COMMONWEALTH OF MASSACHUSETTS

Supreme Judicial Court

No. 10258

Commonwealth of Massachusetts,
Plaintiff-Appellee,

v.

Fremont Investment & Loan,
Defendant-Appellant,

and

Fremont General Corporation,
Defendant

On Appeal from an Interlocutory Order of the Superior Court

BRIEF OF *AMICUS CURIAE* NATIONAL CONSUMER LAW CENTER, CENTER FOR RESPONSIBLE LENDING, AARP, NATIONAL ASSOCIATION OF CONSUMER ADVOCATES, AND NATIONAL ASSOCIATION OF CONSUMER BANKRUPTCY ATTORNEYS IN SUPPORT OF PLAINTIFF-APPELLEE AND ARGUING FOR AFFIRMANCE

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Dated: September 22, 2008

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This brief is filed pursuant to the Supreme Judicial Court's August 4, 2008 request for amicus briefs.

National Consumer Law Center, Inc. ("NCLC") is a national research and advocacy organization headquartered in Boston that focuses on the legal needs of low-income, financially distressed, and elderly consumers. NCLC is a nationally recognized expert on consumer credit issues and has drawn on this expertise to provide information, legal research, policy analyses, and market insight to Congress and state legislatures, administrative agencies, and courts for almost forty years.

NCLC is a nonprofit corporation founded in 1969 at Boston College School of Law. Our staff of eighteen attorneys combines over 160 cumulative years of specialized consumer law expertise. We address the legal problems faced daily by low-income and financially distressed families ranging from illicit contract terms and charges, home improvement frauds, repossessions, debt collection abuses, usury, mortgage equity scams, and bankruptcy to utility terminations, fuel assistance benefit programs, and utility rate structures, as well as many other subjects.

A major focus of NCLC's work has been to increase public awareness of, and to promote protections against, unfair and deceptive practices perpetrated against low-income and elderly consumers. NCLC publishes an eighteen-volume Consumer Credit and Sales Legal Practice Series, including, inter alia, Unfair and Deceptive Acts and Practices (6th ed. 2005 & Supp. 2007). NCLC frequently is asked to appear as an amicus curiae in consumer law cases before courts around the country and does so in appropriate circumstances.

The Center for Responsible Lending ("CRL") is a non-profit policy, advocacy, and research organization dedicated to exposing and eliminating abusive lending practices in the mortgage market. CRL is an affiliate of Self-Help, a non-profit lender that has provided more than $5 billion in financing to help over 50,000 low-wealth borrowers buy homes, build businesses, and strengthen community resources. Long before the abuses in subprime mortgage lending became widely apparent and depressed American economic growth, CRL sought to focus the public's attention on these problems. CRL's research on mortgage lending is regularly relied upon by the media and policymakers.

AARP is the largest membership organization in the nation serving the needs and interests of people ages fifty and older, with forty million members. AARP has advocated on the state and federal level for legislation and regulations to stem the tide of the abusive lending practices that have plagued the mortgage marketplace since the early 1990s. For over seventeen years, AARP attorneys have represented numerous older Americans challenging these practices, which have forced them into foreclosure and the loss of homes they have owned for decades.

The National Association of Consumer Advocates ("NACA") is organized under the laws of the Commonwealth of Massachusetts and is tax exempt under section 501(c)(6) of the Internal Revenue Code. NACA has over 1000 members whose primary interest is the protection and representation of consumers, including consumers who have received unfair subprime mortgages. NACA is interested in this appeal because of its important implications for Massachusetts consumer protection law.

The National Association of Consumer Bankruptcy Attorneys ("NACBA") is a non-profit organization incorporated in 1992 of more than 2500 consumer bankruptcy attorneys nationwide. NACBA's corporate purposes include education of the bankruptcy bar and the community at large on the uses and misuses of the consumer bankruptcy process. Additionally, NACBA advocates nationally on issues that cannot adequately be addressed by individual member attorneys. It is the only national association of attorneys organized for the specific purpose of protecting the rights of consumer bankruptcy debtors. Bankruptcy is often a last resort for homeowners trying to save their homes from foreclosure. As a result, NACBA members frequently represent homeowners who have been victims of predatory lending practices.

