ALASKA LEGISLATURE COMMITTEE FILES 2001-2002 8672

10611 SENATE LABOR & COMMERCE

INTERIM MEETING

10/20/01

STATE OF ALASKA

Tony Knowles, Governor

Department of Labor and Workforce Development

OFFICE OF THE COMMISSIONER

P.O. Box 21149
Juneau, AK 99802-1149
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The Honorable Randy Phillips
Alaska State Senate
P.O. Box 142
Eagle River, AK 99577

October 30, 2001

FAXED 10/30/2001

Dear Senator Phillips:

I am writing to follow up on the questions raised at the October 20 Senate Labor and Commerce Committee minimum wage hearing. Specifically: 1) what percentage of the working population makes the minimum wage, and 2) is there any way to track or define those who are not covered by the minimum wage law.

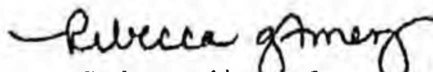
According to the Chief of Research and Analysis of the Department, there is no specific information available for Alaska on the number of workers actually employed at the minimum wage. The Department's Unemployment Insurance system does not collect the hours worked or the hourly pay rate for covered employees.

However, using information from the Occupational Employment Statistics (OES) survey done in cooperation with the US Bureau of Labor Statistics, a rough estimate can be developed. The OES survey does collect information on the number of workers whose rate of pay falls within specified pay ranges. The lowest wage range in the survey is $5.65-$6.74. This is the most detailed wage range for which employment estimates are available. There are approximately 14,400 jobs that paid wages within this range. This is approximately 5.5% of wage and salary employment. Of these workers, 32% were in the eating and drinking industry, 9% in amusement & recreation services, 6% in educational services and 4% in the seafood-processing sector. (See attached table.)

There is no information on persons not covered by unemployment insurance that may be earning the minimum wage (i.e. babysitters & some agricultural workers). These persons are generally in entrepreneurial relationships and are not thought of as wage earners under the definition we must use.

Please let me know if you have further questions or want additional information.

Sincerely,



Rebecca Nance Gamez
Deputy Commissioner

Attachment

Industry	Percent of Total Minimum Wage[1/] Employment	Total Minimum Wage[1/] Employment by Industry
Eating And Drinking Places	32.31	4,664
Amusement & Recreation Services	8.76	1,265
Educational Services	5.61	810
Government	4.39	634
Food And Kindred Products	4.27	617
Hotels And Other Lodging Places	4.09	590
General Merchandise Stores	4.05	584
Food Stores	3.75	542
Miscellaneous Retail	3.47	501
Social Services	3.29	475
Real Estate	3.00	433
Membership Organizations	2.30	332
Automotive Dealers & Service Stations	2.01	290
Health Services	1.61	233
Motion Pictures	1.49	215
Personal Services	1.39	200
Wholesale Trade-nondurable Goods	1.22	176
Transportation By Air	1.21	174
Local And Interurban Passenger Transit	1.11	160
Miscellaneous Repair Services	1.10	159
Auto Repair, Services, And Parking	1.08	156
Business Services	0.98	142
Communications	0.80	115
Holding And Other Investment Offices	0.79	114
Apparel And Accessory Stores	0.69	99
Building Materials & Garden Supplies	0.63	91
Engineering & Management Services	0.53	76
Printing And Publishing	0.42	60
Wholesale Trade-durable Goods	0.40	58
Transportation Services	0.36	52
Special Trade Contractors	0.35	50
Agricultural Services	0.33	48
Transportation Equipment	0.20	29
Museums, Botanical, Zoological Gardens	0.20	29
General Building Contractors	0.19	28
Insurance Agents, Brokers, & Service	0.19	27
Oil And Gas Extraction	0.15	21
Lumber And Wood Products, Except Furni	0.15	21
Security And Commodity Brokers	0.15	22
Trucking And Warehousing	0.13	19
Water Transportation	0.12	17
Depository Institutions	0.12	17
Heavy Construction, Ex. Building	0.11	16
Legal Services	0.10	15
Furniture And Homefurnishings Stores	0.08	11
Nonmetallic Minerals, Except Fuels	0.06	8
Electric, Gas, And Sanitary Services	0.06	9
Insurance Carriers	0.06	8
Miscellaneous Manufacturing Industries	0.05	7
Petroleum And Coal Products	0.03	4
Rubber And Misc. Plastics Products	0.03	4
Services, Nec	0.02	3
Apparel And Other Textile Products	0.01	2
Chemicals And Allied Products	0.01	1
Leather And Leather Products	0.01	1
Instruments And Related Products	0.01	1
Total	100.00	14,435

1/ For the purpose of this analysis, "minimum wage" comprises the $5.65-$6.74 wage range.

Source: Department of Labor and Workforce Development, Research & Analysis Section

ALASKA HOSPITALITY ALLIANCE

Representing Alaska's Finest
Accommodations • Restaurants • Beverage Operations & Hospitality Suppliers

Alaska Restaurant & Beverage Association

Testimony Provided by Karen Rogina of the Alaska Hospitality Alliance in Opposition to Minimum Wage Increases as proposed in SB 46 and SB 132 on Saturday, October 20th, 2001, with supplemental information gathered after a discussion with the Department of Labor.

Alaska's Hospitality Industry opposes minimum wage increases

We oppose minimum wage increases and ask that the issue go through the legislative process rather than the ballot initiative process because the general public is largely unaware of the negative impacts of minimum wage increases. Our opposition to minimum wage increases is based on the following reasons:

1. A Minimum wage increase hurts those employees that it is intended to help . Every time the minimum wage increases employers are faced with having to offset the significant increase to their costs. In the restaurant industry profit margins average 3 – 5 %, which doesn't leave room to absorb minimum wage increases. Since profits are slim, employers are forced to:
   a. Reduce other employee benefits, such as vacation pay and health insurance. Does not help employees.
   b. Reduce the number of employees or cut their hours. This doesn't do anything to raise the wage for tipped employees, it actually negates the increase.

2. According to Rebecca Nance Gamez, Deputy Commissioner and Chris Miller, Chief of Research and Analysis for the state of Alaska Dept of Labor, based on the information available to them, it is impossible to identify the number of minimum wage earners in Alaska. Additionally, they do not have access to information identifying the percent of minimum wage earners who are either 1) teenagers working part-time, 2) tipped employees or 3) actual minimum wage earners working full-time. Furthermore, of those actual non-tipped minimum wage earners working full-time, there is also no data available indicating if these individuals are the primary source of their household income.

   In other words, it is possible, according to the Dept of Labor figures, that the minimum wage earner, working full-time as a sole provider of household income, does not exist in Alaska at all. At the very least, it is arguable that this type of wage earner represents a very small percent of total minimum wage earners. What the Department of Labor is able to provide is gross annual earnings by age. While these statistics reveal that some people over the age of 18 are earning $11,000 per year (the annual wage for a full-time, non-tipped minimum wage earner) there is no way to tell what this person's hourly wage is, if this person is working full time, if they are the sole household wage earner, or if they are a tipped employee working part-time.

   Relying on national statistics, compiled from states with an income tax that track this information, we see that the vast majority of minimum wage earners are teenagers or tipped employees. Tipped employees earn most of their income in tips, which are based on a percentage of the check. This provides for a natural Cost of Living indexing effect right now. For example, this year, menu prices are rising at a rate of 3.1 percent, while inflation is rising at a rate of 2.7%. As restaurateurs increase prices (which many do to keep up with rising costs) then tips go up as a percentage of the menu price.

UNITED IN A COMMON GOAL TO MAKE ALASKA THE MOST HOSPITABLE PLACE ON EARTH!

330 E. Fourth Avenue • Suite 201 • Anchorage, Alaska 99501 • Phone (907) 929-4AHA (4242) • Fax (907) 272-1289

3. Increasing minimum wage reduces opportunity for teenagers to gain valuable work experience, as employers are more likely to hire those with experience as long as they have to pay a higher amount.

4. Survey's show that hourly tipped employees make between $12 - 17 per hour including tips. There is no reason why minimum wage law should concern itself with employees who are earning significantly more than the minimum wage. Minimum wage law was enacted to guarantee certain individuals receive a set minimum wage, it was not intended to include those earning well above minimum wage.

5. Federal tax law recognizes tips as wages, subject to employee paid income tax and FICA tax. Additionally, employers pay unemployment tax and FICA payroll taxes on the tip income of employees. As is the case for at least 44 states, Alaska state tax law should also recognize tips as wages, and therefore allow employers of tipped employees to forgo minimum wage increases.

6. Comparisons of the minimum wage in California, Oregon and Washington with the minimum wage in Alaska is inappropriately like comparing apples and oranges because, the cost of living in the major city centers of all four states varies by up to 100%. Quite often, Alaska's COL index figure is less than that of the major city centers in Washington, Oregon and California.

7. We need to take a look at the big picture implications of what the impacts of all the various bills targeted at the hospitality industry this year, will have on hotels, restaurants and beverage operations if passed. The Hospitality Industry is the target for new legislation, which, if passed, will increase liquor excise taxes by 300%, increase minimum wage with a CPI indexing, reduce the amount of time bars and restaurants can be open and reduce the amount of consumption of beverages based on stricter penalties on DUI laws. Add to that the effects of the Sept 11 terrorist attacks and we are looking at impacts on the industry that have already meant the closing down or downsizing of operations, and hundreds of jobs lost. Further impacting our industry is the ongoing threat of a Statewide Bed tax on hotels, a port tax on cruise ships (80% of occupancy in hotels in the interior during the summer is cruise ship passengers) and the perpetual decline of tourism marketing dollars from the state.

If there must be a minimum wage increase, we ask that you consider the following:

1. A "conditional tip credit" where tipped employees, earning under 8 dollars per hour, including tips, would be eligible for min wage increases and those tipped employees earning over $8 per hour with tips would not be eligible to receive the min wage increase. This would serve as a safety net to insure that those tipped employees who's tips are inconsistent or minimal, will still earn above minimum wage.
2. Institute a Training wage or training credits and a more broad work opportunity Tax Credit so that employers can have resources to supplement the cost of training entry level employees. We need to streamline the process whereby employers are able to obtain monetary support from the state for the training of employees. This will allow employers to pay employees more while covering their extra costs to train the employee.
3. Amend the current minimum wage law to exclude the 20 percent rule an the mandating of 2.5 times the minimum wage for administrative and executive employees.
4. Delay the effective date to 2003 so that employers have a chance to *understand the effects* of other legislation passed in 2002 as well as the sustained impacts from the terrorism attacks and the economy.

The Economic Impact on the Restaurant Industry of Increasing the Federal Minimum Wage from $4.25 to $5.15

Summary of Analysis

Background

In 1996 and 1997, Congress increased the minimum wage for all employees covered by the Fair Labor Standards Act (FLSA). This applied to all enterprises with annual sales of $500,000 or more, as well as all employees who engage in interstate commerce – regardless of the size of their employer. The federal minimum wage was increased in two steps – from $4.25 to $4.75 on October 1, 1996, and from $4.75 to $5.15 on September 1, 1997.

The purpose of this analysis was to assess the impact of the increases in the federal minimum wage on the restaurant industry, and determine what actions were taken by restaurant operators as a result of the minimum wage increases.

Summary

- In general, restaurant operators took a number of actions as a result of the minimum wage increases in 1996 and 1997. Although the most common action was an increase in menu prices, the most dramatic impact was on restaurant industry employment. According to this analysis, more than 146,000 jobs were cut from restaurant payrolls, with operators postponing plans to hire an additional 106,000 new employees.
- For the most part, the increases in the minimum wage had a relatively greater impact on smaller, independent operations located in smaller communities.

⇒ Restaurant industry job losses exceeded 146,000

- The most dramatic impact of the minimum wage increases was a reduction in the number of employees at restaurants. Nearly 14 percent of establishments reported cutting jobs, with the median number of job losses equaling three. This translates into an overall reduction in restaurant industry employment of more than 146,000 jobs.
- Fifteen percent of tableservice operators cut jobs, which translates into an overall reduction of 79,000 jobs. Slightly more than 12 percent of limited-service operators reported cutting jobs, resulting in an overall employment loss of 67,000 jobs.
- These job losses were also reflected in the official government employment figures. Although the restaurant industry continued to post employment growth following the minimum wage increases, the annual net increase in jobs was significantly lower than

in the two years prior to the wage hikes. According to the Bureau of Labor Statistics, eating and drinking places added a net 256,400 jobs in 1994 and 276,400 jobs in 1995. Then, job growth in the industry slowed dramatically – a net increase of 162,400 in 1996, 129,100 in 1997, and 122,100 in 1998.

- Job losses were more likely to occur in smaller communities. Nearly 20 percent of restaurants in areas with populations of less than 15,000 cut jobs, compared to 13 percent of restaurants in areas with populations of 15,000 to 100,000, and 12 percent of restaurants in cities with populations of 100,000 or more.
- Restaurants in the Western region of the country were more likely to reduce their number of employees as a result of the wage increases. Nearly 16 percent of restaurants in the West cut jobs, versus 15 percent in the North Central region, 14 percent in the Northeast, and 10 percent of restaurants in the South.
- Job losses were more common among establishments with lower annual sales volumes. Nearly 17 percent of restaurants with annual sales of less than $500,000 cut jobs, compared to 14 percent of restaurants with sales of $500,000 to $1 million, 13 percent of restaurants with sales of $1 million to $2 million, and 12 percent of restaurants with sales of $2 million or more.
- The type of ownership was also a determining factor in the likelihood of employment reductions. More than 18 percent of sole proprietorships cut jobs, compared to 10 percent of partnerships, 12 percent of public corporations, and 11 percent of private corporations.
- Single-unit operators were also more likely to cut jobs as a result of the minimum wage increase. Nearly 16 percent of single-unit operators cut jobs, versus 10 percent multi-unit operators who did the same.
- The median age of employees that lost their jobs was 22.

⇒ Several employee groups were affected by the job losses

- The employees most affected by job losses across all restaurant-types were cooks. Nearly 54 percent of the restaurants that cut jobs eliminated at least one cook position. This was equally prevalent among tableservice and limited-service restaurants.
- Among tableservice restaurants, the most common job that was eliminated was a waiter or waitress position. More than 61 percent of tableservice restaurants that reduced employees cut at least one waiter or waitress position.
- The employee group most affected by job losses at limited-service restaurants was counter workers. Of the limited-service restaurants that reduced employees, 73 percent of them cut at least one counter worker position.
- Dishwashers and buspersons were cut from the payrolls of 51 percent of tableservice restaurants that reduced the number of employees.

- Salad prep workers were cut by 36 percent of limited-service restaurants that reduced employees, and 25 percent of tableservice restaurants that reduced employees.

⇒ Many operators also postponed plans for new hiring

- In addition to making reductions in their existing payrolls, many restaurant operators also postponed plans for new hiring as a result of the minimum wage increases. Nearly 15 percent of restaurant operators reported that they postponed plans for new hiring, with the median number of jobs postponed equaling 2. This translates into a total of 106,000 new jobs that were postponed as a result of the wage hikes.
- Tableservice restaurant operators were much more likely than limited-service operators to postpone plans for new hiring. More than 18 percent of tableservice operators postponed plans for new hiring (65,000 jobs), while 11 percent of limited-service operators did the same (41,000 jobs).

⇒ Restaurants also reduced the number of employee hours worked

- Another action taken by restaurant operators as a result of the minimum wage increase was a reduction in the number of employee hours worked. More than 28 percent of operators reported reducing employee hours – an action equally common among both tableservice and limited-service restaurants.
- The median reduction in the number of hours worked per week was 9 percent.
- The restaurant employees that saw the greatest reduction in hours worked were back-of-the-house workers. Of the operators that reduced work hours of their employees, nearly 56 percent of them cutback on hours of their cooks.
- More than 75 percent of limited-service operators that cutback on work hours reduced the hours of their counter workers.
- Sixty percent of tableservice operators that cutback on hours reduced the hours of their dishwashers, while 59 percent reduced the work hours of their waiters and waitresses.

⇒ Menu prices rose as a result of the wage hikes

- Many restaurant operators increased menu prices to help absorb the higher labor costs as a result of the minimum wage increases. In fact, increasing menu prices was the most common action taken by operators following the minimum wage increases.
- Forty-two percent of restaurant operators reported increasing menu prices, with a median increase of 5 percent.
- Forty percent of tableservice operators increased menu prices as a result of the minimum wage increases, with a median increase of 7 percent.
- More than 44 percent of limited-service operators reported increasing menu prices, with a median price increase of 5 percent.

- Growth in menu prices was also reflected in the consumer price inflation figures reported by the Bureau of Labor Statistics. For the first time since 1987, menu price inflation exceeded the overall inflation rate – growing 2.8 percent in 1997, compared to a 2.3 percent increase in overall consumer prices. This occurred despite a modest 0.2 percent increase in wholesale food prices during 1997.
- This trend continued into 1998, with menu prices increasing at a 2.6 percent rate – compared to a paltry 1.6 percent increase in overall consumer prices. Once again, this occurred despite the lack of upward pressure from wholesale food prices. In 1998, wholesale food prices actually *declined* 0.3 percent from their 1997 level.

⇒ Restaurant operators added labor-saving equipment

- Many restaurant operators also reported purchasing labor-saving equipment to help alleviate the pressures of rising labor costs. Thirteen percent of operators reported purchasing labor-saving equipment as a result of the minimum wage increases.
- Fourteen percent of limited-service operators purchased new equipment, while 12 percent of tableservice operators did the same.
- As would be expected, the addition of labor-saving equipment had the greatest effect on back-of-the-house employees – through the reduction of employee hours or the elimination of jobs.
- The employee group most affected by the addition of labor-saving equipment was cooks, followed by salad prep workers, counter workers, and dishwashers.

⇒ Other actions taken

- Nearly 12 percent of restaurant operators reported that they postponed plans for expansion and/or renovation as a result of the minimum wage increases.
- Some restaurant operators also cut their hours of operation as a result of the minimum wage increases. Nine percent of restaurant operators cut their hours of operation following the wage hikes – an action slightly more common among limited-service operators. The median number of hours per week that operators cut was 20.
- Eight percent of restaurant operators reported postponing plans to open new units as a result of the minimum wage increases.

Research Design

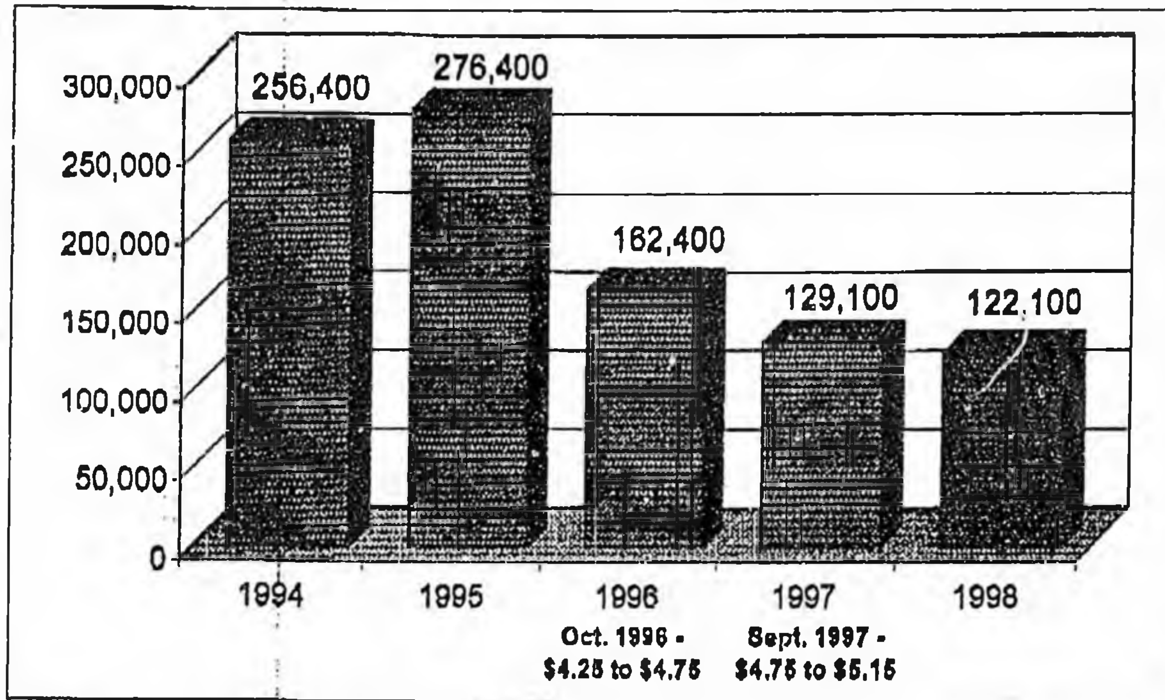
The survey was conducted by International Communications Research (ICR), a survey research firm located in Media, Pennsylvania.

