K&L|GATES

Just Trying to Help: Application of Federal and State Debt Collection Laws in the Workout and Modification Process

Presented by:

Steven M. Kaplan
Jon Jaffe
Brian Forbes
David Tallman

www.klgates.com

K&L GATES

David Tallman
Washington, D.C.

David Tallman is an associate in the mortgage banking and consumer credit group. He represents a broad range of consumer financial services providers, including mortgage lenders, servicers and investors; credit card companies; student loan companies; consumer finance companies; and payments systems providers. His practice focuses on regulatory compliance matters, with an emphasis on mortgage and consumer lending issues, financial privacy and information security requirements. Mr. Tallman is a Certified Information Privacy Professional.

Why Avoid Application of the FDCPA?

- Prohibitions on unfair, abusive, and deceptive practices are not the problem.
  - Ethical creditors, servicers, and debt collectors don't want their vendors using these tactics anyway.
  - Borrowers or enforcement agencies could still nail you with a UDAP action.

Why Avoid Application of the FDCPA? (cont.)

- Primarily, there are three requirements under the FDCPA that can create problems for vendors during the loss mitigation or modification process:
  - True Name Rule
  - Validation of Debt Requirement
  - Mini-Miranda Disclosure Requirement

True Name Rule

- The FDCPA prohibits a debt collector from using "any business, company, or organization name other than the true name of the debt collector's business, company, or organization." 15 U.S.C. § 1692e(14).
- Creditors, servicers, etc., often want their vendors to communicate with consumers using the name of the creditor, servicer, etc.

Validation of Debt Requirement

- The FDCPA requires the debt collector to provide the validation of debt disclosure ("VOD") within five days of the first written communication (or first oral communication if it precedes the first written communication). *Id.* § 1692g(a).
- If vendors were debt collectors, this requirement would be triggered each time a new vendor communicated with a consumer.

Mini-Miranda Disclosures

- The FDCPA requires the debt collector to disclose in the first communication with the consumer that (i) the communication is from a debt collector; and (ii) any information will be used for that purpose. *Id.* § 1692e(11). In subsequent communications, the debt collector must disclose that the communication is from a debt collector. *Id.*

Definition of "Debt Collector"

- Any person who uses any instrumentality of interstate commerce or the mails in any business the principal purpose of which is the collection of any debts, or who regularly collects or attempts to collect, directly or indirectly, debts owed or due or asserted to be owed or due another.
  - "Debt" means any obligation or alleged obligation of a consumer to pay money arising out of a transaction in which the money, property, insurance or services which are the subject of the transaction are primarily for personal, family, or household purposes, whether or not such obligation has been reduced to judgment.
    - Does a loan modification create a new "debt"?

Definition of "Debt Collector" (cont'd)

- For the purpose of Section 808(6) (misleading threats to take any non-judicial action to effect dispossession or disablement of property), the term "debt collector" also includes any person who uses any instrumentality of interstate commerce or the mails in any business the principal purpose of which is the enforcement of security interests.
  - If the person also seeks to collect payment, they are subject to all of the FDCPA, not just Section 808(6). *See, e.g.*, *Wilson v. Draper & Goldberg, PLLC*, 443 F.3d 373 (4th Cir. 2006) (foreclosure attorneys engaging in collection activity in addition to the enforcement of security interests are subject to all of the FDCPA).

Exceptions

- There are several carveouts from this general definition:
  - Any officer or employee of a creditor while, in the name of the creditor, collecting debts for such creditor.
    - "Creditor" means any person who offers or extends credit creating a debt or to whom a debt is owed, but does not include any person to the extent that he receives an assignment or transfer of a debt in default solely for the purpose of facilitating collection of such debt for another.
    - *Kimber v. Federal Financial Corp*., 668 F. Supp. 1480 (M.D. Ala. 1987) – purchaser of delinquent debt is a debt collector even if collecting for its own account

Exceptions (cont'd)

- Any person while acting as a debt collector for another person, both of whom are related by common ownership or affiliated by corporate control, if the person acting as a debt collector does so only for persons to whom it is so related or affiliated and if the principal business of such person is not the collection of debts
- Any officer or employee of the United States or any State to the extent that collecting or attempting to collect any debt is in the performance of his official duties.
- Any person while serving or attempting to serve legal process on any other person in connection with the judicial enforcement of any debt.
- Any nonprofit organization which, at the request of consumers, performs bona fide consumer credit counseling and assists consumers in the liquidation of their debts by receiving payments from such consumers and distributing such amounts to creditors.