Summary of the Argument

Fremont Investment & Loan ("Fremont") devotes considerable attention to arguing that the Superior Court's injunction "is flawed as a matter of public policy." Fremont Br. at 36-42. As described below, amici vigorously disagree. The injunction will ameliorate the harm from Fremont's flawed lending practices. (pp. 8 - 17) Beyond coming "within the penumbra of a common law, statutory, or other established concept of unfairness," Fremont's lending practices exemplified the "immoral, unethical, oppressive, or unscrupulous" conduct prohibited as unfair by Chapter 93A. Milliken & Co. v. Duro Textiles, LLC, 451 Mass. 547, 563 (2008). (pp. 17 - 38)

The promise of subprime mortgage lending is simple: allowing persons without traditional access to credit the opportunity to become homeowners and build long-term wealth. See Souphala Chomsisengphet & Anthony Pennington-Cross, The Evolution of the Subprime Market, 88 Fed. Res. Bank of St. Louis Rev. 31, 31 (2006) (discussing the promise and peril of subprime lending). That promise, however, is fulfilled only when the subprime mortgage is backed by solid underwriting and includes fair terms that the borrower will be able to meet over the long-term. Unfortunately, some subprime lenders disregarded the underwriting process and the fairness of loan terms in focusing on short-term profits that could be gained by catering to Wall Street's insatiable appetite for subprime loans.

Fremont singularly concentrated on the profits to be made by selling more and more loans to Wall Street. As Fremont's 2005 Annual Report explained, "[a]ll of the residential real estate loans originated [by Fremont] are currently sold for varying levels of gain through . . . sales to other financial institutions, and . . . to various investors through securitization transactions." Fremont Gen. Corp., Annual Report (Form 10-K) 28 (Mar. 16, 2006) (emphasis added), available at http://www.sec.gov/Archives/edgar/data/38984/0000950129 06002726/v18050e10vk.htm. Fremont also explained its willingness to do whatever was necessary to meet Wall Street's demands for loans: "The Company seeks to maximize the premiums on . . . sales and securitizations by closely monitoring the requirements of the various institutional purchasers, investors and ratings agencies, and focusing on originating the types of loans that meet their criteria and for which higher premiums are more likely to be realized." Id. at 6.

As the Superior Court cogently reasoned -- reasoning that Fremont has not challenged -- Fremont's lending practices placed borrowers with certain combinations of loan terms into unsustainable mortgages. These mortgages were destined for foreclosure after two or three years when introductory "teaser" interest rates expired, absent fanciful expectations of property appreciation. Super. Ct. Opinion at 18-19 & n.11;[1] see also Fed. Reserve Sys., Truth in Lending, 73 Fed. Reg. 44,522, 44,541 (July 30, 2008) (finding that during the subprime boom poor underwriting combined with extending credit to borrowers with very limited equity was tantamount to "extending credit based on an expectation that the house's value would appreciate rapidly"). In other words, Fremont designed ticking time bombs that would destroy homeowners' wealth while giving them no realistic chance for escape before the explosion, and it added penalties that made escape even more impossible. Such conduct is grossly unfair and should lead this Court to affirm the Superior Court's injunction.

The national consumer, research, and policy groups submitting this brief fully support the Commonwealth's arguments. This brief supplements those arguments by emphasizing three points: (1) the benefit the Superior Court's injunction affords both to past and future Massachusetts borrowers (pp. 8 - 17); (2) the illegally unfair nature of each of the loan terms indentified by the Superior Court, which makes loans with all of those

[1] All citations to "Super. Ct. Opinion" refer to the typeset "Findings of Fact and Conclusions of Law on Plaintiff's Motion for a Preliminary Injunction" issued by Judge Gants on February 25, 2008.

terms manifestly unfair (pp. 17 - 38); and (3) the fact that federal regulators never authorized Fremont's unfair conduct, as demonstrated by their enforcement action against Fremont (pp. 38 - 43).

Argument

I. The Superior Court's Presumption of Unfairness and Injunction Benefits Past and Future Massachusetts Borrowers.

Fremont's unfair subprime lending has greatly harmed its Massachusetts borrowers covered by the Superior Court's injunction. These borrowers now face foreclosure as the inevitable consequence of Fremont's unsustainable loan terms -- foreclosures that will also harm neighbors and communities.

