CURBING BAD BANKS: CHAPTER XIX

Despite Lender Claims to the contrary, Lenders Cannot Demand that the Debtor Liquidate Exempt Assets or Face Denial of Workout—it's Against Consumer Law!

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THE LENDER'S DEMAND FOR THE "APPROVAL BRIBE"

How many times have real estate practitioners and others who do loan workouts seen this one?:

The lender, while accepting the short sale pay-off price, modification, due-date extension, or other proposed resolution, also demands as part of the resolution that the debtor confess to liabilities the debtor would otherwise be legally protected from, waive defenses and offsets the debtor would otherwise be allowed by law to raise, pledge new collateral, or agree to pay the creditor additional monies from funds that would otherwise be protected by law.

Is **"every single time"** pretty much that answer to that? *And now for the REAL question: Can the creditor <u>lawfully</u> do that?* **More times than not, the answer is "NO!"**

Most people are aware that state and federal laws provide debtors a host of exemption rights which prevent a creditor from reaching certain assets in its collection efforts. *Most people are unaware, however, that coercing a debtor into waiving statutory exemptions is generally against federal banking and consumer protection laws, bankruptcy law, and state laws.* Some protective laws apply even when the loan is a commercial or a non-purchase-money consumer loan.

IT'S AGAINST THE LAW TO EVEN *ASK* DEBTORS TO WAIVE EXEMPTIONS AND *EVEN MORESO TO COERCE PAYMENT ON THE THREAT OF DENIAL OF WORKOUT OPTIONS, EXPRESSLY OR IMPLIEDLY.*

In most cases, under state law, agreements to pay a creditor from exempt sources are against public policy and void. A debtor or a debtor's representative should therefore decline to do it and, when confronted with the bribe demand from the lender, should routinely consult with an attorney. Use of an attorney in advance of any substantial debt settlement is always a good idea as there are many other hazards than simply having the lender demand an "approval bribe" from exempt resources.

Often the creditor tries to be cagey by insisting that there is no demand for waiver of exemption, just a demand for money and "the debtor can always refuse the workout." The problem is, the debtor has already produced a sworn financial hardship statement showing no other resources on hand to meet the creditor's demands OTHER than exempt ones, so it is patently obvious that in order to meet the lender's demand, the debtor would have to tap exempt sources.

DON'T FORGET TAX AND CREDIT IMPLICATIONS! WHAT THE LENDER DOES NOT UNLAWFULLY DEMAND AND COLLECT MAY BE LOST SOON ANYWAY

In addition to avoiding monetary concessions to lenders that do not have to be made, most debt settlements also have **tax ramifications**, particularly those that call for liquidating exempt assets such as IRAs and 401Ks or 529 College Savings Plans. Immediate **credit rating** and long-term credit **loan requalification standards** can be either made worse or made better by how the deal with the lender goes down. If you or a client of yours is considering a workout, "rolling over" and doing what the lender demands can be the "poison that keeps on poisoning" the debtor, as consequential tax issues then immediately erupt with IRS and the administrator of the 401k. And for the licensee who (with fiduciary duty intact) told the client borrower to do it saying "he had to", there is even more exposure as the bad news just keeps on coming for the client for years after the deal—and wants to blame someone for it. *The agent caused it with bad advice or even an outright lie.* The borrower DID NOT "HAVE TO DO IT" and in fact should have been advised NOT to do it. This is why it is crucial that borrowers (and agents) obtain competent legal advice to consider the WHOLE picture a workout presents and to "get their law right" before leaping to any conclusions or taking any steps towards commitment.

UNLAWFUL LENDER COERCION TACTICS

There are a host of laws that govern consumer debt settlements, including: The Fair Debt Collection Practices Act, Federal Comptroller and Treasury regulations, the Dodd-Frank Act, Federal Trade Commission regulations, the Fair Credit Reporting Act, and state and federal exemption laws. Common law (case law) has also interpreted and applied these and other laws. Causes of action like "negligent misrepresentation" are claims arising in common law and can give debtors a cause of action against their agents (and creditors) where the statutes and regulations may not. The application and mandates of these laws must be known and appreciated in work-out deals and using the protections needs to be set in stone before the lender confrontation. Indeed, the debtor needs to be "positioned" for these protections well ahead of approaching the creditor or commencing work-outs, as without them being pre-existing, some protections are defeated.

