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Additio. ılly, the SRO would be required to adopt rules requiring its members to refrain from deceptive or exploitative lending practices and to promote, in the words of the Exchange Act, "just and equitable principles of trade."[393] As part of that requirement, Congress could specifically require that the rules contain a suitability requirement. In order to assure enforcement, the SRO also would have to adopt disciplinary rules and procedures to enable it to discipline members for violations of the rules or companion laws. All SRO rules would be subject to government review, amendment, public comment and approval. Finally, federal legislation should prohibit the SRO from imposing any burden on competition that is not necessary or appropriate to accomplish borrower protection.[394]

Although the SRO proposal could be enacted by individual states, it would have the most powerful effect at the federal level. Enactment of a SRO requirement at the national level would make it impossible for lenders and mortgage brokers to evade regulation by migrating to unregulated states. A national SRO also would be cost-effective in two respects. First, the cost of developing rules and instituting a disciplinary apparatus would be spread across market participants in all fifty states. Secondly, uniform national SRO standards would significantly reduce compliance costs for lenders and brokers with operations in multiple states.

3. *A New Cause Of Action For Breach Of The Duty Of Suitability*

While industry self-regulation is essential, it does not force predatory lenders and brokers to internalize the cost of the harm that they cause because it does not necessarily result in

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393 Exchange Act § 15A(b)(6).

394 Two additional sets of rules would be advisable: (1) rules ensuring fair disciplinary procedures and fair internal governance by members; and (2) minimum capital, bonding or insurance requirements for lenders and brokers to help insure that they internalize the costs of any harm they cause.

recompense to victims.[395] Consequently, we recommend legislation creating a new cause of action against subprime mortgage lenders and brokers for breach of a duty of suitability in the making of loans secured by borrowers' homes. We further propose that Congress empower both injured borrowers and the government to bring suitability claims.

a. *Dual Federal/State Jurisdiction*

Ideally, a new cause of action for breach of suitability would be federal in nature. A federal cause of action is essential for several reasons. First, a federal suitability rule would promote certainty and efficiency for interstate lenders by adopting a single suitability standard with nationwide applicability. Second, a federal suitability rule would remove the incentives that now exist to transfer predatory lending operations out of strict states such as North Carolina and New York into unregulated states. Finally, a federal right of action would facilitate enforcement against large interstate lenders with operations in many states.

At the federal level, a new private right of action could take one of two routes. First, Congress could enact a new, freestanding cause of action conferring a duty of suitability. Alternatively, Congress could amend an existing statute to provide a new cause of action for breach of suitability. For example, Congress could amend Section 5 of the Federal Trade Commission Act to add a private right of action for suitability. Or Congress could amend HOEPA to add a new suitability claim, keeping in mind that new remedies would have to be authorized in order to afford appropriate relief.

States also can play a critical role in combating predatory lending. They can pass state analogues to the federal suitability legislation that we propose. Similarly, where state UDAP

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395 Typically, SRO disciplinary sanctions are limited to expulsion, suspension, censure, injunctive-style relief and fines.

statutes are sufficiently broad, state attorneys general and private individuals can rely on those statutes to bring suitability-type claims. Any federal suitability legislation should not limit the states' ability to enact stronger predatory lending laws.[396]

For a number of reasons, federal preemption in predatory lending would be highly undesirable. First, it would destroy the ability of the states to serve as laboratories for developing regulatory techniques. Regulation of predatory lending has been largely ineffective to date and it is not yet always clear where to draw the regulatory line to deter predatory lending without restricting legitimate subprime credit. As the states implement various approaches to redressing predatory lending, their efforts could yield new innovations and valuable insights. Indeed, the North Carolina and New York experiences are expected to yield information on the effect of their particular anti-predatory lending efforts on predatory lenders and the availability of mortgage capital. In a similar vein, state legislation would strengthen the multiple gatekeeper system by empowering state attorneys general and state agencies to enforce predatory lending laws. For these reasons, we strongly oppose federal preemption in the area of predatory lending.[397]

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396 Federal legislation, however, would need to provide a floor. Lenders and brokers would have to comply with federal standards at a minimum and federal standards would preempt any weaker state laws.

397 We recognize that stronger state laws might counteract national uniformity to some extent. However, we believe that the extent to which that could occur would be minimal. In all likelihood, relatively few states would be able to pass stronger predatory lending laws, due in part to the formidable lobbying force of the financial services industry. Indeed, that has been the experience in the area of financial privacy under Title Vo of the Gramm-Leach-Bliley Act of 1999. Title V imposed federal regulation but allowed states to pass stricter financial privacy laws. 15 U.S.C. §§ 6801-6809. Notwithstanding Congress' decision not to impose federal preemption, few, if any, states have enacted stricter financial privacy laws to date. *See, e.g.*, LeBoeuf, Lamb, Greene & MacRae, L.L.P., *State Regulations/Legislation on Gramm-Leach-Bliley Privacy Provisions* (available at <www.insurelegal.com/20001116PrivacyStateRegChart.html>); Adam Wasch, *Session's Bill Preempts States from Tougher Position Than Current Law*, BNA BANKING REP., Aug. 13, 2001 (noting state attempts to pass stricter privacy laws but no enactments).

b. *Agency Enforcement*

We propose a third gate-keeping mechanism: agency enforcement. Consistent with a multiple gatekeeper approach, agency enforcement would provide a powerful additional deterrent to predatory practices. In addition, the enabling legislation could require the appointed agency to exercise its rulemaking and guideline powers to give content to the general duty of suitability. The agency would thus have the mandate to enumerate specific practices that are regulated as unsuitable. The rulemaking process would provide market actors with opportunities for input into the development of the rules. They could rely on agency interpretations for guidance, which would help them in determining whether practices were unlawful. Lastly, rulemaking would give agencies the flexibility they need to add new practices to the list as needed.

At the federal level, agency oversight authority should be located in one agency.[398] Agency jurisdiction could be vested either in the Board of Governors of the Federal Reserve System or the FTC. Each choice has its advantages and disadvantages. The FTC has specific experience in applying suitability to predatory lending cases.[399] In addition, unlike the Federal Reserve, the FTC is not distracted by competing agency goals such as systemic safety and soundness. On the other hand, the Federal Reserve Board has greater independence from political shifts in administrations than the FTC. Similarly, the Federal Reserve brings experience with predatory lending concerns to the table through its administration of HOEPA, although, in contrast to the FTC, the Federal Reserve has not yet embraced suitability as a concept.

398 This would contrast with the approach taken in many federal consumer protection statutes in financial services to date, which have divided enforcement authority among multiple agencies. *See, e.g.*, McCoy, *supra* note ___, §§ 8.02[1][c][iii] (ECOA); 8.02[2][b][ii] (Fair Housing Act).

399 *See* note ___ *supra.*

Vesting rulemaking authority in a government agency can raise enforcement concerns where the agency declines to exercise its authority, whether for political reasons or otherwise. The Federal Reserve engaged in this type of foot-dragging when it delayed using its authority under HOEPA for several years, until December 2000, to strengthen rules against predatory lending. Congress could reduce the risk of potential inaction in a number of ways. In the statute, it could enumerate problematic loan terms and practices and require the agency to promulgate regulations on those subjects by specified deadlines. Congress could also require the agency to report back annually or biannually to explain any statutory item that it had declined to regulate. Lastly, Congress could require the implementing agency to issue advance notices of proposed rulemaking by dates certain in order to solicit public comment on the need for additional changes.

c. *Defining Suitability*

i. *Rules Versus Standards*

In federal securities regulation, suitability is a remarkably vague standard and has best been described as the duty to have "a reasonable basis for recommending a security or investment strategy."[400] While debate has centered around predicating suitability on modern portfolio theory or older views singling out individual securities as unsuitable,[401] there has been relatively little call to reduce the duty of suitability in securities to a set of more particularized conduct rules.[402] Using a general reasonableness standard rather than specific rules has had benefits in securities. On the one hand, courts have interpreted the reasonableness standard

400 Mark J. Astarita, *Brokers Have to be Their Own Judge* (available at <www.seclaw.com/docs/397.htm>).

401 *See, e.g.*, Kerr, *supra* note ____, at 805.

402 *See, e.g.*, Cass R. Sunstein, *Problems With Rules*, 83 CALIF. L. REV. 953 (1995).

broadly to give deference to recommendations by brokers-dealers that are controversial, but arguably suitable. On the other hand, the broad and flexible nature of a reasonableness standard has served to deter new suitability abuses.

In contrast, in addressing predatory lending, Congress, state legislatures and agencies have largely refused to consider a broad reasonableness standard and instead have favored particularized rules.[403] This raises two critical questions: why have policymakers favored rules over standards in addressing predatory lending and does it make sense to continue to do so?

The answers turn on differences between the problems that suitability standards in securities and in lending are designed to address. In securities, suitability addresses only the risk characteristics of the investment that an investor has already purchased. Normally, the investor's ability to pay or the purchase terms are not in question. In subprime mortgage lending, however, suitability addresses an array of loan terms and the borrower's ability to meet those terms, rather than the reasonableness of assessments about the future performance of an investment. Fundamentally, this is a trickier analysis than suitability analysis in securities because it implicates price terms and practices.

Without more, a broad reasonableness standard of suitability in subprime lending would pose the danger of deteriorating into general price regulation. Legitimate lenders would err on the side of caution, rather than risk running afoul of an imprecise suitability standard. The effect of which would be a retraction in the availability of legitimate subprime credit.

One way to avoid general price regulation in subprime mortgage lending is to reduce the duty of suitability to specific rules. Avoiding general price regulation does not mean that pricing

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403 *See, e.g.*,HOEPA, 15 U.S.C. §§ 1601 *et seq.*; General Regulations of the New York Banking Board, Part 4; N.C.G.S. §§ 24-1.1E *et seq.*

practices and terms invariably should be free from regulation. To the contrary, it may be appropriate to regulate pricing terms or practices where those terms or practices send inaccurate price signals,[404] hinder market efficiency or inflict large, unnecessary negative externalities such as asset-based lending that result in foreclosure. Accordingly, in the following suitability standards, we attempt an initial definition of the boundary line between across-the-board price regulation and inefficient pricing practices.

(1) Subprime mortgage lenders and brokers would be prohibited from selling subprime loans that borrowers could not repay out of current income, based on reasonable investigation and consideration of all material facts known to the broker or lender at the loan's inception. Under this standard, lenders would have to lend according to underwriting guidelines and refrain from asset-based lending on owner-occupied properties

(2) All loan fees and charges would have to be transparent and conform to legitimate pricing functions, as defined by the implementing agency. Yield spread premiums, for example, are contrary to legitimate pricing practices because they impose fees on borrowers for higher interest rates than lenders are willing to accept, thereby sending incorrect price signals. Similarly, consistent with the function of points, lenders and brokers should be required to document that points assessed represent a tradeoff for interest, as is true in the prime market. Similarly, charges for periodic services, such as insurance premiums, should be assessed per unit of time over the life of the loan, instead of in a lump sum at closing. Fraudulent pricing practices, of course, would be unlawful.

(3) Refinancings would have to have an economic rationale for borrowers. This standard would specifically address abuses such as flipping and refinancing at higher interest rates with no discernable benefit to the borrower.

(4) Subprime mortgage lenders and brokers would be prohibited from selling loans to borrowers who qualify for prime rates.

The role of these standards would be to assist the appointed regulatory agency in identifying practices that might be predatory *per se* or, at a minimum, could be predatory in some situations.

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[404] By inaccurate price signals, we mean setting the price of loans at what appears to be market rates when, in fact, the prices are the result of harmful rent-seeking.

ii. *Problematic Lending Practices And* Per Se *Rules*

Many attempts to regulate predatory lending, while well-intended, have banned loan practices that are abusive in some situations but not in all. The list of subprime mortgage practices that are truly unsuitable *per se* is relatively short. We believe that subprime mortgage practices are unsuitable *per se* only when those practices result in fraud or lack of transparency, send inaccurate price signals, lack any economic justification to the borrower or result in asset-based lending, *i.e.*, mortgages that borrowers cannot afford to repay at the inception of the loan. Final responsibility for determining what is per se unsuitable should rest with the designated federal oversight agency.

Some problematic practices and terms are not unsuitable *per se*. Lenders may include certain terms because the secondary market demands those terms as a condition of financing loans. For instance, the secondary market may be unwilling to finance subprime loans without prepayment penalties. In other instances, problematic practices and terms may be harmful or helpful to borrowers, depending on the circumstances. Examples may include balloon payments and refinancings at higher interest rates. Nevertheless, in the aggregate, the harm inflicted by such terms may outweigh their benefits, in which case intervention may be justified.

In the case of problematic terms or practices that are not unsuitable *per se*, an outright prohibition could have the undesirable effect of restricting the flow of legitimate credit. Accordingly, the challenge is to identify regulatory tools that can pinpoint when those loans result in harm. Legal presumptions are one way of doing that, *i.e.*, certain terms might be presumptively unsuitable unless the lender is able to provide additional documentation that would rebut the presumption. Safe harbors might provide another way of accomplishing the same goal. It is also possible to permit loan terms that could be predatory, but that are not

unsuitable *per se*, if the loans are made to people who have high incomes and/or significant assets. Akin to the accredited investor rules in securities, the assumption is that these borrowers have the resources to protect themselves against predatory lenders.

iii. *Avoiding Regulatory Arbitrage*

While a rule-based system provides needed certainty to lenders, it is substantially more prone to evasion than an open-ended suitability standard. Lenders will have economic incentives to evade specific rules through new, unforeseen practices or loan terms. Indeed, one of HOEPA's major failings is that it does not give the Federal Reserve discretion to address new, abusive practices that fall outside of the practices that are enumerated in the act.

At the same time, an unadorned clause prohibiting unsuitable loans outright would be inadvisable without additional safeguards. Such a clause would raise the specter of common-law courts expanding the suitability doctrine to penalize new practices or loan terms, without input from the regulatory agency, consumers or lenders. The certainty that lenders need would furthermore be undermined. For that reason, we recommend that Congress provide the oversight agency with authority to regulate additional loan terms or practices without limitation, subject to notice and public comment, where the agency finds those terms or practices to be unsuitable.

iv. *Who Decides? Proceeding By Agency Rulemaking*

The question of who decides what suitability means is foundational and is critical to the success of the new duty. In securities, suitability derives from multiple, overlapping definitions by multiple decision-makers in multiple fora. The SEC defines suitability in agency adjudication and rulemakings, courts do so in Rule 10b-5 cases, and the NASD and exchanges make their

own definitions in disciplinary cases. As a result, there has been some degree of uncertainty and inconsistency in the application of suitability to securities sales.[405]

There is reason to believe that in subprime mortgage lending, however, a decentralized definitional framework like the one that has evolved in securities would be cause for concern. Unless the power to define suitability is carefully cabined, there is a danger that courts making suitability determinations would cross over the line into government price regulation. Moreover, courts lack the expertise to engage in economic analysis or solicit public input, both of which are needed to craft rules that work.