The sample was drawn from a list of single-unit locations of eating places in the United States, as provided by American Business Lists. Owners and managers of eating places nationwide were surveyed to determine how the minimum wage increases in 1996 and 1997 may have affected their business. In total, 1001 interviews were completed.

Interviewing was conducted by ICR between February 26 and March 19, 1998.

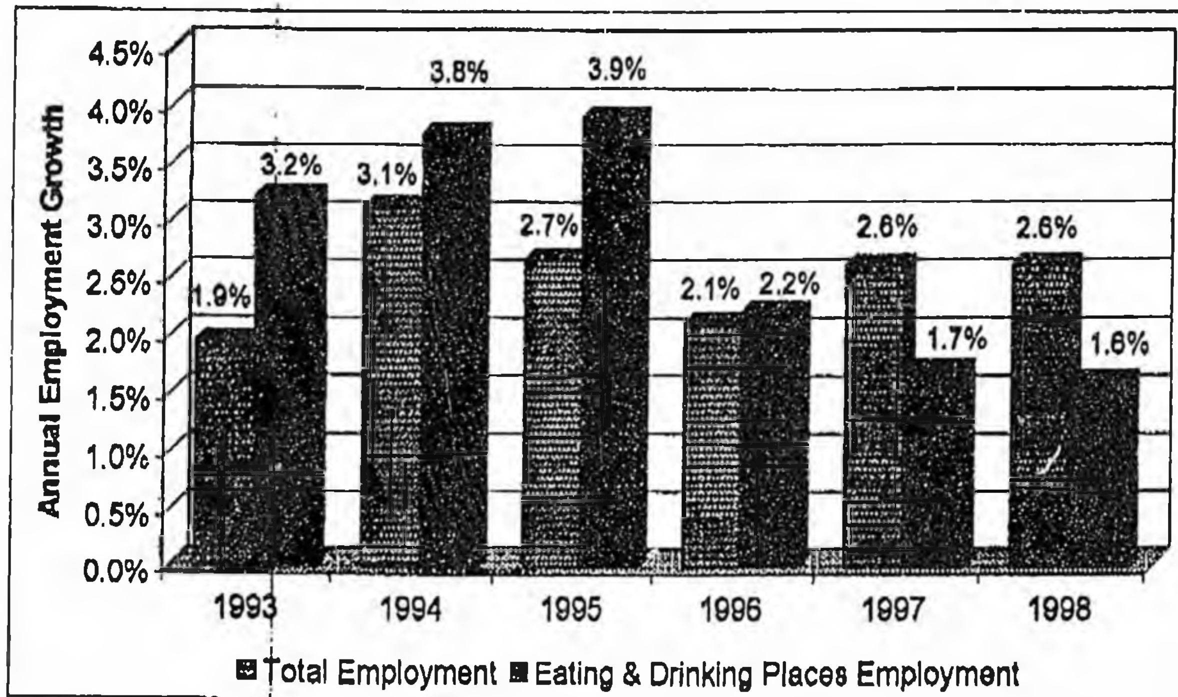
To estimate the overall economic impact for the entire restaurant industry, the National Restaurant Association Research Department made projections from the ICR results based on the total number of tableservice and limited-service restaurant unit counts. The unit counts for the restaurant industry are based on the 1992 Census of Retail Trade, with current estimates developed by the National Restaurant Association Research Department.

**Eating and Drinking Place Employment Growth
1994 to 1998**



Source: Bureau of Labor Statistics

After Outpacing Overall Employment Growth Each Year in the 1990s, Job Growth at Eating and Drinking Places Fell Sharply in 1996, 1997 and 1998



Source: Bureau of Labor Statistics

October 25, 2001

Representative Andrew Halcro
716 W. 4th Ave
Anchorage, AK 99501 via email only

Dear Representative Halcro:

Re: HB182 Review Comments

I have looked over your subcommittee's most recent working draft of HB182. And although it has been awhile, I also remember reviewing this bill's Senate counterpart during last session. Unfortunately, I have been unable to attend your working group meetings, although I applaud your efforts to bring closure to the areas of greatest difficulty.

I support your efforts to give Alaska motor vehicle dealers equal footing with other dealerships and with the manufacturers. However, in doing so, I do not want to unnecessarily create hardships for small dealers.

At our October 20 Senate Labor & Commerce meeting I said I would send you comments and questions for your consideration as your subcommittee continues to work through this legislation.

1) What purpose does dealer registration serve? Is a business license insufficient? How much will it cost to deal with the increased registration?
2) How many car dealerships in Alaska will be impacted by this legislation?
3) I've read the description of motor vehicles required to be registered under AS 28.10, but please clarify whether HB 182 would apply ONLY to cars, trucks and motorcycles. Does it also apply to all terrain vehicles, snowmachines or other motorized vehicles?
4) Would the revised Sec. 08.66.090(C) cover financial institutions that resell vehicles they repossess? How would this impact the annual Avis rental car sale advertised through the Alaska State Employees Credit Union and elsewhere?
5) Manufacturer Practices: "A manufacturer...may not coerce ... a dealer to accept delivery of a motor vehicle... that has not been ordered by the dealer" - has this happened to any dealers in Alaska?
6) What is the standard for "coercion"? greater than entice, but does it require a threat?
7) What is a Dealer-obligor service contract? (Page 13, lines 17-18)

8) What is the purpose of Sec 45.25.430 Awards to Employees? Why can't a manufacturer award a dealers' employees? Why does that award have to go through the dealer?
9) Sec. 45.25.650 VINS - Shouldn't this read "A dealer may not knowingly purchase or sell a vehicle that has an altered or removed VIN plate <u>and</u> may not alter or remove a VIN plate (rather than [**or**])?
10) Sec. 45.25.910 Sales Contracts doesn't state that it is the buyer's responsibility to return the vehicle if the financing falls through. Is this covered elsewhere? One could speculate that it's in the sales contract, but then why are we spelling out (d) buyer's requirements?
11) I'm still not clear why this bill requires a showroom and office - again, the consumer base for dealerships with showrooms or a lot on a grassy corner are selling different products to consumers who may choose to shop in both places. If this is about consumer safety why is the state's current "lemon law" not adequate protection?
12) In the CS on page 4, lines 7-9, "dealer" is defined as a person who sells 5 or more vehicles in any 12 consecutive months; yet on page 32, lines 8-11, a "motor vehicle dealer" is defined as a person who sells 3 or more vehicles in consecutive months. Is there supposed to be a difference?
13) What happens if a dealer or manufacturer is out of compliance with this chapter? What is the penalty? Does this law codify current practices between Alaska dealers and manufacturers? Does it include elements of other states' laws?

Thank you for considering these comments and questions. I offer them constructively and hope to continue to improve the competitive climate for Alaska motor vehicle dealers.

Sincerely,

Loren Leman
Senator

cc: Senator Randy Phillips, Chairman Senate Labor & Commerce Committee
Representative Lisa Murkowski, Chairman House Labor & Commerce Committee (co-Sponsor of HB 182)

Proposed bill relating to Increasing Alaska's Minimum Wage.

In accordance with AS 15.45.090, a copy of the proposed bill is to be included on the petition booklet if the proposed bill is 500 words or less.

Bill Increasing Alaska's Minimum Hourly Wage

BE IT ENACTED BY THE PEOPLE OF THE STATE OF ALASKA

Section 1. Findings and Declaration

The people of the State of Alaska find and declare that:

(a) An increase in Alaska's minimum wage will help ensure a minimum standard of living for the health and well being of every Alaskan,

(b) Alaskans working full-time at the current minimum wage earn far below the federal poverty level for a family of three,

(c) The U.S. West Coast states of Washington, Oregon and California already have a higher minimum wage than the State of Alaska,

(d) A fair minimum wage indexed to the cost of living will help low- income workers keep pace with inflation.

Section 2. Purpose

The purpose and intent of enacting this legislation is to raise Alaska's minimum wage to $7.15 per hour effective January 1, 2003 and thereafter adjusted annually for inflation.

Section 3. AS 23.10.065(a) is repealed and reenacted to read:

(a) Except as otherwise provided for in law, an employer shall pay to each employee a minimum wage, as established herein, for hours worked in a pay period whether the work is measured by time, piece, commission or otherwise. An employer may not apply tips or gratuities bestowed upon employees as a credit toward payment of the minimum hourly wage required by this section. Tip credit as defined by the Fair Labor Standards Act as amended does not apply to the minimum wage established by this section. Beginning with the passage of this Act, the minimum wage shall be $7.15 per hour effective January 1, 2003 and thereafter, adjusted annually for inflation. The adjustment shall be calculated each September 30, for the proceeding January - December calendar year, by the Alaska Department of Labor, using the CPI-Anchorage. Such adjustment shall take effect January 1 of the following year.

Section 4. If the minimum wage determined under Section 3 is less than one dollar over the federal minimum wage, the Alaska minimum wage shall be set at one dollar over the federal minimum wage. This amount shall be adjusted in subsequent years by the method established in Section 3.

REPORT FROM HOUSE L&C SUB- COMMITTEE ON HB#182

Senate Labor & Commerce Committee
October 20, 2001 10:AM

BILL HISTORY

April 11, 2001, Heard in committee and assigned to a sub-committee of Rep Murkowski, Rep. Hayes and Chaired by Rep. Halcro.

April 27, 2001, Teleconference with participants (Alaska Auto Dealers Association, Auto Manufacturers Alliance, Department of Law)

June 19, 2001, Sub-committee meeting at Anchorage LIO with all participants.

July 26,2001, Private meeting with the Department of Law and Steve Conn representing AkPirg.

August 2, 2001, Private meeting with Ford Motor Company which included Rep. Murkowski and the Department of Law

August 16, 2001, Private meeting with the Alaska Auto Dealers Association which included Rep. Murkowski and the Department of Law

October 2, 2001, Established next sub-committee on **November 8, 2001**

WHAT'S BEEN HAPPENING?

- The two sides have been working out their disagreements.
- The sub-committee removed the costly DMV oversight
- The sub-committee is looking at incorporating consumer protection benefits to the bill
- The sub-committee is committed to having a draft to go forward before session re-convenes
- Ed Sneffen from the Department of Law has been a key participant

HB#182 report on 10/20/01

OUTSTANDING ISSUES

- Termination
- Succession
- Subsidiaries
- Warranty
- Department of Law suggestions

WHAT'S HAPPENING NOW?

- November 8, 2001 the sub-committee will hold a teleconference meeting to review the progress of the two sides to resolve outstanding issues and the possible addition of consumer protection measures.
- The sub-committee plans to address any outstanding issues during the meeting and end with a revised draft.
- The sub-committee draft will then be presented to the full House Labor & Commerce Committee in January 2002.

ALASKA STATE LEGISLATURE

Chair:
Labor and Commerce

Member:
Military and Veterans Affairs
Community and Regional Affairs
Legislative Council
Joint Armed Services

REPRESENTATIVE LISA MURKOWSKI
Government Hill • Elmendorf • East Anchorage

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Phone: (907) 465-3783
Fax: (907) 465-2293
Representative_Lisa_Murkowski@legis.state.ak.us

Interim:
716 West 4th Avenue
Anchorage, AK 99501-2133
Phone: (907) 269-0174
Fax: (907) 269-0177

Sponsor Statement
HB 182
Motor Vehicle Sales and Dealers

Alaska is the only state in the nation without a comprehensive motor vehicle act. HB 182, as requested by the Alaska Automobile Dealers Association (AADA), addresses the need to regulate and license motor vehicle manufacturers, motor vehicle dealers, and other persons engaged in selling, repairing, and purchasing vehicles in this state.

HB 182 establishes a motor vehicle advisory board to advise the commissioner of the Department of Administration on appeals and disputes between manufacturers and dealers, manufacturer's changes to new vehicle franchises, proposed regulations, and violations by licensees. Presently, legal disputes between manufacturers and dealers are governed by, interpreted, and adjudicated by out-of-state courts. This can often be an uncertain and expensive proposition for Alaska dealers. HB 182 brings agreements made between manufacturers and dealers under jurisdiction of the Alaska courts. And, since not all dealers and others engaged in the automobile business are licensed by the state, HB 182 mandates a comprehensive licensing structure for all those engaged in automobile business in Alaska.

Some franchise agreements are only offered for short durations and require periodic renewal, even though dealers may be required to invest millions of dollars to obtain or expand their franchises. Many auto dealers are reluctant to make such substantial investments without some assurance from their manufacturer. HB 182 sets forth uniform processes to renew, amend, gain, or terminate franchise agreements. Additionally, HB 182 provides uniform guidelines for designating successors in case of death or incapacity of franchisees.

Dealers are generally dependent on manufacturers as their sole-source supplier. Such dependence gives rise to policies that are otherwise of no value to the dealer—commonly called franchise insurance. Additionally, manufacturers, in order to reduce warranty expenses, require dealerships to perform certain administrative and other functions, oftentimes without reasonable reimbursement. In both instances, dealers have no choice but to pass along the expenses to the consumer. HB 182 clearly defines areas of manufacturer responsibility and mandates fair payment for all incurred expenses relating to warranty and extended service contract repairs. HB 182 also prohibits such manufacturer abuses as franchise insurance.

HB 182 is a comprehensive motor vehicle act that provides guidelines to protect dealers and consumers from abuses within the automobile industry. I urge your favorable support.

Last Updated April 6, 2001
Staff Contact: Amy Erickson 465-4954

22-LS0239\L
Bannister
10/19/01

CS FOR HOUSE BILL NO. 182( )

IN THE LEGISLATURE OF THE STATE OF ALASKA

TWENTY-SECOND LEGISLATURE - SECOND SESSION

BY

Offered:
Referred:

Sponsor(s): REPRESENTATIVES MURKOWSKI, Halcro

A BILL

FOR AN ACT ENTITLED

1 **"An Act relating to certain motor vehicles, including motorcycles; relating to the**
2 **registration of motor vehicle dealers; eliminating certain registration requirements for**
3 **certain motor vehicle buyers' agents; relating to acts and transactions involving motor**
4 **vehicles and to the acts and practices of certain persons and entities involved in motor**
5 **vehicle transactions; and providing for an effective date."**

6 **BE IT ENACTED BY THE LEGISLATURE OF THE STATE OF ALASKA:**

7 *** Section 1.** AS 08.66.010 is amended to read:
8 **Sec. 08.66.010. Dealers to register.** A dealer in motor vehicles [,
9 TRAILERS, OR SEMI-TRAILERS] shall, as a condition to engaging in business in
10 the state, register biennially with the **department** [DEPARTMENT OF
11 ADMINISTRATION].
12 *** Sec. 2.** AS 08.66.030 is amended to read:
13 **Sec. 08.66.030. Form of application.** The **department** [DEPARTMENT OF

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New Text Underlined [DELETED TEXT BRACKETED]

1 ADMINISTRATION] shall prescribe and furnish the form of application for dealer
2 registration **under AS 08.66.010**. The application must contain
3 (1) the name under which the business is conducted;
4 (2) the location of **the** business;
5 (3) the name and address of all persons having an interest in the
6 business and, in the case of a corporation, the application shall contain the name and
7 address of the two principal officers;
8 (4) the name and make of all vehicles handled;
9 (5) **a statement of** whether or not used vehicles are handled;
10 (6) a statement that the applicant is a bona fide dealer in motor
11 vehicles [, TRAILERS, OR SEMI-TRAILERS] with an established business at the
12 location given;
13 (7) if the applicant sells a motor vehicle as a new or current model
14 motor vehicle having a manufacturer's warranty, the name of the manufacturer of the
15 motor vehicle and the date and duration of the applicant's sales and service agreement
16 with the manufacturer; **and**
17 (8) other information the **department** [DEPARTMENT OF
18 ADMINISTRATION] requires to administer **this chapter** [AS 08.66.010 -
19 08.66.090].
20 *** Sec. 3.** AS 08.66.040 is amended to read:
21 **Sec. 08.66.040. Filing application for registration.** The application shall be
22 filed with the **department** [DEPARTMENT OF ADMINISTRATION]. Upon receipt
23 of the application, the department shall examine it and may make an investigation of
24 the information in it. If the department is satisfied that the dealer is entitled to
25 registration, and the fees have been paid and a bond filed, the department shall assign
26 a distinctive registration number to the dealer and file the dealer's application and
27 index it alphabetically and numerically. A dealer is registered when the department
28 assigns a registration number.
29 *** Sec. 4.** AS 08.66.050 is amended to read:
30 **Sec. 08.66.050. Renewal of registration.** A dealer shall renew the
31 registration required by **this chapter** [AS 08.66.010 - 08.66.090] before January 1

every two years.

*** Sec. 5.** AS 08.66.060 is repealed and reenacted to read:

Sec. 08.66.060. Bond. (a) An applicant for a dealer registration under AS 08.66.010 shall file with the application and shall maintain in force while registered a bond in favor of the state that is executed by a surety approved by the commissioner. The amount of the bond shall be $50,000, except that the amount of a bond for a dealer who sells only motorcycles shall be $25,000. The bond must be conditioned on the dealer's

(1) doing business in compliance with this chapter and the other laws of this state; and

(2) not committing fraud or making fraudulent representations in the course of doing business as a dealer.

(b) A surety may cancel the bond required by (a) of this section by giving notice in writing to the commissioner or the commissioner's designee. However, cancellation does not relieve a surety of liability arising before cancellation or a liability that has accrued on the bond before cancellation. The commissioner or the commissioner's designee shall retain the canceled bond on file and may not relieve a surety of a liability arising before cancellation or accruing on the bond before cancellation.

(c) A bond filed under (a) of this section is valid for renewal of a dealer registration unless the surety has provided a written notice of cancellation to the commissioner.

(d) In this section, "commissioner" means the commissioner of administration.

*** Sec. 6.** AS 08.66.070 is amended to read:

Sec. 08.66.070. Action on bond. If a person suffers loss or damage by reason of fraud, fraudulent representations, or **a** violation of **a** [ANY] provision of **this chapter or another law of this state** [AS 08.66.010 - 08.66.090] by a dealer, the person has a right of action against the dealer and a personal right of action against the surety upon the bond. The aggregate liability of the surety **may** [DOES] not exceed the amount of the bond.