The fact is that a debtor can beat back the negligent or intentional misconduct of creditors and debt collectors and use their own aggressive and unlawful "settlement ultimatums" against them as leverage for a superior and final resolution when the creditors are violating these laws. The violation of the debtor's rights becomes not just a "defense" to the demands, but also potent grounds for offensive debtor responses against the lender, as creditor violations of consumer protection laws all give debtors some mighty counterclaim remedies.

THE AGENTS' DUTIES

Any professional working with distressed properties or doing work-outs has a duty to know these rules and laws as violating them or abetting a lender to violate them can expose the agent to liability to the debtor as well, not just from the consumer laws themselves but also as violations agency and licensure law. Any debtor "resolution" that allows the debtor to pay funds which are protected by law from the lenders, leaves the debtor no funds for post-settlement recovery, hobbles the debtor with more obligations, or which merely positions the debtor for a devastating "second bite" liquidation by IRS taxing the debt relief, or by the creditor (such as by waivers, promissory notes, confessions of judgment or by collateralizing more precious assets for the loan concession) is no "resolution" at all. In fact, ***it's an avoidable "giveaway" egregiously and gratuitously dooming the client/debtor and as such, just plain malpractice by the debtor's licensed agents, counselors and negotiators*.**

Obtaining the advice of legal and tax counsel before a substantial debt dispute will likely pay for itself many times over by avoiding the above worst-case scenarios. If you or a client have not planned ahead, however, that door is closed and hell is to pay.

Now that this article has your attention, the remainder of it discusses laws which prohibit lender from forcing massive borrower concessions and what the proper response is. Obviously, this a "pure law" and one will need to get a lawyer involved on the "debtor rescue team" early on when these issues arise, as they do in so many short-sales and debt settlements. With the assistance of competent legal counsel, one can often avoid the liability precipice and still put together a deal.

BEWARE DEBTOR "HARDSHIP" FINANCIAL DISCLOSURES: They are a Road-Map to Meat for the Vultures!

Creditors seeking to collect debts frequently request financial disclosures from the borrower when negotiations begin (or as part of the "hardship" establishment in modifications and short-sales). What is said here includes not only these but any debt work-out done for a consumer-debtor. In some cases, like with the Federal loan modification programs, information about the borrower's income, expenses, assets and liabilities is mandated to determining if the borrower "qualifies". The debtor is often called upon to provide verification of income through multiple weeks of pay-stubs, several years' income-tax returns, and banking account statements. Additional information requested of the debtor about reserve or consumer assets and liabilities not in question is superfluous to debt-to-income calculations and that makes questions about these gratuitous and perhaps even creditor over-reaching. This is certainly so if the "financial statement" requested inquires about assets that are exempt from creditor executions no matter what they owe, such as by asking about 401(K)s or (in most but not all states) IRAs, 529 college savings account, or several other savings vehicles—all of which out "entirely out of play" by statute. There are many more exemptions. The assets immune to creditor-seizures or demands are usually a very long list and can vary by state. See the list of them, federal and for each state, by going to www.eckleylaw.com and logging into the search box "exemptions".

The point is this: If the creditor cannot ever reach these exempt assets, cannot even execute on them no matter how "egregiously" large the debtors' debt is and if they are by state and federal law not even eligible to be considered (even in bankruptcy) as assets available to meet debts as a matter of federal law and the creditor cannot even be compelled by a Federal Judge to release them to anyone—by what right does the lender ask about them or give any impression at all that these come into play in its determination

or hardship? ***It's simple: They have no right. Not under any state or federal law and not under any lawful federal guidelines***.

There is more: Even giving the creditor a summary of assets which includes a large and valuable block of **non-exempt assets** (those which can be liquidated for a debt) only provides the creditor with a roadmap to finishing the job of emptying the debtor's pockets in the event a workout is not had and collection ensues. And if the block is big enough, it even kills any potential resolution as it acts to do nothing more than waive too much meat before the vulture's beak to resist. When a debtor has too many non-exempt assets so that resolution on the basis of "poverty" is unlikely, why show those cards at all?

EXEMPT ASSETS AND THE LAW:

Since any implication by the lender that it can either consider or obtain exempt assets under any guise is a misrepresentation by the lender (and the agent if he or she concurs with or assist the creditor in doing this), even asking for it is questionable and denying it is entirely appropriate and lawful where any consideration of "resources or net worth lawfully available to meet general debts" is concerned. The next question is how the creditor purports to or actually uses the information if it is given. The simple answer is, in most states, by statute, a creditor **may not** use the assets or even enforce an agreement by the debtor to waive his or her statutory exemptions. For example, in Arizona, Ariz. Rev. Stat. § 33-1132 provides:

Notwithstanding any agreement to the contrary, a waiver of the exemption rights provided by this article shall be void and unenforceable . . .