For these reasons, the power to define which terms or practices are "unsuitable" in subprime mortgage lending should be limited to the federal oversight agency, at least for purposes of private relief and government enforcement. Courts specifically would be prohibited from condemning loan terms or practices as unsuitable unless those terms or practices were already prohibited by statute or by rule.[406]

Within the agency, furthermore, definitions should be issued through the formal rulemaking process, not through agency adjudication. Formal rulemaking would have four advantages over agency adjudication. It would make more effective use of agency expertise. It would enlist invaluable input from the general public. It would provide greater consistency than case holdings. Finally, it would afford prior notice to lenders.[407]

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405 The extent of such uncertainty and inconsistency has been subject to debate. *Compare, e.g.*, Kerr, *supra* note ___ at 811-12 ("[t]he NASD and NYSE suitability standards are very vague and adjudicated case-by-case") *with* Madison, *supra* note ___, at 286 ("it would be difficult . . . to argue that a suitability requirement is a burdensome imposition"). Whatever the consequences, they have not proven fatal. Suitability determinations are made all the time in securities and have become routine.

406 For similar reasons, jury findings on suitability should be limited to answers to special interrogatories.

407 Although the SRO for the subprime mortgage industry might adopt a different definition of suitability for purposes of disciplining members, that definition would probably not diverge sharply from the agency's own definition because the SRO's definition would be subject to agency review and approval.

d. *Waiver*

In requiring suitability, a question arises whether borrowers should be allowed to waive suitability protections. In other words, if lenders were to determine that mortgages were unsuitable for particular loan applicants and advise the applicants to that effect, should the applicants be allowed to waive their right to claim breach of suitability?[408]

Waiver is a thorny question because it goes to one of the core rhetorical debates in predatory lending, pitting "free choice" against paternalism. If waiver were prohibited, lenders would be forced to deny certain loans that they otherwise would make. On the other hand, if waiver were allowed, desperate borrowers might agree to loans that were likely to result in bankruptcy or foreclosure.

The downside of prohibiting waiver bears closer examination. We preface that examination by noting that framing the issue in terms of choice and free will obfuscates the issue because it assumes that free will can be formed in the first place. To the contrary, the market for predatory loans is a market that relies on deception, naïveté and information asymmetries, circumstances that are inimical to the formation of free will. The exercise of free will requires adequate information on which to make informed decisions. However, the very aim of predatory lending is to assure that free choice is *negated* by exploiting information asymmetries and disparities in power on the part of vulnerable borrowers. Under the circumstances, to frame the issue as one of consumer choice sorely misses the point.

[408] In securities, commentators have questioned whether suitability determinations should be subjective or objective. *See, e.g.*, Roach, *supra* note ___, at 1174-79, 1181-85. The subjective/objective dichotomy may be more appropriate to suitability in securities, which employs a relatively vague standard, than in subprime mortgage lending, which is better suited to bright-line rules.

The more fruitful approach is to weigh the costs and benefits of waiver. In analyzing the effect of a no-waiver rule, it is helpful to think about the application of such a rule to different groups of borrowers: (1) borrowers who obtain subprime loans but actually qualify for prime loans; (2) borrowers who cannot repay their loans under any circumstances on the terms proffered; (3) borrowers who obtain loans that they can afford to repay but that contain terms that are unsuitable; and (4) borrowers who could repay their loans but who are denied credit nevertheless due to an overly restrictive reading of suitability. With respect to the first group, prime-eligible borrowers, there is little harm if subprime lenders deny them credit because of a no-waiver rule. These borrowers could qualify for cheaper credit in the prime market. In fact, a no-waiver rule for prime-eligible borrowers would have the salutary effect of creating an incentive for subprime lenders to refer prime applicants to their prime affiliates, if they have them. In that setting, the small cost of a no-waiver rule – some inconvenience to the loan applicant – would far outweigh the potential harm to borrowers in the form of needlessly costly credit.

For the second group, borrowers who cannot repay their loans, a no-waiver rule would decrease the likelihood that subprime lenders would make loans to them in the first place. Some loans should not be made and mortgages to borrowers who cannot afford the repayments are among them. These loans injure the borrowers by draining money required for other necessities and often leading to impaired credit, bankruptcy and foreclosure. They also impose heavy external costs on society because they can lead to homelessness, dependence on the state and neighborhood decline due to abandoned properties. While such a rule may be paternalistic, borrowers and lenders are not the only ones with interests at stake. So does society. Furthermore, in some cases the borrowers may qualify for credit elsewhere on more affordable

terms. If a no-waiver rule restricts these borrowers access to lenders who make loans that the borrowers cannot afford, the borrowers might look elsewhere for credit, which ultimately could help create a more efficient market.

For the third group of borrowers -- people who can afford to repay their subprime loans, but whose loans contain predatory terms -- the no-waiver rule may also be beneficial. For these borrowers, a no-waiver rule would discourage subprime lenders from inserting predatory terms into loans. To the extent that this leads to denials of credit, the borrowers can seek credit elsewhere from lenders who engage in legitimate lending practices and for whom the fear of lawsuits is diminished.

The hardest case to evaluate involves borrowers who could repay the loans but who are denied credit due to over-regulation. This could happen if government regulations imposed bright-line rules that were broader than they needed to be to achieve suitability. Alternatively, lenders might give an overly strict reading to a government rule that contains some play, in which case the no-waiver rule could discourage lenders from making legitimate loans to eligible borrowers for fear of running afoul of the suitability standards. For example, under a government rule that prohibits subprime lenders from making loans that borrowers cannot repay out of current income, lenders would have to institute loan underwriting guidelines. A lender with particularly conservative guidelines might deny borrowers credit because of suitability concerns and the inability to contract for waiver. Of course, if a borrower in this situation did not qualify under one lender's guidelines, the borrower could still apply to other lenders whose guidelines would allow the loan. Even in the case of bright-line government rules that are overly harsh, the borrower might be able to qualify for a different loan with different loan terms such as

lower principal. Nevertheless, in some situations, a no-waiver rule likely would mean that creditworthy borrowers could not qualify for mortgages at all.

The question, then, is whether waiver should ever be allowed. The problem with waiver is that it opens a back door through which lenders and brokers can engage in the same abuses that militated in favor of regulation in the first place. Waiver would give a green light to lenders to tempt borrowers who were susceptible to abuse into waiving their rights. This would be true even if waiver provisions were accompanied by disclosures because, as we have discussed, disclosures fail to perform their intended purpose. More importantly, waiver would interfere with the evolution of a truly efficient subprime market. To encourage an efficient market, borrowers need incentives to shop and lenders need incentives to make loan terms more transparent. If no-waiver rules help discourage subprime lenders from making unsuitable loans, *e.g.*, to prime-eligible borrowers who can qualify for better rates and to borrowers who cannot repay on the terms that they are offered, borrowers will shop elsewhere for credit on more appropriate terms and from lenders who make loan terms transparent.

The argument against waivers is harder to justify in the presence of over-regulation. However, identifying over-regulation is not always easy. Furthermore, if waivers are allowed because of the risk of over-regulation, lenders will insist on waivers for all their customers, regardless whether they are over-regulated. In effect, waivers could undermine the suitability requirement altogether.

The harmful effects of unwise waivers redound to the harm of society, not just borrowers. Given that external harm, lenders and borrowers should not be permitted to exercise waivers in ways that would foist external injury on third parties. When balancing the risk of loss of credit

to the over-regulated against the tremendous social and individual costs of predatory lending, the balance tips in favor of a no-waiver rule.

e. *Defining "Subprime:" Re-examining HOEPA's Triggers*

The suitability proposal that we advance in this article would be limited to the market for open-end or closed-end subprime loans secured by senior or junior liens on borrowers' homes. Given that we recommend restricting suitability requirements to the subprime market, it is necessary to define the subprime market. There are a number of different ways to describe the market, each of which we discuss and critique below.

To date, HOEPA and most other legislation and administrative rules governing subprime loans (usually called "high-cost loans") rely on "trigger" systems, whereby only loans that exceed certain floors on interest rates or points and fees are regulated. There are two different triggers that have been used to identify high-cost loans subject to regulation: (1) loans with APRs that exceed the yield on Treasury securities of comparable maturity by a set percentage; or (2) loans whose total points and fees exceed some percentage of the total loan amount or some fixed sum, whichever is greater.[409]

HOEPA, which uses both interest, and points and fees triggers, creates perverse incentives for lenders to restyle interest as non-interest charges in order to fall beneath HOEPA's triggers. HOEPA is so easily evaded that an estimated 98 percent of subprime mortgage loans fall below its triggers.[410] HOEPA's points and fees triggers have another unfortunate, unintended result that has not been appreciated. As already discussed, HOEPA's definition of

[409] *See, e.g.*, HOEPA, 15 U.S.C. §§ 1602(aa)(1)-(aa)(4); 12 C.F.R. 226.32 §§(a)(1), (b)(1); N.C. G.S. §§ 24-1.1E(a)(4), (a)(6); General Regulations of the New York Banking Board §§ 41.1(d)-(e).

[410] John Weicher's data suggests, for example, that HOEPA triggers for interest rates might have to be lowered to three percent. *See* note ___ *supra.*

total points and fees omits certain major price terms. As a result, subprime lenders, who want to evade HOEPA, write loans that contain price terms that do not fall within HOEPA's total points and fees calculation. These price terms tend to be more complex than the terms contained in traditional prime products. In this respect, the trigger system works against transparency in pricing in the subprime market.

If Congress were to adopt triggers, we propose that they be set at a substantially lower level that approximates the average historical price spread between A and A- mortgages.[411] We further propose that Congress empower the oversight agency with authority to determine and adjust the proper trigger levels following an economic analysis of historic and current spreads. In addition, to avoid the loophole in HOEPA's triggers, we advise that the term "total points and fees" be defined to include all points and fees (including points and fees that are financed) assessed to borrowers without exception.

Even with these measures, triggers may not be the best solution. There is always the risk that lenders will cease or retract their subprime lending if the number of loans subject to regulation increases.[412] Lenders who stay in the market despite the increased regulation will always have incentives to find new ways to evade the triggers and avoid regulation. For example, they might abandon predatory loan terms and instead opt for tying high-cost products such as homeowner's insurance to loans with legitimate terms that would fall outside any

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411 *See* note ___ *supra.*

412 *See* Michael E. Staten & Gregory Elliehausen, *The Impact of the Federal Reserve Board's Proposed Revisions to HOEPA on the Number and Characteristics of HOEPA Loans* 13-14 (working paper July 24, 2001) (studying the effect of North Carolina's predatory lending legislation and finding that there was a reduction in the supply of mortgage credit in the state around the same time that the legislation was enacted); *but see Data on Predator Law Impact Cause a Stir,* AM. BANKER, August 22, 2001, at 13 (citing criticisms regarding the methodology and conclusions in the Staten and Elliehausen study).

suitability regulations. Or, lenders could attempt to evade the triggers by purchasing individuals' homes and leasing them back at exorbitant rents.

An alternative method for determining whether loans are subject to suitability requirements would be to focus on borrower characteristics. In the home mortgage market, lenders categorize borrowers as prime or subprime based on their individual credit characteristics and the amount of equity that they have in their property (the loan-to-value ratio). Arguably, a lender's characterization of a borrower under its own guidelines would determine whether the borrower's loan was subprime and, therefore, regulated. The problem with relying on lenders' classifications of borrowers is that there is no dominant, much less uniform, underwriting tool. Some lenders use their own proprietary credit scoring models. Others rely primarily on FICO scores.[413] These various tools do not generate consistent results, *e.g.*, borrowers may be classified as subprime using FICO scores, but prime using credit scoring models.[414] And, even when lenders use these tools they do not necessarily adhere to the categorizations that their models or the FICO scores generate.

One yardstick that could be employed to identify borrowers as prime or subprime is Fannie Mae's and Freddie Mac's underwriting criteria for their purchase of home loans. Both Fannie Mae and Freddie Mac use automated underwriting systems, respectively called Desktop Underwriting and Loan Prospector.[415] The clear advantage of using Desktop Underwriting

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413 FICO scores are statistically generated credit scores that lenders use to evaluate borrowers' creditworthiness. Fair, Isaac and Co. developed the FICO scoring model and makes it available to lenders through credit bureaus. *See* <www.fair.isaac.com.>.

414 *See* Keith D. Harvey, *et al., Disparities in Mortgage Lending, Bank Performance, Economic Influence and Regulatory Oversight* (Working Paper May 2000) (documenting that borrowers' risk classifications vary depending on the risk assessment model employed).

415 *See, e.g.*, Product Profiles (available at <http://www.newamer.com/profiles.htm#FANNIE MAE PRODUCTS>); Fannie Mae, Announcement 00-03, Attachment 1 (available at <http://www.efanniemae.com/singlefamily/forms_guidelines/guide_announcements/db_guide_announcements.jhtml

and/or Loan Prospector would be greater consistency in borrowers' classifications as prime or subprime.[416] In addition, lenders who sell their loans to Fannie Mae and Freddie Mac already have access to the GSEs' underwriting systems.[417]

Defining the prime market according to borrower characteristics and loan-to-value ratios would have at least two benefits. First, because credit-risk models are dynamic in nature, underwriters could adjust their definitions of prime in response to changing economic conditions and new credit risk data. Second, defining the subprime market based on market classifications of borrowers as subprime or prime would eliminate the incentive for lenders to pile on complex terms and fees to evade HOEPA triggers, which might lead to the development of subprime products with simpler, more transparent terms.

The key question is this: would a market-based definition be less vulnerable to evasion than a system of triggers? Under a market-based approach, lenders would have incentives to manipulate the line between prime and subprime by treating the best subprime borrowers as prime customers in order to escape regulation. To some extent, of course, the market would act

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?role=#00-03>); Freddie Mac, AUTOMATED UNDERWRITING, *supra* note ____, ch. 4. Fannie Mae and Freddie Mac also do some manual underwriting based on FICO scores. *See, e.g.*, Kim R. Anderson, *GSEs See Automation as Spurring Low-Mod Housing*, NATIONAL MORTGAGE NEWS, June 12, 2000, at 22; Brian Angell, *A Score to Settle; Consumer demand is high for credit scores. What is the holdup?*, US BANKER, Aug. 2000, at 34.

[416] Determining the application of suitability based on the classification of borrowers as prime or subprime using DU and/or LP is not free of problems. For example, lenders could make subprime loans to people whom the underwriting systems categorized as prime borrowers and these lenders would not be subject to the suitability requirements. This is because the reference point for determining the applicability of suitability would be borrowers' characteristics, not loan terms. One way around this dilemma would be to have a special coverage provision that would extend suitability to borrowers whom the underwriting systems categorized as prime, but who could prove that their lenders failed to offer them their prime products.

[417] Fannie Mae, *Raines Calls For Open System With Lender Access to Multiple Automated Underwriting Systems; Pledges to Waive DU Fees on Market Expansion Products; Announces Partnership with MBA on Technology, Lender Profitability Issues,* News Release (April 19, 1999) (available at <www.fanniemae.com/news/pressreleases/0264.html>); *see also* Franklin D. Raines, Remarks Prepared for the Mortgage Bankers Association National Secondary Mortgage Conference (April 19, 1999) (available at <http://www.fanniemae.com/news/speeches/speech_38.html>) (citing that at the time of Raines' remarks, 850 lenders were using Desktop Underwriting and processing about 31,000 loan submissions per day).

as a brake on such evasion, because the marginal cost of making prime loans to subprime borrowers likely would exceed the marginal profit. On the other hand, a market-based definition of subprime might have negative consequences for the prime market that we cannot anticipate.