*** Sec. 7.** AS 08.66.080 is amended to read:

1 Sec. 08.66.080. **Penalties.** A dealer who fails to register and file a bond as
2 required by **<u>this chapter</u>** [AS 08.66.010 - 08.66.090] is guilty of a violation. A dealer
3 who knowingly violates a provision of **<u>this chapter</u>** [AS 08.66.010 - 08.66.090] is
4 guilty of a class A misdemeanor.
5 * **Sec. 8.** AS 08.66.090 is repealed and reenacted to read:
6 **Sec. 08.66.090. Definitions.** In this chapter,
7 (1) "dealer" means a person who sells, leases, solicits, brokers, or
8 arranges for sale or lease of five or more new or used motor vehicles in any 12
9 consecutive months, regardless of who owns the vehicles; "dealer" does not include
10 (A) a receiver, a trustee, an administrator, an executor, a
11 guardian, or another person appointed by a court or a person performing duties
12 as a public officer;
13 (B) a person disposing of a motor vehicle acquired and actually
14 used for the person's own use or for the use of a family member of the person,
15 or acquiring a motor vehicle for the person's own use or for the use of a family
16 member of the person if the vehicle is acquired and used in good faith and not
17 for the purpose of avoiding the provisions of this chapter;
18 (C) a person who sells motor vehicles as an incident of the
19 person's principal business but who is not engaged primarily in the selling of
20 motor vehicles;
21 (D) an employee of an organization arranging for the purchase
22 or lease by the organization of a vehicle for use in the organization's business;
23 (E) a publication, broadcast, or other communications media
24 when engaged in the business of advertising, but not otherwise arranging for
25 the sale of a motor vehicle owned by another person;
26 (2) "department" means the Department of Administration;
27 (3) "motor vehicle" means a motor vehicle that is required to be
28 registered under AS 28.10.
29 * **Sec. 9.** AS 45 is amended by adding a new chapter to read:
30 **Chapter 25. Motor Vehicle Transactions.**
31 **Article 1. Applicability; Venue; Corporate Affiliates.**

1 Sec. 45.25.010. **Applicability.** The provisions of this chapter are remedial
2 and apply to a contract, including a franchise, between a manufacturer and its dealers
3 in this state.
4 Sec. 45.25.020. **Jurisdiction; choice of law.** The courts of this state have
5 jurisdiction over a legal dispute between a manufacturer located in or outside this state
6 and a dealer located in this state, and the dispute is governed by and interpreted and
7 adjudicated under the law of this state.
8 Sec. 45.25.030. **Corporate affiliates.** (a) A manufacturer may not use a
9 subsidiary corporation, affiliated corporation, partnership, association, or other person
10 to accomplish what would otherwise be prohibited for the manufacturer under this
11 chapter.
12 (b) This section does not limit the right of a person included within the scope
13 of this section to engage in reasonable and appropriate business practices consistent
14 with an existing trade practice that is not prohibited by this chapter.
15 **Article 2. Franchise Agreements.**
16 Sec. 45.25.100. **Consistency with state law.** The terms and conditions in a
17 motor vehicle franchise agreement that are inconsistent with the law of this state do
18 not have any force or effect.
19 Sec. 45.25.110. **Termination of franchise agreements.** (a) A manufacturer
20 may not terminate a franchise with a new motor vehicle dealer unless the manufacturer
21 has
22 (1) satisfied the notice requirements of this chapter;
23 (2) shown that there is good cause for the termination of the franchise;
24 and
25 (3) acted in good faith and, if the reasons underlying the good cause
26 can be corrected by the dealer, the dealer has failed for 60 days after delivery of the
27 notice required by AS 45.25.120 to make the corrections.
28 (b) Notwithstanding (a) of this section, a manufacturer may not terminate a
29 franchise agreement because of the death or incapacity of an owner if the owner is not
30 listed in the franchise as one on whose expertise and abilities the manufacturer relied
31 in the granting of the franchise.

1 **Sec. 45.25.120. Notice of termination.** (a) A manufacturer shall furnish a
2 notice of termination of a franchise agreement to a new motor vehicle dealer at least
3 (1) 90 days before the effective date of a termination, except as
4 required under (2) or (3) of this subsection;
5 (2) 15 days before the effective date of a termination when the new
6 motor vehicle dealer
7 (A) is insolvent or is the subject of a bankruptcy or receivership
8 proceeding;
9 (B) has failed to conduct its customary sales and service
10 operations during its customary business hours for seven consecutive business
11 days; this subparagraph does not apply to closures due to acts of God or
12 circumstances beyond the direct control of the new motor vehicle dealer; or
13 (C) is convicted of a felony involving moral turpitude or fraud
14 under the law of this state, another state, a territory, or the District of
15 Columbia;
16 (3) 180 days before the effective date of the termination if the
17 manufacturer or distributor is discontinuing the sale of the product line.
18 (b) Notice required under (a) of this section must be in writing, shall be sent
19 by certified mail or personally delivered to the new motor vehicle dealer, and must
20 contain
21 (1) a statement of intention to terminate the franchise;
22 (2) a statement of the reasons for the termination; and
23 (3) the date on which the termination takes effect.
24 **Sec. 45.25.130. Threat of termination.** A manufacturer or manufacturer
25 representative may not coerce or attempt to coerce a dealer to enter into an agreement
26 with the manufacturer or a subsidiary of the manufacturer, or to do any other act unfair
27 to the dealer, by threatening to terminate a franchise agreement between the
28 manufacturer or subsidiary of the manufacturer and the dealer.
29 **Sec. 45.25.140. Required manufacturer purchase of inventory and other**
30 **items at termination.** (a) If a franchise agreement with a new motor vehicle dealer is
31 terminated by a manufacturer, the manufacturer shall purchase the dealer's

1 (1) inventory consisting of new motor vehicles that have been acquired
2 from the manufacturer within the preceding 24 months at a price not less than the
3 original manufacturer's price to the dealer, if the motor vehicles have not been altered
4 or damaged, the motor vehicles have not been driven more than 200 miles, and
5 certificates of title have not been issued;
6 (2) unused, undamaged, and unsold parts purchased from the
7 manufacturer or a supplier approved or required by the manufacturer at a price not less
8 than the manufacturer's or approved supplier's current price to the dealer, if the parts
9 are currently offered for sale by the manufacturer or a supplier in a current parts
10 catalog and are in salable condition;
11 (3) equipment, signs, and furnishings that have not been altered or
12 damaged and that the manufacturer required the dealer to be purchased from the
13 manufacturer or an approved source at fair market value; and
14 (4) special tools that have not been altered or materially damaged and
15 that the manufacturer or distributor required the dealer to purchase from the
16 manufacturer or distributor or an approved source at fair market value within five
17 years immediately preceding the termination of the franchise.
18 (b) The manufacturer shall make the payment for the purchase under (a) of
19 this section within 90 days after the effective date of the termination if the new motor
20 vehicle dealer has clear title to the inventory and has conveyed title and possession of
21 all compensable items to the manufacturer.
22 **Sec. 45.25.150. Required manufacturer compensation for dealer facilities.**
23 (a) If a manufacturer terminates a franchise agreement with a new motor vehicle
24 dealer, the manufacturer shall compensate the dealer for dealer facilities as follows:
25 (1) if the dealer is leasing the facilities from a lessor other than the
26 manufacturer, the manufacturer shall pay the new motor vehicle dealer a sum equal to
27 the rent for the unexpired term of the lease or two years' rent, whichever is less, or a
28 longer term as is provided in the franchise agreement between the dealer and
29 manufacturer; or
30 (2) if the dealer owns the facilities, the manufacturer shall pay the new
31 motor vehicle dealer a sum equal to the reasonable rental value of the dealer facilities

for two years.

(b) This section does not relieve a dealer of the obligation to mitigate damages under a lease, prevent a manufacturer from occupying and using the dealer facilities while paying rent, or preclude a manufacturer from negotiating a lease termination, sublease, or new lease.

(c) This section does not apply if the termination of the franchise agreement is the result of the dealer's

(1) voluntary act;

(2) insolvency; or

(3) conviction of a felony involving moral turpitude or fraud.

(d) In this section, "dealer facilities" means the real estate, buildings, fixtures and improvements devoted to the conduct of business under a new vehicle franchise or in the conduct of a used vehicle business.

Sec. 45.25.160. Prevention or refusal to honor transfer of dealership ownership. A manufacturer may not unreasonably prevent or refuse to honor a transfer of ownership of a dealership.

Sec. 45.25.170. Notice and objection regarding transfer. (a) If a new motor vehicle dealer proposes to sell or otherwise transfer the ownership of the dealership, the dealer shall give the manufacturer written notice that identifies the dealer's proposed transferee and general information on the financial ability and qualifications of the proposed transferee.

(b) If the manufacturer objects to the proposed transferee, the manufacturer may send the owner and the proposed transferee notice of the objection, by registered or certified mail, return receipt requested. A notice of objection must state in detail all facts that constitute the basis for the objection. Failure by the manufacturer to send a notice of objection within 30 days after receiving the dealer's notice or within 10 days after the manufacturer receives from the proposed transferee the information requested under AS 45.25.180, whichever is later, constitutes a waiver by the manufacturer of any right to object to the proposed transferee.

Sec. 45.25.180. Right to additional information. A manufacturer, upon receipt of written notice from a dealer of the identity of the dealer's proposed

1 transferee, may require within the 30 days allowed under AS 45.25.170(b) for an
2 objection that the proposed transferee promptly provide personal and financial data
3 reasonably necessary to determine the financial ability and qualifications of the
4 proposed transferee.
5 **Sec. 45.25.190. Intervening death or incapacity.** If a dealer dies or becomes
6 incapacitated before a manufacturer receives notice of the identity of the dealer's
7 proposed transferee and the proposed transferee is a family member of the dealer, the
8 existing franchise agreement remains in effect, and the proposed transferee succeeds
9 to all of the dealer's rights and obligations in the dealership and under the franchise
10 agreement.
11 **Sec. 45.25.200. Manufacturer's right of first refusal.** In the event of a
12 proposed sale or other transfer of a franchised dealership to a person other than the
13 manufacturer who granted the franchise, the manufacturer may not exercise a right of
14 first refusal to acquire the dealership or dealership assets if the proposed sale or
15 transfer is conditioned on the manufacturer's or dealer's entering into a franchise
16 agreement with the proposed new owner or other transferee unless
17 (1) the manufacturer notifies the dealer in writing within 30 days of the
18 manufacturer's receipt of a completed proposal for the proposed sale or other transfer;
19 (2) the exercise of the right of first refusal results in the dealer
20 receiving the same consideration as or greater consideration than the dealer contracted
21 to receive for the proposed sale or other transfer;
22 (3) the proposed sale or transfer does not involve the sale or other
23 transfer to
24 (A) a family member of the dealer;
25 (B) a qualified manager;
26 (C) a person who has been employed continuously by the
27 dealer for at least 10 years; or
28 (D) a person, other than an individual, controlled by a person
29 described in (A) - (C) of this paragraph; and
30 (4) the manufacturer agrees to pay the reasonable expenses, including
31 attorney fees that do not exceed the usual, customary, and reasonable fees charged for

1 similar work done for other clients incurred by the proposed purchaser or transferee
2 before the manufacturer's exercise of the right of first refusal in negotiating and
3 implementing the contract for the proposed sale or other transfer; however, the
4 payment is not required if the dealer has not submitted or caused to be submitted an
5 accounting of the expenses within 30 days of the dealer's receipt of the manufacturer's
6 written request for the accounting; a manufacturer may request an accounting before
7 exercising the right of first refusal.
8 **Sec. 45.25.210. Unreasonable restrictions.** A manufacturer or manufacturer
9 representative may not directly or indirectly impose unreasonable restrictions on a
10 dealer relating to the transfer or sale of the dealership, by stock transfer or otherwise,
11 or to the transfer, sale, or assignment of a dealer franchise. In this section,
12 "unreasonable restrictions" includes restricting a dealer's right to renew a franchise,
13 unreasonable termination of a franchise, unreasonable discipline of a dealer,
14 noncompetition covenants, site-control agreements, the right of first refusal to
15 purchase agreements, option to purchase agreements, and unreasonable requirements
16 to comply with subjective manufacturer standards.
17 **Article 3. Manufacturer Practices.**
18 **Sec. 45.25.300. Orders and deliveries.** (a) A manufacturer or manufacturer
19 representative may not coerce or attempt to coerce a dealer to accept delivery of a
20 motor vehicle, motor vehicle parts or accessories, or another commodity, that has not
21 been ordered by the dealer.
22 (b) A manufacturer may not require, coerce, or attempt to coerce a new motor
23 vehicle dealer to
24 (1) order or accept delivery of a new motor vehicle with special
25 features, accessories, or equipment not included in the list price of the motor vehicles
26 as publicly advertised by the manufacturer; or
27 (2) purchase or order a new motor vehicle as a precondition of
28 purchasing, ordering, or receiving other new motor vehicles; this paragraph does not
29 prevent a manufacturer from requiring that a new motor vehicle dealer fairly represent
30 and maintain an inventory of the full line of new motor vehicles that are covered by
31 the franchise agreement.

Sec. 45.25.310. Promotions. A manufacturer may not require, coerce, or attempt to coerce a new motor vehicle dealer to

(1) participate monetarily in an advertising campaign or contest, or to purchase unnecessary or unreasonable quantities of any promotional materials, training materials, training programs, or showroom or other display decorations or materials at the expense of the new motor vehicle dealer; this paragraph does not preclude a manufacturer from including an unitemized uniform charge in the base price of a new motor vehicle charged to the dealer, unless the charge is attributable to advertising costs incurred or to be incurred by the manufacturer in the ordinary course of its business, if the uniform charge is in effect for vehicles sold to dealers in all other states; or

(2) participate in a manufacturer's national or regional marketing promotion that arbitrarily and adversely economically affects the dealer.

Sec. 45.25.320. Capital structure and financing changes. A manufacturer may not require, coerce, or attempt to coerce a new motor vehicle dealer to change the capital structure of the new motor vehicle dealer or the means by or through which the new motor vehicle dealer finances the operation of the dealership if the dealer at all times meets any reasonable capital standards determined by the manufacturer under uniformly applied criteria.

Sec. 45.25.330. Additional new motor vehicle line. A manufacturer may not require, coerce, or attempt to coerce a new motor vehicle dealer to refrain from participation in the management of, investment in, or acquisition of another line of new motor vehicles or related products.

Sec. 45.25.340. Dealership location and facilities. A manufacturer may not require, coerce, or attempt to coerce a new motor vehicle dealer to change the location of the dealership, or to make any substantial alterations to the dealership premises or facilities if the change or alteration would be unreasonable or if there is not a sufficient supply of new motor vehicles to justify the expansion in light of the current market and economic conditions.

Sec. 45.25.350. Release or referral. A manufacturer may not require, coerce, or attempt to coerce a new motor vehicle dealer to assent before the occasion arises to

a release, assignment, novation, waiver, or estoppel that would relieve a person from liability to be imposed by law or to require a controversy between a new motor vehicle dealer and a manufacturer to be referred to a person other than a court if the referral would be binding on the dealer.

Sec. 45.25.360. Prices and charges. (a) A manufacturer may not require, coerce, or attempt to coerce a new motor vehicle dealer to

(1) sell a new motor vehicle at a minimum or maximum price that has been fixed by the manufacturer;

(2) pay more for a delivery or destination charge than for a delivery or destination charge in the contiguous United States if the manufacturer has an equalized delivery or destination charge in the contiguous United States; or

(3) offer or adhere to menu prices set by the manufacturer for service, parts, or accessories.

(b) A manufacturer may not increase the price of a new motor vehicle that a new motor vehicle dealer has ordered and that the manufacturer has accepted for immediate delivery for private retail or private commercial consumers before the new motor vehicle dealer receives the manufacturer's written official price increase notification. A sales contract signed by a private retail consumer or a purchase order signed by a private commercial customer constitutes evidence of an order if the vehicle is in fact delivered to that customer. Price differences applicable to new models or series may not be considered a price increase or price decrease. This subsection does not apply to price changes resulting from the addition to a new motor vehicle of required or optional equipment, revaluation of the United States dollar, in the case of foreign-make vehicles or components, an increase in transportation charges due to increased rates imposed by carriers, or new tariffs or duties imposed by the United States or another governmental authority.

(c) A manufacturer may not vary the price charged to a franchised new motor vehicle dealer located in this state for new motor vehicles or the reimbursement paid to a franchised new motor vehicle dealer for parts and labor reimbursement for warranty, policy, or service contract repairs based on the dealer's (1) purchase of new facilities, supplies, tools, equipment, or other merchandise from the manufacturer; (2)

1 relocation, remodeling, repair, or renovation of an existing dealership or construction
2 of a new facility; or (3) participation in training programs sponsored, endorsed,
3 recommended, or required by the manufacturer. This subsection does not preclude a
4 manufacturer from establishing sales contests or promotions that are of limited
5 duration and that provide or award dealers or consumers a rebate or incentive, or
6 prohibit a manufacturer from providing assistance or encouragement to a franchised
7 dealer to remodel renovate, recondition, or relocate the dealer's existing facilities, if
8 the assistance, encouragement, or reward is not determined on a per vehicle basis.
9 (d) For the purposes of (c) of this section, the price of a vehicle includes the
10 manufacturer's use of rebates, credits, or other consideration that has the effect of
11 causing a variance in the price of a new motor vehicle offered to a franchised dealer
12 located in the state.
13 **Sec. 45.25.370. Electronic deliveries and sales.** A manufacturer may not
14 require, coerce, or attempt to coerce a new motor vehicle dealer to deliver new motor
15 vehicles or otherwise participate in a plan where the manufacturer sells new vehicles
16 directly or through a subsidiary to a customer through electronic or other means.
17 **Sec. 45.25.380. Dealer-obligor service contracts.** A manufacturer may not
18 sell or offer to sell dealer-obligor service contracts.
19 **Sec. 45.25.390. Delivery of motor vehicles, parts, and accessories.** (a) A
20 manufacturer may not, within a reasonable time after receipt of a retail order from a
21 dealer having a franchise for the retail sale of a new motor vehicle sold or distributed
22 by the manufacturer or distributor, delay, refuse, or fail to deliver motor vehicles or
23 motor vehicle parts or accessories in reasonable quantities relative to the dealer's
24 facilities and sales potential in the dealer's market area. The delivery to another dealer
25 of a motor vehicle of the same model as and similarly equipped to the vehicle ordered
26 by a motor vehicle dealer who has not received delivery but who has placed a written
27 order for the vehicle before the order of the dealer receiving the vehicle is evidence of
28 a delayed delivery of or refusal to deliver a new motor vehicle to a new motor vehicle
29 dealer within a reasonable time.
30 (b) This section does not apply to a delay or refusal caused by acts beyond the
31 control of the manufacturer.

(g) In this section, "retail order" means an order placed for a buyer who is not a motor vehicle dealer franchised to sell the same line-make.

Sec. 45.25.400. Disclosure. (a) A manufacturer shall, upon request, disclose to a new motor vehicle dealer handling a line-make the manner and mode of allocation and distribution of that line-make within the state.

(b) A manufacturer may not require, coerce, or attempt to coerce a dealer to disclose to the manufacturer information concerning a customer or a third party if the customer or third party objects or the disclosure is otherwise unlawful.

(c) A manufacturer may not release to an outside party, except under subpoena or as otherwise required by law, confidential business, financial, or personal information that may be provided by a new motor vehicle dealer to the manufacturer, without the express written consent of the new motor vehicle dealer.

Sec. 45.25.410. Vehicles in transit. A manufacturer may not count a vehicle that is still in transit between the manufacturing or assembly plant and a new motor vehicle dealer as a vehicle available for sale or in the dealer's supply of vehicles for sale if counting that vehicle as available for sale or in the dealer's supply adversely affects a system under which the manufacturer allocates vehicles to its dealers in other states.

Sec. 45.25.420. Certification. A manufacturer may not require certification of

(1) any classification of employee of a dealer in this state for a job-related function or reimbursement unless the manufacturer provides in this state the same or greater frequency, level, quality, and type of training for a dealer or dealership employee in this state that it provides for dealers and dealership employees in other states; or

(2) a dealer or a dealership employee for a job function if the certification requirement would adversely affect a motor vehicle owner's or lessee's receiving prompt warranty or service contract repairs at the closest possible franchised dealership facility or dealer subcontractor facility.