Exemptions (cont'd)

- Any person collecting or attempting to collect any debt owed or due or asserted to be owed or due another to the extent such activity:
  - Is incidental to a bona fide fiduciary obligation or a bona fide escrow arrangement.
  - Concerns a debt which was originated by such person.
  - Concerns a debt obtained by such person as a secured party in a commercial credit transaction involving the creditor.
    - Notwithstanding this exclusion, the term "debt collector" includes any creditor who, in the process of collecting his own debts, uses any name other than his own which would indicate that a third person is collecting or attempting to collect such debts.
  - Concerns a debt which was not "in default" at the time it was obtained by such person.

Definition of "In Default"

- The term "in default" is not defined in the FDCPA.
  - FTC Position
    - "The definition of 'default' in the loan agreement or an express state or federal law should generally govern." FTC Staff Opinion by Thomas E. Kane (May 23, 2002).
      - Unclear how to handle a contradiction between loan agreement and express law.
    - If there is no definition of "default" in the contract, and no appropriate definition under another law, then the reasonable standards of the creditor should govern.

Definition of "In Default" (cont'd)

- At least one court has held that a loan is subject to the FDCPA because the servicer believed (incorrectly) that the loan was in default at the time of the servicing transfer, and sent a notice of default to the borrower as soon as it began servicing the loan.
  - The court acknowledged in a footnote that the reverse outcome would be true—a servicer would not be subject to the FDCPA if it did not believe a loan was in default at the time it acquired servicing.

Definition of "In Default" (cont'd)

- Other courts take a hybrid approach - considering a servicer to be a "debt collector" if the loan actually is in default, as those term is defined in the debt contract. However, the servicer will also be a "debt collector" if the totality of the circumstances suggest that the servicer considers the loan to be in "default"—apparently regardless of whether the loan actually is in "default" under the contractual definition.

Preemption

- Preemption of state restrictions on collection activity is limited
  - Section 816: The FDCPA does not preempt any state laws regulating debt collection, "except to the extent that those laws are inconsistent with any provision of [the FDCPA], and then only to the extent of the inconsistency."
    - "A State law is not inconsistent with [the FDCPA] if the protection such law affords any consumer is greater than the protection provided by" the FDCPA.
  - The FTC interprets this provision as expressly adopting what courts sometimes call "conflict preemption" standard. Under this standard, the FDCPA only preempts a state law only if:
    - Compliance with both the state law and the federal law is a "physical impossibility"; or
    - The state law stands as an obstacle to the full accomplishment and execution of the federal law's purposes and objectives.

Jon Jaffe
San Francisco, CA

Jon Jaffe works with banks, savings associations, mortgage bankers and brokers, consumer and commercial finance lenders, real estate professionals, and e-commerce companies. He advises clients in the areas of general corporate law, mergers and acquisitions, commercial real estate, consumer and commercial lending, and secured transactions. In addition, he also counsels clients on matters involving e-commerce and electronic delivery of financial services.

Application of Debt Collection Laws to Various "Players" – Debt Collectors

The FDCPA applies only to "debt collectors," but it is not always clear whether a person is a debt collector.

There are a number of classes of persons expressly excluded from the definition of "debt collector." This portion of the webinar will address the following:

Debt Collectors (cont.)

- Employees of a creditor, but only while collecting debts for and in the name of the creditor.
- Servicers, provided the debt was not in default at the time it was obtained by the servicer.
- Affiliates by common corporate ownership or control of another who is not a debt collector.

Application of Debt Collection Laws to Various "Players" – Creditors

- Although not expressly set forth in the FDCPA, entities that qualify as "creditors" are generally excluded from the definition of the term "debt collector." See, e.g., Commentary on § 803(6)(3).
- The FDCPA defines "creditor" as "any person who offers or extends credit creating a debt or to whom a debt is owed, but excludes from the term any person to the extent that he receives an assignment or transfer of a debt in default solely for the purpose of facilitating collection of such debt for another."
- The legislative history of the FDCPA indicates clearly that Congress intended the terms "debt collector" and "creditor" to describe mutually exclusive classes of individuals – that is, a party could be a "creditor" or a "debt collector" in connection with a given loan, but not both.

Creditors (cont.)

- The definition of “creditor” excludes any party that acquires “a debt in default solely for the purpose of facilitating collection of such debt for another.”

- The FTC and some courts have concluded that a person cannot claim to be a “creditor” in connection with any loan that was in default at the time that it was acquired.