There are political, philosophical, and regulatory issues that arise in any effort to define the loans to which suitability should apply. Triggers are close cousins to price controls and can be evaded. Relying on the GSEs underwriting systems to classify borrowers has certain advantages over triggers; however, if Congress were to adopt Desktop Underwriting and Loan Prospector as the tools for classifying borrowers, it effectively would be legislatively authorizing the GSEs to define the subprime market. Another potential problem could arise, if as some commentators predict,[418] risk-based pricing becomes the norm, in which case neither borrowers nor their loans will be classified as prime or subprime and the underwriting tools would be of no help in determining which loans would be subject to suitability.[419] In sum, both approaches are imperfect, but each is adequate to the regulatory task if properly tailored.

f. *Relief*

One major justification for a new cause of action for breach of suitability is that it could provide remedies that are tailored to the specific harm that borrowers suffer. Victims of predatory lending can suffer two types of harm: retroactive harm and prospective harm. Borrowers may have paid illegal charges in the past, for example or, in the worst case, may have

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418 Bogdon & Bell, *supra* note ____, at 23-27.

419 It is also possible that an industry standard would have the effect of limiting LMI borrowers access to capital because they would not fall neatly within the operative parameters. *See supra*, pages ____ (discussing the virtues of relationship-based banking for LMI borrowers); Tommy Fernandez, *Is Personal Touch Vanishing with Credit Agencies?"* AM. BANKER, JULY 18, 2001, AT 12 ("[s]ome lenders warn that the demise of manual underwriting has bred a growing class of credit-impaired borrowers who are being shunned by small [lending] firms").

lost their homes to foreclosure. Prospectively, borrowers who are still in their homes may be facing foreclosure or an obligation under their loan agreements to pay future charges that the law deems illegal. Accordingly, remedies for breach of suitability need to address both past and future harm. In addition, the scheme for relief should redress any additional unjust enrichment that accrues to predatory lenders and brokers when the benefits of engaging in predatory lending practices exceed the harm to the plaintiffs. [420]

For illegal charges already paid, the statute should authorize relief in the form of damages or disgorgement with interest. For past foreclosures, the statute should create a right of redemption if lenders still own the property. With respect to prospective relief, breach of suitability should be an absolute defense to foreclosure. In addition, Congress should give courts equitable power to reform loans to conform to the law and to strike down illegal terms.[421] In some situations, it may be appropriate to permit borrowers to rescind their loans.[422] In steering cases, courts should be empowered to order refinancing at then prevailing prime rates or reformation of loans. Injunctions should be available to reschedule loan payments, to enjoin illegal lending practices, to require reporting of timely mortgage payments,[423] to reschedule missed payments to the end of the loan and to correct erroneous credit records.

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[420] *See* L.L. Fuller & William R. Perdue, *The Reliance Interest in Contract Damages: 1*, 46 YALE L.J. 52, 53-54 (1936); *see generally* L.L. Fuller & William R. Perdue, *The Reliance Interest in Contract Damages 2*, 46 YALE L.J. 373 (1937). For example, if a lender received a kickback to make a predatory loan, the kickback should be subject to disgorgement.

[421] For example, equitable relief in the form of loan reformation would be justified where a lender convinces a homeowner to refinance a zero interest mortgage (such as a Habitat for Humanity loan) at higher interest. In all but the most unusual circumstances, the interest term should be reformed to a rate of zero.

[422] For instance, in schemes resembling equity funding programs where lenders convince borrowers to refinance the equity in their homes and invest the loan proceeds in retirement accounts with unfavorable returns, the loans should be forgiven and the borrowers should be made whole for their losses.

[423] Some predatory lenders refuse to report timely mortgage payments to credit bureaus because they fear that borrowers will refinance with other companies as their payment histories improve. *See, e.g., New assault on your*

Finally, the new right of action should include a substantial statutory penalty that would serve to deter predatory lending, to encourage victims to vindicate their legal rights and to attract representation by the private bar.[424] At this point, we oppose open-ended punitive damages due to the risk of excess deterrence.[425] Instead, we propose that all victims of suitability violations receive treble damages or statutory damages, whichever is higher, regardless of the lenders' or brokers' intent or the egregiousness of their conduct. In computing treble damages, actual damages plus any amounts subject to disgorgement should be included. Statutory damages are necessary as a deterrent because, in many cases, the borrowers' relief will be injunctive only, in which case there will not be any actual damages to treble. The amount of the statutory damages should depend on the number of times defendants have been found liable for suitability violations in general, *i.e.*, for each violation the statutory damages should rise. In addition, to avoid obsolescence over time, statutory damages should be indexed to inflation. Finally, the statute should authorize reasonable attorneys' fees and costs in order to attract able representation. These fees and costs should be available regardless whether the cases are resolved through settlement, arbitration or final judgment.[426]

In all likelihood, the most satisfactory resolution of predatory lending cases will come about through private settlements, particularly where lenders are worried about reputational concerns. Settlements offer the flexibility to forge creative solutions that are tailored to the loans

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credit rating, CONSUMER REPORTS, Jan. 2001, at 20; Geoffrey M. Connor, *Banking Law -- How to Be a Predatory Lender and how banks can put an end to the practice*, N.J. L.J., Sept. 4, 2000.

[424] In order to be sufficiently substantial to meet the goals of deterring predatory lending and attracting representation, any penalty must be far above the $11,000 authorized in Fair Housing Act claims. 24 C.F.R. § 180.671.

[425] *Cf.* Engel, *supra* note ____ at 1192 (discussing the risk of excess deterrence in discrimination cases).

[426] *See id.* at 1189-90 (discussing the effect that limitations on attorneys' ability to recover fees in housing discrimination cases that settle has had on attorneys' willingness to bring fair housing claims).

and the borrowers in question. To encourage settlements and avoid undue litigation costs, Congress might wish to require court-ordered mediation as a prerequisite to litigation.

g. *Defendants*

The utility of a suitability requirement depends critically on the ability to enforce it against predatory lenders and brokers, some of who have fly-by-night operations with little capitalization. They can dissolve and reincorporate, sometimes in other states, practically overnight. Their lack of capitalization coupled with the ease with which they can dissolve enables predatory lenders and brokers to evade liability for the harm that they cause borrowers.

Accordingly, we propose disregarding the corporate form under highly limited circumstances in order to impose personal liability for predatory lending against shareholders, officers or directors. Personal liability would only attach where the corporate lender or broker: (1) was judgment-proof due to undercapitalization; or (2) dissolved in order to evade liability.[427] If either one of those threshold requirements was met, then any shareholder, officer or director of the lender would be personally liable for monetary, injunctive and equitable relief.[428]

There has been some debate whether secondary market purchasers should be held liable for purchasing predatory loans. On the one hand, secondary market actors, by purchasing predatory loans, create a market for predatory lenders and brokers. On the other hand, suitability violations take place at the time of the loan application and closing, before secondary market purchasers are involved. On a practical level, it would be difficult, if not impossible, to impose the same suitability requirements on secondary market purchasers that we propose applying to

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[427] Among other things, evidence of later re-incorporation or resumption of business through a non-corporate entity could provide evidence of intent.

[428] *Cf.* Holley v. Crank, No. 99-56611, 2001 U.S. App. LEXIS 17031 (9th Cir. July 31, 2001) (holding owners and officers of corporation vicariously liable for an employee's violation of the Fair Housing Act).

lenders and brokers. This is because loan purchasers do not have access to original loan documentation and other information that would enable them to determine whether loans meet all the requirements for suitability.

Just the same, there are two circumstances in which injured borrowers should be able to raise suitability violations by lenders or brokers against secondary purchasers. First, breach of suitability should be an absolute defense to foreclosure actions by secondary market owners of notes. HOEPA already incorporates this notion by abrogating the holder-in-due-course rule for HOEPA loans. At a minimum, the holder-in-due rule course likewise should be abrogated when subprime borrowers raise lack of suitability as a defense to foreclosure. Second, borrowers should be allowed to bring affirmative suitability claims against secondary market participants who do not have basic internal controls[429] and written policies against buying loans with illegal predatory features.

h. *Arbitration*

For the reasons that we have already discussed,[430] oppressive mandatory arbitration clauses have been a major obstacle to predatory lending relief. However, we are reluctant to condemn arbitration outright. Potentially, a cause of action for breach of suitability could create hundreds of thousands of relatively small claims, which would be well-suited for alternative dispute resolution. Arbitration normally costs less than litigation and results in swifter outcomes, both of which could be valuable to cash-strapped plaintiffs.[431] Finally, political realities must be

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429 For evaluating such internal controls, *In Re Caremark Int'l Inc. Derivative Litigation*, 698 A.2d 959 (Del. Ch. 1996, would provide an appropriate standard.

430 *See* Section ___ *supra*.

431 *See, e.g.*, Marc L Steinberg, *Securities Arbitration: Better for Investors Than The Courts?*, 62 BROOK. L. REV. 1503, 1505-06, 1512-14 (1996).

taken into account. Congress is unlikely to ban arbitration clauses altogether in subprime loan agreements, in part due to federal policy favoring arbitration under the Federal Arbitration Act.[432]

Accordingly, our task is not to reject arbitration, but to craft an arbitration scheme that is effective. In our view, the key to making arbitration work in subprime lending is threefold. First, arbitration should be strictly optional and not mandatory. Currently, there is no proof that arbitration in subprime lending is fairer or more efficient than litigation in courts and victims should not be denied judicial redress, at least until such proof exists.[433] Second, any arbitration should be conducted under the SRO's auspices or those of the American Arbitration Association (AAA). Finally, the code of arbitration developed by the SRO should be subject to review, revision and approval by the federal oversight agency.[434] For claims arbitrated through the SRO,

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[432] *See, e.g.*, Moses H. Cone Memorial Hospital v. Mercury Constr. Co., 460 U.S. 1, 24-25 (1983).

[433] *Cf.* Richard E. Speidel, *Contract Theory and Securities Arbitration: Whither Consent?*, 62 BROOK. L. REV. 1335, 1360-61 (1996) (arguing the same with respect to securities).

In that regard, it is essential to provide subprime borrowers with a meaningful option to exercise their opt-out rights. Because of the high-pressure nature of closings and the vulnerability of many LMI borrowers, lenders should not be allowed to include form arbitration clauses in loan agreements at closing. Instead, Congress should require lenders to wait for some period after closing, *e.g.*, thirty days, before presenting arbitration agreements to borrowers so that borrowers can focus adequately on the consequences of agreeing to arbitration. In addition, any arbitration agreements signed by borrowers should be reviewed and signed by an attorney or a HUD-certified counselor. *Cf.* G. Richard Shell, *Fair Play, Consent and Securities Arbitration: A Comment on Speidel*, 62 BROOK. L. REV. 1365, 1376 (1996) (the Commodities Futures Trading Commission forbids commodities professionals from refusing to serve customers who decline to sign an arbitration agreement and requires standard commodities brokerage agreements to state: "You need not sign this [arbitration] agreement to open an account" with the broker in question.).

[434] *Cf.* Shell, *supra* note ___, at 1366 ("the only realistic way for the securities arbitration system to reform itself is via governmental regulatory action in cooperation with self-regulatory organizations").

In securities, the SEC oversees SRO arbitration rules and must approve any changes in light of the requirements of the Exchange Act. 15 U.S.C. §§ 78s(b)(2), (c).

arbitrators could award relief based not only on suitability as defined by the federal regulations, but also based on the SRO's disciplinary rules governing suitability.[435]

We again turn to the securities industry to craft safeguards for the arbitration of suitability claims. In cases brought by public customers, mandatory NASD arbitration uses panels of professionally trained arbitrators, a majority of whom must be "public arbitrators" who lack recent ties to the securities industry.[436] NASD arbitral awards are now published online[437] and the NASD will suspend member firms for failing to pay arbitral awards pending appeal in federal appeals courts.[438] We advocate a similar scheme of supervised arbitration for mortgage lending in the subprime market. In particular, we recommend that the SRO be required to institute the minimum, non-waivable on safeguards listed below.[439]

- Customers should have a right to arbitrate either before the SRO or the AAA.

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435 *Cf.* Steinberg, *supra* note ___, at 1514-15 (securities arbitrators "may render awards premised on applicable self-regulatory organization ('SRO') standards, industry custom, or even concepts of equity and fairness").

436 *See id.*, *supra* note ___, at 1505 n.10, 1514; Securities Industry Conference on Arbitration, Uniform Code of Arbitration § 8(a)(2); NASD Code of Arbitration Procedures Rules 19(c)-(d).

437 Obtain NASD Arbitration Awards Online (available at <www.nasdadr.com/arb_awards.asp>). *See also NASD To Make Arb Results Available Via Web*, FINANCIAL NET NEWS, May 21, 2001, at 2; *NASD Set to List Arbitration Cases on the Internet*, L.A. TIMES, May 17, 2001, § 3, at 4.

438 *See* NASD Code of Arbitration Procedures § 10330(h); NASD Notice to Members 00-55 (Sept. 18, 2000) ("if arbitration awards are not complied with in a timely manner, NASD Dispute Resolution currently institutes suspension proceedings"). *See also* Don Bauder, *Investors score rare win in battle with brokerage*, SAN DIEGO UNION-TRIBUNE, May 12, 2001, at C-2 (April 26, 2001 ruling by NASD hearing officer suspended member firm for refusing to pay award to investors after it lost an appeal in federal district court); Gretchen Morgenson, *Putting Some Weight Behind Arbitration*, N.Y. TIMES, June 10, 2001, § 3, at 10.

439 The NASD Code of Arbitration Procedure, the arbitration rules of the New York Stock Exchange, the rules of the AAA and the Statement of Principles of the National Consumer Dispute Advisory Council provide good initial reference works for crafting appropriate guidelines. The Statement of Principles is available at <http://www.adr.org/education/education/consumer_protocol.htm>. *See also* Martin H. Malin, *Privatizing Justice but by How Much? Questions* Gilmer *Did Not Answer*, 16 OHIO STATE JOURNAL ON DISPUTE RESOLUTION 589 (2001) (arguing for various protections in employment arbitration proceedings); Shelly Smith, *supra* note ___, at 1222-35 (discussing the need for safeguards in arbitration proceedings involving consumer contracts).

- All arbitration clauses in subprime mortgage loan agreements would have to specify that arbitration would be conducted arbitrators certified by the SRO or the AAA operating under the auspices of that certifying body.

- The public should be given an opportunity for notice and comment on the oversight agency's review of SRO arbitration rules and amendments to those rules.

- Aggrieved borrowers should have a meaningful role in selecting the panel's arbitrators, under a system such as the AAA's "list method" of selecting arbitrators.

- Every arbitrator on an arbitration panel must be a public arbitrator without significant ties to the mortgage industry.[440]

- Every arbitrator should have a law degree in order to ensure adequate analysis of the legal claims.

- Arbitration panels should be required to apply all statutory and common law that is applicable to the claims presented.[441]

- Arbitration panels must issue short written opinions, signed by the arbitrators who concur, that summarize the material issues in controversy, how those issues were resolved, the reasons for the decision and the relief sought and awarded.[442] In addition, the panel should certify that it resolved all claims presented by the claimant.

- All arbitration awards should be published.[443]

- Arbitration panels must have authority to award all remedies authorized by law, including statutory damages, as well as reasonable attorneys' fees and costs.

- Arbitration agreements may not include any condition that limits the ability of a party to file any claim in arbitration or the ability of arbitrators to make any award.