Sec. 45.25.430. Awards to employees. A manufacturer may not award money, goods, services, or any other benefit to an employee of a new motor vehicle

1 dealer, either directly or indirectly, unless the benefit is promptly accounted for and
2 transmitted to, or approved by, the new motor vehicle dealer.
3 **Sec. 45.25.440. Compensation for dealership.** A manufacturer may not
4 prevent or attempt to prevent a dealer from receiving fair and reasonable
5 compensation for the value of a franchised dealership.
6 **Sec. 45.25.450. Requiring transfer of interest.** A manufacturer may not
7 require, coerce, or attempt to coerce a new motor vehicle dealer to sell, transfer, or
8 otherwise issue stock or other ownership interest in the dealership to a general
9 manager or other person involved in the management of the dealership other than the
10 dealer principal or dealer operator named in the franchise, unless the dealer principal
11 or dealer operator is an absentee owner who is not involved in the operation or
12 management of the dealership on a regular basis.
13 **Sec. 45.25.460. Legal fees and costs.** A manufacturer may not require that, in
14 a civil or administrative proceeding in which a new motor vehicle dealer asserts a
15 claim, right, or defense arising under this chapter or under the franchise, the dealer or
16 a nonprevailing party compensate the manufacturer or prevailing party for court costs,
17 attorney fees, or other expenses incurred in litigation.
18 **Sec. 45.25.470. Conditions for receiving vehicles.** (a) A manufacturer may
19 not require that a franchised new motor vehicle dealer located in this state pay an extra
20 fee, purchase unreasonable or unnecessary quantities of advertising displays or other
21 materials, or remodel, renovate, or recondition the dealer's existing facilities in order
22 to receive a particular model or series of vehicles manufactured or distributed by the
23 manufacturer for which the dealer has a valid franchise.
24 (b) This section does not prohibit or prevent a manufacturer from requiring
25 that a franchised dealer located in this state purchase special tools or equipment, stock
26 reasonable quantities of certain parts, or participate in training programs that are
27 reasonably necessary for the dealer to sell or service a model or series of motor
28 vehicles.
29 **Sec. 45.25.480. Separate agreements.** A manufacturer may not require a
30 separate dealer agreement with a new motor vehicle dealer already a party to a dealer
31 agreement with the manufacturer for the retail sale or leasing of a particular new

1 motor vehicle model made or distributed by the manufacturer or restrict the right of a
2 dealer to sell all products marketed under the trademark for which the dealer has a
3 valid franchise.
4 **Sec. 45.25.490. Claims.** (a) A manufacturer shall pay a claim made by the
5 manufacturer's franchised dealer for compensation for sales incentives, delivery,
6 preparation, warranty repairs, transportation claims, recall work, and service contract
7 repairs, including labor, parts, rental vehicle reimbursement, and other covered
8 expenses, within 30 days after receipt of a claim from the dealer. If a claim is
9 disapproved, the dealer shall be notified in writing of the grounds for disapproval. A
10 claim not specifically disapproved in writing within 30 days after receipt is considered
11 approved and payment is due immediately.
12 (b) A dealer's failure to comply with the specific requirements of the
13 manufacturer for processing the claim does not constitute grounds for denial of the
14 claim or reduction of the amount of compensation to the dealer as long as reasonable
15 documentation or other evidence has been presented to substantiate the claim.
16 (c) A claim that has been approved and paid may not be charged back to the
17 dealer unless it can be shown that the claim was false or fraudulent, that the repairs
18 were not properly made according to industry standards or were unnecessary to correct
19 the defective condition, or that the dealer failed to reasonably substantiate the repairs.
20 (d) A manufacturer or distributor may not deny a claim, reduce the amount to
21 be reimbursed to the dealer, or charge back a portion of the claim if 12 or more
22 months have passed since the claim was submitted, or if the dealer has provided
23 reasonably sufficient documentation that the dealer made a good faith attempt to
24 perform the work in compliance with the written policies and procedures of the
25 manufacturer and actually performed the work.
26 **Sec. 45.25.500. Exports and chargebacks.** (a) A dealer may not be charged
27 back or otherwise held liable for sales incentives or charges related to motor vehicles
28 sold by the dealer and subsequently exported if the dealer can demonstrate that the
29 dealer exercised due diligence and that the sale was made in good faith and without
30 knowledge of the purchaser's intention to export the motor vehicle.
31 (b) A manufacturer may not process a chargeback against a dealer without

first providing the dealer with a detailed list of specific policies the dealer has violated and a detailed explanation of the policy or procedure the dealer should have followed to avoid the chargeback.

(4) A manufacturer or administrator may not contract with a person to audit a dealer in this state for compliance with any of the manufacturer's policies or procedures if the auditor's compensation is in any way based on the amount charged back to the dealer or recovered from the dealer.

Article 4. Dealer Practices.

Sec. 45.25.600. Prohibited use of term. A motor vehicle dealer may not use the word "invoice" in an advertisement for the sale of a motor vehicle, unless

(1) the advertisement contains the following statement: "A factory invoice may not reflect factory holdbacks or rebates paid to the dealer"; and

(2) the word "invoice," as used by the motor vehicle dealer, means the itemized statement that a manufacturer sends to the dealer that clearly defines the make, model, model year, and vehicle identification number of the vehicle shipped to the dealer, that identifies all factory installed accessories, and that states the amount originally charged to the dealer by the manufacturer for the vehicle delivered to the dealer's principal place of business.

Sec. 45.25.610. Refusal to sell on advertised terms. A dealer may not refuse to sell a motor vehicle under the terms or conditions that the dealer has advertised. This section does not apply if

(1) the dealer can document that the advertised term was the result of an error on the part of the advertising medium or an outside advertising agent; or

(2) the refusal is based on an error that was made in good faith by the dealer and was clearly and conspicuously a mistake, and the dealer corrected the error as soon as the dealer knew or reasonably should have known of the error.

Sec. 45.25.620. Advertised price. A dealer may not

(1) advertise a selling price for a motor vehicle that does not include all internal dealer fees in the advertised selling price; or

(2) use the word "free" or a similar term in connection with the purchase of a vehicle whose price is arrived at through bargaining or when the offer is

1 contingent on purchasing something whose price is marked up to recover all or part of
2 the cost of the "free" merchandise.
3 **Sec. 45.25.630. Advertised comparisons.** (a) A dealer may not advertise a
4 comparison with a manufacturer's suggested retail price, unless the
5 (1) advertised price is in fact the manufacturer's suggested retail price
6 listed on the monroney sticker, including accessories and options physically attached
7 to the motor vehicle at the time of delivery to the dealer and any charge to the dealer
8 for transportation to the dealer, after all manufacturer discounts and manufacturer
9 savings listed on the monroney sticker have been deducted;
10 (2) advertised manufacturer's suggested retail price does not include
11 any charges added by the dealer;
12 (3) advertised manufacturer's suggested retail price is referred to as the
13 "manufacturer's suggested retail price" or "MSRP";
14 (4) advertisement clearly and conspicuously discloses that the
15 manufacturer's suggested retail price is a price set by the manufacturer and does not
16 necessarily reflect the price actually paid by consumers in the trade area; and
17 (5) advertisement does not otherwise conflict with or detract from a
18 requirement or disclosure under (1) - (4) of this section.
19 (b) In this section, "monroney sticker" means the window sticker required by
20 15 U.S.C. 1231 - 1233 (Automobile Information Disclosure Act).
21 **Sec. 45.25.640. Advertised discounts.** A dealer may not advertise a discount
22 offered by the manufacturer, including a manufacturer rebate or other reduction in
23 price offered by the manufacturer, without disclosing that the manufacturer is the
24 source of the discount.
25 **Sec. 45.25.650. Identification number plates.** A dealer may not knowingly
26 purchase or sell a vehicle that has an altered or removed vehicle identification number
27 plate, or alter or remove a vehicle identification number plate.
28 **Sec. 45.25.660. Required documentation.** A dealer shall hold a
29 manufacturer's statement of origin, a title, or a properly executed consignment
30 agreement for a vehicle when the dealer displays the vehicle for sale or exchange or
31 sells the vehicle.

1 Sec. 45.25.670. **Trade-ins.** A dealer may not transfer title to a trade-in
2 vehicle or perform any repairs or reconditioning to a trade-in vehicle before the
3 completion of the sales transaction for which the vehicle is a trade-in.
4 **Article 5. Warranties and Service.**
5 **Sec. 45.25.700. Written specifications.** A motor vehicle manufacturer or
6 manufacturer's subsidiary shall specify in writing to each of its motor vehicle dealers
7 in this state the dealer's obligations for preparation, delivery, warranty, and service
8 contract service on its products or the products it covers, the schedule of compensation
9 to be paid to a dealer for parts, work, and service in connection with warranty service,
10 recall service, and service contract service or maintenance that is the responsibility of
11 the manufacturers, and the time allowances for the performance of warranty work and
12 service.
13 **Sec. 45.25.710. General payment requirement.** In addition to any other
14 payment under this chapter for warranty work, a manufacturer shall pay its dealer for
15 a category of warranty repair or service contract repair that was actually performed by
16 the dealer in this state for the line-make of vehicle for which the dealer has a franchise
17 if the repair was covered by the manufacturer's warranty or service contract at any
18 other dealership that has a franchise to sell that line-make of motor vehicle in this state
19 or in a majority of the other 49 states of the United States.
20 **Sec. 45.25.720. Compensation for diagnostic work.** A schedule of warranty
21 or service contract compensation must include reasonable compensation for diagnostic
22 work, whether or not a problem is found when it has been reported by the owner, and,
23 in addition to repair service and labor, for the labor required to complete and transmit
24 warranty and service contract claims and to transmit any substantiating
25 documentation.
26 **Sec. 45.25.730. Service time allowances.** When warranty work or service
27 contract work is performed, a manufacturer shall provide reasonable and adequate
28 service time allowances for the work to be performed, and the allowances must be
29 equal to the allowances published in the manufacturer's labor time standard manual or
30 another industry-wide recognized labor time guide manual for repairs performed by
31 experienced automotive technicians using hand tools, whichever is greater. When

1 reasonable compensation is determined under this section, the factors to be given
2 consideration must include the compensation paid by other manufacturers to their
3 dealers, the retail price dealers charge their retail customers for parts used to perform
4 similar work and paid to dealers for parts, and the prevailing wage rates, including
5 employment benefits, being paid by dealers and the prevailing retail labor rate posted
6 by dealers in the community in which the dealer is doing business if the prevailing
7 rates and prices are not unreasonable.

8 **Sec. 45.25.740. Verification of complaints.** If a motor vehicle that is covered
9 by a manufacturer's warranty or service contract is brought to a dealer and the owner
10 describes a concern that, if verified, could reasonably lead to a covered warranty or
11 service contract repair, the dealer shall make a diligent and reasonable attempt to
12 verify the owner's complaint, and the manufacturer or administrator shall reimburse
13 the dealer for the actual diagnosis time spent at the dealer's current warranty labor rate,
14 whether or not a covered defect or failure is diagnosed. If, after a reasonable effort,
15 the dealer is unable to verify the owner's complaint, the dealer shall notify the owner
16 in writing of the diagnostic steps performed and the diagnostic results.

17 **Sec. 45.25.750. Compensation of repairing franchisee.** When a motor
18 vehicle that is covered by a manufacturer's warranty or service contract is brought to a
19 dealer that has a franchise to sell the line-make of motor vehicles in this state, if the
20 dealer determines a motor vehicle covered by the franchise has a nonconformity
21 covered by the manufacturer's warranty or a necessary repair covered by the
22 manufacturer's service contract, and if the dealer subsequently fixes the nonconformity
23 or performs the covered repair, the manufacturer shall pay the dealer for the labor
24 associated with fixing the nonconformity or performing the covered repair.

25 **Sec. 45.25.760. Compensation for manufacturer or administrator**
26 **requirements.** (a) If a manufacturer or an administrator requires a franchised dealer
27 to perform a diagnostic task that leads to, could reasonably lead to, or confirms
28 completion of a repair covered by a warranty or service contract, the manufacturer or
29 administrator shall reimburse the franchised dealer for the actual diagnosis time at the
30 dealer's current warranty labor rate, and the labor shall be considered labor over and
31 above the labor that is included in an applicable published labor time standard or that

1 was performed by the repairing technician.

2 ([illegible]) If a manufacturer or an administrator requires a dealer or dealership
3 employee to obtain prior approval before performing a repair covered by a warranty or
4 service contract, the manufacturer or administrator shall reimburse the dealer at the
5 dealer's normal warranty labor rate for the actual time spent by a dealership employee
6 to obtain the prior approval.

7 ([illegible]) If a manufacturer or an administrator requires a dealer or dealership
8 employee to contact factory personnel in order to obtain unpublished diagnostic
9 processes or repair procedures or to clarify diagnostic processes or repair procedures,
10 the manufacturer or administrator shall reimburse the dealer at the dealer's normal
11 warranty labor rate for the actual time spent by a dealership employee to obtain the
12 information.

13 ([illegible]) If a manufacturer or an administrator requires a dealer to transmit digital
14 images, video images, photographs, documents, or other material to the manufacturer
15 for prior approval of warranty or service contract repairs, the manufacturer shall
16 reimburse the dealer for the actual cost of transmitting the material.

17 **Sec. 45.25.770. Timely performance.** (a) A motor vehicle manufacturer or
18 manufacturer's subsidiary shall timely

19 (1) perform, and, through a policy or procedure, may not cause a
20 dealer to be unable to timely perform a manufacturer's warranty obligations with
21 respect to a motor vehicle that the dealer has a franchise to sell; or

22 (2) compensate its motor vehicle dealers for warranty parts at the
23 prevailing retail rate according to the requirements or other factors set out in this
24 section, or under the schedule of compensation provided the dealer described in this
25 chapter.

26 (b) A new vehicle manufacturer or manufacturer's subsidiary shall commence
27 and complete repairs or maintenance covered by a new vehicle warranty or service
28 plan as quickly as possible and without unreasonable delay.

29 **Sec. 45.25.780. Indemnification.** A manufacturer or manufacturer's
30 subsidiary shall indemnify and hold harmless its franchised dealers against a court
31 judgment for damages or a settlement agreed to by the manufacturer, including court

costs and reasonable attorney fees of the motor vehicle dealer, arising out of a complaint, claim, or court action relating to the alleged defective negligent manufacture, assembly, or design or a new motor vehicle, part, or accessory, or to other functions by the manufacturer, factory branch, distributor, or distributor branch, beyond the control of the dealer.

Sec. 45.25.790. Repair of air emission related components. A dealer or repair facility may not repair or replace an air emission related component on a motor vehicle that requires emission certification without performing, once the repair is complete, an emission test to verify that the repair is effective. A manufacturer or administrator may not refuse to fully reimburse a dealer at the dealer's current hourly warranty rate for performance of an emission test required under this section for a repair or replacement that is covered by an emission defect warranty, other warranty, or service contract.

Sec. 45.25.800. Power train requirements. A dealer or repair facility may not repair or replace a power train component on a motor vehicle that is operated in this state without performing, once the repair is complete, the necessary test to confirm that the repaired or replaced component is operating within the manufacturer's specifications. A manufacturer or administrator may not refuse to reimburse a dealer at the dealer's current hourly warranty rate for performance of the test required under this section to confirm that a repaired or replaced power train component covered by a warranty or service contract is operating within the manufacturer's specifications.

Sec. 45.25.810. Provision of alternate transportation. (a) A motor vehicle manufacturer or administrator shall provide, at the manufacturer's expense, reasonable alternate transportation for an owner whose vehicle is covered by an express warranty or an authorized service plan if

(1) the vehicle is unsafe or inoperable and has been brought to a franchised dealer or to a subcontracting repair facility working in cooperation with the franchised dealer;

(2) covered repairs cannot begin the same working day because of the decision of the manufacturer or administrator to require prior approval before the dealer may commence the covered repairs; and

1 (3) for any reason beyond the control of the dealer, oral prior approval
2 may not be obtained that same day or repair parts for the vehicle required by the
3 manufacturer are not available at the dealership and the manufacturer or its authorized
4 suppliers cannot provide the repair parts within two working days.
5 (b) A manufacturer is in compliance with the provisions of (a) of this section
6 if the manufacturer authorizes the repairing dealer to provide reasonable alternate
7 transportation for the owner at the manufacturer's expense.
8 (c) When a dealer is authorized to provide transportation, the dealer shall
9 attempt to provide a rental vehicle that is a similar model, or has similar characteristics
10 to the owner's vehicle, through its own rental fleet or from the fleet of another rental
11 company.
12 (d) A manufacturer or administrator shall reimburse the owner or the dealer
13 for the cost of the rental in the same manner and time frame the manufacturer or
14 administrator uses to reimburse the dealer for warranty repairs, and the manufacturer
15 or administrator may not include the rental car expense in the expenses that are used to
16 compare the dealer to other dealers for audit purposes or for the purposes of prior
17 warranty approval.
18 **Sec. 45.25.820. Selection of dealership.** A manufacturer or administrator
19 may not require or cause, for any reason, a motor vehicle owner to take a vehicle
20 covered by a warranty for warranty repair to a dealership in this state other than the
21 manufacturer's franchised dealership closest to the motor vehicle owner's residence or
22 to the location where the motor vehicle's nonconformity became apparent to the motor
23 vehicle owner, whichever is closer. In any case involving warranty repairs or service
24 contract repairs, the motor vehicle owners shall have the option, for any covered
25 repair, to have the vehicle towed to and repaired at the manufacturer's expense by the
26 dealership that sold the motor vehicle to the motor vehicle owner if the dealership is
27 within 35 miles of the location where the vehicle became inoperable due to the
28 nonconformity.
29 **Sec. 45.25.830. Hazardous material.** (a) When a warranty or service
30 contract repair results in the removal of hazardous or potentially hazardous material
31 from a motor vehicle, the manufacturer or administrator shall reimburse the repairing

1 dealership for the reasonable cost the dealership incurs that results from or is
2 associated with the disposal of the material.
3 (b) A manufacturer doing business in this state shall notify its franchised
4 dealers of any hazardous or potentially hazardous material, including asbestos in brake
5 linings, contained in the motor vehicles and replacement parts it manufacturers or
6 distributes. As part of the required notification, the manufacturer shall provide
7 recommended procedures for the handling and disposal of the hazardous or potentially
8 hazardous material and shall assume any liability the dealer may later incur for the
9 handling or disposal of the hazardous or potentially hazardous material if the dealer
10 follows the manufacturer's recommended handling and disposal procedures.
11 **Sec. 45.25.840. Damages before delivery to carrier or transporter.** A
12 manufacturer is liable for all damages to a new motor vehicle manufactured by the
13 manufacturer before delivery to a carrier or transporter. If a new motor vehicle dealer
14 determines the method of transportation, the risk of loss passes to the dealer upon
15 delivery of the new motor vehicle to the carrier. Except as provided in this section,
16 the risk of loss from delivery of a new motor vehicle remains with the manufacturer
17 until the new motor vehicle dealer or the new motor vehicle dealer's designee accepts
18 the new motor vehicle from the carrier.
19 **Sec. 45.25.850. Damage during transit.** (a) If a new motor vehicle is
20 damaged while in transit when the manufacturer designates the carrier or the means of
21 transportation, or if a new motor vehicle is otherwise damaged before delivery to the
22 dealer, the dealer shall notify the manufacturer of the damage within three working
23 days or within additional time as authorized by the franchise agreement of the
24 occurrence of the delivery of the new motor vehicle and request authorization from the
25 manufacturer to repair the damages or replace the parts or accessories damaged.
26 (b) If the manufacturer refuses or fails to authorize repair or replacement of
27 the damage within three working days after the manufacturer receives notification of
28 damage from the dealer, ownership of the new motor vehicle reverts to the
29 manufacturer, and the dealer does not have an obligation, financial or otherwise, for
30 the damage to the new motor vehicle.
31 (c) A manufacturer may not fail to disclose in writing to a new motor vehicle

dealer, at the time of delivery of a new motor vehicle, the nature and extent of damage or post-manufacturing repairs made to a new motor vehicle while in the possession or under the control of the manufacturer if the cost of the post-manufacturing repairs exceeds three percent of the manufacturer's suggested retail price or an amount stated in the manufacturer's policy regarding disclosure of damage, whichever is lower.

(c) A manufacturer is not required to disclose to a new motor vehicle dealer that the glass, tires, or bumper of a new motor vehicle was damaged if the damaged item has been replaced with original or comparable equipment.

(d) This section does not relieve the dealer of the obligation to cooperate with the manufacturer as necessary in filing a transportation damage claim with the carrier.

Sec. 45.25.860. Disclosure of damages. (a) Before entering into a new motor vehicle sales contract, a new motor vehicle dealer shall disclose in writing to a purchaser of the new motor vehicle any known damage and repair to the new motor vehicle if the damage exceeds five percent of the manufacturer's suggested retail price as calculated at the dealer's authorized warranty rate for labor and parts. A new motor vehicle dealer is not required to disclose to a purchaser that glass, tires, bumpers, or cosmetic parts of a new motor vehicle were damaged at any time if the damaged item has been replaced with original or comparable equipment. A replaced part is not part of the cumulative damage required to be disclosed under this subsection.

(b) If disclosure is not required under this section, a purchaser may not revoke or rescind a sales contract due to the fact that the new motor vehicle was damaged and repaired before completion of the sale.

