection with secondary mortgage loans made to Pennsylvania borrowers. Based on these alleged violations of the UTPCPL, plaintiffs ask the court to award them treble damages, plus attorneys’ fees and costs.

Although the amended complaint focuses on violations of Pennsylvania law by FirstPlus Bank (and arguably FirstPlus Financial, Inc.), plaintiffs did not sue FirstPlus Bank. Instead, in the amended complaint, plaintiffs’ counsel sued twelve Delaware business trusts and seven other entities which plaintiffs allege are “current holders or assignees of certain of the second mortgage notes” between FirstPlus Bank and the borrowers. The majority of the defendants are the business trusts that issued private mortgage-backed securities. The amended complaint does not allege any wrongdoing or unlawful conduct by any of the defendants, but contends that, as assignees of the mortgage notes, the defendants are liable for the wrongful acts of FirstPlus Bank and its affiliate.

For relief, plaintiffs ask the court to certify all FirstPlus Bank Pennsylvania borrowers for purposes of a class action, to award each class member damages equal to three times the total of the allegedly illegal interest charges, costs and fees, to declare that the loan agreements are void or voidable and that borrowers need not repay the loans, as well as costs of the suit, attorneys' fees, interest and "an appropriate incentive fee" and, in the alternative, to order that each class member's loan agreement be reformed prospectively to reflect the maximum permissible interest rate under Act 6.

After the filing of the first *Koebler* complaint, all defendants filed preliminary objections arguing that the case should be dismissed for plaintiffs' failure to state a claim. Before the preliminary objections were argued, plaintiffs' counsel filed an amended complaint to which answers or motions are due in late July. We anticipate that plaintiffs' counsel will file amended complaints similar to the *Koebler* amended complaint in all the Pennsylvania cases.

II. WASHINGTON CLASS ACTION: *BERTRAND, ET AL. v. PACIFIC EXCHANGE MORTGAGE LENDER, ET AL.*

Lawyers acting for second mortgage loan borrowers filed a total of thirteen separate class actions in late May and throughout June 2001 in the Superior Court for King County, Washington, which is the county in which Seattle is located. *Bertrand, et al. v. Pacific Exchange Mortgage Lender, et al.* is a prototype case and the remainder of this review focuses on the *Bertrand* complaint and Pacific Exchange as the lender or originator. The complaint also name numerous other defendants, including business trusts and other entities, each of which the complaint asserts is a current or former holder or assignee of certain of the second mortgage notes between the lender and the plaintiffs. The complaint was ostensibly filed on behalf of the named plaintiffs and all persons who obtained second mortgage loans from the lender secured by real property in Washington from January 1, 1996 through the present, and who were charged interest rates in excess of state limits.

The *Bertrand* complaint alleges that the respective lender made second mortgage loans at interest rates in excess of the amount allowed under the Washington Usury Law (the "Usury Law") (Rev. Code Wash. §§ 19.52.005 *et seq.*). The Usury Law prescribes the highest permissible rate of interest that applicable institutions may charge for residential mortgage loans. *Id.* § 19.52.020(1). The Usury Law provides that the penalty for charging a greater rate of interest than allowed by statute is a recalculation of the amount the creditor is due, which may include a reduction in the amount due the creditor equal to twice the amount of interest paid, as well as costs and attorneys' fees. *Id.* § 19.52.030(1). However, the Usury Law expressly provides that a usurious interest rate does not void the loan contract. *Id.*

The plaintiffs then allege that in order for the lender to charge rates in excess of the rate established under the Usury Law, the lender would have to be licensed under the Washington Consumer Loan Act (the "Act") (*id.* §§ 31.04.005 *et seq.*), and that the lender was not so licensed when it made the loans to the plaintiffs. The Act authorizes applicable entities to charge higher interest rates than those permitted under other statutory provisions, requires such entities to be licensed, and contains certain provisions regarding rates, fees, and terms. *Id.* §§ 31.04.005, 31.04.035, 31.04.105, 31.04.125. The Act does not apply to certain institutions, including any person doing business under and as permitted by any law of the State of Washington or the United States relating to banks, savings banks, trust companies, savings and loan or building and loan associations, or credit unions. *Id.* § 31.04.025. While a person may be subject to fines or criminal penalties for violation of the Act (*see id.* § 31.04.175), the Act does not provide for the right of a private individual to bring a cause of action.

Through allegations that the lender charged interest rates in excess of the amount allowed under Washington law, the plaintiffs seek from the defendants (including the lender and the other defendants representing "current or former holders or assignees" of the notes) a judgment for damages, including recalculation of the loans in accordance with the Usury Law, plus attorneys' fees, interest,

and costs. On the basis of the alleged excessive interest rates, the plaintiffs also seek a judgment declaring that the loan agreements are illegal and unenforceable contracts and that the plaintiffs are relieved from any obligation to make further payments of principal or interest on their notes. Alternatively, the plaintiffs seek reformation of the loan agreements, with a refund of all allegedly illegal interest. While the complaint provide that the “assignee defendants,” as holders of the notes securing the plaintiffs’ mortgages, are liable to the plaintiffs for the acts of the lender, the complaint does not describe any legal basis for liability on the part of the assignee defendants for violation of the Usury Law or the Act.

The plaintiffs then claimed that since the defendants (again, including the lender and the assignee defendants) allegedly charged excessive interest rates in violation of Washington law, defendants committed a per se violation of Washington’s Consumer Protection Law (see id. §§ 19.86.010 et seq.). Furthermore, the plaintiffs allege that the defendants were guilty of negligence, in that they had a duty to exercise reasonable and ordinary care in the calculation of interest rates, that they breached that duty by failing to disclose to the plaintiffs that the interest rates were usurious, and that they knew or should have known that the rates were usurious. The plaintiffs therefore claimed that the defendants are liable for damages to the plaintiffs. The complaint does not describe any legal basis for liability for violation of Washington’s Consumer Protection Law or for negligence on the part of the assignee defendants.

The plaintiffs also attempted to address any statutes of limitations that may apply to the lawsuit. Statutes of limitations are laws that generally prescribe time period limitations upon a right of a person to bring an action; after the time period has expired, the person is generally no longer allowed to bring the action. The plaintiffs claimed that any applicable statute of limitations has been “tolled” or suspended by the defendants’ “fraudulent concealment, denial, misrepresentation, and/or failure to disclose the facts as alleged herein” and that therefore the defendants are legally prevented from asserting an applicable statute of limitations in their defense.

For relief, the complaint asks the court to certify the set of plaintiffs as a class for purposes of a class action; to award damages (including “exemplary,” or punitive, damages), as well as the costs of the suit, reasonable attorneys’ fees, and interest; to enjoin the defendants from charging usurious interest rates on second mortgage loans in the future; to order that each class member’s loan agreement be recalculated in accordance with the Usury Law; to order defendants to disgorge “ill-gotten” profits by charging excessive interest rates; and to declare that the loan agreements with the plaintiffs are void or voidable.

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