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[440] Under the NASD rules, an arbitrator is considered a "public arbitrator" if he or she has not worked in the securities industry within the past three years. NASD, CODE OF ARBITRATION PROCEDURES §§ 10308(a)(4)-(a)(5). Thus, a lawyer who retired three years ago, but who had spent his or her entire career representing securities firms, would qualify as a public arbitrator. *See* NASD, SECURITIES ARBITRATION REFORM: REPORT OF THE ARBITRATION POLICY TASK FORCE 96-97 (1996). We would not recommend adopting this standard for the mortgage lending industry and would opt instead for requiring "public arbitrators" to have more attenuated relationships with the industry.

[441] *See* Edward Brunet, *Toward Changing Models of Securities Arbitration*, 62 BROOK. L. REV. 1459, 1490-92 (1996); Therese Maynard, *McMahon: The Next Ten Years*, 62 BROOK. L. REV. 1533, 1555-56 (1996).

[442] *See* Brunet, *supra* note ___, at 1488–90.

[443] Similarly, we would oppose confidential settlements in suitability cases filed in court.

- Mandatory arbitration clauses must not forbid participation in class action lawsuits.
- Arbitral awards must be promptly paid to plaintiffs pending appeals.
- Federal courts should be authorized to review arbitral awards for errors in applicable law,[444] in addition to the more circumscribed scope of review that is authorized in the Federal Arbitration Act.[445]

D. *Critiques Of Suitability In Subprime Mortgage Lending And Responses*

The principal thrust of this Article is to settle the question whether additional relief is necessary to combat predatory lending. As we have shown, information asymmetries allow predatory lenders to thrive and the current patchwork of remedies has been wholly ineffective in combating predatory lending.[446] In the absence of a new remedy, borrowers and society continue to suffer and this harm will only worsen in a weakening economy.[447]

We do recognize, however, that there are numerous arguments against intervening to curb predatory lending at all, as well as criticisms of our particular proposal.[448] In this section of the paper, we identify and respond to these criticisms.

1. *Normative Objections*

Some oppose a suitability standard in subprime lending on moral grounds, akin to the debate over bankruptcy reform. They contend that borrowers should take personal responsibility for the loans they decide to accept. After all, the argument goes, no one is forcing them to take out loans.

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444 *See* Speidel, *supra* note ___, at 1362 (recommending addition of the same standard in securities).

445 9 U.S.C. §§ 10(a)(1)-(a)(5).

446 *See* Section ___ *supra.*

447 *See, e.g., Analysts say mortgage fraud rises as economy slows*, SUNDAY STAR-NEWS (Wilmington, N.C.), Apr. 1, 2001, at 2B ("'The reason is, the lenders have to keep feeding the monster to pay the overhead, so they might push a loan through, even though it doesn't fit or they might just phony up some documents'").

Arguments of this sort are about free choice and the responsibility to accept the consequences of one's decisions. However, predatory lending is not about free choice, it is about the suppression of free choice. When predatory lenders target vulnerable homeowners who do not understand what they are signing, and then deny these borrowers access to vital information about their loans and hurry them into signing, free choice is nowhere to be seen.

Compounding matters, the financial straits of LMI borrowers frequently put them in a classic double bind. The building code inspector, the debt collector, the bondsman, or the IRS may be knocking at the door. The roof may be leaking or the car they need for transportation to work may have broken down. Their child may need costly medical care, but they have no medical insurance. In cases such as these, the choice is between two evils, one of which is certain and the other of which is ill understood. Thus it is not surprising, as behavioral economists have found, that people who are facing crises are more likely to take risks.[449]

Critics counter that many victims of predatory lending refinance their mortgages to buy luxury items such as TVs, stereos and cars, not to pay for emergencies or home repairs. In their view, the law should not reward profligate conduct by providing borrowers redress for predatory loans, the proceeds of which they used inappropriately to purchase luxury goods.

Concerns about profligate use of loan proceeds are present regardless whether borrowers are low income, middle class or affluent;[450] however, the social consequences of LMI borrowers

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448 *See, e.g.*, David Wessel, *An Inner-City Predator Needs a New Leash*, WALL ST. J., Apr. 19, 2001, at A1.

449 *See, e.g.*, Amos Tversky & Daniel Kahneman, *Advances in Prospect Theory: Cumulative Representation of Uncertainty*, 5 J. RISK & UNCERTAINTY 297 (1992); Amos Tversky & Daniel Kahneman, *Rational Choice and the Framing of Decisions*, 59 J. BUS. S251 (1986). *See also* Roger G. Noll & James E. Krier, *Some Implications of Cognitive Psychology for Risk Regulation*, 19 J. LEGAL STUD. 747 (1990); Langevoort, *supra* note ___ at 637.

450 *See, e.g., Understanding Cash Out Refinancing*, Bankrate, Aug. 24, 2001 (available at <www.thebankingchannel.com/comm/story.jsp?story=TBCK5J5OYOC>); Freddie Mac, Press Release, *Loan Refinancings That Took Equity Out of Houses Rose in Second Quarter of 2001* (Aug. 21, 2001) (available at <www.freddiemac.com/news/archives2001/2qupb01.htm>). More affluent borrowers refinance loans or take out

entering into predatory loans and engaging in profligate spending[451] are more severe. The borrowers can go bankrupt, and become homeless.[452] When they go bankrupt, their other creditors are hurt. When they become indigent, taxpayers are called on to support them. The severe external effects of default and foreclosure on society justify predatory lending protections, even when home equity is used to finance luxury purchases.

Another, related argument that critics make it response to anti-predatory lending proposals is that any protections are paternalistic and interfere with borrowers' exercise of free choice. The argument is that predatory lending legislation will prevent borrowers from obtaining loans that contain terms that are acceptable to both lenders and borrowers, but that the law deems predatory or, with our proposal, unsuitable. We recognize that there is a paternalistic element to the suitability requirement. But we contend that the burden of limited restrictions on free choice is outweighed by the severe negative effects of predatory loans on borrowers and on society. In addition, as we discuss, suitability may make it possible for many of these borrowers to obtain loans from other lenders on better terms.

2. *Market Arguments*

There are a number of market-based arguments that critics have advanced in support of their position that predatory lending legislation is unnecessary and/or counterproductive. One argument is that predatory lending protections create incentives for borrowers to "game the system," by taking out loans that they know they cannot repay and then seeking loan forgiveness,

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second mortgages to finance needed or desired expenditures with their untapped equity, including renovations or home repairs, college education, medical bills, taxes, credit card debts or vacations. *See, e.g.*, Teresa A. Sullivan *et al.*, THE FRAGILE MIDDLE CLASS: AMERICANS IN DEBT 225 (2000).

451 There are no sound data indicating the extent to which borrowers use loan proceeds to engage in profligate spending.

452 *See supra* notes ____ and accompanying text (discussing why borrowers put their homes at risk).

claiming that their loans were unsuitable. This argument might have credence for unsecured loans when borrowers are judgment-proof, but would not apply here where borrowers' homes are at stake. Very few homeowners can afford to engage in that type of brinksmanship, particularly not LMI borrowers, because if they are wrong, they will lose their homes to foreclosure.[453]

The most oft-heard criticism is that a suitability rule would result in credit constraints.[454] To the extent that this criticism refers to loan denials because the borrowers cannot repay their loans out of current and expected income, we endorse this outcome because these loans should not be made in the first place. Furthermore, it is possible that these borrowers will not be shut out of the credit market altogether. Rather, many of these borrowers may qualify for legitimate subprime or even prime loans elsewhere with better, more affordable terms.[455] As for other problematic terms and practices, the operative question is not whether narrowly targeted regulations would have some constraint on credit. Instead, the question is whether the potential harm from carefully crafted, targeted regulations outweighs the harm of maintaining the status quo. Thus, what is called for is a cost-benefit analysis to determine what suitability rules would best address the harm that occurs from predatory lending without inordinately limiting the availability of credit. We believe that our proposal for an SRO that can develop best practices rules, a federal rulemaking process with full public input and a feedback loop for revision of rules is best-suited to perform that cost-benefit analysis.

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[453] Of course, if borrowers materially mislead lenders as to their ability to repay their loans, lenders would have a defense to any suitability claims.

[454] *See, e.g.*, Charles W. Calomiris & Robert E. Litan, *Homeownership That's Too Important to Risk*, N.Y. TIMES, Aug. 20, 2001, at A21 ("[n]ew laws on the pattern of some already passed at the state and local level could do great harm by discouraging lenders from making any subprime loans at all").

[455] *See* notes ___-___ *supra* and accompanying text.

Some critics of suitability and other efforts to combat predatory lending take the position that recent losses in the subprime market[456] indicate that predatory lending is not profitable and that the market will "correct" itself and predatory lending will cease. We disagree with this conclusion on several grounds. First, no one has established a correlation between reduced profitability in the subprime market and predatory lending. The losses in the subprime market could be attributable to the overall economic slowdown,[457] inadequacies in the risk assessment models used by subprime lenders, or a host of other economic or institutional factors.

As we discussed previously, the market, as it is currently structured, will not curb predatory lending. In short, secondary market actors can protect themselves against the risk of default by inserting recourse provisions when they purchase packages of loans. Predatory lenders insulate themselves from losses when they originate loans by making loans at high interest rates to borrowers with significant equity in their property. In addition, they finance huge fees, often repeatedly. At foreclosure, these lenders, even those who end up holding loans pursuant to recourse provisions, can recoup the unpaid interest and fees.

It is possible that, in the absence of interventions to curb predatory lending, legitimate subprime lending will decrease. If predatory brokers are deceiving legitimate subprime lenders, causing the lenders to suffer losses, predatory lenders will gain a larger market share.[458] Legitimate subprime lenders, many of which are major institutional lenders who have to answer

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456 *See, e.g.*, Paul Beckett & John Hechinger, *Subprime Loans Could Be Bad News for Banks*, WALL ST. J., Aug. 9, 2001, at C1 ("[t]hat subprime has been deteriorating is clear. In May [2001], . . . the percentage of subprime mortgages nationwide that were seriously delinquent rose to 6.37% from 5.55% at the end of the last year").

457 *Id.*

458 *See, e.g.*, Laura Mandaro, *Wamu Primed For More Subprime*, AM. BANKER, Aug. 20, 2001, at 1 (discussing Bank of America's decision to exit subprime mortgage lending); Riva D. Atlas, *Bank to Drop 2 Businesses To Tighten Up Its Operations*, N.Y. TIMES, Aug. 16, 2001, at C1 (same).

to shareholders and often regulators, cannot sustain losses for long. The substantial goodwill and long-term reputational interests of these firms, moreover, mean that they cannot simply dissolve and reincorporate under different names. In contrast, fly-by-night predatory lenders do not have these constraints. If they suffer losses that they cannot absorb, they can file for bankruptcy or simply dissolve. The principals can then go underground for awhile, form a new corporation and resume predatory lending anew.

It is also possible that publicity about unchecked predatory lending may make legitimate subprime lenders wary of making high-risk loans and thereby reduce the options for high risk borrowers who are seeking credit.[459] If shareholders and regulators put pressure on legitimate subprime lenders to avoid even the appearance of predatory lending, these lenders will adopt more conservative lending practices, which would have the effect of enlarging the market for predatory lenders.[460]

3. *Concerns About Frivolous Litigation*

Some concede that additional remedies are needed, but oppose the creation of a private cause of action.[461] We strongly believe that private relief is necessary for three reasons. First and foremost, a private cause of action is economically efficient because it places liability on the parties who are able to avoid the harm of predatory lending with the least cost, *i.e.*, predatory

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459 *Cf.* John Hechinger & Patrick Barta, *supra* note ____ at A1 (citing examples of banks that have dropped their subprime units because of fear of charges of predatory lending).

460 *See, e.g.*, Michele Heller, *FTC Veteran: Keep the Heat On Predators*, AM. BANKER, Aug. 17, 2001 (quoting former FTC official David Medine to the effect that if "legitimate lenders leav[e] that market, it's going to leave it wide open for predatory lenders to continue to dominate it.").

461 Litan, *Prudent Approach*, *supra* note ____, at 2 ("[t]he more prudent course is for policy makers at all levels to wait for more data to be collected and reported by the Federal Reserve so that enforcement officials can better target practices that may be unlawful under existing statutes. In the meantime, Congress should provide the federal agencies charged with enforcing existing statutes with sufficient resources to carry out their mandates, as well as to support ongoing counseling efforts") (emphasis omitted).

lenders and brokers. Second, the compensatory aspect of the private right of action is important because it requires lenders and brokers to internalize the cost of the harm that they cause, thereby undercutting their incentives to engage in predatory lending. Third, we strongly advocate private relief because the government often lacks the resources and the will to pursue civil claims when it has enforcement authority.[462] If the government were given the sole power to enforce suitability and the designated agency, for financial, bureaucratic or political reasons, failed to fully exercise its power, tens of thousands of predatory lending victims nationwide would have no or only limited recourse.

One argument in opposition to establishing a private cause of action is that it might spawn frivolous lawsuits. The concern is that dishonest borrowers will enter into legitimate, suitable loans and then challenge the loans because they regret having taken them out in the first place. Our response is that bright-line suitability rules or presumptions in lieu of fuzzy standards, plus adequate documentation by lenders of compliance, should keep frivolous lawsuits to a minimum.

Some critics focus on class actions and contend that attorneys will bring frivolous strike suits in order to extract settlements and/or will settle meritorious claims on terms that benefit themselves at plaintiffs' expense. We believe that these concerns about class action abuses are overstated. To begin with, class actions are not necessarily easy to certify in predatory lending cases. For instance, in damages class actions under Fed. R. Civ. P. 23(b)(3), plaintiffs must show that the common issues predominate over the individual ones in order to win certification.

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462 Michael Selmi, *Public vs. Private Enforcement of Civil Rights: The Case of Housing and Employment*, 45 U.C.L.A. REV. 1401, 1438 (1998) (in referring to enforcing the fair housing and employment discrimination laws, stating that "the government's enforcement efforts have largely failed").

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ASSURE LEGIBILITY OR PAGINATION

lenders and brokers. Second, the compensatory aspect of the private right of action is important because it requires lenders and brokers to internalize the cost of the harm that they cause, thereby undercutting their incentives to engage in predatory lending. Third, we strongly advocate private relief because the government often lacks the resources and the will to pursue civil claims when it has enforcement authority.[462] If the government were given the sole power to enforce suitability and the designated agency, for financial, bureaucratic or political reasons, failed to fully exercise its power, tens of thousands of predatory lending victims nationwide would have no or only limited recourse.

One argument in opposition to establishing a private cause of action is that it might spawn frivolous lawsuits. The concern is that dishonest borrowers will enter into legitimate, suitable loans and then challenge the loans because they regret having taken them out in the first place. Our response is that bright-line suitability rules or presumptions in lieu of fuzzy standards, plus adequate documentation by lenders of compliance, should keep frivolous lawsuits to a minimum.

Some critics focus on class actions and contend that attorneys will bring frivolous strike suits in order to extract settlements and/or will settle meritorious claims on terms that benefit themselves at plaintiffs' expense. We believe that these concerns about class action abuses are overstated. To begin with, class actions are not necessarily easy to certify in predatory lending cases. For instance, in damages class actions under Fed. R. Civ. P. 23(b)(3), plaintiffs must show that the common issues predominate over the individual ones in order to win certification.