(c) In this section,

(1) "cosmetic parts" means parts that are attached by and can be replaced in total through the use of screws, bolts, or other fasteners without the use of welding or thermal cutting and includes windshields, bumpers, hoods, or trim panels;

(2) "manufacturer's suggested retail price" means the retail price of the new motor vehicle suggested by the manufacturer and includes the retail delivered price suggested by the manufacturer for each accessory or item of optional equipment physically attached to the new motor vehicle at the time of delivery to the new motor vehicle dealer that is not included within the retail price suggested by the manufacturer

for the new motor vehicle.

Sec. 45.25.870. Discrimination. A manufacturer may not unfairly discriminate among new motor vehicle dealers with respect to warranty reimbursements or authority granted new motor vehicle dealers to make warranty adjustments with retail customers.

Article 6. Sales and Service Contracts.

Sec. 45.25.900. Title transfer. A dealer may not transfer the title for a new or used vehicle to a buyer before financing is final and complete.

Sec. 45.25.910. Sales contracts. (a) A motor vehicle sales contract must be in writing, signed by both the seller and buyer, and completed as to all essential provisions before the signing of the contract by the buyer and before delivery of the vehicle to the buyer.

(b) A dealer may not obtain a signed motor vehicle sales contract from the buyer until any financing terms reflected on the motor vehicle installment contract are final and complete.

(c) Notwithstanding the requirements of this section, if a dealer arranges financing for a buyer, the dealer may deliver the motor vehicle to the buyer before final approval by the financing entity if

(1) the buyer and seller sign an agreement separate from the motor vehicle installment contract on an 8 1/2 x 11 inch sheet of paper that clearly and conspicuously informs the buyer that final financing arrangements have not yet been approved and that clearly sets out the amount that will be financed, the annual percentage rate of the finance charge, the amount of the finance charge, the number and frequency of payments, and the amount of each payment;

(2) the separate agreement clearly and conspicuously informs the buyer that accepting delivery of the vehicle before final financing approval obligates the buyer to terms of the motor vehicle sales contract if the terms on the separate agreement are identical to the terms finally approved by the financing entity; and

(3) the separate agreement provides that the separate agreement, the motor vehicle sales contract, and any and all other conditions of the purchase will be void if any of the terms contained in the separate agreement are changed by either the

1 dealer or the financing institution as a condition of sale or final financing approval.

2 (d) If a buyer's final financing is not approved within seven business days
3 from the date of the separate agreement and, as a result, the transaction is not
4 completed, the dealer shall return the buyer's entire down payment, and the buyer's
5 trade-in, if any, shall be returned to the buyer in the same condition and with not more
6 than 10 miles accumulated on the odometer from when the motor vehicle was
7 delivered to the dealer.

8 (e) In this section, "sales contract" includes an installment sales contract, a
9 short-term sales contract, and a single-payment contract.

10 **Sec. 45.25.920. Financing coercion prohibited.** (a) A manufacturer, a
11 manufacturer representative, or an officer or agent of a manufacturer may not coerce
12 or attempt to coerce a motor vehicle dealer in this state to sell, assign, or transfer a
13 motor vehicle installment contract to a specified finance company, to a class of
14 finance companies, or to another specified person.

15 (b) A manufacturer, a manufacturer representative, an officer or agent of a
16 manufacturer, or a person affiliated with the manufacturer may not

17 (1) offer to provide information to a dealer concerning a prospective
18 customer who contacts the manufacturer or a person affiliated with the manufacturer
19 about the manufacturer's or distributor's products; and

20 (2) condition the provision of the information referred to in (1) of this
21 subsection to a dealer on the agreement of the dealer to sell or lease a motor vehicle to
22 the prospective customer only if the financing or leasing for the transaction is done by
23 a finance company or lease company that has a relationship or is affiliated with the
24 manufacturer.

25 (c) The provisions of (b) of this section do not prohibit a finance company or
26 lease company that is affiliated with a manufacturer from

27 (1) servicing existing loans or leases, including arranging financing or
28 a lease upon the maturity of an existing loan or lease;

29 (2) negotiating with an existing debtor or lessee who is in default under
30 the terms of a loan or lease, including working with a dealer to retake or dispose of a
31 motor vehicle retaken from the existing debtor or lessee; or

(3) providing information concerning a customer who qualifies to purchase a new motor vehicle under a motor vehicle purchase program sponsored by a manufacturer for factory employees, manufacturer retirees, or factory vendors or under another reasonably similar new vehicle purchase program offered by a manufacturer or distributor.

Sec. 45.25.930. Service contracts. (a) A motor vehicle service contract must be in writing and contain all essential provisions regarding the administration of the contract. If a dealer presents a service contract to the customer as an "application" for a contract, it must be clearly and conspicuously marked as an application and must disclose the applicable rules for obtaining a final service contract.

(b) If a service contract is included in a motor vehicle sale, the seller shall, before delivery of the motor vehicle, give to the buyer a written statement with all pertinent blank spaces filled in that shall be signed by both the buyer and seller and that clearly and conspicuously

(1) explains the difference between a service contract and a warranty;

(2) discloses the maker of or obligor on the service contract;

(3) describes the relationship between the maker and the seller of the service contract;

(4) for a vehicle that is a used vehicle, notifies the buyer that the seller may not disclaim implied warranties if the seller is the maker or obligor of the service contract; and

(5) includes all other disclosures required by law.

(c) A dealer may not disclaim or limit implied warranties for a motor vehicle for which the dealer is a maker of a service contract sold for that motor vehicle. However, a dealer may disclaim or limit implied warranties as otherwise allowed by law, regardless of the make or model of the motor vehicle if the dealer is merely the seller, not the maker, of the service contract and does not otherwise extend any written warranties on the motor vehicle that is purchased.

(d) In this section, "maker" means the person that makes, frames, and executes a service contract and assumes any obligation due to the purchaser, but does not include a dealer if the dealer merely sells the service contract as the agent of a service

1 contract company doing business in this state.

2 **Article 7. Miscellaneous Provisions.**

3 **Sec. 45.25.950. Acts of manufacturer representatives, motor vehicle**
4 **salespersons, employees, and agents.** (a) A dealer or manufacturer is responsible
5 for the acts of a manufacturer representative or motor vehicle salesperson while the
6 representative or salesperson is acting as the dealer's or manufacturer's agent.

7 (b) A manufacturer is responsible for the acts of its employees, agents, or
8 manufacturer representatives while the employees, agents, or representatives are
9 acting in the conduct of the manufacturer's business, whether or not the manufacturer
10 approved, authorized, or had prior knowledge of the acts.

11 **Sec. 45.25.960. Requirement of principal place of business.** (a) A dealer
12 shall at all times maintain a principal place of business in the state. The principal
13 place of business must include a permanent building that contains, at a minimum, an
14 established office and an established salesroom.

15 (b) To qualify as an established office under (a) of this section, the office must
16 (1) contain at least 400 square feet of floor space in a permanent and
17 enclosed building; and
18 (2) be a place where books, records, and files required by the
19 department are kept.

20 (c) To qualify as an established salesroom under (a) of this section, the
21 salesroom must
22 (1) contain at least 400 square feet of floor space in a permanent and
23 enclosed building;
24 (2) display, or be located immediately adjacent to, a sign having block
25 letters not less than six inches in height on a contrasting background, clearly and
26 distinctly designating the trade name of the business, unless prohibited by law;
27 (3) be a place at which the business of bartering, trading, and selling
28 motor vehicles is carried on in good faith on an ongoing basis and where the dealer
29 can be contacted by the public at reasonable times; and
30 (4) be a place where books, records, and files required by the
31 department are kept.

(d) An established salesroom includes the area contiguous to the premises on which the salesroom is located, but does not include a tent, a temporary stand, or other temporary quarters.

Sec. 45.25.970. Arbitration. A franchise agreement, whether written or oral, between a motor vehicle dealer and a manufacturer shall be considered to contain an agreement to submit a dispute under this chapter to arbitration under AS 09.43.020 - 09.43.180 (Uniform Arbitration Act) if either the motor vehicle dealer or the manufacturer elects to have the dispute determined by arbitration. For the arbitration, the motor vehicle dealer and the manufacturer shall each select one arbitrator, and both parties shall select the third arbitrator.

Article 8. General Provisions.

Sec. 45.25.980. Applicability. If a provision of this chapter conflicts with another provision of this title, this chapter controls.

Sec. 45.25.990. Definitions. In this chapter,

(1) "administrator" means a person who administers any part of the warranty coverage for a new or used vehicle or the service contract for a new or used vehicle on behalf of a manufacturer or audits or examines a dealer's performance or administration of a service contract, of a warranty, or of maintenance or repairs performed on covered vehicles in this state;

(2) "broker" means arrange or offer to arrange, for a fee, commission, or other valuable consideration, a transaction involving the sale, purchase, or lease of a new motor vehicle by a new motor vehicle dealer or by a motor vehicle salesperson acting at the direction of a new motor vehicle dealer;

(3) "dealer" means a new motor vehicle dealer or used motor vehicle dealer;

(4) "dealership" means the business entity that is operated by a motor vehicle dealer;

(5) "distributor" means a person or entity who sells or distributes new or used motor vehicles to motor vehicle dealers or who maintains or sends distributor representatives within or to this state to sell or distribute new or used motor vehicles to motor vehicle dealers in this state; in this paragraph, "distributor representative"

1 means a representative employed by a distributor branch, distributor, or wholesaler
2 who sells or distributes new or used motor vehicles to franchised motor vehicle dealers
3 in this state;
4 (6) "distributor branch" means a branch office maintained by a
5 distributor or wholesaler who sells or distributes new or used motor vehicles to
6 franchised motor vehicle dealers in this state;
7 (7) "factory branch" means a branch office maintained by a
8 manufacturer for directing and supervising the representatives of the manufacturer;
9 (8) "family member" means a spouse, child, stepchild, grandchild,
10 stepgrandchild, parent, stepparent, brother, stepbrother, sister, or stepsister;
11 (9) "franchise" means an oral or written arrangement for a definite or
12 indefinite period in which a manufacturer, distributor, or motor vehicle wholesaler
13 grants to a motor vehicle dealer a license, sales and service agreement, or contract of
14 any kind to use a trade name, service mark, or related characteristic, and in which
15 there is a community of interest in the wholesale or retail marketing of related motor
16 vehicles or services;
17 (10) "franchised" means having a franchise;
18 (11) "fraud" includes a promise or representation not made honestly or
19 in good faith, and an intentional failure to disclose a material fact;
20 (12) "good faith" means honesty in fact and the observation of
21 reasonable commercial standards of fair dealing in the trade;
22 (13) "lease" means a contract by which a person owning a motor
23 vehicle grants to another person the right to possess, use, and enjoy the motor vehicle
24 for a specified period of time in exchange for periodic payment of a stipulated price,
25 and in which the use of the vehicle is granted for a period of 12 or more months;
26 (14) "line-make" means a new motor vehicle that is offered for sale,
27 lease, or distribution under a common name, common trademark, or common service
28 mark;
29 (15) "manufacturer" means a person or the person's subsidiary who
30 manufacturers, imports, distributes, or assembles new motor vehicles and includes an
31 administrator, a distributor, a distributor branch, and a factory branch;

1 (16) "manufacturer representative" means any employee or agent of a
2 manufacturer who engages in the business of contacting a manufacturer's respective
3 franchised dealers for the purpose of making or promoting the sale of the
4 manufacturer's vehicles, parts, accessories, or services;
5 (17) "motor vehicle" means a motor vehicle that is required to be
6 registered under AS 28.10, but does not include a motor home, a recreational vehicle,
7 or a motorcycle;
8 (18) "motor vehicle dealer" means a person, other than a manufacturer,
9 who sells, leases, solicits, brokers, or arranges for sale or lease, of three or more new
10 or used motor vehicles in any 12 consecutive months, regardless of who owns the
11 vehicles; "motor vehicle dealer" does not include
12 (A) a receiver, trustee, administrator, executor, guardian, or
13 other person appointed by a court or a person performing duties as a public
14 officer;
15 (B) a person disposing of a motor vehicle acquired and actually
16 used for the person's own use or for the use of a family member of the person
17 if the vehicle is acquired and used in good faith and not for the purpose of
18 avoiding the provisions of this chapter;
19 (C) a person who sells motor vehicles as an incident of the
20 person's principal business but who is not engaged primarily in the selling of
21 motor vehicles;
22 (D) an employee of an organization arranging for the purchase
23 or lease by the organization of a vehicle for use in the organization's business;
24 (E) a publication, broadcast, or other communications media
25 when engaged in the business of advertising, but not otherwise arranging for
26 the sale of a motor vehicle owned by another person;
27 (F) a person acquiring an interest in a motor vehicle for a
28 family member of the person;
29 (19) "motor vehicle salesperson" means a person who is employed by
30 a motor vehicle dealer as a salesperson or sales representative to solicit, sell, lease,
31 broker, or exchange motor vehicles under the direction of a motor vehicle dealer;

1 (20) "new motor vehicle" means a motor vehicle that has not been
2 previously sold to and registered to a person except a distributor, wholesaler, or motor
3 vehicle dealer for resale;
4 (21) "new motor vehicle dealer" means a motor vehicle dealer for new
5 motor vehicles or for new and used motor vehicles;
6 (22) "sale" means the issuance, transfer, agreement for transfer,
7 exchange, gift, pledge, hypothecation, or mortgage in any form, whether by transfer in
8 trust or otherwise, of a motor vehicle, an interest in a motor vehicle, or a related
9 franchise;
10 (23) "service contract" means an optional agreement that is separate
11 from a contract for the sale of a motor vehicle, and that covers certain repair or
12 maintenance functions beyond coverage provided by a warranty;
13 (24) "terminate" includes nonrenewal;
14 (25) "used motor vehicle" means a motor vehicle that has been
15 previously sold to and registered to a person other than a distributor, wholesaler, or
16 motor vehicle dealer;
17 (26) "used motor vehicle dealer" means a motor vehicle dealer for used
18 motor vehicles.
19 *** Sec. 10.** AS 45.50.471(b)(33) is amended to read:
20 (33) violating **AS 08.66** [AS 08.66.010 - 08.66.090] (motor vehicle
21 dealers);
22 *** Sec. 11.** AS 45.50.471(b) is amended by adding a new paragraph to read:
23 (43) violating AS 45.25 (motor vehicle transactions).
24 *** Sec. 12.** AS 45.50.572 is amended by adding a new subsection to read:
25 ([illegible]) AS 45.50.562 - 45.50.596 do not apply to action taken by a person to
26 comply with AS 45.25 or to action refrained from by a person in order to comply with
27 AS 45.25 (motor vehicle transactions).
28 *** Sec. 13.** AS 08.66.015, 08.66.200, 08.66.210, 08.66.220, 08.66.230, 08.66.240,
29 08.66.250, 08.66.260, 08.66.270, 08.66.280, 08.66.290, 08.66.300, 08.66.310, 08.66.320,
30 08.66.330, 08.66.350; and AS 45.50.471(b)(34) are repealed.
31 *** Sec. 14.** The uncodified law of the State of Alaska is amended by adding a new section to

1 read:

2 APPLICABILITY. Sections 9, 11, and 12 of this Act apply to a franchise, as that term
3 is defined in AS 45.25.990, that is entered into on or after the effective date of this Act.

4 * **Sec. 15.** The uncodified law of the State of Alaska is amended by adding a new section to
5 read:

6 TRANSITION. The minimum floor space requirements for an established salesroom
7 imposed under AS 45.25.960(c), enacted by sec. 9 of this Act, do not apply to a motor vehicle
8 salesroom that was in existence on or before the effective date of this Act.

9 * **Sec. 16.** This Act takes effect July 1, 2002.

STATE OF ALASKA

Tony Knowles, Governor

Department of Labor and Workforce Development

OFFICE OF THE COMMISSIONER

P.O. Box 21149
Juneau, AK 99802-1149
Phone: (907) 465-2700
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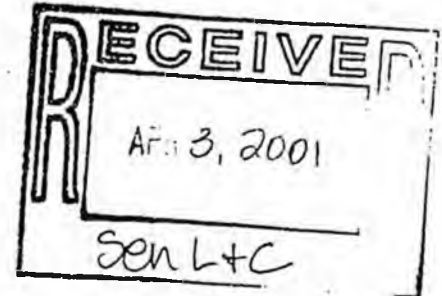
April 2, 2001



The Honorable Randy Phillips
Chair, Senate Labor and Commerce Committee
Capitol, Room 103
Juneau, AK 99801

Dear Senator Phillips:

I respectfully request that you schedule Senate Bill 46, raising the minimum wage in Alaska, for a hearing at your earliest convenience.

Alaska prides itself on being a rich state, not only in natural resources, but also opportunities. But our current minimum wage is lower than California's, Washington's. and Oregon's. A single parent with two children working full time at the current state minimum hourly wage will earn $11,752 per year or 66 percent of the 2000 poverty level which is $17,690 for a family of three.

Using fourth quarter 1998 Department of Labor data, approximately 14,000 Alaska workers, or 5.5 percent of the wage and salary employment, received hourly wages between $5.65 and $6.74. Contrary to popular belief, the majority of these workers are adults, not teenagers embarking on their first jobs. The median age of Alaskans working in typically low paying jobs, such as waitresses and waiters is 29; sales clerks, 34; cannery workers, 32; and child-care workers, 27.

No working Alaska family should depend on a job that keeps them in poverty. Senate Bill 46 recognizes the value of all Alaska's workers and their right to earn a decent, livable wage.

Please make this bill a priority of your committee and schedule it for a hearing soon. Your favorable consideration of this request is very much appreciated.

Sincerely,

Ed Flanagan
Commissioner

Use Caution Before You Borrow

More homeowners than ever before are at risk of losing their homes and financial security because of a growing practice in mortgage lending called "predatory lending."

Predatory lenders are unscrupulous lenders who make loans with exorbitant fees and/or costs, high prepayment penalties, hidden balloon payments, up-front premium credit insurance. They often lend to people who can't afford their loan and use a variety of techniques to strip equity from the homes of these vulnerable consumers. The result is often heartbreaking; homeowners who lose the homes they had owned outright in exchange for a relatively small amount of cash.

Most lenders abide by a code of ethics, disclose all lending terms and lend money only to those who can afford to repay it. Not so with predatory lenders. Federal and state legislation across the country is being considered to stop these lending practices. The first line of defense however, begins with each individual borrower.

Here are some tips to help you protect yourself against predatory lenders:

- Know your lender. Get references from friends, family and business acquaintances. Use established companies with good reputations. Call the Better Business Bureau and see if they have a lot of complaints.

- Beware of door-to-door sales, telephone solicitations and TV ads that sound too good to be true, especially from lenders you've never heard of or done business with before.

- Don't be pressured by a loan officer. Sales pressure usually means the salesperson is looking out for themselves, not you. You can change your mind.

- Shop around. Compare fees, interest rates, and other terms. It takes a little effort, but you can save a lot of money.

- Never sign blank documents. Always know and understand what you are signing. Don't hesitate to ask questions until you understand what you're being asked to sign.

- If the terms of your loan are suddenly changed at the closing table, refuse to close. Often predatory lenders will add fees or costly insurance at the last moment and will pressure you in to closing.

For more information about home mortgage loans, serviced in Alaska by Alaskans, contact First National Bank's Home Loan Center at 561-HOME (4663).

A Tale Of Three Markets: The Law And Economics Of Predatory Lending[*]

by

Kathleen C. Engel[†] and Patricia A. McCoy[‡]

September 1, 2001

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[*] Copyright 2001 Kathleen C. Engel and Patricia A. McCoy.

This project received generous support from the Cleveland-Marshall Fund. Innumerable people have given us feedback on this research. In particular, we thank Linda Ammons, Adam Bass, Tom Bier, Tom Bogart, Charles Bromley, James Carr, Diane Citrino, Ruth Clevenger, John Day, John Deal, Lisa Donner, Ron Feldman, Cassandra Jones Havard, Susan Helper, Carol Heyward, Ned Hill, Keith Hylton, Howell Jackson, Dennis Keating, Kermit Lind, Vivian Rogers, Kunal Parker, Fred Rebitzer, Jim Rebitzer, Rachel Robinson, David Snyder, Ken Temkin, James Tierney, James A. Walrath, Paul Weese, Alan Weinstein, Larry White, and Page Wittkamp. We give special thanks to our superb research assistants, Melissa Horn, Kelly Delaney and Maureen McGuire. We apologize to anyone we have overlooked. In thanking people, we are not suggesting that they endorse the arguments that we have made in the article. All errors are ours alone.