- There is also a legal fiction that has been applied to so called “de facto” employees, as articulated in the FTC’s De Mayo Letter.

Application of Debt Collection Laws to Various "Players" – Creditors and Affiliates

- As previously noted, the FDCPA excepts from the definition of "debt collector," "any person while acting as a debt collector for another person, both of whom are related by common ownership or affiliated by corporate control, if the person acting as a debt collector does so only for persons to whom it is so related or affiliated and if the principal business of such person is not the collection of debts."

Creditors and Affiliates (cont.)

- To fit within this exception, an affiliate would need to satisfy three conditions:
  - The affiliate and the "other person" must be related by common ownership or be affiliated by corporate control;
  - The affiliate must perform debt collection activities only for its affiliates; and
  - The affiliate's principal business may not be the collection of debts. Courts have interpreted the phrase "principal business" broadly. One court held that an affiliate "need only show that debt collection does not represent the single most significant activity." Another court held that where an entity engages in typical loan servicer activities (e.g., answering borrower customer service questions, handling billing disputes, etc.), that conduct is not considered the collection of debts and, accordingly, would provide a basis for satisfying the second prong.

Creditors and Affiliates (cont.)

- Assuming an affiliate meets these criteria, the affiliate must address another issue – should the affiliate collect in its own name or in the name of the affiliated entity on whose behalf it is collecting?

- The resolution of this issue is not entirely clear. At least one court has stated that the affiliate need not collect under the name of its affiliated creditor. Naturally, consumer advocates disagree.

Application of Debt Collection Laws to Various "Players" – Creditors and Assumed Names

- Even if a "creditor" is not a "debt collector," the creditor can make itself a debt collector by using an assumed name.
- There are two provisions of the FDCPA that relate to the name that a servicer may use. One provision says a creditor that collects debts in a name other than its own will cause the creditor to be a "debt collector" if the name it uses would indicate that a third person is collecting or attempting the debts. The second provision prohibits a debt collector from using any name other than its own when collecting debts.
- Several courts have held that the use of a licensed trade name, including a trade name for a division of a company, does not violate this prohibition, at least in circumstances where the trade name is not being used under circumstances that would mislead the least sophisticated consumer about the identity of the party collecting the debt.
- The standard for determining whether a creditor's use of an assumed name turns the creditor into a debt collector appears to be whether the assumed name is misleading to the consumer. If it is not, a creditor should be permitted to use its full business name, the name under which it usually transacts business, or a commonly-used acronym.

Application of Debt Collection Laws to Various "Players" - Servicers

- The FDCPA excludes from the term "debt collector," "any person collecting or attempting to collect any debt owed or due or asserted to be owed or due another to the extent such activity . . . concerns a debt which was not in default at the time it was obtained" by that person.
- According to the FDCPA's legislative history, this exemption is intended to include "mortgage service companies and others who service outstanding debts for others, so long as the debts were not in default when taken for servicing."
- Thus, the statutory distinction between a "servicer" and a "debt collector" turns on whether the loan was in "default" at the time it was obtained.
- The term "default" raises a number of issues.
- A servicer may be a debt collector for purposes of one loan, but not another.

Application of Debt Collection Laws to Various "Players" - Component Servicers

- For our purposes, a component servicer encompasses vendors engaged by the named servicer to perform special functions, e.g., private label loan modification companies and door knockers.

- Many servicers and component servicers do not treat the component servicers' communications with the borrowers as being subject to the FDCPA.

- You should first ask whether the component servicer's functions fit within the definition of "debt collector"? That is, is the principal purpose of the component servicer's business the collection of debts, or does it regularly collect or attempt to collect, directly or indirectly, debts owed or due or asserted to be owed or due another?

Component Servicers (cont.)

- This is a particularly uncertain area of the law.
- If a component servicer is a debt collector, it still might not be subject to the most problematic provisions of the FDCPA – the validation of debt notice (VOD) and the mini-Miranda.
- Most of the FDCPA's provisions, including the VOD and mini-Miranda, regulate "communications" between debt collectors and debtors. The FDCPA defines communication narrowly to include only "the conveying of information regarding a debt directly or indirectly to any person through any medium."

Component Servicers (cont.)

- Ultimately, this may require a case by case determination, based on the nature and extent of the component servicer's communications with the borrower.
- At one end of the spectrum is a comment made in the dicta of Bailey v. Security National Servicing Corporation, a decision by the United States Court of Appeals for the Seventh Circuit. The court said that Section 807 (which prohibits false, deceptive, or misleading representation or means in connection with the collection of a debt, and which imposes the mini-Miranda requirement) applies only to letters that specifically demand payment of a past-due debt.
- The court explained that Section 807 applies only to communications "in connection with the collection of any debt." The court's unstated premise was that a communication is in connection with the collection of any debt only if the communication contained a specific demand for a past-due payment.