Fortunately, the Superior Court's injunction allows these borrowers to work with Fremont to restructure their loans and avoid foreclosure. It reflects the Superior Court's equitable requirement that "Fremont, having helped borrowers get into this mess, now must take reasonable steps to help them get out of it." Super. Ct. Opinion at 28. The injunction should also benefit future borrowers who will receive loans without similarly unfair terms that leave them destined for foreclosure.

A. Unfair Subprime Lending, as Practiced by Fremont, Has Destroyed Home Ownership and Home Values.

Unfair subprime lending has led to a national foreclosure crisis with layers of collateral damage. As of June 30, 2008, 18.67% of subprime loans were at least thirty days delinquent nationwide and another 11.81% were in foreclosure. Mortgage Bankers Ass'n, National Deliquency Survey: Q208, at 5 (2008). Massachusetts has even higher rates, with 22.76% of its subprime loans at least thirty days delinquent and another 12.67% in foreclosure. Id. In other words, over one-third of Massachusetts borrowers with subprime loans were unable to keep up with their payments as of June 30.

Ultimately, researchers project that over 2.2 million families nationwide -- representing roughly one in five subprime borrowers -- will lose their homes because of foreclosures on subprime loans. Ellen Schloemer et al., Losing Ground: Foreclosures in the Subprime Market and Their Cost to Homeowners 11-18 (2006), available at http://www.responsiblelending.org/pdfs/foreclosure-paper-report-2-17.pdf. Here in Massachusetts, nearly 15,000 families who received subprime loans in 2005 and 2006 will lose their homes. Ctr. for Responsible Lending, Subprime Spillover: Foreclosures Cost Neighbors $202 Billion; 40.6 Million Homes Lose $5,000 on Average 18 (2008) [hereinafter "Subprime Spillover"], available at http://www.responsiblelending.org/pdfs/subprime-spillover.pdf.

Indeed, even after accounting for first-time home purchases made with subprime loans, the current wave of subprime foreclosures will lead to a net nationwide loss in homeownership by roughly one million families -- creating a massive loss of wealth. Ctr. for Responsible Lending, Subprime Lending: A Net Drain on Homeownership 2-5 (2007) [hereinafter "Net Drain"], available at http://www.responsiblelending.org/pdfs/Net-Drain-in-Home-Ownership.pdf. Fremont fails to account for the mass foreclosures now facing subprime borrowers when claiming subprime lending has been "the primary vehicle for wealth accumulation" for low- and moderate-income families. See Fremont Br. at 36-37. Fremont's cursory attempt to herald subprime lending as a boon to populations of color similarly fails to reflect the effect of foreclosures. See id. at 37. In fact, the net homeownership losses from subprime lending will most acutely affect Latinos and African Americans because they received a disproportionate share of subprime loans. Net Drain, supra, at 5; Schloemer et al., supra, at 23.

Surrounding homeowners are also affected by foreclosures: homes lose nearly one percent of their value for each foreclosure within one-eighth of a mile. Dan Immergluck & Geoff Smith, The External Cost of Foreclosure: The Impact of Single-Family Mortgage Foreclosures on Property Values, 17 Housing Pol'y Debate 57, 58 (2006). In Massachusetts, this effect will cause a $4.5 billion loss in surrounding property values -- nearly $4,500 per affected neighbor. Subprime Spillover, _supra_, at 18. Foreclosures also harm the budgets of the Commonwealth's cities and towns by reducing property tax bases and adding costs associated with vacant homes. _See, e.g._, Kathleen Conti, _Revere: Foreclosure Costs_, Boston Globe, Sept. 4, 2008, at T2.

Remarkably, Fremont ignores the harm it has caused to borrowers, neighboring homeowners, and local governments. _See_ Fremont Br. at 41-42 (dismissing the criticism of subprime lending in "the popular press" and the impact to subprime borrowers). Such ignorance is stunning from a company forced into bankruptcy by the ruinous effect of unfair subprime lending. _See_ Commonwealth Br. at 41 & n.21. In light of Fremont's blindness to the realities of its unfair lending, its ignorance of the duties imposed by Massachusetts consumer protection laws comes as no surprise.