[†] Assistant Professor of Law, Cleveland-Marshall College of Law, Cleveland State University.

[‡] Professor of Law, Cleveland-Marshall College of Law, Cleveland State University.

Condemning predatory lenders as immoral, however, does not tell us what needs to be done. Similarly, criticizing borrowers for impulsive borrowing and spending does not take into account the market failures that enable predatory lenders to flourish and exploit unsophisticated borrowers. Nor does it address the serious negative externalities that predatory lending inflicts, not only on borrowers, but on society at large in the form of bankruptcies, foreclosures, poverty and deteriorating neighborhoods.

To advance the debate beyond the realm of moral accusations, we need to determine how incentive structures in the home mortgage market have fueled predatory lending and how these incentives can best be countered. In this article, we embark on these tasks. We argue that the market incentives that historically led lenders to engage in credit rationing have given way to a market where lenders can profit from exploiting new information asymmetries to the detriment of unsophisticated borrowers. We further argue that government intervention is needed to curb these lending abuses and propose a remedy – suitability – that is narrowly tailored to address these harms.

The Article proceeds in four parts. Following this introduction, in Section II, we identify five problems associated with the various lending practices that have been characterized as predatory. We define predatory lending as a syndrome of abusive loan terms or practices that involve one or more of these five problems.

In Section III, we begin by describing the information asymmetries that until recently led to credit rationing. We then describe how changes in the financial services market have altered the conventional home mortgage market. In particular, we argue that an increase in the amount of capital available for mortgages due to securitization, increased incentives for lenders to specialize in lending to low and moderate income borrowers and new information asymmetries

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I. INTRODUCTION

Predatory lending – exploitative high-cost loans to naïve borrowers, resulting in soaring rates of foreclosures – has dominated the headlines in recent years.[1] There is fierce debate over how best to respond to this surge in predatory loans.[2] Too often, the debate over predatory lending has been couched in moral terms. Opponents of predatory lending air exposés of unscrupulous lenders and diabolical tactics. Industry supporters, on the other hand, question the seriousness of predatory lending, blame borrowers for their profligacy, and assert that existing remedies suffice.

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[1] The Coalition for Responsible Lending recently estimated that predatory lending costs U.S. borrowers $9.1 billion annually. ERIC STEIN, QUANTIFYING THE ECONOMIC COST OF PREDATORY LENDING (July 25, 2001) (available at <www.responsiblelending.org/CostofPredLend.PDF>); *cf.* Robert E. Litan, *A Prudent Approach To Preventing "Predatory" Lending* 3-6 (Working Paper Feb. 2001) (tracing the corresponding growth in the subprime market) (hereinafter "Litan, *Prudent Approach*"). One of the most noteworthy indicia of the rise in predatory lending has been an unprecedented rise in foreclosures across the country. Between 1990 and 1998, when interest rates were dropping, the home foreclosure rate increased by 384 percent. *See* UNITED STATES CENSUS BUREAU, STATISTICAL ABSTRACT OF THE UNITED STATES, BANKING, FINANCE AND INSURANCE, Table No. 823, "Mortgage Delinquency and Foreclosure Rates: 1980 to 1998" (1999). The bulk of these foreclosures actions involved borrowers who had subprime -- including predatory -- loans. *See* Cathy L. Mansfield, *The Road to Subprime 'HEL' was Paved with Good Congressional Intentions: Usury Deregulation and the Subprime Home Equity Market*, 51 S.C. L. REV. 473 (2000); *see also* NATIONAL TRAINING AND INFORMATION CENTER, PREYING ON NEIGHBORHOODS: SUBPRIME MORTGAGE LENDING AND CHICAGOLAND FORECLOSURES 11-21 (Sept. 21, 1999) (available at <http://www.ntic-us.org/preying/preying.html>) (hereinafter cited as "PREYING ON NEIGHBORHOODS") (noting that in metropolitan Chicago alone, foreclosures nearly doubled from 1993 to 1998. Subprime lenders and services accounted for 1.4 percent of the foreclosures in 1993, but 35.7 percent of the 1998 foreclosures).

Predatory lending is highly visible; however, gaps in reported data have hampered efforts to accurately assess the extent of the problem. In December 2000, the Federal Reserve Board proposed remedying that gap by expanding the types of data that must be reported on home mortgage loans under the Home Mortgage Disclosure Act (HMDA), and by expanding the nonbank entities required to file HMDA reports. Under the proposed regulation, HMDA reporting entities would have to report on all home mortgage refinancings, home improvement loans and home equity lines of credit. In addition, lenders would have to report the annual percentage rates of these loans, regardless whether the loans fell within the Home Ownership and Equity Protection Act or whether the loans involved mobile homes. *See* Federal Reserve System, Proposed Rule, *Home Mortgage Disclosure*, 65 Fed. Reg. 78656 (Dec. 15, 2000).

[2] *See, e.g., Lending Group Forces Delay of Predatory Ordinance*, NATIONAL MORTGAGE NEWS, Aug. 24, 2001 (available at <www.thebankingchannel.com/comm/story.jsp?story=TBCMJK3OYOC>) (reporting statement by trade association representative that "his group is willing to challenge any local effort to regulate" subprime lending).

Condemning predatory lenders as immoral, however, does not tell us what needs to be done. Similarly, criticizing borrowers for impulsive borrowing and spending does not take into account the market failures that enable predatory lenders to flourish and exploit unsophisticated borrowers. Nor does it address the serious negative externalities that predatory lending inflicts, not only on borrowers, but on society at large in the form of bankruptcies, foreclosures, poverty and deteriorating neighborhoods.

To advance the debate beyond the realm of moral accusations, we need to determine how incentive structures in the home mortgage market have fueled predatory lending and how these incentives can best be countered. In this article, we embark on these tasks. We argue that the market incentives that historically led lenders to engage in credit rationing have given way to a market where lenders can profit from exploiting new information asymmetries to the detriment of unsophisticated borrowers. We further argue that government intervention is needed to curb these lending abuses and propose a remedy – suitability – that is narrowly tailored to address these harms.

The Article proceeds in four parts. Following this introduction, in Section II, we identify five problems associated with the various lending practices that have been characterized as predatory. We define predatory lending as a syndrome of abusive loan terms or practices that involve one or more of these five problems.

In Section III, we begin by describing the information asymmetries that until recently led to credit rationing. We then describe how changes in the financial services market have altered the conventional home mortgage market. In particular, we argue that an increase in the amount of capital available for mortgages due to securitization, increased incentives for lenders to specialize in lending to low and moderate income borrowers and new information asymmetries

have made it possible for predatory lenders to thrive. We argue that the convergence of these forces has produced three markets for home mortgages: a prime market, a legitimate subprime market, and a predatory market.

The prime market provides mortgages to low-risk borrowers with strong credit histories. Legitimate subprime lenders, who are usually nonbank[3] lenders, cater to borrowers who have experience shopping for credit but who, for one reason or another, lack the sterling credentials needed to qualify for prime loans. Predatory lenders, on the other hand, target naïve people who, because of historical credit rationing, discrimination, the exodus of banks from inner-city neighborhoods and other social and economic forces, are disconnected from the credit market and hence are vulnerable to predatory lenders' hard-sell tactics.

In Section III, we conclude by describing why predatory lenders have not been driven out by competition. In sum, we contend that because of reputational and regulatory concerns, banks and thrifts shy away from lending to borrowers who typically become victims of predatory lenders. In addition, we argue that legitimate, nonbank subprime lenders, whom we would expect to compete with predatory lenders, have adopted marketing strategies that do not reach the victims of predatory lending.

Based on this understanding of the home mortgage market, in Section IV, we ask which remedy or remedies would force predatory lenders to internalize the harm that they cause. To that end, we evaluate extant remedies for redressing predatory lending, including market vehicles, remedies sounding in contract or the Uniform Commercial Code, antifraud statutes, disclosure laws, consumer education and counseling, price regulation, and antidiscrimination

[3] Throughout the paper, the term "nonbank lenders" refers to lending entities that are not federally insured depository institutions.

laws. We conclude that neither market forces nor any of the remedies just described would succeed in curbing predatory lending. Furthermore, price regulation would curtail the availability of credit. Instead, a direct approach that addresses abusive loan terms and practices, without re-imposing usury limits, would offer the best protection against predatory lending.

In the final part of the Article, Section V, we propose such a remedy: a duty of suitability in subprime mortgage lending. In fashioning a suitability remedy, we draw on the suitability requirement in securities and insurance to impose a similar obligation on subprime lenders and brokers, albeit one that is tailored to the subprime mortgage market. This new duty of suitability puts the onus of preventing predatory lending on those who can afford it most cheaply, *i.e.*, predatory lenders and brokers, by authorizing the federal government and aggrieved victims to sue for loan reformation, disgorgement and damages. In addition, we propose formation of an industry self-regulatory organization under federal supervision to promote the development of best practices rules. Our position is that suitability achieves the balance between the need to curb predatory lending and the need to encourage beneficial market activity.

II. "PREDATORY LENDING" DEFINED

In 2000, Senator Phil Gramm, then the chairman of the Senate Banking Committee, famously asserted that predatory lending could not be addressed until it could be defined.[4] With that remark, Senator Gramm shrewdly seized on the difficulties in defining predatory lending to date, while stoking the flames that have surrounded any attempt at definition. Opponents of reforms to redress predatory lending have maintained that in the absence of a definable problem.

[4] *See* Michele Heller & Rob Graver, *Gramm Takes Stand Against Predator Bills*, AM. BANKER, Aug. 24, 2000, at 1 ("As the regulators themselves admit, there is no definition of predatory lending. I don't know how we can hope to address the problem before we have decided what it is"); *see also News Conference with Senator Phil Gramm*, Federal News Service (Jan. 22, 2001).

remedies are not needed.[5] Conversely, some community activists have brushed definitional issues aside, reasoning that "you know predatory lending when you see it."

Any serious attempt to address the problem of predatory lending, however, must be able to describe it. To date, predatory lending generally has been described as a catalogue of onerous lending practices, which are often targeted at vulnerable populations and result in devastating personal losses, including bankruptcy, foreclosure and the loss of borrowers' homes.[6]

These catalogues provide a useful starting point for detecting and describing the pathologies that underlie predatory lending. When these lists are examined, five basic problems

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[5] *See, e.g.*, *In Reality, "Predatory Lending" Isn't Easy to Define*, NEWS & OBSERVER (RALEIGH, N.C.), Oct. 24, 2000, at A10.

[6] In one of the most exhaustive catalogues of predatory lending practices, Patricia Sturdevant and William J. Brennan, Jr., listed a broad array of exploitative terms and practices, including:

- racial targeting in advertising and loan solicitations
- loans in connection with home improvement scams
- kickbacks in the form of yield spread premiums
- steering to high-cost lenders
- loan payments in excess of the borrowers' ability to repay, resulting in foreclosure (equity skimming)
- fraud on borrowers and on secondary market buyers via falsified loan applications, forged signatures, inflated appraisals and the like
- high annual interest rates
- high points
- balloon payments
- negative amortization
- padded or duplicative closing costs and fees
- insurance packing and single premium credit life insurance
- excessive prepayment penalties
- mandatory arbitration clauses
- loan flipping (repeated refinancings by the same lender)
- refinancings of low- or no-interest mortgages at higher rates
- shifting unsecured debt into mortgages
- making loans in excess of 100 percent of the loan-to-value ratio of the underlying collateral
- abusive collection practices
- foreclosure abuses

See Patricia Sturdevant & William J. Brennan, Jr., *A Catalogue of Predatory Lending Practices*, 5 THE CONSUMER ADVOCATE 4 (1999). *See also* Mansfield, *supra* note ___, at 532-61.

emerge. We can thus define predatory lending as a syndrome of abusive loan terms or practices that involve one or more of the following five problems:[7]

(1) loans structured to result in seriously disproportionate net harm to borrowers;

(2) harmful rent seeking;

(3) loans involving fraud or deceptive practices;

(4) other forms of lack of transparency in loans that are not actionable as fraud; and

(5) loans that require borrowers to waive meaningful legal redress.

Most, if not all, predatory loans combine two or more of these problems. Similarly, some abusive terms or practices fall into more than one category. Rather than serving as a proposed statutory definition, our definition of predatory loans is intended as a diagnostic tool for identifying problematic loan terms that require redress.

In the overwhelming percentage of cases, predatory loans are a subset of subprime loans, which are loans with higher interest rates that are designed for borrowers with impaired credit or who do not otherwise qualify for loans in the conventional prime market.[8] Nevertheless, legitimate subprime loans and predatory loans are analytically distinct. Legitimate subprime loans do not display any of the five markers of predatory loans listed above. Conversely,

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[7] As we argue later in this Article, predatory lenders target vulnerable consumers for financial exploitation, often because of their race, gender, income or class. However, predatory loans can occur in the absence of such targeting and therefore we do not include it as a defining feature.

[8] *See* Testimony of Donna Tanoue, former Chairman of the FDIC, before the House Committee on Banking and Financial Services, 2000 WL 19304112 (May 24, 2000). The Interagency Guidance on Subprime Lending defines subprime lending as credit extensions "to borrowers who exhibit characteristics indicating a significantly higher risk of default than traditional bank lending customers." Board of Governors of the Federal Reserve System *et al.*, Interagency Guidance on Subprime Lending 1 (Mar. 3, 1999); *see also* Board of Governors of the Federal Reserve System, Expanded Interagency Guidance for Subprime Lending Programs (Jan. 31, 2001). Subprime loans have higher interest rates to compensate lenders for the higher risk of default. *See, e.g.*, Departments of the Treasury and Housing and Urban Development, *Curbing Predatory Home Mortgage Lending* 28 (June 20, 2000) (hereinafter cited as "HUD-Treasury Report").

predatory loans are not necessarily subprime. It is possible for prime interest loans to display one or more of the problems that are common to predatory loans.

While the definition of predatory loans is not restricted to the subprime market,[9] that is where predatory loans are most prevalent. Accordingly, predatory loans in the subprime market are the focus of our analysis. In particular, because of the personal and social consequences of default and foreclosure, we have identified loans secured by first or subordinate mortgages on borrowers' homes as the most pressing area of concern.

A. *Loans Structured To Result In Seriously Disproportionate Net Harm To Borrowers*

In the subprime market, numerous conventional underwriting standards have been relaxed in order to facilitate loans to less creditworthy customers. Many of the standards that have been relaxed redound to the mutual benefit of subprime lenders and borrowers.[10] In some instances, however, lenders have overridden conventional underwriting norms in order to structure loans that inflict seriously disproportionate harm on borrowers, often in catastrophic proportions. Because the harm seriously outweighs the benefit of those loans to borrowers and society at large, such practices are predatory in nature.

The foremost example today involves violations of the norm that no mortgage shall be made to anyone who, on the face of the loan application, cannot afford the monthly payments (a

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[9] North Carolina attempted to grapple with this problem in its 1999 predatory lending statute, which regulates certain predatory practices in *all* consumer loans under $150,000, regardless whether those loans are high-cost and thus subprime. *See* N.C.G.S. §§ 24-1.1A(c)-(c2), (g), 24-1.1E(a)-(b), 24-10.2(b)-(e). Similarly, predatory loans are not restricted to a single product line, but rather run the gamut of consumer loan products, from car loans and credit card abuses to closed-end home mortgage loans.

[10] Examples include loans to borrowers with histories of late payments or bankruptcies or higher debt-to-income ratios, and loans with higher loan-to-value ratios. *See, e.g.*, JOHN WEICHER, THE HOME EQUITY LENDING INDUSTRY: REFINANCING MORTGAGES FOR BORROWERS WITH IMPAIRED CREDIT 30, 34, 60-61 & table 4.4 (1997).

practice known as "asset-based lending").[11] These are the quintessential predatory loans and the borrowers often suffer bankruptcy or lose their homes to foreclosure as a consequence.[12]

Asset-based loans are fundamentally repugnant because they violate widely shared beliefs about the acceptable outer limits of mortgage lending. In the case of asset-based lending, the foremost belief is that home mortgages should not be structured with the primary objective of foreclosure. That belief is rooted in a variety of rationales. One is based on distributive justice, *i.e.*, that home ownership provides a basic necessity of life and should not be deprived as a result of exploitation. Another related rationale, rooted in efficiency concerns, is that homelessness imposes unacceptably large negative externalities on society as well as on the homeless. Finally, loans that result in bankruptcy and/or foreclosure pose undue risks of loss to ultimate holders of those notes, raising concerns about economic efficiency and possibly systemic risk.[13]

Asset-based lending often spawns another abusive practice known as "loan flipping," in which lenders persuade homeowners to refinance their mortgages repeatedly at extremely short

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[11] Arguably, due to the high costs of foreclosure, lenders are not acting in their best interests when they make loans without regard to borrowers' ability to repay the loans. Evidence, however, suggests the contrary. If borrowers have sufficient equity in their homes when they default, lenders can repeatedly refinance the borrowers' loans upon default, each time tacking huge fees onto the principal. Alternatively, where lenders can convince secondary market purchasers to purchase predatory loans, the lenders can foist future losses off on these unsuspecting purchasers. *See* text accompanying notes ___ *infra*.

[12] *See, e.g.*, HUD-Treasury Report, *supra* note ___, at 21, 22, 24-25, 27 n.12; Sturdevant & Brennan, *supra* note ___, at 37; Hargraves v. Capital City Mortgage Corp., Plaintiffs' Statement of Points and Authorities in Opposition to Defendant's Motion for Judgment on the Pleadings, or in the Alternative, for Summary Judgment, at 1, 19, Civ. No. 98-1021 (JHG)/(AK) (D.D.C.); Mortgage Bankers Association of America, Best Practices/Legislative Guidelines: Subprime Lending, Legislative Guidelines ¶ 6 (available at <http://www.mbaa.org/resident/lib2000/0525b.html>);
cf. Fannie Mae, Lender Letter No. 03-00 (Apr. 11, 2000) ("the borrower [must have] a reasonable ability to make the mortgage payments and [must be] likely to do so"). PREYING ON NEIGHBORHOODS, *supra* note ____, at 23-27 (suggesting that foreclosure rates in Chicago are rising because "loans are being pushed upon borrowers who are not able to repay them."

[13] This latter problem is endemic of the agency problems among brokers, lenders and secondary market purchasers that we discuss later in this Article.

intervals, up to three or four times a year.[14] Since the borrowers are usually cash-poor, any prepayment penalties and "refinancing" charges are wrapped into the old principal and then financed. Predatory lenders manufacture these situations by making asset-based loans in the first place with payments that the borrowers cannot meet. When the borrowers default, as is sure to happen, the lenders offer them an opportunity to escape foreclosure by refinancing. Flipping offers borrowers temporary relief in the form of lower monthly payments by extending the loan periods.[15] Ultimately, however, the borrowers end up owing higher total principal and interest to the lenders. Thus, "loan flipping" results in "equity stripping," as owners' home equity declines with each refinancing. As equity vanishes and total loan balances rise, the borrowers' ability to refinance with legitimate lenders drops. Eventually the borrowers leverage all of their equity and then default, sometimes leaving secondary market purchasers holding the bag.[16]

Likewise, from borrowers' perspectives, there is usually little economic rationale for mortgages with negative amortization. Under negative amortization, scheduled payments are not enough to cover the interest due, causing the outstanding principal to increase with time. As a result, borrowers who make regular payments actually lose equity in their homes as time goes

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[14] In December 2000, the Federal Reserve Board proposed prohibiting creditors or assignees of high-cost loans under HOEPA from refinancing these loans within the first twelve months unless the refinancings are in the borrower's interest. The Board also elicited comment on whether prepayment penalties and points assessed in refinancings by those creditors or assignees should be included in computing HOEPA's trigger on points and fees. *See* Federal Reserve System, Proposed Rule, *Truth in Lending*, 65 Fed. Reg. 81438 (Dec. 26, 2000) (hereinafter "Federal Reserve, *Truth in Lending*).