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462 Michael Selmi, *Public vs. Private Enforcement of Civil Rights: The Case of Housing and Employment*, 45 U.C.L.A. REV. 1401, 1438 (1998) (in referring to enforcing the fair housing and employment discrimination laws, stating that "the government's enforcement efforts have largely failed").

Loan underwriting decisions often turn on facts that are unique to the borrowers, making commonality difficult to prove.[463]

To the extent that class actions can be certified in predatory lending suitability cases, the goal should be on limiting the possibilities for abuse, and not on denying class actions claims wholesale. With respect to the risk that attorneys will bring frivolous suits, we note that counsel must already certify under Rule 11[464] that the claims they are pursuing are non-frivolous, have evidentiary support and are not being presented for harassment or delay. Making Rule 11 sanctions for frivolous filings mandatory for class counsel in predatory lending cases would give that provision real force, although we strongly advise against mandatory sanctions for plaintiffs.

With respect that class counsel will enter into exploitative settlements of meritorious claims, some of the safeguards in the Private Securities Litigation Reform Act of 1995 (PSLRA) should be extended to suitability claims for predatory lending. Named class plaintiffs could be required to swear that they reviewed the complaint and authorized its filing, and that they will

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463 *See* United Cos. Lending Corp. v. Sargeant, 20 F. Supp. 2d 192, 210 (D. Mass. 1998) (declining to certify a class in a predatory lending case because "individual factual questions predominate over those common to the class"); Peters v. Cars To Go, Inc., 184 F.R.D. 270, 277-80 (W.D. Mich. 1998) (court certified one class, but denied certification for another due to lack of commonality). *Cf.* Hoffman v. Grossinger Motor Corp., 218 F.3d 680, 683 (7th Cir. 2000) (refusing to construe TILA in a subprime auto loan case in a way that "would make the class action a truly fearsome instrument of consumer-finance litigation").

In part for these reasons, securities class actions rarely assert breach of suitability. For instance, a study of securities class actions filed in 1999 found that the most prevalent claims were for improper revenue recognition and overstated assets. According to the study, "[o]ther prevalent areas included purchase accounting, liabilities and accounting estimates." Suitability was not mentioned. *See* PRICEWATERHOUSECOOPERS, 1999 SECURITIES LITIGATION STUDY 2-3 (1999) (available at <http://securities.stanford.edu/research/reports/19990301pwc103000.pdf>); *see also* Mukesh Bajaj *et al.*, *Securities Class Action Settlements: An Empirical Analysis* 3-4, 15 (2000) ("the vast majority of cases involved allegations concerning corporate disclosures") (available at <http://securities.stanford.edu/research/studies/20001116_SSRN_Bajaj.pdf>). The prevalence of mandatory arbitration clauses governing suitability claims in securities also explains the paucity of securities class actions.

464 Fed. R. Civ. P. 11(b).

not accept added payments for serving as named plaintiffs without court approval.[465] In addition, total attorneys' fees should be limited by statute to a reasonable percentage of the actual recovery to the class (including statutory damages) and settlements under seal should be barred.[466]

D. *Other Needed Areas Of Regulatory Attention*

Our proposal relies on governmental, SRO and private enforcement of suitability. Designing a cause of action and an array of enforcement mechanisms was our top priority because our purpose was to address the core incentive structures that fuel predatory lending. We do not wish to downplay the fact, however, that other aspects of subprime mortgage lending contribute to predatory lending and require attention. We have not discussed those problem areas in detail because they fall outside the scope of the Article. Nevertheless, a comprehensive approach to predatory lending will need to come to grips with these problems.

1. *Regulation Of Mortgage Brokers*

In the abstract, one might think of mortgage brokers as professionals who help borrowers find loans on the best terms. In practice, mortgage brokers serve a very different function because of the incentive structure in the industry. Brokers work for and are paid by loan originators, not borrowers. Brokers can facilitate predatory lending by scouting out unsophisticated borrowers and convincing them to pay the highest possible prices. While these

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465 *See* 15 U.S.C. § 78u-4(a)(2)(A).

We note that formerly it was easy to manufacture securities fraud class actions by having a staff member in class counsel's firm buy stock of every company in the S&P 500 or another broad index of stocks. The PSLRA contains a number of provisions that are designed to curb those abuses and ensure the independence of named class plaintiffs. *See generally* 15 U.S.C. § 78u-4. In contrast, the danger of manufactured suitability claims in the home mortgage area of this type is quite low. Manufacturing a claim would require class counsel to take the absurd and unethical step of convincing an employee or another unsuspecting individual to go out and obtain a predatory loan secured by his or her home.

466 *See* 15 U.S.C. §§ 78u-4(a)(5)-(a)(6).

mortgage brokers have financial incentives to deceive lenders as well as borrowers,[467] in the final analysis they have no incentive to protect borrowers, but do care about their relationships with lenders, who provide them with repeat business. Our proposal seeks to realign those incentives by requiring brokers to take suitability into account. In addition, mortgage broker licensing, capital or bonding requirements and sanctions could be useful in remedying these problems.[468]

2. *Regulation Of Appraisers*

Inflated appraisals often lie behind predatory loans.[469] Like mortgage brokers, real estate appraisers have perverse incentives to inflate property values. Lenders, who sell loans on the secondary market, want appraisals that will satisfy secondary market purchasers. Appraisers who can produce such appraisals will be the most valued and utilized by lenders. In 1989, Congress required federal banking regulators to tighten federal regulation of appraisers used by federally insured banks and thrifts.[470] At a minimum, those provisions should be extended to appraisers of subprime mortgage properties generally. In addition, appraisers who are guilty of inflated appraisals should be subject to suit under state UDAP statutes.

3. *Due Diligence By The Secondary Market*

Due diligence by the secondary market, particularly by the private secondary market, has been lax to date and has failed to deter capital flows to predatory lenders. It is unreasonable to expect secondary market purchasers to unbundle mortgage-backed securities and examine every single mortgage. However, we recommend the adoption of minimum standards for secondary

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467 *See* notes ___-___ *supra* and accompanying text.

468 *See e.g.*, N.C.G.S. §§ 53-243.01- 243.15 (North Carolina's Mortgage Lending Act).

469 *See* note ___ *supra.*

470 *See* 12 U.S.C. §§ 3331, 3339, 3341, 12 C.F.R. §§ 34.41-34.47, 225.61-225.67, 323.1-323.7, 564.1-564.8; McCoy, *supra* note ___, § 6.04[4].

market purchasers, which could have the effect of filtering out predatory loans, for example, by prohibiting secondary market purchasers from purchasing loans that include the financing of single premium credit life insurance.[471] In addition, it is reasonable to require that secondary market purchasers require periodic audits of loans purchased from originators with high loss ratios in an effort to uncover predatory lending.

4. *CRA Credit For Predatory Loans*

In a similar vein, banking organizations should be barred from receiving CRA credit for predatory loans.[472] Banking entities that originate subprime mortgages should not get CRA credit unless their subprime loans meet the best practices standards of the SRO and the enforcement agency's suitability guidelines. Banking organizations that purchase subprime mortgages, either individually or in bundles, should not receive CRA credit unless they have instituted due diligence provisions along the lines suggested above.

5. *Federal Agencies Need To Responsibly Exercise Their Preemption Privilege*

In the American dual banking system,[473] federal preemption is a long-held and jealously guarded prerogative. As we discussed *supra*, in the area of mortgage lending federal preemption could have the unfortunate effect of hampering state predatory lending reforms that are stronger than their federal counterparts. The most prominent example is challenges to state laws on grounds that state prohibitions against subprime terms and practices such as loan flipping,

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[471] *Cf.* Office of Thrift Supervision, Advance notice of proposed rulemaking, *Responsible Alternative Mortgage Lending*, 65 Fed. Reg. 17811, 17818 (Apr. 5, 2000) (seeking comment on whether OTS should "encourage thrifts to inquire whether securitizers from whom they purchase interests in loan pools have conducted their own due diligence efforts with regard to the underlying loans").

[472] *See* HUD-Treasury Report, *supra* note ___, at 106.

negative amortization, financing of points and fees and balloon payments are federally preempted under AMTPA.[474] Recently, for instance, the Fourth Circuit held that AMTPA preempted a Virginia statute limiting the size of prepayment penalties in home loans.[475] Similarly, OCC expansion of national bank powers to issue credit life insurance under expansive readings of the National Bank Act[476] may have inadvertently set the stage for certain credit life insurance abuses.

Federal banking regulators that enjoy the privileges of federal preemption need to exercise those privileges responsibly. The Office of Thrift Supervision, for instances, administers AMTPA and has authority to modify its implementing regulations to permit state regulation of non-price terms. In April 2000, OTS issued an advanced notice of proposed rulemaking seeking comment on whether, due to predatory lending concerns, AMTPA's regulations should be modified.[477] OTS should complete that task and modify AMTPA's rules, to the extent possible, to permit regulation of non-price terms in subprime mortgages by the

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473 For a general description of the dual banking system, *see* McCoy, *supra* note ___, § 3.02.

474 *See, e.g.*, Michael Bologna, *Mortgage Brokers' Suit Says U.S. Law Preempts Illinois Predatory Lending Rules*, BNA BANKING REP., July 30, 2001, at 201 (describing Illinois Ass'n of Mortgage Brokers v. Office of Banks and Real Estate, No. 01-C5151 (N.D. Ill. filed July 13, 2001)); *Predatory Lending Regulations, Laws Spread Across the Nation*, BNA BANKING REP., Apr. 30, 2001, at 776. For a description of AMTPA, *see* notes ___-___ *supra* and accompanying text.

475 *See* National Home Equity Mortgage Ass'n v. Face, 239 F. 3d 633 (4th Cir. 2001).

Similar preemption challenges might be possible under the DIDMCA. For a description of the DIDMCA, *see* notes ___-___ *supra* and accompanying text. In addition, special usury provisions in the National Bank Act and the Federal Deposit Insurance Act preempt state usury laws for national and state banks and permit these banks to export high interest rates from states where they are located to other states. *See* 12 U.S.C. §§ 85, 1831d(a); Smiley v. Citibank (South Dakota), 517 U.S. 735 (1996); Marquette Nat'l Bank v. First of Omaha Serv. Corp., 439 U.S. 299, 301 (1978). *Cf.* Paul Beckett, *Why Patricia Heaton Could Cause Problems For a GE-Owned Bank*, WALL ST. J., Mar. 30, 2001, at A1 (discussing lawsuit contending that a credit card bank formed by GE was a "state bank" that took deposits and therefore was eligible to export high interest rates to more protective states).

476 12 U.S.C. § 24 (Seventh); *see generally* McCoy, *supra* note ___, § 5.02[5][b][i][A].

477 Office of Thrift Supervision, Advance notice of proposed rulemaking, *Responsible Alternative Mortgage Lending*, 65 Fed. Reg. 17811, 17815-17 (Apr. 5, 2000).

states. Similarly, the Office of the Comptroller of the Currency should regulate exploitative terms in credit life insurance and similar products.

6. *Marketing Abuses*

Predatory lenders locate their prey through aggressive telemarketing and door-to-door solicitation. Aggressive regulation of both types of marketing, within the bounds of the First Amendment, could help shut off this vital pipeline for new customers to predatory lenders.

7. *SEC Material Litigation Disclosures*

If shareholders and people contemplating stock purchases learn that a stock issuer has significant suitability claims pending, they may divest or elect not to purchase stock. This risk creates an incentive for firms to develop mechanisms to detect predatory lending. Under SEC regulations implementing the Securities Act of 1933, issuers of securities must disclose all material pending legal proceedings to which they are party.[478] Litigation is not "material" unless similar claims, taken together, seek damages exceeding ten percent of the issuer's current assets.[479] In suitability claims, where injunctions may form the primary relief or the damages sought are small, the ten percent trigger may not be satisfied. Amending the SEC rule to add a trigger for a large number of small claims would address that problem. In addition, amending the definition of "material pending legal proceedings" to include arbitrations and agency proceedings, at least for subprime mortgage claims, would be advisable.

VI. CONCLUSION

Predatory lending is more than a fleeting problem. As foreclosures and bankruptcies mount, and neighborhoods decay, predatory lenders and brokers continue their practices

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[478] Regulation S-K, Item 103.

unabated and, more importantly, virtually free of sanctions. Our study of the forces that have contributed to the emergence of predatory lending and of the extant remedies available to victims of predatory lending has led us to conclude that without government intervention to impose a suitability standard, predatory lending will persist with devastating social consequences.

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479 *Id.* Instr. 2.

WORKER COMP. AUDIT REV. 02/22/01

ALASKA STATE LEGISLATURE
SENATOR RANDY PHILLIPS
Senate District L

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Senate Labor & Commerce Committee

MEMORANDUM

TO: Committee Members
Senators: Austerman, Davis,
Leman and Torgerson

FROM: Senator Randy Phillips Kim Pop for

SUBJECT: Work Comp Audit Review
Senate L&C 1:30

DATE: 2-22-01

TELECONFERENCE: ANCHORAGE, FAIRBANKS, KETCHIKAN

NOTIFICATION: WCCA, AK Labor-Management Ad Hoc Committee, AK Laborer's Union, AKPIRG, Risk & Insurance Management Society, AK Independent Insurance Agents & Brokers Assn., AK Injured Workers Alliance, and DOL, DCED, and LB&A.

WITNESSES ANCHORAGE LIO:

Barbara Williams, AKPIRG and AK Injured Workers Alliance (278-3661)

Ed Tisdel, V. President, AK Chapter,
Risk and Insurance Management Society (777-3024)

Nola Cedargreen, President, AK Chapter,
Risk and Insurance Management Society (330-8448)

Judy Peterson, WCCA (562-1633)

Herb Everett, WCCA Board Member (337-0095)

Kevin Dougherty, Gen. Counsel, AK Laborers Union (276-1640)

Call-in ANC Bob Lohr, Director, Division of Insurance (269-7900)

WITNESSES JUNEAU:

Paul Grossi, Director, Workman's Compensation Division (465-6059)

Sara McNair-Grove, Actuary, Division of Insurance (465-2573)

Pat Davidson, LB&A - prepared with summary and Q&A (465-3830)

WITNESSES KETCHIKAN LIO:

Listen Only: Pam Scott, AK Timber Insurance Exchange, Ketchikan (225-9451)

ALASKA STATE DISTRICT COUNCIL OF LABORERS

Laborers International Union of North America, AFL-CIO
2501 Commercial Drive, Suite 140
Anchorage, Alaska 99501 • 907/276-1640

Public Employee Local 71
Don Valesko, Business Manager
Laborers Local 942
Joe Thomas, Business Manager
Laborers Local 341
Mano Frey, Business Manager

Blake Johnson
President

Don Valesko
Business Manager/Secretary Treasurer

January 25, 2001

Senator Randy Phillips
Alaska Legislature
Juneau, Alaska
[By Facsimile]

Re: Your Request for Comment on Worker Compensation Audit

Dear Senator Phillips:

Thank you for your request for comment on the Legislative Audit (07-4601-00) on Worker Compensation. Overall I was impressed with the indepth review and pinpoint identification by the Audit of several problem areas in our Alaska Worker Compensation Act.

Ad Hoc Committee Perspective

I served as the Labor Ad Hoc co-chair for the 1999-2000 term in which the Alaska labor and Alaska Employer communities met to consider and address several mutual concerns with the Worker Compensation Act.