B. The Superior Court's Injunction Will Aid Borrowers Who Received Unfair Fremont Loans and Stop Lenders from Making Similarly Unfair Loans.

The Superior Court's injunction provides critically important aid to Fremont borrowers facing foreclosure. The injunction requires Fremont to work to modify the loans so that they become sustainable. Super. Ct. Opinion at 27. Numerous financial and political leaders have pushed for loan modifications that eliminate unsustainable terms as an essential step in resolving the subprime foreclosure crisis. _See,_ e.g., Henry M. Paulson Jr., Secretary of the Treasury, Prepared Remarks Before the Housing Town Hall Meeting in Kansas City (Dec. 18, 2007), available at http://www.treas.gov/press/releases/hp742.htm; Stacy Kaper & Emily Flitter, Frank: Put Loan Mods in Higher Gear, Am. Banker, Sept. 18, 2008, at 1 (reporting on Congressman Barney Frank's efforts to ensure more loan modifications). Successful modifications even result in lenders realizing greater returns than they receive through foreclosure. See Paulson, supra. Nevertheless, many borrowers have been unable to modify their loans because lenders are unable to process such requests in the short timeframe between default and foreclosure. See State Foreclosure Prevention Working Group, Analysis of Subprime Mortgage Servicing Performance 1-3 (Apr. 2008), available at http://www.csbs.org/Content/NavigationMenu/Home/StateForeclosureApril2008.pdf (findings by representatives of eleven state attorneys general, including Massachusetts, and two state banking departments). Moreover, concern about legal constraints often stymies modifications. See Kaper & Flitter, supra, at 1.

By pausing the otherwise rapid foreclosure process and providing legal blessing for workouts, the Superior Court's injunction will break down these barriers to modifications -- modifications that help avoid foreclosure and save borrowers, surrounding neighbors, and municipalities from the costs of foreclosure.

Contrary to Fremont's representation, the Superior Court did not render Fremont's loans unsecured. See Fremont Br. at 37-40. Such hyperbole -- and the consequences Fremont claims flow from the mischaracterized injunction -- fails to reflect the Superior Court's recognition that foreclosure may be "the proper last resort" for loans covered by the injunction. Super. Ct. Opinion at 27-28.

Fremont also is entirely backwards in arguing that the injunction "will only make it more difficult for [subprime] borrowers to refinance, and likely will increase borrower's [sic] distress and their rates of delinquency." Fremont Br. at 40-41. In the current mortgage market, borrowers are having great difficulty refinancing their homes in the face of imminent interest rate resets because many have very little or even negative equity in their homes. See Edmund L. Andrews & Louis Uchitelle, Rescues Weighed as Homeowners Wallow in Debt, N.Y. Times, Feb. 22, 2008, at 1 ("[M]illions of [Americans] are trapped in their homes. . . . [T]he vast majority -- embedded in their communities, their children in public schools, their reputations at stake -- wait nervously in hope that prices will bottom and rise once again, eliminating their negative equity and restoring their freedom to sell or refinance."). This problem will be further exacerbated, and more borrowers will have trouble finding lenders willing to offer funds that are only partially secured by homes, if foreclosures and the corresponding decline in surrounding property values continue unabated in Massachusetts. On the other hand, fewer houses will go into foreclosure and consequently property values will stabilize if the injunction is upheld. This effect will allow borrowers to refinance into more responsible loans.

Upholding the Superior Court's injunction also helps to ensure that no lender in the future will make loans with the combination of terms identified as illegal in Fremont's loans. Although lenders should have always known such unfair terms violated Chapter 93A, they will now have no doubt that the combination of terms identified by the Superior Court is illegal.

This Court should ignore Fremont's unsupported fear mongering about the Superior Court's injunction "increasing the price for mortgage credit." Fremont Br. at 41. Research has proven that consumers benefit from state-imposed restrictions on unfair subprime lending. Increased state regulations both successfully remove harmful features from the market and allow borrowers to retain ready access to subprime credit. Wei Li & Keith S. Ernst, Do State Predatory Lending Laws Work? A Panel Analysis of Market Reforms, 18 Housing Pol'y Debate 347, 380-88 (2007). In fact, that retained credit has similar or better interest rates than the rates available in states with weaker regulations. Id. In line with these empirical findings, Massachusetts saw little decrease in the presence of subprime lenders when new regulation of underwriting practices and fees took effect at the start of this year. See Binyamin Appelbaum, Most Lenders Accept Tough New Mortgage Rules in Mass., Boston Globe, Jan. 10, 2008, at E1. Accordingly, Massachusetts borrowers will benefit from this Court fleshing out the unfair loan terms that Chapter 93A has always prohibited.