[15] *See, e.g.*, HUD-Treasury Report, *supra* note ___, at 21, 73-74; Jeff Bailey, *A Man and His Loan: Why Bennie Roberts Refinanced 20 Times*, WALL ST. J., Apr. 23, 1997, at A1; Sturdevant & Brennan, *supra* note ___, at 39.

[16] For unsuspecting secondary market purchasers who find themselves in this situation, the costs of foreclosure usually erase any profit from the predatory loan. *See generally* Michael H. Schill, *An Economic Analysis of Mortgage Protection Laws*, 77 VA. L. REV. 489 (1991) (reviewing the costs associated with foreclosure).

on.[17] Other examples of loans that result in seriously disproportionate net harm to borrowers include loans where lenders persuade borrowers to shift unsecured debt into mortgages in order to strip the equity out of their homes or where lenders insist on financing higher principal amounts than customers request.[18] Still another refinancing abuse involves lenders who induce homeowners to refinance no-interest or low-interest mortgages at higher interest rates without economic justification.[19]

Similarly, the harm seriously outweighs the benefit where lenders steer naïve borrowers who qualify for prime-rate loans (or other loans on better terms) to costlier loans that are better

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[17] *See, e.g.*, HUD-Treasury Report, *supra* note ___, at 91-92. Reverse mortgages under the Home Equity Conversion Mortgage program administered by HUD are an exception. These reverse mortgages permit elderly homeowners to cash out their home equity in exchange for an income stream. Reverse mortgages are heavily regulated, however, and are subject to mandatory counseling requirements. *See id.* at 92.

Concerns about the injurious effects of negative amortization led the Federal Reserve Board, pursuant to its authority under HOEPA, to ban negative amortization in high-cost, closed-end home mortgage refinance loans. 12 C.F.R. § 226.32(d). Today, mortgages with negative amortization provisions are limited to loans that are not covered by HOEPA.

[18] *See, e.g.*, Nina Simon, *Predatory Lending From Around the Country: A Broad Range of Tools* 3; Sturdevant & Brennan, *supra* note ___, at 40; Hargraves v. Capital City Mortgage Corp., Brief of the United States as Amicus Curiae in Support of Plaintiffs' Opposition to Defendant's Motion for Judgment on the Pleadings or, in the Alternative for Summary Judgment, at 1, 6, Civ. No. 98-1021 (JHG)/(AK) (D.D.C.); Teresa Dixon Murray, *Borrower Beware Predatory Mortgage Brokers Don't Give Terms Promised, Causing Some to Lose Their Homes*, PLAIN DEALER, Aug. 28, 2000, at 1C.

[19] *See* Sturdevant & Brennan, *supra* note ___, at 39-40. In the most egregious cases, lenders convince borrowers to refinance their original zero-percent Habitat for Humanity loans in the early years of those mortgages. *See, e.g.*, Sandra Fleishman, *Fed Favors Tougher Loan Rules; Abuses in Subprime Lending Are Targeted*, WASHINGTON POST, Dec. 14, 2000, at E1; Joe McDermott, *Predatory Lending Termed "A Major Problem,"* THE MORNING CALL (ALLENTOWN), Dec. 10, 2000, at B1; Richard A. Oppel Jr. & Patrick McGeehan, *Along With a Lender, Is Citigroup Buying Trouble?*, N.Y. TIMES, Oct. 22, 2000, at § 3, p. 1. The Federal Reserve Board's December 2000 proposed rule under HOEPA would prohibit creditors in the first five years of zero-interest rate or other low-cost loans from refinancing these loans with higher-rate loans, unless the refinancings were in the interest of the borrowers. Federal Reserve, *Truth in Lending*, *supra* note ____ at 81438.

Of course, some refinancings at higher interest rates have a valid economic justification from the borrowers' perspectives. For instance, homeowners who have substantial equity in their homes and who obtained their mortgages years ago at lower interest rates may wish to refinance, even though interest rates have risen, in order to finance children's college educations or home improvements. Absent other indicia of predatory lending, these loans can be legitimate where the homeowners qualify to afford the monthly loan payments.

suited for customers with weaker credit ratings.[20] Such steering is frequently fueled by "yield spread premiums," which are side payments by lenders to mortgage brokers for persuading borrowers to agree to higher interest rates when the lenders in fact are willing to extend credit to the borrowers at lower rates.[21] In computing finance charges under the Truth in Lending Act (TILA), lenders do not have to include yield spread premiums.[22] Even when yield spread premiums are disclosed, few, if any borrowers understand the purpose of those payments or the fact that their interest rates are higher as a result.

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[20] For instance, a Freddie Mac study reported that anywhere from between ten and thirty-five percent of subprime borrowers qualified for prime-rate loans. *See* Freddie Mac, AUTOMATED UNDERWRITING: MAKING MORTGAGE LENDING SIMPLER AND FAIRER FOR AMERICA'S FAMILIES ch. 5 & nn.5-6 (Sept. 1996) (hereinafter "Freddie Mac, AUTOMATED UNDERWRITING") (available at <http://www.freddiemac.com/corporate/reports/moseley/mosehome.html>). *See also* Sturdevant & Brennan, *supra* note ___, at 37; Stein, *supra* note 1, at 9-10; *cf.* Fannie Mae, Lender Letter No. 03-00 (Apr. 11, 2000) ("Lenders that offer higher cost products that are designed for less creditworthy borrowers should not steer applicants to these products if they can qualify for a lower-cost standard mortgage product").

[21] *See, e.g.*, HUD-Treasury Report, *supra* note ___, at 40; Simon, *supra* note ___, at 22-23. For a description of the finance charge for purposes of TILA, *see* text accompanying note ___ *infra.*

[22] *See, e.g.*, Kenneth M. Lapine, *Referral Fees and Other Compensation Issues Under the Real Estate Settlement Procedures Act of 1974, in* BANKING LAW (1998); Ralph J. Rohner & Fred H. Miller, TRUTH IN LENDING 121, 187-88 (2000). Courts are divided over whether yield spread premiums are prohibited kickbacks or legitimate payments for goods and services under RESPA, 12 U.S.C. §§ 2601(b)(2), 2607(a), (c). *Compare* Culpepper v. Inland Mortgage Corp., 132 F.3d 692 (11th Cir. 1998) (yield spread premiums are prohibited kickbacks; reversing grant of summary judgment for lender); DuBose v. First Security Sav. Bank, 974 F. Supp. 1426 (N.D. Ala. 1997) (denying lenders' motion for summary judgment on grounds that yield spread premiums may be illegal referral fees); Martinez v. Weyerhaeuser Mortgage Corp., 959 F. Supp. 1511 (S.D. Fla. 1996) (same); Mentecki v. Saxon Mortgage, Inc., 1997 U.S. Dist. LEXIS 1197, No. 96-1629-A, slip op. (E.D. Va. Jan. 10, 1997) (denying lender's motion to dismiss; borrowers stated a claim that a yield spread premium violated the anti-kickback provisions of RESPA); Moses v. Citicorp Mortgage, Inc., 982 F. Supp. 897 (E.D.N.Y. 1997) (same) *with* Barbosa v. Target Mortgage Corp., 968 F. Supp. 1548 (S.D. Fla. 1997) (a yield spread premium was a lawful payment for services). *See also* Robert M. Jaworski, *Overages: To Pay or Not to Pay, That is the Question*, 13 BANKING L.J. 909 (1996) (questioning legality of yield spread premiums under RESPA); Leonard A. Bernstein, *RESPA Invades Home Equity, Home Improvement and Mobile Home Financing*, 48 CONSUMER FIN. L.Q. 194, 197 (1994) (same).

In 1999, the Department of Housing and Urban Development (HUD) issued a policy statement on the legality of yield spread premiums paid by lenders. 64 Fed. Reg. 10079 (Mar. 1, 1999). HUD does not consider yield spread premiums illegal *per se*. Rather, the legality of those payments is to be judged according to two questions: (1) were goods, services or facilities actually provided for the compensation paid?; and (2) were the payments reasonably related to the value of those goods, services or facilities? *Id.* at 10085-86.

B. *Harmful Rent-seeking*

Although predatory loans can include prime-rate loans, predatory lending more commonly entails higher subprime interest rates and fees. High costs are not problematic *per se*. However, when subprime lenders use their market power to charge rates and fees that exceed the rates and fees they would obtain in a competitive market, they extract harmful rents from borrowers.[23] Such rent-seeking is another common feature of predatory lending.

From the viewpoint of distributive justice, interest *per se* and high interest in particular have been condemned as usurious since ancient times because they impose heavy costs on those who are least able to pay them. With experience, however, it has become apparent that subprime loans to riskier borrowers entail increased costs that lenders must be able to recoup. Subprime loans historically have had higher rates of delinquency, default and foreclosure than loans in the prime market.[24] As a result, they carry higher interest rates to compensate for the increased risk.[25] In addition, higher interest rates, either alone or with prepayment penalties, compensate lenders for the fact that subprime loans "tend to be prepaid at a much faster rate than prime mortgages."[26]

Origination costs and servicing costs of subprime loans are higher as well. Subprime loans are more expensive than prime loans to originate because they require closer scrutiny of

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[23] *See, e.g.*, 3 THE NEW PALGRAVE DICTIONARY OF ECONOMICS AND THE LAW 315-22 (Peter Newman ed. 1998) (commenting that "[r]ent seeking is unproductive; it destroys value by wasting valuable resources"). For discussion of how subprime lenders can exert such market power, *see* Section ___ *infra*.

[24] *See* WEICHER, *supra* note ___, at 56-57 & table 4.1, 69, 74-88; HUD-Treasury Report, *supra* note ___, at 28; *see also* Sturdevant & Brennan, *supra* note ___, at 38 ("Predatory lenders may charge rates of 19 to 25 percent, or 2 times rates being charged for conventional mortgages, which are usually obtainable at rates of 7 to 7.5 percent").

[25] *See generally* Dwight M. Jaffee & Thomas Russell, *Imperfect Information, Uncertainty, and Credit Rationing*, 90 QUARTERLY J. ECON. 651 (1976).

[26] HUD-Treasury Report, *supra* note ___, at 28; *see also* WEICHER, *supra* note ___, at 69.

income and credit history and result in a lower percentage of approved applications.[27] Concomitantly, subprime mortgage loans on average are substantially smaller than prime mortgages. Their smaller average loan size makes the origination costs for subprime loans higher than prime loans, not only in absolute dollars but also as a percentage of loan amounts.[28] Likewise, servicing costs are higher because subprime borrowers are more likely to default than their prime counterparts and loan administration requires more constant vigilance.[29]

While subprime loans generally are more expensive than prime loans for legitimate reasons, the high cost of subprime loans may also evince rent-seeking in certain cases. The practice of steering prime borrowers to high-cost lenders is one example of pricing that is designed to harmful extract rents. Rents can also inhere in added fees and closing costs, including fees for items such as credit reports and document preparation that exceed market rates.[30] Other forms of padding are even more blatant. Lenders may bill borrowers for duplicative charges, fees for services never rendered or surcharges on government recording fees.[31] In a similar manner, credit life insurance and similar types of insurance have been singled out for pricing abuses. The insurance abuses are rife and range from premium charges that are high relative to actual loss payouts, single-premium payments for insurance that extends beyond

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[27] *See* WEICHER, *supra* note ___, at 67; HUD-Treasury Report, *supra* note ___, at 28. This assumes, of course, that underwriting is actually performed, which is not always true in asset-based loans by predatory lenders.

[28] *See* WEICHER, *supra* note ___, at 61-62, 67, 69-70; HUD-Treasury Report, *supra* note ___, at 28.

[29] *See* WEICHER, *supra* note ___, at 56-57 & table 4.1, 69, 74-88; HUD-Treasury Report, *supra* note ___, at 28.

[30] *See* Sturdevant & Brennan, *supra* note ___, at 38-39. In a recent study of settlement fees, Mark Shroder found "huge deviations in total lending and title fees paid for transactions" of similar value to sellers. He further found that higher fees for particular line items correlated positively with higher fees for other line items, suggesting that "some people are candidates for high fees in both title insurance and lending." Mark Shroder, *The Value of the Sunshine Cure: Efficacy of the RESPA Disclosure Strategy* 14-15, Figure 2, Table 4 (Working Paper Apr. 14, 2000).

the life of the loan, policies issued to borrowers who do not qualify for insurance[32] and insurance policies written on total indebtedness, not on repayment of the principal.[33]

C. *Fraud Or Deceptive Practices*

The most blatant forms of predatory lending involve the age-old problem of fraud. All of the deceptive practices in this category are in violation of existing laws, such as state fraud statutes, state consumer protection laws, state fiduciary duties or federal disclosure statutes such as TILA[34] or the Real Estate Settlement Procedures Act (RESPA).[35]

Lending fraud comes in endless varieties and is only limited by the ingenuity of the perpetrator. Nevertheless, recent incidents in the home lending market can be divided into two basic types of fraud. The first type of fraud consists of deception aimed at borrowers.[36] Among the many types of deception that have been reported in this regard, the more notorious include fraudulent disclosures, failures to disclose information as required by law, bait and switch tactics, and loans made in collusion with home repair scams. Fees may be financed without the

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31 *See* Sturdevant & Brennan, *supra* note ___, at 38-39.

32 Older homeowners, for example, often do not qualify for credit life insurance due to advanced age.

33 *See* HUD-Treasury Report, *supra* note ___, at 81, 88 & n.85, 89, 91; Sturdevant & Brennan, *supra* note ___, at 39; *Unscrupulous Lenders Exploit Poor, Elderly*, ATLANTA JOURNAL-CONSTITUTION, Dec. 13, 1998, at R4; *cf.* Freddie Mac, Seller Guide Bulletin, Single-Premium Credit Insurance Products (Apr. 21, 2000) (available at <http://www.freddiemac.com/sell/selbultn/421indltr.html>) (prohibiting prepaid single-premium credit life insurance in mortgages sold to Freddie Mac); Fannie Mae, Lender Letter No. 03-00 (Apr. 11, 2000) (same for mortgages sold to Fannie Mae). *See generally* National Association of Insurance Commissioners, A BACKGROUND STUDY OF THE REGULATION OF CREDIT LIFE AND DISABILITY INSURANCE (1970); National Consumer Law Center, COMPUTING RATES FOR CREDIT LIFE INSURANCE AND CREDIT ACCIDENT AND HEALTH INSURANCE (Feb. 6, 1976).

34 15 U.S.C. §§ 1601 *et seq.*

35 12 U.S.C. §§ 2601 *et seq.*

36 *See generally* HUD-Treasury Report, *supra* note ___, at 24, 79-90; Expanded Interagency Guidance for Subprime Lending Programs, *supra* note ___; Hargraves v. Capital City Mortgage Corp., Brief of the United States as Amicus Curiae in Support of Plaintiffs' Opposition to Defendant's Motion for Judgment on the Pleadings or, in the Alternative for Summary Judgment, at 1, 6-13, Civ. No. 98-1021 (JHG)/(AK) (D.D.C.); Lara Becker *et al.*, *Some Subprime Lenders are Causing Pain for Residents*, DEMOCRAT AND CHRONICLE, Feb. 27, 2000, at A1.

borrowers' knowledge, title in their property may be secretly conveyed or liens on their homes may be deliberately concealed. Borrowers may be defrauded into thinking that they must buy credit life insurance in order to proceed to closing or that a lender is officially affiliated with a federal agency such as the Veterans Administration or FHA. Brokers may dupe borrowers into believing that they are acting in the best interests of the borrowers when their real financial loyalties are to the lenders. Brokers and lenders may lure borrowers to closing by promising to finance needed home repairs to fix housing code violations or to refinance loans later on at lower rates.

The other type of fraud consists of deception that is aimed at capital sources, such as secondary market purchasers of loans,[37] federal loan guarantors and sometimes even loan originators themselves. Such fraud typically takes the form of falsified loan applications or inflated real estate appraisals.[38] For instance, a lending officer may induce an unsuspecting, impoverished borrower to sign a blank loan application, which the mortgage broker or lender then falsifies to paint a glowing picture of the borrower so that the loan easily can be resold on the secondary market. Similarly, unscrupulous lenders may commission inflated appraisals to support a federal loan guarantee; unscrupulous mortgage brokers may do the same to justify a higher amount of principal. In most cases, the borrowers are unaware of the fraud and generally are the secondary victims. This second form of fraud is symptomatic of agency problems that

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[37] All references to the secondary market in this Article denote the market for the sale of mortgage-backed securities to investors, either through private placements or public offerings. Institutional investors such as banks and thrifts and government-sponsored entities such as Fannie Mae and Freddie Mac purchase mortgage-backed securities in private placements. The public can invest in mortgage-backed securities through public offerings.

[38] *See, e.g.*, HUD-Treasury Report, *supra* note ___, at 21-22, 80; Sturdevant & Brennan, *supra* note ___, at 37; Patrick Barta, *Is Appraisal Process Skewing Home Values?*, WALL ST. J., Aug. 13, 2001, at A-1 (hereinafter "Barta, *Is Appraisal process Skewing*").

characterize lenders, borrowers, mortgage brokers, federal loan guarantors and the secondary market, as we will describe.

D. *Other Forms Of Lack Of Transparency That Are Not Actionable As Fraud*

In other mortgages that are devoid of fraud, lack of transparency may still be a problem. In contrast to loans involving fraud, this group of loans involves misleading omissions that are currently countenanced by law.

In most mortgages, federal law requires the disclosure of certain loan terms or costs, either under TILA[39] or RESPA.[40] Both statutes seek to supply consumers with standardized cost information about mortgage loans in order to facilitate comparison shopping. TILA does so by requiring lenders to disclose two key figures, the finance charge and the annual percentage rate (APR). The finance charge purports to measure the total cost of credit in dollars, including interest payments, points, origination fees and private mortgage insurance. The APR provides a different measure of total credit costs by translating the lump sum finance charge into an effective interest rate per year.[41]

RESPA seeks to provide consumers with adequate disclosures about closing costs for mortgages. Under RESPA, lenders must provide borrowers with two different disclosure statements. In the good faith estimate of settlement costs (GFE), lenders must provide borrowers

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39 15 U.S.C. §§ 1601 *et seq.*

40 12 U.S.C §§ 2601 *et seq.*

41 *See generally* HUD & Federal Reserve Board, *Truth in Lending Act and the Real Estate Settlement Procedures Act*, Joint Report to Congress, Executive Summary I (July 1998) (available at <http://www.federalreserve.gov/boarddocs/rptcongress/tila.pdf>) (hereinafter cited as "HUD-Fed Joint Report"); Rohner & Miller, *supra* note ___, at 179.

with an itemized estimate of the closing costs. Later, at the closing, lenders must provide a HUD-1 settlement statement that reflects the actual closing costs that borrowers must pay.[42]

Both RESPA and TILA have loopholes that hinder effective disclosure. Under TILA, significant costs are excluded from the finance charge and APR, meaning that the reported total cost of credit is too low. These exclusions include fees for credit reports, appraisals, inspections by lenders, flood certifications, document preparation, title searches and title insurance, as well as notary fees, recording fees and government taxes.[43] RESPA's disclosure system has flaws in timing and enforcement. GFEs do not have to be provided until three days after application, after an application fee has already been paid. Furthermore, since lenders face no liability for errors on the GFE or the HUD-1 settlement statement, estimates sometimes bear little relationship to actual costs. Both flaws mean that GFEs are not useful tools for comparison shopping.[44] Similarly, while borrowers may request their HUD-1 settlement statements a day before closing, they do not need to be informed of that right and there is no requirement that advance settlement statements be accurate.[45]

Other pricing practices that are not regulated by TILA and RESPA hamper transparency as well. In the prime mortgage industry, points generally are accompanied by a reduction in the

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[42] *See generally* HUD-Fed Joint Report, *supra* note ___, Executive Summary II.

[43] *See id.* at VII-XI.

[44] *See id.* at XI. In a recent survey of GFEs, economist Mark Shroder found that many of the GFEs were off by "a fair amount" and that a minority of borrowers received "large underestimates." Shroder, *supra* note ___, at 12.