Or in California, see Cal. Civ. Code. § **703.040** which provides:

A purported contractual or other prior waiver of the exemptions provided by this chapter or by any other statute . . . is against public policy and void.

Or in Nevada, see Nev. Rev. Stat. § 21.112.11 which provides:

*A judgment creditor **shall not require a judgment debtor to waive** any exemption which the judgment debtor is entitled to claim.*

Federal bankruptcy law also prohibits enforcement of a waiver of exemption rights. See 11 U.S.C. § 522(e), which provides:

(e) A waiver of an exemption executed in favor of a creditor that holds an unsecured claim against the debtor is unenforceable

Federal regulations also bar banks from seeking or enforcing waivers. See Federal Reserve Regulations at 12 C.F.R. § 227.13, which provide:

It is an unfair act or practice for a bank to enter into a consumer credit obligation that contains, or to enforce in a consumer credit obligation purchased by the bank, any of the following provisions:

(b) Waiver of exemption. An executory waiver or a limitation of exemption from attachment, execution, or other process on real or personal property held, owned by, or due to the consumer . . .

While this prohibition applies only to "Consumer" debt which is limited to "goods, services, or money for personal, family, or household use other than for the purchase of real property," arguably even a loan for the purchase of real property which is being refinanced (and thus not for "purchase"), or cases where the lender attempts to have borrower repay a deficiency with a separate, new note (and thus not for the "purchase"), fit within the definition. Bandit notes like this even where there are no properties subject to seizure or over the top of a debt for which there is no legal recourse are commonly demanded by the creditor, are unlawful and ought not to be permitted by the agent.

The Federal Trade Commission ("FTC") also bars lenders from requesting confessions of judgment or waivers of exemptions, among other protections. See 16 CFR § 444.2(a) and the FTC's regulation does not limit the definition of "consumer" to exclude residential mortgages like the Federal Reserve Regulation above.

The Federal Trade Commission also bars consumer waiver of *other* FTC consumer protections. See 16 CFR § 321.4 which provide:

It is a violation of this part for any person to obtain, or attempt to obtain, a waiver from any consumer of any protection provided by or any right of the consumer under this part.

FTC consumer protection regulations include 16 CFR § 321.3 which prohibits any "material misrepresentation, expressly **or by implication**, in any commercial communication, regarding any term of any mortgage credit product". This broad regulation easily encompasses communications about the borrower's exemption rights, the enforceability of any agreement to waive exemptions, or false threats of liability were the borrower is protected under State laws, such as under anti-deficiency laws or where a financial statement demanded by the creditor demands specific information about the whereabouts of exempt assets and the account numbers and contents of exempt retirement plans on pain of denial of the otherwise satisfactory workout if it is not pro-offered by the debtor.

The Comptroller of the Currency and Department of Treasury regulations, 12 CFR § 37 *et seq*, limit banks' ability to extract borrower concessions in "debt cancellation contracts and debt suspension agreements". 12 CFR §37.3(c) prohibits banks from requiring a "lump sum, single payment for the contract payable at the outset of the contract, where the debt subject to the contract is a residential mortgage loan." In most cases, creditors live by the "bird in hand" theory and are seeking payment from exempt sources because those sources, unlike the debtor's checking accounts and non-exempt income, have accumulated reserves for a large lump sum payment. If the workout is for a residential mortgage loan, it is unlawful to require lump sum payment of the settlement amount.

Violations of State or Federal regulations will support claims other state law claims which are available to consumers, such as negligent misrepresentation and extortion.

Section 807 of the Fair Debt Collection Practices Act ("FDCPA") prevents debt collectors from using **"**any false, deceptive, or misleading representation or means in connection with the collection of any debt" including in subsection (4), the "representation or implication that nonpayment of any debt will result in . . . the seizure, garnishment, attachment, or sale of any property or wages of any person unless such action is lawful and the debt collector or creditor intends to take such action." Nor can a creditor misrepresent "the character, amount, or legal status of any debt" or make a "threat to take any action that cannot legally be taken or that is not intended to be taken." § 807(2)(A) and (5), respectively.