The Ad Hoc Committee agreement was reached in December 1999, and thus did not have the benefit of the Legislature Audit that was not released to the public until February 2000.

Those of us on the Ad Hoc Committee were very pleased to see that much of our proposed bill aligned with the Audit on several issues. We addressed many of the Audit's concerns.

In respect to the Employer Community, I cannot give a specific comment on the Audit from the Ad Hoc Committee since the Ad Hoc Committee did not make such a specific review.

Alaska Labor Perspective

From the perspective of Alaska Labor, I can state that the Audit did cogently identify problems with:

A) uninsured employers (hurts employees and insured employers)
B) frivolous controversies and DOI ineffective policies
C) the need to increase funeral, rehabilitation, and PPI benefits affected by inflation,
D) inclusion of overtime wages

Fortunately, both C and D were addressed by the Ad Hoc Committee draft proposal. The other issues are real problems that would require exhaustive review to reach a fair consensus. I believe that the Alaska business license notification (referenced at page 47 of the Audit) is a practical measure to be strongly considered. In fairness to the Employer community, I cannot speak for them on these issues.

Thank you for your work in Juneau.

Sincerely,

Kevin Dougherty

Audit Report

DEPARTMENT OF COMMUNITY AND ECONOMIC DEVELOPMENT STATE BOARD OF REGISTRATION FOR ARCHITECTS, ENGINEERS AND LAND SURVEYORS SUNSET REVIEW

October 20, 2000

Audit Control Number:

08-20001-00

Division of Legislative Audit

P.O. Box 113300, Juneau, Alaska 99811-3300

LEGISLATIVE BUDGET AND AUDIT COMMITTEE

DIVISION OF LEGISLATIVE AUDIT

The Legislative Budget and Audit Committee is a permanent interim committee of the Alaska Legislature. The committee is made up of five senators and five representatives, with one alternate from each legislative chamber. The chairmanship of the committee alternates between the two chambers every legislature.

The committee is responsible for providing the legislature with audits of state government agencies. The programs and activities of state government now cost more than $6 billion a year. As legislators and administrators try increasingly to allocate state revenues effectively and make government work more efficiently, they need information to evaluate the work of governmental agencies. The audit work performed by the Division of Legislative Audit helps provide that information.

As a guide to all their work, the Division of Legislative Audit complies with generally accepted auditing standards established by the American Institute of Certified Public Accountants and with government auditing standards established by the U.S. General Accounting Office.

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October 20, 2000

Members of the Legislative Budget
and Audit Committee:

In accordance with the provisions of Title 24 of the Alaska Statutes, the attached report is submitted for your review.

DEPARTMENT OF COMMUNITY AND
ECONOMIC DEVELOPMENT
STATE BOARD OF REGISTRATION FOR
ARCHITECTS, ENGINEERS AND LAND SURVEYORS
SUNSET REVIEW

October 20, 2000

Audit Control Number
08-20001-00

This audit was conducted under the requirements of Alaska Statutes 44.66.050 and the authority of AS 24.20.271(1). In the report, we assess the operations and performance of the State Board of Registration for Architects, Engineers and Land Surveyors utilizing the criteria set out in AS 44.66.050(c). This statutory criteria is intended to be used to assess whether the activities of a given board, commission, council, agency, or program is effectively meeting a demonstrated public need.

Currently, under AS 08.03.010 (c)(3) the board is scheduled for termination on June 30, 2001. The board would be allowed one year from this date in which to conclude its affairs, if not extended by legislative action. We recommend that the legislature extend the board until June 30, 2005.

The audit was conducted in accordance with generally accepted government auditing standards using the criteria set out in AS 44.66.050(c). Fieldwork procedures utilized in the course of developing the findings and discussion presented in this report are discussed in the Objectives, Scope, and Methodology section of this report.

Pat Davidson

Pat Davidson, CPA
Legislative Auditor

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OBJECTIVES, SCOPE, AND METHODOLOGY

In accordance with the intent of Titles 24 and 44 of the Alaska Statutes (sunset legislation), we have reviewed the activities of the State Board of Registration for Architects, Engineers, and Land Surveyors. As required by AS 44.66.050(a), the committee of reference shall consider this report during the legislative oversight process to determine whether the board should be reestablished. Currently, AS 08.03.010(c)(3) states that the board will terminate on June 30, 2001, and will have one year from that date to conclude its affairs.

Objectives

The objectives of our review were:

1. To determine if the termination date of the board should be extended.

2. To determine if the board is operating in the public's interest. The assessment of the operations and performance of the board, was based on criteria set out in AS 44.66.050(c). Criteria set out in this statute relate to the determination of a demonstrated public need for the board.

Scope and Methodology

Another auditor at our direction and supervision conducted a majority of this review. We followed professional standards to determine that the other auditor was independent and that their work was competent and sufficient.

Our audit reviewed the operations and activities of the State Board of Registration for Architects, Engineers, and Land Surveyors for the period of FY 98 through FY 00. During the course of our examination, we reviewed and evaluated the following:

1. Applicable statutes and regulations.

2. Compliance with statutes and regulations related to the licensing of architects, engineers, land surveyors, and landscape architects.

3. Minutes of meetings of the board.

4. Licensing and investigation files.

5. Complaints filed with the Division of Occupational Licensing and the Department of Law.

6. Office of the Ombudsman on-line closed case files.

7. Reading files maintained at the Division of Occupational Licensing.

8. Other documents deemed pertinent.

We also conducted interviews with employees of the Department of Community and Economic Development, Division of Occupational Licensing.

ORGANIZATION AND FUNCTION

The State Board of Registration for Architects, Engineers and Land Surveyors is a regulatory board consisting of 11 members appointed by the governor. The board consists of two civil engineers, two land surveyors, one mining engineer, one electrical or mechanical engineer, one engineer from another branch of the profession of engineering, two architects, one landscape architect,[1] and one public member.

Alaska Statute requires each board member to have been a resident in the State for three consecutive years immediately preceding an appointment.

Additionally, except for the public member and the non-voting landscape architect position, board members must be registered and have a minimum of five years of professional practice in their field.

Alaska Statutes 08.48.101 and 08.48.111 establish the powers of the board. They include:

1. Adopting regulations.

2. Describing the contents, conducting and establishing a minimum score for passing examinations.

3. Suspending, revoking, or refusing to issue or renew a license.

4. Issuing licenses to practice to architects, engineers, and land surveyors who meet standards of education and training deter nined to be necessary by the board.

Department of Community and Economic Development, Division of Occupational Licensing

STATE BOARD OF REGISTRATION FOR ARCHITECTS, ENGINEERS AND LAND SURVEYORS
as of October 1, 2000

Professional Members

Daphne E. Brown, Chair, Architect
Patricia Piersol, Architect
Linda Cyra-Korsgaard, Landscape Architect
Kathleen L. Gardner, Mechanical Engineer
Donald J. Iverson, Electrical Engineer
D. Lance Mearig, Civil Engineer
Robert E. Miller, Civil Engineer
Ernie Siemoneit, Mining Engineer
Patrick H. Kalen, PLS – Land Surveyor
Scott McLane, PLS – Land Surveyor

Public Member

Marcia R. Davis, Esq. Public Member

[1] In a non-statutory clause included in 1998 legislation providing for the licensing of landscape architects, the membership of the board was expanded, although the following provisions were attached. Section 31 of Chapter 47 of the 1998 session laws provided the following:

> *TEMPORARY BOARD MEMBER. After considering recommendations made by the Alaska chapter of the American Society of Landscape Architects, the governor shall appoint a landscape architect to the Board of Registration for Architects, Engineers, and Land Surveyors. The person appointed under this section:*
> *(1) must have been a resident in the state for three consecutive years immediately preceding appointment;*
> *(2) serves in an advisory, nonvoting capacity on the board;*
> *(3) is not entitled to receive state money for per diem or travel expenses for work as a board member;*
> *(4) serves a term that expires June 30, 2001; and*
> *(5) must be registered as a landscape architect]..*

The Department of Community and Economic Development, Division of Occupational Licensing provides administrative and investigative assistance to the State Board of Registration for Architects, Engineers, and Land Surveyors. Administrative assistance includes budgetary services and functions such as collecting fees, maintaining files, receiving and issuing application forms, and publishing notices of examinations and meetings.

Alaska Statute 08.01.065, mandates the department, with the concurrence of the board, adopt regulations to establish the amount and manner of payment of fees for applications, examinations, licenses, registration, permits, investigations, and all other fees as appropriate for the occupations covered by the statute.

Alaska Statute 08.01.087 empowers the Division of Occupational Licensing with the authority to conduct an investigation on its own initiative or in response to a complaint.

REPORT CONCLUSIONS

In our opinion, the State Board of Registration for Architects, Engineers, and Land Surveyors is operating in an efficient and effective manner and should continue to regulate architects, engineers, land surveyors and landscape architects. We believe the board is safeguarding the public interest by ensuring the competence and integrity of those who hold themselves out to the public as registered architects, engineers, land surveyors, and landscape architects.

The State Board of Registration for Architects, Engineers, and Land Surveyors has been found to serve a public purpose and has demonstrated an ability to conduct its business in a satisfactory manner. The board continues to propose changes to regulations to improve the effectiveness of the regulatory oversight provided for registered architects, engineers, land surveyors and landscape architects licensed in the State of Alaska. Existence of the board provides more assurance that the various professionals it oversees are competent, and promotes maintenance of the integrity of the professions involved.

Alaska Statute 08.03.010(c)(3) requires the State Board of Registration for Architects, Engineers, and Land Surveyors be terminated on June 30, 2001. Under AS 08.03.020, the board has a one-year period to administratively conclude its affairs. We recommend the legislature extend the board's termination date to June 30, 2005.

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FINDINGS AND RECOMMENDATIONS

Recommendation No. 1

The legislature should consider revising statutes requiring continuing education for architects, engineers, and land surveyors.

Architects, engineers, and land surveyors overseen by the board currently are not required to obtain continuing education when renewing their licenses. This is contrast to most other licensed professionals in Alaska, who are required to demonstrate they are receiving continuing education in their field in order to maintain an awareness of the changes taking place in their profession.

Continuing professional education requirements do not provide absolute assurance of the competency of licensed professionals. Such requirements, however, provide reasonable assurance that the professional is at least keeping abreast with new developments and maintains an awareness of the changes taking place in their profession.

It is our understanding that the current board supports voluntary continuing professional education, but opposes making such instruction mandatory. The reasons behind the board's reluctance to mandate continuing education are twofold. A majority of the board favors fewer regulations for professional engineers, architects, and land surveyors as a matter of general principle. Other board members have expressed concerns that any requirements the State may adopt for continuing education may conflict with similar requirements of national organizations or other licensing jurisdictions. Such conflict may make it difficult for professionals to maintain membership in national organizations or relocate to other jurisdictions.

Many national organizations maintain continuing education requirements as a requirement for membership; however, there is no mandate that requires that licensees in the State of Alaska to maintain current affiliation with a national organization. As a result, there is no requirement in place that professional architects, engineers, and land surveyors keep abreast of current developments and maintain a minimum level of competency in their professional field.

Review of the continuing education requirements of other state boards and licensing jurisdictions indicates that the national trend is towards implementing and requiring continuing education. Sixteen states currently have minimum continuing education requirements for professional architects prior to renewal of their licenses, and another 12 states have recently considered or are considering legislation addressing continuing education requirements. Twenty-four states have mandatory continuing education requirements for professional engineers, and land surveyors for renewing their licenses.

The National Council of Examiners for Engineers and Surveyors (NCEES), has established guidelines for continuing education statutes and regulations for possible use by various state legislatures and licensing boards. Similarly, the American Institute of Architects (AIA) has established minimum guidelines for aiding licensing jurisdictions in their efforts to establish minimum continuing education requirements. Use of such guidelines in developing state requirements would promote consistency with other jurisdictions and not necessarily create an undue burden on professionals that choose to relocate from one jurisdiction to another.

We recommend that the legislature consider adopting appropriate statutes and the board regulations requiring that some level of continuing education be mandated.

Recommendation No. 2

The legislature should consider revising the structure of the State Board of Registration for Architects, Engineers, and Land Surveyors.

Mining engineers account for less than one percent (0.76%) of the board's total registrants. However, AS 08.48.011(b)[2] requires that the board's membership consists of 10 professionals, one of which must be a mining engineer. The board has supported legislation to alter the composition and eliminate the requirement for the mining engineer. The board has indicated on many occasions that it is often difficult to find a qualified mining engineer who is willing to fill the designated seat. This is due to the relatively few licensed mining engineers in the State.

We recommend that the legislature consider revising AS 08.48.011(b) to eliminate the specific requirement that a mining engineer be a member of the board. Such a change would not preclude a mining engineer from sitting on the board, since the statute currently allows for an engineer from any branch of the profession. The legislature may also want to consider the advisability of designating a board seat for a representative from the landscape architect profession. This profession, which came under the purview of the board in 1998 is currently represented by a non-voting, "temporary" board member.[3]

[2] The board consists of two civil engineers, two land surveyors, one mining engineer, one electrical or mechanical engineer, one engineer from another branch of the profession of engineering, two architects, and one public member.

[3]The legislation establishing landscape architects under the board, did provide for a temporary board seat to represent the profession. The landscape architect representative served in an advisory, nonvoting capacity, was not entitle to state funding for per diem or travel costs for board work, and had a term expiring June 30, 2001.

Recommendation No. 3

In order to improve statutory clarity, the legislature should consider amending the board's statutes related to licensure of architects by comity.

The current statutory requirement, AS 08.48.191(a), for licensure by comity or endorsement for architects is unclear and subject to challenge.

The statue reads as follows (with annotation added):

> *A person holding a certificate of registration authorizing the person to practice architecture in a state, territory, or possession of the United States, the District of Columbia, or a foreign country, or holding a certificate of qualification issued by the National Council of Architectural Registration Board, that, in the opinion of the board, meets the requirements of this chapter, based on verified evidence, may, upon application, be registered in accordance with the regulations of the board.* [Emphasis added.]

The way the statute is currently worded is, in the view of the board, semantically unclear. Currently, the board requires National Council of Architectural Registration Board (NCARB) "blue book" certification, a nationally recognized standard for indicating that an applicant has met minimum technical knowledge qualifications for licensure. As a result of this interpretation, it is not currently possible for an architect registered out of state to be licensed in Alaska without NCARB certification. However, the board has been advised if an architect is registered in another jurisdiction but does not currently have the NCARB certification, they likely could be licensed if the board was ever challenged on its interpretation of this statute.

The board's current interpretation of the statute is not unreasonable. However, it is advisable to restructure the semantics of the statute in order to foreclose any future possible challenge. It does appear that the statute, as currently worded, could be successfully challenged.

We recommend that the legislature revise the wording of this statute to clarify the board's authority of requiring NCARB certification for licensure, and the extent to which the board shall be required to provide licensure to individuals without NCARB "blue book" certification. Deleting the current phrase from AS 08.48.191(a), *"holding a certificate of registration authorizing the person to practice architecture in a state, territory, or possession of the United States, the District of Columbia, or a foreign country, or . . ."* may avoid further confusion in this area.

(Intentionally left blank)

ANALYSIS OF PUBLIC NEED

The following analysis of board activities relate to the "public need factors" set out in the "sunset" review law, AS 44.66.050. The italicized, shaded, and bold face phrases are taken from AS 44.66.050 (c) (1) – (9). These analyses are not intended to be comprehensive, but address those areas we were able to cover within the scope of our review.