Component Servicers (cont.)

- At the other extreme, some courts have held that the mini-Miranda requirement applies basically to any communication from a debt collector to a consumer, even when the communication does not mention the debt, much less specifically demand payment.

- A number of courts fall between these two extremes. For example, several courts have concluded that the mini-Miranda requirement applies to a letter the purpose of which is to get the debtor to pay a debt, but not to a letter that has another purpose.

- Courts disagree on whether a message asking the consumer to call the debt collector back, and which does not mention the debt, must contain the required disclosures.

K&L GATES

Steve Kaplan
Washington, D.C.

Mr. Kaplan concentrates his practice in transactional and regulatory compliance matters related to consumer financial products. His practice includes:

- Advising clients on (i) compliance with federal and state laws governing the licensing and practices of financial institutions, including mortgage lenders, consumer finance companies, loan servicers, and prepaid card issuers, and (ii) the federal preemption of state laws regulating financial products;
- Acting as regulatory counsel in connection with investments or acquisitions related to mortgage loans, consumer loans and other consumer financial products;
- Performing specialized regulatory compliance due diligence;
- Assisting with structuring operations and developing compliance and due diligence programs; and
- Assisting in administrative enforcement actions and litigation involving regulatory compliance matters.

Mr. Kaplan is a frequent lecturer at seminars and conferences sponsored by the Mortgage Bankers Association of America, America's Community Bankers and other industry-related groups on various legal issues relating to consumer financial products. He has also written articles on various issues relating to consumer financial products, including the Real Estate Settlement Procedures Act and state mortgage finance regulatory compliance issues.

DE FACTO EMPLOYEES

- PURPOSE
  - Limit application of FDCPA and state collection agency laws

Background

- In 2002, FTC concluded that employees of a collection agency could qualify as de facto employees of a creditor—and thus take advantage of the exception from the definition of debt collector for "any officer or employee of a creditor while, in the name of the creditor, collecting debts for such creditor."
- According to FTC, application of de facto employee exemption depends on the degree of control and supervision exercised by the creditor over the agency employees' collection activity, and how similar that control and supervision is to that exercised by the creditor over its own employees.
- Relevant facts include whether the creditor directly supervises and monitors the collection activities of the agency employees and, if so, how that supervision and monitoring is carried out; whether the creditor trains the agency employees; and whether the agency employees are subject to the same rules.

Application in the Real World

- Is the Servicer the Creditor?
  - The FDCPA defines creditor as “any person who offers or extends credit creating a debt or to whom a debt is owed, but such term does not include any person to the extent that he receives an assignment or transfer of a debt in default solely for the purpose of facilitating collection of such debt for another.”
  - If a servicer owns the loan and is servicing it for its own account then the servicer will be the party to whom the debt is “owed.”

Extending Application to Other Contexts

- What if the servicer is not the creditor? The de Mayo letter does not address expressly whether an employee of a vendor for a servicer might be considered a de facto employee of the servicer for purposes of different FDCPA provisions.

- Effectively and successfully using the de Mayo letter.

What About Contract Provisions?

What About State Laws?

- Loan Servicer
- Collection Agency
- Mortgage Broker
- Loan Originator/SAFE Act

Brian Forbes
Boston, MA

Mr. Forbes is a partner in the Boston office of K&L Gates and concentrates his practice in general commercial litigation including federal and state class action litigation. Mr. Forbes regularly represents banking, mortgage lending and consumer financial services institutions in consumer class actions and individual litigation matters. He has represented a variety of corporate and individual clients in jury and non-jury civil litigation matters in federal and state courts throughout the United States, including California, Florida, Georgia, Illinois, Louisiana, Maryland, Massachusetts, Missouri, New Jersey, New York, Ohio, Pennsylvania, Texas, Washington, and Wisconsin.

Managing Liability Exposure Under Debt Collection Laws

- Walking the Line: The limitations of statutory coverage to communications that are not made “in connection with” the collection of debt.
- Litigation Risks: Exposure to individual and class claims.

Are Loan Workout Efforts Subject To The FDCPA?