The current economic crisis caused by the defaults and foreclosures produced by unfair subprime lending -- not to mention the unprecedented federal government bailouts it has required -- demonstrate that laws requiring responsible underwriting standards and fair mortgage terms are necessary prerequisites for consumer and economic wellbeing. Apparently blind to the realities of the past year, Fremont continues to repeat tired industry rhetoric that prophylactic state regulations restrict access to credit and disrupt the benefits of unregulated markets. See Fremont Br. at 37-42. But fair competition is aided by robust fair lending laws and enforcement. Otherwise, bad industry actors -- such as Fremont -- lead lenders into a self-perpetuating race toward the bottom.

II. The Superior Court Correctly Identified An Unfair Combination of Loan Terms.

Fremont ignores the Superior Court's careful analysis that specific terms in its loans created an unfair act or practice. Instead, Fremont mischaracterizes the Superior Court's ruling by arguing that not all subprime lending violates Chapter 93A. See Fremont Br. at 28-29 (defending its compliance with Chapter 93A because "[s]ubprime loans play a valid and entirely appropriate economic role in facilitating home ownership by individuals who otherwise would be unable to obtain mortgage loans"). That argument, however, is irrelevant to whether specific terms violate Chapter 93A.

Each of the loan terms identified by the Superior Court is independently unfair because each greatly heightens the unsustainability of the loans and chance of foreclosure. The combination of these features therefore is manifestly unfair, particularly in light of the Superior Court's cogent analysis that Fremont's particular combination results in inescapable and unsustainable loans that will cause borrowers to lose their homes. See Super. Ct. Opinion at 17-19; see also FitchRatings, Drivers of 2006 Subprime Vintage Performance 3 (Nov. 13, 2007) [hereinafter "Drivers"] (observing, based on loan performance data from securitized loans, that "layering on additional risk factors" causes an increased likelihood of default).

A. The Unfairness of Teaser Rate Adjustable Rate Mortgages with Looming Payment Shock.

The Superior Court's first two identified terms -- adjustable rate mortgages ("ARMs") with an introductory period of fixed interest of three years or less and a rate during that period at least three percent lower than the rate anticipated to apply afterwards -- describe a loan that has gained an apt moniker: the "exploding ARM." Gretchen Morgenson, Beware of Exploding Mortgages, N.Y. Times, § 3, at 1 (June 10, 2007). Loans with such terms experience large interest rate hikes, and consequently payment hikes, after the introductory period ends regardless of changes in market interest rates.

Subprime ARMs originated in recent years have greatly increased odds -- ranging between 62% and 123% depending on the origination year -- of resulting in foreclosure, even when accounting for variations in credit scores. Schloemer et al., supra, at 21. The most recent foreclosure statistics support those findings: 19.41% of the nation's subprime ARMs were in foreclosure on June 30, 2008 compared to 4.88% of subprime fixed rate mortgages. Mortgage Bankers Ass'n, supra, at 7, 9. Massachusetts data shows a similar disparity, with 20.73% of subprime ARMs in foreclosure[2] compared to 5.10% of subprime fixed rate mortgages. Id.

These results have been explained by the teaser rate feature and resulting payment shock -- the vast majority of subprime ARMs contained teaser rates in recent years. Schloemer et al., supra, at 21, 26. In

[2] Another 26.53% of Massachusetts subprime ARMs were at least thirty days delinquent, meaning perilously close to half of Massachusetts borrowers with subprime ARMs were unable to make their payments as of June 30. Mortgage Bankers Ass'n, supra, at 9.

line with that explanation, financial analysts reviewing subprime loans originated in 2005 with teaser rates that expired after two years have determined that "delinquencies spike after the rate reset at month 24." Drivers, supra, at 5. Data on subprime loan performance also demonstrates that default rates rise as the magnitude of the payment shock increases. Analysts calculated that every twenty percent increase in payment shock causes ARM default rates to increase by 130 basis points. Lehman Brothers, Estimating Option-ARM Losses, MBS Strategy Weekly, June 20, 2008, at 3, 6.