[45] *See* HUD-Fed Joint Report, *supra* note ___, Executive Summary XIX. HOEPA provides somewhat stronger protections for the scant one percent of subprime laws that fall within its coverage. Under HOEPA, the lender must make certain written disclosures three days before closing. *See* 12 C.F.R. § 226.32; notes___- ___ *infra* and accompanying text.

interest rate.[46] The purpose of this tradeoff is to afford borrowers the option of defraying part of the cost of borrowing by paying a liquidated sum up-front in points in exchange for lower interest payments in the future. For similar reasons, conventional lending norms state that prepayment penalty provisions go hand-in-hand with reductions in interest rates.[47]

The rationale for these norms is to afford borrowers a choice in how they wish to defray the time-price differential of money. Legitimate lenders provide such a choice. Predatory lenders, in contrast, subvert this conventional tradeoff by layering points or prepayment penalties on top of high interest rates on a take-it-or-leave-it basis. In competitive loan markets, market forces and disclosures are generally sufficient to curb such abuses. In the market for predatory loans, however, disclosures are usually incomprehensible and market forces do not provide sufficient constraints against that conduct, for reasons that we will explain.

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[46] *See, e.g.*, Kathleen E. Keest & Elizabeth Renuart, THE COST OF CREDIT REGULATION AND LEGAL CHALLENGES 163 (2d ed. 2000) ("points are usually treated as a discount withheld from the loan, thus reducing the amount that the borrower receives") (footnote omitted) (hereinafter cited as "THE COST OF CREDIT"); Sturdevant & Brennan, *supra* note ___, at 38; WEICHER, *supra* note ___, at 67 (in the legitimate subprime market, "[t]he higher the interest rate a borrower is willing to pay, the fewer points may be charged, and conversely").

[47] *See In Reality, "Predatory Lending" Isn't Easy to Define*, *supra* note ____ ("[p]lease keep in mind that having no prepayment penalty is a double-edged sword: it helps with eliminating prepayment penalties at the price of a much higher interest rate"); WEICHER, *supra* note ___, at 71-74.

Under the HOEPA, the Federal Reserve Board limits prepayment penalties for high-cost, closed-end home mortgage refinance loans. Prepayment penalties are only allowed if they are in effect for no more than five years following closing, if the refinancing is performed by someone other than the original lender or an affiliate, and if the consumer's total monthly debts at closing (including the HOEPA loan) do not exceed half of her verified monthly gross income. 12 C.F.R. § 226.32(d). Loans that are outside of HOEPA's coverage are not subject to these restrictions on prepayment clauses.

E. *Loans That Require Borrowers To Waive Meaningful Legal Redress*

Many home mortgage loans, particularly subprime loans, contain non-negotiable, mandatory arbitration clauses that bar the borrowers from seeking judicial redress.[48] Some clauses may prohibit borrowers from joining plaintiff class actions against lenders. Other clauses shift lenders' attorneys' fees on to the borrower.[49]

III. MARKET SEGMENTATION AND PREDATORY LENDING

As we have suggested, the pathologies that epitomize predatory lending are the product of market failures in the subprime mortgage market. In this section of the paper, we describe how changes in the financial services market have altered the conventional home mortgage market and given rise to predatory lending. In particular, we argue that today's home mortgage market is replete with information asymmetries that predatory lenders have exploited to the detriment of borrowers who are disconnected from the credit market.

We begin with a discussion of the conventional theory of the market for home mortgages and the impact of historical lending practices on low and moderate income (LMI) borrowers. Later, we examine the ways in which securitization, new mortgage products, and incentives for lenders to focus on LMI borrowers have altered the home mortgage market. We then explain

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[48] *See* Shelly Smith, *Mandatory Arbitration Clauses In Consumer Contracts: Consumer Protection and the Circumvention of the Judicial System*, 50 DEPAUL L. R. 1191, 1191-92 (2001) (discussing the problems with mandatory arbitration clauses in consumer contracts).

[49] *See* HUD-Treasury Report, *supra* note ___, at 99.

In the recent case of Green Tree Financial Corp.-Alabama v. Randolph, ___ U.S. ___, 121 S. Ct. 513 (2000), which involved a TILA claim by a borrower against a mobile home finance lender, the loan contained a mandatory arbitration clause that was silent as to arbitration procedures, costs and fees. The borrower sought to invalidate the arbitration clause, arguing that she did not have sufficient resources to pay if the arbitration eventually resulted in fees. In a 5-to-4 decision, the Supreme Court rejected her claim for lack of evidence of prohibitive fees: "[W]here, as here, a party seeks to invalidate an arbitration agreement on the ground that arbitration would be prohibitively expensive, that party bears the burden of showing the likelihood of incurring such costs." ___ U.S. at ___, 121 S. Ct. at 522. While the Court suggested that prohibitive filing fees or charges by the arbitrator would

predatory lenders' emergence and how they have been able to exploit information asymmetries to the detriment of many LMI borrowers. In the concluding section, we explain why the market will not correct these inefficiencies.

A. *The Conventional Theory Of The Market For Home Mortgages*

In a market with full information about borrowers' characteristics, we would expect that the price[50] of a loan would reflect the risk presented by the borrower. All else being equal and with full information, for every borrower, lenders could determine a loan price that would be the risk-adjusted equilibrium price. The reality, however, is that lenders do not have full information about the risk that borrowers will default, the costs of foreclosure if they do default and the net amount recoverable in the event of foreclosure. As a result, lenders cannot accurately identify borrowers who present the greatest risk and cannot price loans accurately based on risk

Twenty years ago, Stiglitz and Weiss recognized that this lack of information creates an adverse selection problem that prevents the market for mortgages from clearing.[51] The key to this adverse selection problem is that high interest rates deter the borrowers who are risk-averse and who present a low risk of default. Conversely, high interest rates are less likely to deter borrowers who are willing to take on high levels of risk and who present a greater risk of

provide grounds for striking down an arbitration clause, it created a Catch-22 by requiring litigants to proceed to arbitration in order to adduce proof that they face excessive fees at all.

[50] The price of loans includes the nominal interest rate, points, insurance and all other fees associated with a loan.

[51] Joseph E. Stiglitz & Andrew Weiss, *Credit Rationing in Markets with Imperfect Information*, 71 AMER. ECON. REV. 393 (1981) (hereinafter Stiglitz & Weiss, *Credit Rationing)*; Joseph E. Stiglitz & Andrew Weiss, *Macro-Economic Equilibrium and Credit Rationing* (NBER Working Paper Series No. 2164, 1987). For an expanded discussion of the Stiglitz and Weiss model, *see* William C. Gruben, *et al.*, *Imperfect Information and the Community Reinvestment Act*, ECON. REV. 27, 30-31 (Summer 1990).

default.[52] Thus, according to Stiglitz and Weiss, if lenders raise interest rates, they will attract loan applicants who present elevated risks of default and they will deter borrowers who present lower default risks.[53]

Given that lenders cannot identify the less risky borrowers and that high interest rates will deter the very borrowers whom they seek to attract, lenders will set the price of loans below the market-clearing rate.[54] Lenders further reduce their risk by limiting the amount that borrowers can borrow.[55] This has the effect of creating an additional safeguard against default by risky borrowers and deters risky borrowers that want to borrow more money than lenders will permit.[56] The result under the Stiglitz and Weiss model is that: (1) the demand for loans will exceed the supply; (2) to the extent that lenders can identify applicants[57] who are high default risks, [58] the

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[52] Less risk-averse borrowers will be more likely to assume loan obligations that they cannot meet. This may be because they have an inflated sense of their ability to meet their loan obligations, they are by nature risk-taking, they do not understand the loan terms and/or the personal costs of default may be low for them. For an analysis of the private costs of default, *see* Jan K. Brueckner, *Mortgage Default with Asymmetric Information*, 20 J. R.E. FINANCE & ECON. 251, 252 (2000).

[53] *See* Michael Klausner, *Market Failure and Community Investment: A Market-Oriented Alternative to the Community Reinvestment Act*, 143 U. PENN. L. REV. 1561, 1566-68 (1995) (observing that if lenders were to make loans to the highest bidders, the lenders would be loaning to the riskiest and least risk-averse borrowers).

[54] Stiglitz & Weiss , *Credit Rationing, supra* note ___, at 394.

[55] This could be done through loan-to-value ratios or through across-the-board limits on the maximum size of loans.

[56] *See* Brueckner, *supra* note ___, at 252, 264.

[57] Sometimes it is not possible to observe the risk presented by borrowers, *e.g.*, if borrowers do not participate in the credit economy and, therefore, have no credit history. Even where it may be possible to evaluate the risk borrowers present, the cost of obtaining and evaluating the relevant information may exceed the benefit of extending credit to these borrowers. *See* Klausner, *supra* note ___, at 1568.

[58] The determination that borrowers are risky can be based on array of different factors. It could be that the borrowers have weak or no credit histories. In other cases, borrowers may not have financial information in a form that is easy for lenders to assess or there may be a risk that the underlying collateral will not retain its value.

lenders will reject their applications for loans; and (3) among the remaining applicants in the queue, who are observationally indistinct, some will receive loans and other will not.[59]

Until the late 1980s, the home mortgage market behaved as Stiglitz and Weiss predicted. Federally insured banks and thrifts dominated the market for home mortgage loans.[60] There was minimal risk-adjusted pricing,[61] each bank was limited in the amount of funds it could lend[62] and demand exceeded supply.[63] Most importantly, for the purposes of this paper, credit rationing significantly constrained the amount of mortgage capital available to low and moderate income borrowers. This is because LMI borrowers tend to present greater risks of default than their more affluent counterparts.[64]

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59 The reason that lenders will not lend to all observationally indistinct borrowers is that when lenders set the price of loans at a rate below the market clearing level, the amount of funds that they can raise to lend is limited. The marginal cost of procuring additional funds that would meet the demand of the excluded, observationally indistinct borrowers would exceed the marginal benefit that would accrue from lending to them. For a model of this phenomenon, *See* Stiglitz & Weiss, *Credit Rationing*, *supra* note ___, at 397.

The theory of credit rationing persists even if borrowers are able to provide collateral. For a discussion of the role of collateral in credit rationing, *see* Dwight M. Jaffee & Franco Modigliani, *A Theory and Test of Credit Rationing: Reply*, 66 AM. ECON. REV. 913 (1976).

60 As one author described the market: "the banking system had a monopoly on the liquid assets of the nation." Lowell Bryan, *The Risks, Potential and Promise of Securitization*, *in* A PRIMER ON SECURITIZATION 171-72 (Leon T. Kendall & Michael J. Fishman, eds. 1996). Finance companies and other nonbank lenders wrote home loans, but they only represented a fraction of the home mortgager market.

61 John V. Duca & Stuart S. Rosenthal, *Do Mortgage Rates Vary Based on Household Default Characteristics? Evidence on Rate Sorting and Credit Rationing*, 8 J. REAL ESTATE FINANCE & ECON. 99, 107 (1994).

62 Leland C. Brendsel, *Securitization's Role in Housing Finance: The Special Contributions of the Government Sponsored Enterprises*, *in* Kendall & Fishman, *supra* note ____, at 19.

63 Lewis S. Ranieri, *The Origins of Securitization, Sources of its Growth, and its Future Potential*, *in* Kendall & Fishman, *supra* note ____, at 32.

64 Keith N. Hylton & Vincent D. Rougeau, *Lending Discrimination: Economic Theory, Econometric Evidence, and the Community Reinvestment Act*, 85 GEO. L.J. 237, 259 (1996); Klausner, *supra* note ___, at 1568.

While there was some rate sorting in the past, *i.e.*, offering borrowers different loan prices based on their observable levels of risk, the overwhelming evidence reveals that credit rationing had the effect of rationing most LMI borrowers out of the home mortgage market. Stiglitz & Weiss, *Credit Rationing*, *supra* note ___, at 406; Duca & Rosenthal, *supra* note ___, at 101-02.

B. *Changes In The Home Mortgage Market*

Beginning in the 1980s, several changes in the financial services market led to an increase in the amount of capital available to lend and spurred the emergence of new types of lenders. The most important changes were the securitization of home mortgages, the availability of new mortgage products and incentives for lenders to increase their lending activity in LMI neighborhoods.

1. *Securitization*

Freddie Mac spearheaded the securitization movement in the 1970s in an effort to increase the amount of available mortgage capital. Widespread securitization by government-sponsored entities (GSEs)[65] and the private sector began in the 1980s and by 1993, sixty percent of home mortgage loans were securitized.[66] In the process, securitization single-handedly transformed the financial services market. It is now routine for lenders to originate loans and sell them to secondary market institutions, which provide a steady stream of capital to lend.[67]

Securitization is the process of converting packages of home loans into securities that are backed by collateral in the form of loans.[68] The first step in the securitization process is for a

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[65] The most well-known GSEs today are Fannie Mae and Freddie Mac.

[66] Brendsel, *supra* note ___, at 17-19. During the same time period, investment fund managers were looking for new investment vehicles and mortgage-backed securities fit the bill. Leon T. Kendall, *Securitization: A New Era in American Finance, in* Kendall & Fishman, *supra* note ___, at 2-3.

[67] Securitization not only generates more mortgage capital, it also adds value by reducing risks and costs through diversification. For example, by pooling individual loans, the collective risk of a package of loans defaulting is less than the average risk of any one loan going into default.

In addition, once loans are securitized, under the holder in due course rule, borrowers typically cannot defend non-payment on the grounds that the lenders engaged in unlawful activity related to the loan, for example, by committing certain types of fraud on borrowers. *See* notes ___ *infra* and accompanying text. This has the effect of increasing the value of the loans upon securitization.

[68] Tamar Frankel, *Securitization (Asset-Backed Securities and Structured Financing), in* FINANCIAL PRODUCT FUNDAMENTALS: A GUIDE FOR LAWYERS 4-2 (1999).

lender to make loans to borrowers. The loans then are bundled and transferred to an entity, often known as a "special purpose vehicle" (SPV) that passively holds the loans.[69] The SPV adds credit-enhancements that have the effect of reducing the risks associated with defaults.[70] The SPV then creates and issues the mortgage-backed securities and sells the securities to investors.[71] The proceeds from the sale of the securities are passed on to the entity that sold the loans less the expenses that the SPV incurred. In some cases, the SPV services the loans, *i.e.*, collects the loan payments, and distributes the proceeds to the investors.[72] Other times, the seller of the loans retains the servicing rights.

Securitization, by making possible a constant flow of money to the home mortgage market, has dramatically altered the business of mortgage lending. Banks and other lenders do not suffer from liquidity restraints and more funds are available to lend borrowers. Securitization also has created opportunities for nonbank lenders to enter the home mortgage market.[73] Lenders no longer need to be large financial institutions with significant deposits and capitalization. Rather, thinly-capitalized mortgage bankers and finance companies can originate loans for sale on the secondary market.[74]

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69 These entities may take a number of different organizational forms, *e.g.*, trusts, corporations, or partnerships. Frankel, *supra* note ___, at 4-4.

70 Examples of credit enhancements are insurance and third-party guarantees. Frankel, *supra* note ____, at 4-15; Kendall, *supra* note ____ at 4. In addition, secondary market purchasers can require recourse provisions, which also reduce the risks associated with default.

71 When loans are securitized by government-sponsored entities, the GSEs purchase and package the loans, create the securities and market the securities through brokers. Brendsel, *supra* note ___, at 21.

72 As discussed *infra* at note ____ and accompanying text, when sellers retain servicing rights, they have a greater interest in the quality of the loans.

73 Brendsel, *supra* note ___, at 24.

74 *Id.*

2. *Expanded Mortgage Products*

Historically, lenders primarily offered cookie-cutter, fixed-rate loans. Coincident with the expansion of the home mortgage market in the early 1980s, Congress enacted the Depository Institutions Deregulation and Monetary Control Act of 1980 (DIDMCA)[75] and the Alternative Mortgage Transactions Parity Act of 1982 (AMTPA),[76] both of which paved the way for the proliferation of new mortgage products.[77]

In DIDMCA, Congress extended the favorable variable rate ceiling for national banks to all federally insured banks and thrift institutions[78] and preempted all state usury ceilings on "interest, discount points, finance charges, or other charges" for loans secured by first mortgages on debtors' homes, including conventional homes and mobile homes.[79] As a result, lenders who wanted to charge higher rates had new incentives to refinance first mortgages, rather than to offer junior mortgages, whether home equity lines or otherwise, that were subject to state usury laws.[80]

Along a similar vein, in AMTPA, Congress extended the liberal mortgage lending regulations for federally chartered depository institutions to most lenders making senior and

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[75] Pub. L. No. 96-221, 94 Stat. 164 (1980).

[76] Pub. L. No. 97-320, 96 Stat. 1469 (1982).

[77] *See generally* Office of Thrift Supervision, Advance notice of proposed rulemaking, *Responsible Alternative Mortgage Lending*, 65 Fed. Reg. 17811, 17813-14 (Apr. 5, 2000).

[78] 12 U.S.C. §§ 1463(g), 1785(g), 1831d(a); *see also* 12 U.S.C. § 85. That change permits insured depository institutions of all types to set interest rates as high as one per cent over the discount rate on ninety day commercial paper in effect at the Federal Reserve District in which the institution "is located." *Id.*

[79] 12 U.S.C. § 1735f-7a.

[80] Although Congress permitted the states to enact laws opting out of federal preemption, only sixteen did so, either in part or in whole. *See* THE COST OF CREDIT, *supra* note ___, at 64, 72-74; Julia Patterson Forrester, *Mortgaging the American Dream: A Critical Evaluation of the Federal Government's Promotion of Home Equity Financing*, 69 TULANE L. REV. 373, 398-400 (1994) (hereinafter "Forrester, *American Dream*"); Mansfield, *supra* note ___, at 492-520.

junior residential mortgages.[81] These regulations preempted old restrictions that limited lenders to making fixed-rate, amortizing mortgages.[82] As a result, lenders received the green light to make adjustable rate mortgages, mortgages with balloon payments and non-amortizing mortgages where borrowers pay off the interest but not the principal.

3. *Incentives To Lend To LMI Borrowers*

Both market incentives and federal initiatives have made it appealing for some lenders to focus on LMI borrowers. In the past, credit rationing excluded many potential LMI borrowers from the home mortgage market. As a result, there have been high levels of demand for loans and little competition from traditional lenders in LMI neighborhoods. In addition, many LMI homeowners experienced a rise in their wages and home values in the 1990s.[83] Lenders have tapped into borrowers' increased cash flow and have secured their loans with borrowers' increased equity.

In terms of federal initiatives, one piece of legislation that has encouraged lenders to focus on LMI borrowers is the 1992 Federal Housing Enterprise Financial Safety and Soundness

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81 12 U.S.C. §§ 3801 *et seq.*

82 Congress gave states an opt-out provision, but only six states chose to exercise that option. *See* THE COST OF CREDIT, *supra* note ___, at 64, 72-74, 109-111; Office of Thrift Supervision, Advance notice of proposed rulemaking, *Responsible Alternative Mortgage Lending*, 65 Fed. Reg. 17811, 17813-14 (Apr. 5, 2000); Forrester, *American Dream, supra* note ___, at 400-01. The act authorizes lenders to make alternative mortgage loans as long as the transactions are "in accordance with" appropriate and applicable OTS regulations. OTS is giving consideration to whether to amend those regulations in some way to deter predatory loans. *See Responsible Alternative Mortgage Lending, supra*, at 17815-16.

83 Arthur Kennickell *et al.*, *Family Finance in the U.S.: Recent Evidence from the Survey of Consumer Finances*, 83 FED. RES. BULL. 1, 5 (January 1997); Glenn B. Canner *et al.*, *Recent Developments in Home Equity Lending*, FED. RES. BULL. 241, 249 (April 1998) (hereinafter "Canner et al., *Recent Developments*").

Low and moderate income borrowers are the fastest growing group of borrowers in the mortgage market. Keith N. Hylton, *Banks and Inner Cities: Market and Regulatory Obstacles to Development Lending*, 17 YALE J. ON REG. 197, 205 (2000) (citing John R. Wilke, *Giving Credit: Mortgage Lending to Minorities Shows a Sharp 1994 Increase*, WALL ST. J., Feb. 13, 1996, at A1).