- The threshold issue: Is the communication in connection with the collection of debt?
- Two central teachings of *Bailey v. Security Nat'l Servicing Corp.*, 154 F.3d 384 (7th Cir. 1998):
  - A servicer collecting on a forbearance agreement that is current at the time of transfer is not a "debt collector" for purposes of the FDCPA.
  - A letter that does not demand payment of specified past-due installments does not violate the FDCPA because such a communication is not made "in connection with the collection of any debt."

Putative Class Action Cases Applying *Bailey's* "in connection with collection of any debt" holding

- In *Porter v. Fairbanks Capital Corp.*, the court held that a videotape encouraging borrowers to contact the loan servicer and suggesting possible loan workout options did not demand payment and could not be construed as a communication in connection with the collection of any debt. *Porter v. Fairbanks Capital Corp.*, No. 01 C 9106, 2003 WL 21210115 (N.D.Ill. May 21, 2003).

- In *Gillespie v. Chase Home Finance, LLC,* the court held that a letter to the consumer inviting the consumer to consider various loan workout options was not "in connection with the collection of any debt." *Gillespie v. Chase Home Finance, LLC,* No. 3:09-CV-191-TS, 2009 WL 4061428 (N.D. Ind. Nov. 20, 2009).

Cases Applying *Bailey's* "in connection with collection of any debt" holding (cont.)

- ***Additional decisions applying Bailey**:*
  - *Mabbitt v. Midwestern Audit Serv., Inc.*, No. 07-11550, 2008 WL 723507 (E.D. Mich. Mar.17, 2008), letter notifying consumer that her outstanding balance had been transferred to her new account for her "convenience in making payment" did not contain language that she was "required to pay the debt" and thus was not communication in connection with the collection of any debt.
  - *Wexler v. Banc of America Auto Fin. Corp.*, No. 00-C-865, 2000 WL 1230497, at *2 (N.D. Ill. Aug. 25, 2000), "a letter that does not demand payment does not qualify as communication in connection with the collection of any debt subject to the FDCPA."
  - *Santoro v. CTC Foreclosure Serv. Corp.*, 12 Fed. Appx. 476, 480 (9th Cir. 2001), letter sent to debtor who had retained counsel did not violate FDCPA where letter merely suggested workout options.

- **The law is still evolving.** Some courts, especially those outside of the jurisdiction of the Seventh Circuit, view the language "in connection with the collection of any debt" broadly. For example, some courts have concluded that communications that do not state amounts for past due payments, may nonetheless be subject to the FDCPA.

Class Certification Issues

- Increase in FDCPA class actions lawsuits
- The set-up: Defendant sent (or caused to be sent) a form letter and/or communication to putative class members in violation of FDCPA.
- Possible Defenses:
  - Standing
    - A plaintiff with a loan that is not in default at transfer may lack standing to represent class of defaulted borrowers; in other words, the defendant is not a "debt collector" covered by the FDCPA.
  - Typicality
    - Plaintiffs who are subject to the *Bailey* defense may not have claims that are typical of the claims of the putative class they seek to represent.
  - Predominance
    - Individual questions of fact and law predominate over common questions, where in each case, the Court must determine whether a loan was current at the time of transfer to determine whether FDCPA applies to defendant's communications with a particular borrower.
    - The "default" question – uniform treatment vs. transaction-specific inquiry.

Damages Under FDCPA

- Statutory Damages under the FDCPA
  - Individual action: Capped at $1,000.
  - Class action: Statutory damages are capped at the lesser of $500,000 or 1.0% of the defendant's net worth.
  - "Gaming" the scope of the class to evade the statutory cap:
    - Geographic: For example an Illinois-only class may leave open the possibility of lawsuits in other jurisdictions. At least one federal appeals court has held that the cap on statutory damages under the FDCPA cannot be invoked to limit recovery in suits filed in other jurisdictions that seek redress for the same alleged wrong. *See Mace v. Van Ru Credit Corp.*, 109 F.3d 338, 342-343 (7th Cir. 1997).
    - Pursuing different actions against the same debt collector based upon different communications.
    - Actions under state debt collection statues and/or state unfair and deceptive trade practice statutes, which statutes may also provide for declaratory and injunctive relief.

Damages under FDCPA (cont.)

- Actual damages available in both individual actions and class actions.
  - Similar to other consumer finance class actions, many courts have determined that claims for actual damages are not suitable for class treatment because of the need for individualized evidence of damages for each class member.
- Attorney's fees and costs for successful debtors.

K&L|GATES

Questions?

Presented by:

Steven M. Kaplan Jon Jaffe Brian Forbes David Tallman

www.klgates.com