Determine the extent to which the board, commissions, or program has operated in the public interest.

The board through its administration of the licensure of architects, engineers, land surveyors, and landscape architects, has endeavored to present competent professionals to the public. There is a public need for this board because of the professional expertise required to practice the various professions within its purview. The licensing of applicants who meet necessary qualifications is necessary to protect the public's safety, health, and welfare.

The board is responsible for adopting regulations to ensure only persons with the proper qualifications are admitted into the profession. The public needs the board to discipline, suspend, or revoke licenses of practitioners who have committed acts listed at AS 08.48.291 and AS 08.48.295. Licensees are required to stamp final drawings, specifications, surveys, plats, plates, reports, or similar documents with a seal bearing the registrant's name, registration number and the profession for which they are registered. By affixing this seal and signing the documents, the registrant certifies that these documents were prepared by or under the registrant's direct supervision, and that the registrant has met the minimum standards set to protect public safety, health, and welfare.

The board has established regulations governing its duties and licensure requirements, enforced the laws for issuing licenses in a uniform and consistent manner, held meetings, and administered examinations in accordance with statutory requirements.

Determine the extent to which the operations of the board, commission, or agency program has been impeded or enhanced by existing statutes, procedures, and practices, which it has adopted, and any other matter, including budgetary, resource, and personnel matters.

Over the last three complete fiscal years of operation (FY 98 – FY 00) the board met the statutory requirement that it meet at least four times during the year. Teleconferences were held to address board concerns between regularly scheduled quarterly meetings.

As discussed in the Findings and Recommendations section of this report, we have the following concerns about operations of the board:

1. Assurance of professional competency could be enhanced through the implementation of continuing education requirement for registrants. (See Recommendation No. 1.)

2. Consideration should be given to changing the composition of the board. (See Recommendation No. 2.)

3. Consider clarification of semantics of the statute related to licensure by comity and endorsement for architects. (See Recommendation No. 3.)

Determine the extent to which the board, commission, or agency has recommended statutory changes that are generally of benefit to the public interest.

A variety of changes have been made to the board's statutes and regulations over the past three years. The most significant changes have been:

1. Additional educational and experience requirements for engineers applying for licensure.
2. Verification of work experience for land surveyors.
3. Adoption of eligibility requirements for applicants to sit for the Fundamentals of Engineering examination.
4. The landscape architect profession became a profession within the purview of the board. The board has adopted regulations and has offered its first exam under the new regulations. The regulations are consistent with the current statutes for architects, engineers, and land surveyors and allows the board to regulate the profession with the same consistency and in the same manner in which it currently oversees the other license-holders under its purview.

Determine the extent to which the board, commission or agency has encouraged interested persons to report to it concerning the effect of its regulations and decisions on the effectiveness of services, economy of service, and availability of services that it has provided.

The location, date, and time of upcoming board meetings and notices of proposed changes in regulations are published in the *Anchorage Daily News*, the *Fairbanks Daily News-Miner* and the *Juneau Empire*. The board's meeting agenda sets aside adequate time for the board to take public comment. Minutes from the meetings of the board reflect public participation throughout the meeting. Proposed regulations are often circulated to those affected by the proposed regulations through professional trade journals, public notice advertisement, or direct mail correspondence from the Division of Occupational Licensing.

Determine the extent to which the board has encouraged public participation in the making of its regulations and decisions.

Public notice of proposed regulations are published in major newspapers. Meetings are adequately advertised, and time is set aside for public testimony. The board reviews all public correspondence at its meetings.

Determine the efficiency with which public inquiries or complaints regarding the activities of the board, commission, or agency filed with it, with the department to which a board or commission is administratively assigned, or with the office of the ombudsman have been processed and resolved;

During the past three fiscal years (FY 98 – FY 00) the Division of Occupational Licensing has received 97 complaints concerning persons licensed by the board. The division completed 68 investigations of the 97 complaints, and resolved 52 without board action. The resolutions involved 15 warning letters, 11 instances of voluntary compliance, 22 determinations of no violation, and four other administrative closures. The division also completed an additional 24 investigations from complaints received prior to FY 98.

For the 16 complaint investigations brought to the board, 9 involved final denial of a license to an aggrieved applicant; 6 board orders (referred to as "cease and desist" orders) to licensees to stop various activities; and, the revocation of 1 license.

Determine the extent to which the board regulates entry into an occupation or profession and whether it has presented qualified applicants to serve the public.

Listed below is a summary of new licenses and permits issued by the board for the period under review.

New Licenses and Permits Issued (Exclusive of Renewals)	FY 98	FY 99	FY 00	Total	Current as of June 30, 2000
Professional Engineers	194	147	231	572	3,933
Professional Architects	12	8	16	36	519
Professional Land Surveyors	6	12	-	18	630
Professional Landscape Architects	-	-	6	6	6
Corporate Authorizations	21	24	48	93	335

The board is statutorily responsible for the issuance of all licenses. A person may apply for licensure by examination or by using past performance records. Licensure using past performance records is more commonly referred to as licensure by comity. The application process for licensing appears reasonable and appropriate.

Determine the extent to which state personnel practices, including affirmative action requirements, have been complied with by the board to its own activities and the area of activity or interest.

The Office of the Ombudsman received no complaints regarding the Division of Occupational Licensing. We did not find any evidence that the board was not complying with the state personnel practices, including affirmative action in qualifying applicants. In no instances has the board denied an applicant a license based on personal attributes.

Determine the extent to which statutory, regulatory, budgeting or other changes are necessary to enable the board to better serve the interest of the public and to comply with the factors enumerated in this subsection.

Please refer to the Findings and Recommendations section of this report.

Tony Knowles, Governor

Alaska Department of Community and Economic Development

Division of Occupational Licensing
P.O. Box 110806, Juneau, AK 99811-0806
Telephone: (907) 465-2534 • Fax: (907) 465-2974 • Text Telephone: (907) 465-5437
Email: license@dced.state.ak.us • Website: www.dced.state.ak.us/occ/

November 22, 2000

Legislative Budget and Audit Committee
Division of Legislative Audit
PO Box 113300
Juneau, AK 99811-3300

Dear Ms. Davidson,

Thank you for this opportunity to comment on the Preliminary Audit Report (#08-20001-00). We concur that the Board of Registration for Architects, Engineers and Land Surveyors should be continued through June 30, 2005. Our comments regarding the audit recommendations follow.

Recommendation No. 1. The legislature should consider revising statutes requiring continuing education for architects, engineers, and land surveyors.

The board discussed this recommendation at length during its November 16-17 meeting. The board supports continuing education requirements. The board and the division recommend amending the statutes so the board may, by regulation, require continuing education for license renewal. This amendment would allow the board to develop continuing education requirements that best serve the public. Flexible statutory authority would permit the board to adjust continuing education regulations when experience with the system demonstrated a need for change.

Recommendation No. 2. The legislature should consider revising the structure of the state Board of Registration for Architects, Engineers and Land Surveyors (BRAELS).

The percentage of Alaska engineers who are mining engineers is low. The board does not believe the relatively small number of mining engineers has made it difficult to fill the designated board seat. Several years ago the legislature considered removing the requirement that one of the five engineers on the board be a mining engineer, and the legislature decided not to make the change. The designation of board seats does not have to correlate to the percentage of licensees. The importance of competent mining engineering to sound state development may warrant a designated board seat.

Recommendation No. 3. In order to improve statutory clarity, the legislature should consider amending the board's statutes related to licensure of architects by comity.

The board has adopted regulations that address this issue. However, a statutory change may help clarify the law and reduce the potential for litigation.

Sincerely,

Catherine Reardon
Director

SB

6

LEGAL SERVICES

DIVISION OF LEGAL AND RESEARCH SERVICES
LEGISLATIVE AFFAIRS AGENCY
STATE OF ALASKA

(907) 465-3867 or 465-2450
FAX (907) 465-2029
Mail Stop 3101

State Capitol
Juneau, Alaska 99801-1182
Deliveries to: 129 6th St., Rm. 329

MEMORANDUM February 7, 2001

SUBJECT: Sectional Summary of Notice of Eviction to Mobile Home Park Dwellers (SB 6)

TO: Senator Johnny Ellis
Attn: Tyson Fick

FROM: Kathryn L. Kurtz KLK
Legislative Counsel

You have requested a sectional summary of the above-described bill.

As a preliminary matter, note that a sectional summary of a bill should not be considered an authoritative interpretation of the bill and the bill itself is the best statement of its contents. If you would like an interpretation of the bill as it may apply to a particular set of circumstances, please advise.

This bill requires that a mobile home park tenant being evicted due to a change in the use of land be given one year's notice, unless the park owner or operator pays the costs of relocating the mobile home. It prohibits park owners and operators from requiring these tenants and mobile home park tenants whose parks are being converted to common interest communities to vacate during the winter.

Section 1. Changes the definition of unlawful holding by force in the landlord tenant act to take into account the new notice to quit provisions of section 3.

Section 2. Changes the subsection on reasons for evicting a mobile home park tenant to take into account the new notice to quit provisions of section 3.

Section 3. Adds a new subsection requiring that a mobile home park tenant being evicted due to a change in the use of the land on which the mobile home is located be given a quit date between April 1 and September 30 and at least 365 days notice of eviction, unless the mobile home park owner or operator pays the actual cost of moving the mobile home, not to exceed $5,000, in which case only 180 days notice need be given.

Section 4. Existing law provides one year's notice for a trailer park tenant being evicted due to a conversion to a common interest community; this section adds a requirement that the quit date fall between April 1 and September 30, to correspond to the changes made in section 3.

KLK:glc
01-106.glc

ALASKA STATE LEGISLATURE

Senate Rules Committee
•
Senate Judiciary Committee
•
Department of Law
Budget Subcommittee

While in Session
State Capitol, Rm. 9
Juneau, Alaska 99801
(907) 465-3704
Fax: (907) 465-2529
•
While in Anchorage
716 West 4th Ave., Ste 440
Anchorage, Alaska 99501
(907) 269-0169
fax: (907) 269-0172

SENATE MINORITY LEADER
JOHNNY ELLIS

Sponsor Statement
Senate Bill 6

In July 2000 an Anchorage rezoning decision evicted 220 lower-income mobile home owners and their families. This change created both a net loss of mobile home spaces as well as a decrease in available lower income housing. As communities have grown, areas once considered marginal for development have become more desirable which means more rezoning and evictions are expected.

As the specter of rezoning was raised in the spring of 2000, Archbishop Francis Hurley and United Way Director Dennis McMillian formed a task force to address how relocations of mobile home communities impact the larger community of Anchorage. The "Anchorage Response to Manufactured Housing Community Relocation" Task Force Report prepared a report for the Anchorage Assembly. This bill addresses the task force's legislative action recommendations.

What this bill does: It updates the Alaska Landlord Tenant Act to accommodate the needs of mobile home community members by changing the "notice to quit requirement" from 180 days to 360. Should the landlord not wish to give 360 days notice, they may still give 180 days notice with the requirement then to pay up to $5000 in relocation fees of the tenant. The increase in notice is intended to allow the displaced residents to find a new space for their mobile home, or save up the deposit and other fees before moving into an apartment.

Who supports this bill: Catholic Social Services, the Archdiocese of Anchorage, and mobile home community residents.

This bill is important because it helps to form a strategy to alleviate the strain involved with the loss of affordable housing stock caused by displacement of residents in manufactured home communities as there is continuing rezoning and commercial redevelopment. By helping to soften the blow and smooth the transition in an eviction this bill would take a proactive stance in preventing the disenfranchisement of a potentially at risk segment of society.

I recommend support and swift passage of this important piece of legislation.

ALASKA STATE LEGISLATURE

Senate Rules Committee
•
Senate Judiciary Committee
•
Department of Law
Budget Subcommittee

While in Session
State Capitol, Rm 9
Juneau, Alaska 99801
(907) 465-3704
Fax: (907) 465-2529
•
While in Anchorage
716 West 4th Ave., Ste 440
Anchorage, Alaska 99501
(907) 269-0169
fax: (907) 269-0172

SENATE MINORITY LEADER
JOHNNY ELLIS

TO: Honorable Randy Phillips, Chairman
Senate Labor and Commerce Committee

FROM: Senator Johnny Ellis

DATE: February 15, 2001

RE: Hearing request for Senate Bill 6

Dear Senator Phillips,

On behalf of the Archdiocese of Anchorage, Catholic Social Services, the Salvation Army, the United Way, and residents of manufactured home communities, I would like to request a hearing in the Senate Labor and Commerce Committee on Senate Bill 6 "an Act relating to required notice of eviction to the dwellers, tenants, and owners of mobile homes in mobile home parks before redevelopment of the park."

This bill is born from the Anchorage Response to Manufactured Housing Community Relocations Task Force Report drafted mid-September 2000. It is an important piece of legislation which would do a great deal to prevent the possibility of a potentially at risk segment of society from being evicted without recourse in the event of the rezoning and redevelopment of a manufactured home community. Senate Bill 6 is widely supported in the community, by civic organizations and developers alike. This is targeted legislation that effectively addresses a specific need.

Your favorable consideration of this request will be appreciated.

Sincerely,

Senator Johnny Ellis

ARCHDIOCESE OF ANCHORAGE
225 CORDOVA STREET • ANCHORAGE, ALASKA 99501
907/258-7898 • fax: 907/279-3885

February 13, 2001

Senator Johnny Ellis
State Capitol, Room 9
Juneau, AK 99801-1182

Re: **SB 6 - An Act relating to required notice of eviction to mobile home park dwellers and tenants before redevelopment of the park.**

Dear Senator Ellis:

I am writing in support of SB6. As you know, the Anchorage community is faced with the possible rezone of two manufactured home communities – Alaska Village Mobile Home Park and Plaza 36 Mobile Home Community. Several hundred residents will be displaced if the Municipality of Anchorage approves these rezone petitions and the development goes forward.

During the past year, I had the privilege of serving on the Anchorage Manufactured Home Community (MHC) Task Force, formed specifically to address the potential suffering that might result from the displacement of hundreds of families. Those serving on the task force found that the issues were formidable:

1) there would result a loss of already scarce affordable housing due to the closure of manufactured home communities;
2) homes not code compliant, but having grandfather rights, would require costly code compliance when moved;
3) older manufactured homes are no longer moveable or may not be acceptable in existing manufactured home communities;
4) the cost of disconnecting and relocating a home is prohibitive to many MHC residents;
5) self-sufficient individuals and families may be forced into poverty due to the cost of a move or the loss of their manufactured home due to its age and lack of mobility.

SB 36 mirrors legislation that was recommended in the Task Force Report. It provides some incentive for the owner/developer to consider the needs of the tenants when changing the use of the property. By expanding the notice requirement to 365 days, it was the hope that tenants would have adequate time to make relocation plans and,

if necessary, seek the assistance of social service agencies. However, not to unduly burden the owner/developer, the proposed legislation allows the owner/developer to essentially "buy down" the time to 180 days, by compensating the tenants for the costs of their move.

It should be noted that the $5,000 maximum compensation in the proposed legislation also appeared in the Task Force Report. This amount was not the result of any specific study of relocation costs on the part of the Task Force. In fact, the cost of disconnecting, relocating, and reestablishing a manufactured home might well exceed $5,000.