Whether a creditor is a "debt collector" is often a complicated legal question. In general, one who "collects the debt of another" is a "debt collector." For most residential mortgages, servicers and the creditor or bank that owns the debt are generally not "debt-collectors" unless they become a servicer after the borrower has defaulted or purchased or obtained ownership of the debt while in default. *Holmes v. Telecredit Service Corp*., 736 F. Supp. 1289, 1293 (D. Del. 1990).

Unlike the Federal Regulations above, the Fair Debt Collection Practices Act provides for consumer private right of action and monetary penalties for the consumer that proves a violation.

Last on Federal Regulations, the Dodd Frank Act, still evolving and subject to change as it is flushed out with regulations, may effect the application of Federal and State laws. § 1044(B)(1) of the Act appears to retain pre-existing Federal preemption of state laws for nationally chartered banks. State laws will be pre-empted by Federal laws if they are inconsistent. *Barnett Bank of Marion County, N. A. v. Nelson, Florida Ins. Comm'n'r, et al*., 517 U.S. 25 (1996). But the tougher consumer laws between the two will be enforced. The Dodd Frank Act specifically states in § 1041(a)(2) of the Act that:

a statute, regulation, order, or interpretation in effect in any State ***is not inconsistent*** *with the provisions of this title* ***if the protection*** *that such statute, regulation, order, or interpretation* ***affords to consumers is greater than the protection provided under this title.***

In other words, state laws are not preempted even if they differ from Federal consumer protections if the state laws offer greater consumer protections.

Returning to lender demands for exemption waivers, under state laws, the lender's efforts can give rise to liability if it misrepresents its right to, or intent to, collect upon exempt property or misrepresents the debtor's rights to the exemption and if it DEMANDS money directly from those exempt properties either expressly or impliedly, when the debtor has no other assets. This includes **criminal liability** in many cases. For example, see A.R.S. § 13-2320 which governs residential mortgage fraud and provides criminal liability if the creditor or debt-collector:

1. Knowingly makes any deliberate misstatement, misrepresentation or material omission during the mortgage lending process that is relied on by a . . . borrower . . .

2. Knowingly uses or facilitates the use of any deliberate misstatement, misrepresentation or material omission during the mortgage lending process that is relied on by a . . . borrower . . .

3. Receives any proceeds or other monies in connection with a residential mortgage loan that the person knows resulted from a violation of paragraph 1 or 2 of this subsection.

Notably, the creditor is not liable if it "is not aware that the information that is relied on by the . . . borrower . . . is a deliberate misstatement, misrepresentation or material omission." § 13-2320(C), but, at the same time, it is hard to imagine a lender who has been ill-advised or non-advised by those cadres of lawyers working for them. In any event, it **is imperative that a debtor or debtor's agent or legal counsel inform the lender of the debtors' rights in writing, early and often** so the lender cannot claim "ignorance" of the law**.** If the creditor is found guilty of this violation it is a class 4 felony, and a pattern of practice that violates this section is a class 2 felony. § 13-2320(D). YES, the creditor can go to jail for attempting an end-run around exemption rights. Most debtors and their agents will likely settle for a superior and final work-out obtained by keeping the creditor within the law.

Another law, Ariz. Rev. Stat. § 13-1802(A)(3), makes it a "theft" if a person "obtains services or property of another by means of any material misrepresentation with intent to deprive the other person of such property or services". This includes misrepresentations about the applicability of exemption rights or other consumer protections, or the enforceability of agreements to waive them.

CONCLUSION: RESIST THE ATTACK; CONSIDER THE COUNTERATTACK

The bottom line here: The consumer (and you) have state and federal legal rights and the lenders are glad to violate all of them as long as you and your clients are fools enough to fall for it. Knowing the "red flags" of lender-invasion is a first inning. Early, effective legal representation is important to prevent the violations, document them and ultimately stop them when they occur is the rest of the ball game. But there is more.

When the creditor goes across sacred legal lines like this and generates liability for itself, these violations BECOME TRADING CHIPS FOR THE BORROWER TO USE TO BETTER THE SETTLEMENT AND PERHAPS EVEN TURN THE NEGOTIATION TIDE, ENTIRELY. ***Now it's not just the lender wagging "shame on the borrower and commanding the consumer "pay up and shut up"; it's "double shame on the scofflaw lender who did than and now let's just hack a couple more yards off the deal in settlement of borrower's counterclaims for egregious lender misconduct."*** You get the rest.

'Nuff said!