While serving on the Task Force and working with the tenants of manufactured home communities, it became apparent to me that mass displacement places an undue burden on the tenants and the social services of the community. If a change of use is, indeed, in the best interest of the community, then efforts to alleviate suffering of displaced persons must be shared by the owner/developer and the community.

SB6 is one step toward protecting the interests of manufactured home owners in Alaska. It does not address the needs of those whose homes will be lost in any change of use of a manufactured home community, but it is a first step. Further efforts will, undoubtedly, be required at the local level.

I urge you to support SB6.

Respectfully,

Angela A. Liston
Director
Department of Justice and Peace

Catholic Social Services
Beyond Shelter Program
276-3046

Memorandum

To: Senator Bettye Davis
Senator Johnny Ellis

Cc: Representative Eric Croft
Representative Lisa Murkowski

From: Stephanie Wheeler

Date: 02/28/01

Re: Senate Bill 6

I am the Program Director for the Beyond Shelter and St. Francis House programs – programs of Catholic Social Services.

Thank you for the opportunity to provide input for Senate Bill 6. Currently the Beyond Shelter Program is assisting with the relocation planning of forty-two (42) Plaza 36 residents needing to relocate the Plaza 36 Mobile Home Community by May and July. The concerns/issues of relocating a mobile home community are many and Senate Bill 6 addresses two of these major concerns for residents needing to relocate: adequate notice of closure and financial compensation for relocation costs.

Adequate planning for Mobile Home Residents is crucial for residents who are impacted by the redevelopment of their community. A 365-day notice will help residents explore options and finalize a plan for relocation. Additionally, Senate Bill 6 addresses the issue of relocating during appropriate seasons, so residents are not being forced to move during the winter months.

In conjunction with adequate planning time, financial compensation will assist residents with some of the relocation costs so that residents are not forced to abandon or sell their homes but can successfully relocate their homes to another area.

Mobile Homes/parks help meet the housing needs and provide a source of low cost housing to many families living in Alaska. We encourage the legislature to begin addressing other issues such as code compliance (or neglect issues) and help to establish acceptance for resident-owned mobile home communities in the private market. The cost for inspections and upgrades can be overwhelming for many residents who need to bring their homes up to code.

As two Anchorage area mobile home communities currently face the challenge of relocation, the total impact will not be fully understood until residents actually relocate. It is our hope that residents currently facing relocation and those who may be facing relocation in the future are not left homeless by this process. Thank you!

The Salvation Army
Alaska Divisional Headquarters
Mailing Address: P.O. Box 101459
143 E. Ninth Avenue · Anchorage, Alaska 99510-1459
(907) 276-2515 · FAX (907) 276-1424

Founded In 1865
By William Booth
John Gowans
General
David Edwards
Territorial Commander
Terry W. Griffin
Divisional Commander

February 15, 2001

ALASKA STATE LEGISLATURE
Senator Johnny Ellis, Minority Leader
FAX #1-907-269-0172; Attention: Tyson Fick
Anchorage, Alaska

RE: **Sectional Summary of Notice of Eviction to Mobile Home Park Dwellers**
Senate Bill 6

Dear Senator Ellis;

On behalf of The Salvation Army Alaska Division and the Divisional Commander, Lt. Colonel Terry W. Griffin, I am writing this letter in support of Senate Bill 6 (which includes the amendments for tenants and landlords of mobile home parks).

This bill is important because it helps to develop strategy to alleviate the strain involved with the decrease of affordable housing caused by the displacement of residents of mobile home parks due to rezoning and commercial redevelopment in the Anchorage area.

Please add our names to the list of supporters for this Bill.

Thank you for your attention and assistance.

Sincerely,

C. Joe Murray, Major
DIVISIONAL SECRETARY

C/c: Lt. Colonel Terry W. Griffin, Alaska Divisional Commander
Dennis McMillian, Director, United Way of Anchorage

100 1898 - 1998
Into a Second Century of Service

Anchorage Response To Manufactured Housing Community Relocations

Task Force Report

Overview

In the spring of 2000, Archbishop Francis Hurley contacted Dennis McMillian, Executive Director of United Way of Anchorage, concerning the inevitable relocation of residents of Alaskan Village Mobile Home Court. Archbishop Hurley was concerned that while many of the residents, though inconvenienced by the relocation, would be able to adapt to the change, some of the residents would not successfully move their home and adapt to new surroundings. There was legitimate concern that this relocation could. in effect, create a new group of high risk, potentially homeless, citizens.

In June of 2000, Dennis McMillian and Angela Liston representing the Archdiocese, met with members of the "Go Team", a grass-roots citizens group consisting of residents of Alaskan Village. At that meeting, it was determined that the emphasis of the Archdiocese and United Way effort would be to focus on researching how this relocation issue impacts the entire community and future neighborhood relocations, rather than focusing on the Alaskan Village move. However, it was also determined that if at all possible the effort would attempt to produce a report that could give guidance to the residents, the developer and the Municipality on the Alaskan Village relocation.

After that meeting, Dennis McMillian, Angela Liston, and Karleen Jackson, Executive Director of Catholic Social Services, (CSS), determined that United Way and CSS should convene a task force to review the issues and produce such a report. They met with members of the Assembly in mid-July to seek their approval and assistance in this effort and received their support.

On June 29, 2000, a group of forty citizens comprised of residents of manufactured home communities, professionals involved in the housing industry, government officials, bank officers, non-profit professionals, and planners met to discuss the issues and determine a course of action. This large group divided into four work groups with specific responsibilities. They were:

- Community Data - A group responsible for gathering the best available data on the number and location of manufactured home communities, the available spaces in those communities, and to the best of their ability, indicators of how such communities could identify their risk of re-development; and,
- Code Compliance - A group with the responsibility to look at existing building codes and code enforcement efforts regarding the manufactured housing industry in Anchorage and Alaska; and,
- Community Response - A group with responsibility to develop a comprehensive list of services available to assist individuals and/or their homes relocated by such re-development. They were also tasked to determine how this information could be made available to the public; and
- Community and Legal Support - This group was tasked with reviewing legislative actions taken in other states that could be useful in Alaska, and

determining what volunteer efforts in the community could lessen the impact on displaced residents.

The individual groups met during July and prepared a draft report for full group review on July 27. Final revisions were made and submitted by mid-September in preparation of this report.

The volunteers involved in this effort are to be commended for their long hours and hard work developing what we hope to be a non-biased report to the Anchorage Assembly and Mayor for review.

Team Members

Name	Group Affiliation, if known
MHC Task Force Facilitators:	
Dennis McMillian	United Way of Anchorage
Kelly Fehrman	Catholic Social Services
Karleen Jackson	Catholic Social Services
Community Data Team:	
Facilitator:	
Barbara Symmes	Providence
Members:	
Loretta DeBord	Alaska Village "Go" Team
Jewel Jones	MOA
Norman Kallander	CIHA
Kevin Waring	Anchorage Citizen
Bob Maier	Alaska Manufactured Homes Assn
Denise Henderson	Rep. Pete Kott
Sue Fison	MOA
Fred Jenkins	United Way
Sheila Howe	Northeast Community resident
Ronnie Stork	Muldoon Family Center
Pastor Ron Martinson	Alaska Lutheran Synod
Community Compliance Team:	
Facilitator:	
Tim Sullivan	Weed and Seed Project
Members	
Melinda Taylor	Anchorage Assembly
Paul Johnson	HUD
David Pree	Rep. Eldon Mulder
Jeri Walters	NBA
Will Theuer	Anchorage Citizen
Mac Carey	Carey Homes
Mackenna John	Alaska Village "Go" Team
Hazel Welch	Manufactured Home Resident

Team Members (continued)

Name	Group Affiliation, if known
Community Response Team:	
Facilitator:	
Gail West	HUD
Members	
Jan Jones	Consumer Credit Counseling Services
Norm Kallendar	Cook Inlet Housing Authority
Mary Jane Michael	Anchorage Neighborhood Housing Services
Pastor Wilbert Mickens	Good Shepherd Baptist Mission
Brenda Moore	Christian Health Associates
Rev. Ted Moore	Leake Temple
Teresa Nelson	Key Bank
Judith DeSpain	Alaska Housing Finance Corp.
Lynn Taylor	Municipality of Anchorage
Sam Meneses	Catholic Social Services
Barbara Baker	AHFC
Kris Duncan	AHFC
Community and Legal Support Team:	
Community Response Team:	
Facilitator:	
Liz Forrer	Alaska Humanities Forum
Members:	
Angela Liston	Archdiocese of Anchorage
Julie Bailey	Northrim Bank
Chris Main	
Mac Carey	Carey Homes
MacKenna Johns	Alaska Village "Go" Team
Rebecca Powell	
Individuals not listed in teams above who attended Task Force Meetings:	
Laura Robertson	
Judy Billington	Manufactured Home Resident
Clark Rukelderfer (sp?)	Manufactured Home Resident
Lorna Roberts	Alaska Village "Go" Team
Lanny Bennett	Alaska Village "Go" Team
Miriam Mastacusa	Anch Assembly - Cheryl Clementson

Community Data

This team's task was to do research and present facts and data as a basis for assumptions that it or other teams might present in the final report.

Abbreviation: MHC = Manufactured Home Communities (this terminology is used to denote groups/communities of mobile homes/manufactured homes)

Facts:

1. Team leaders secured a map of the Anchorage bowl from the MOA showing all existing individual manufactured homes and manufactured home communities (MHC's). Two-thirds of MHC's and MH spaces lie within the Renaissance Zone and within northeast Anchorage.
2. Commercial redevelopment of MHC's reduces the availability of scarce residential land in the Anchorage Bowl. In this regard, one of the strategies recommended in the Draft Anchorage 2020 plan (page 55) is: "Avoid the loss of new housing capacity from rezoning of residential land for other uses". The effect on housing supply of potential rezoning of Alaska Village and other MHCs, as well as vacant residential land, is the issue this strategy was meant to address.
3. Because of location and size of tracts, MHC's are at risk for closure for commercial redevelopment.
4. More than 50% of manufactured homes in MHC's were built in the 1970's (MOA Planning Dept). Current zoning, codes, MHC restrictions, and age/condition of MHC's present significant obstacles to relocation of older manufactured homes.
5. The median value of manufactured homes in Anchorage is $11,400 (MOA Planning Dept).
6. The 2000-2002 MOA Housing & Community Development Consolidated Plannotes the shortage of affordable housing stock. Access to both rental and homeownership opportunities is constrained among Anchorage's low and moderate income households.. The only neighborhood in which the median selling prices for homes is affordable to very low, low, or moderate income families is Mountain View at $69,607 (Housing MLS data updated 6/30/99)
7. Many of the existing MHC's have water, sewage, and soil contamination problems.
8. Four Seasons is the only existing MHC in Anchorage that is redeveloping into a modern MHC.
9. Thirty-four of the sixty-six MHC's in Anchorage have less than 30 spaces. Of the total of 5,713 spaces in MHC's in Anchorage, 4545 (80%) are occupied. Neeser Construction is surveying MHC's in Anchorage to determine the number of available spaces.

Assumptions:

1. Displacement of residents will continue as MHC's undergo rezoning and commercial redevelopment.
2. There is a shortage of public strategies to alleviate the loss of affordable housing stock caused by displacement of residents in MHC's that are closed.

Code Compliance

The study group met numerous times to discuss current codes and zoning that affect Manufactured Housing Communities (MHC) and the residents of those neighborhoods. These meetings were prompted by the recent request for a change in zoning at Alaska Village.

First, we had to examine the codes that applied to the MHC and determine if there were any codes that were extraordinary regarding Manufactured Housing. We found none. In fact, we observed that the code dealt well with the life, health and safety issues codes are intended to address.

However, what became obvious after interviewing members of the Alaska Village Community and other manufactured home representatives was that the Municipality' ability to enforce code was hampered by the judicial system. The judiciary is reluctant to enforce to the letter of the law when it means families are being evicted from their homes. The question of private property rights is ever present regarding enforcement in the manufactured housing communities.

Those homes that are pre 1976 are grandfathered, insofar as code is concerned. However if and when the home moves it then falls under the current code. Required updates can be quite costly. For instance, a home could need new wiring, a new electrical box, a new water heater, a new furnace, and a new roof, all in addition to the cost of physically moving the home. In some cases the home might not be worth moving, because of structural problems and the aforementioned code issues. Title of the homes is an issue for owners who did not receive one at the time of sale and still do not have one. Delinquent personal property taxes will be an issue for some.

We have also recently been made aware of inconsistency with regard to inspections. When a home is ready to move there is a pre-inspection to let the home owner know approximately what items will need to be replaced or repaired when they arrive at their new neighborhood. However, it seems that a different inspector requires different compliance at the new community that costs the homeowner much more that they had originally anticipated. Improved coordination and internal communication by the MOA would benefit the homeowners.

Options offered by the Code and Zoning Study Group are:

- The MOA could review its inspection process so that the homeowners will be impacted minimally by the stress of voluntary or involuntary move.
- The Municipal Assembly could resurrect the Manufactured Housing Ordinance that has been languishing in MOA Legal since December of 1998. This ordinance would permit post-1976 manufactured homes to be treated the same as conventional site-built homes.
    - Any zoning of residential land to business or commercial needs to be done with the highest concern for affordable housing needs in Anchorage...perhaps a land swap to make a no net loss of residential land.

Community Response

Committee Discussion

The committee identified four groups of people who may need the resources identified by the committee for assistance during the closure of a manufactured home community. Those four groups are:

- potential homebuyers
- potential renters
- potentially homeless
- people who are able and want to move their current manufactured homes to a new community

Within the four groups, two subgroups were also identified:

- the disabled
- seniors

To gather information on resources that may be helpful to the four groups and two subgroups, the committee created a survey to identify a wide variety of resources.

Committee Action

The committee surveyed potential resources and identified an existing, but little used, database of resources for the homeless and very low income.

- surveyed all agencies, organizations and businesses that received the Anchorage Consolidated Plan
- surveyed utilities that may have delayed-payment plans or options for families who are unable to pay the full deposit for a new hook-up
- identified

Responses to the survey have been compiled and are currently being merged into the existing database of resources. Completion of this project is tentatively schedule for mid-November 2000.

Once the final database is complete, it will be housed at the Municipality of Anchorage (through the Safe City program), and will be linked to: Alaska Housing Finance Corp., AKinfo, Cook Inlet Housing Authority and HUD Web pages.

Community and Legal Support

The first issue this group worked on was to understand the lifestyle of many residents of manufactured home communities. Many individuals strongly feel that living in manufactured housing, as compared to apartments or condominiums enhances their lives. They urge the Anchorage community to find ways and means to accommodate their choice to live in manufactured housing. Many feel that with current land use conditions, their lifestyle is in jeopardy.

This committee also determined that when a manufactured housing community is relocated, there should be formalized support from the larger community to help individuals adapt to the change. Although the comparison of persons displaced by a natural disaster did not ring true to all participants, all agreed that neighborhood relocation is a traumatic experience for those affected therefore support from others could help with the transition.

This committee recommends that some organization facilitate an event similar to A Day of Caring, to help residents successfully complete such relocations. The plan would be to call on volunteers and community groups to "adopt" individuals and/or families and assist them during their relocation. Work continues to determine the appropriate organization to head such an effort.

The other task of this group was to review legal options for the Municipality and State. The following pages describe some of these options.