Compounding the unfairness of the payment shock is the fact that many subprime borrowers were steered into exploding ARMs when they could have received a loan with a fixed thirty-year interest rate only fifty to eighty basis points higher than the teaser rate. See Letter from the Coalition for Fair & Affordable Lending to Ben S. Bernanke et al. (Jan. 25, 2007) (mortgage industry lobbying group noting the industry's common rate difference). Indeed, Fremont had just such a practice. For example, its January 14, 2005 pricing quotations for mortgage brokers specified that borrowers could receive a fixed rate mortgage for a mere seventy-five basis point increase over an ARM's teaser rate. JA0087 ("Fixed 30/30 +.750"). Meanwhile, without any change in market interest rates, the interest rate on Fremont's ARMs would increase 275 basis points once the teaser rate expired. Id. ("ARM Margin = . . . [(start rate + 2.75)-(6 mo LIBOR index)]").

By offering loans to subprime borrowers with vanishing teaser rates, Fremont sold borrowers on deceptively low monthly payments, even though those payments were certain to skyrocket and render the loan unsustainable. Such conduct epitomizes unfairness, particularly when directed at the subprime market's target population of vulnerable borrowers with existing credit problems and limited financial sophistication. See Spence v. Boston Edison Co., 390 Mass. 604, 616 (1983) ("[A]n act might be unfair if practiced upon a commercial innocent yet would be common practice between two people engaged in business."); see also Alison Shelton, A First Look at Older Americans and the Mortgage Crisis 5 (2008) ("[T]he impact of subprime lending appears to fall disproportionately heavily on older (age 50 and over) Americans. Older holders of subprime first mortgages are 17 times more likely to be in foreclosure than older holders of prime loans. For consumers under age fifty, the comparable multiple is about 13."). As the chairman of the United States Senate Banking Committee observed last year:

> [T]he fact that any reputable lender could make these kinds of [teaser rate] loans so widely available to wage earners, to elderly families on fixed incomes, and to lower-income and unsophisticated borrowers, strikes me as unconscionable and deceptive. . . .

> The[] adjustments [of payments after the teaser rate expires] are so steep that many borrowers cannot afford to make the payments and are forced to refinance, at great cost, sell the house, or default on the loan. No loan should force a borrower into this kind of devil's dilemma. These loans are made on the basis of the value of the property, not the ability of the borrower to repay. This is the fundamental definition of predatory lending.[3]

B. The Unfairness of Ignoring Unaffordable Anticipated Monthly Payments.

Although Fremont used the deceptively low monthly payment to lure borrowers into unsustainable loans, it knew the borrowers' expected payment obligation once the teaser rate expired. See 12 C.F.R. pt. 226, Supp. I, Official Staff Commentary to Regulation Z § 226.17(c)(1)-10 (requiring lenders to calculate a payment schedule for periods after the teaser rate expires). Based on that obligation, Fremont's own standards for the maximum loan payment that a borrower's income would support dictated that many of its Massachusetts subprime loans were unaffordable. See Super. Ct. Opinion at 8 & n.5 (detailing Fremont's general policy that borrowers needed to have no more than a fifty or fifty-five percent debt-to-income ratio and that a "substantial" number of its Massachusetts borrowers did not meet that standard based on the

[3] Mortgage Market Turmoil: Hearing Before the S. Comm. on Banking, Housing, and Urban Affairs, 110th Cong. (2007) (statement of Sen. Dodd, Chairman), available at http://banking.senate.gov/public/index.cfm?Fuseaction=Hearings.Testimony&TestimonyID=8316a5fd-dbfd-4e1b-a85b-63c5ef5b4992&HearingID=4ccca4e6-b9dc-40b1-bab5-137b3a77364d.

payments required after the teaser rate expired).[4] Nevertheless, Fremont approved Massachusetts subprime loans based only on consideration of the monthly payments required by the teaser rate. Id. at 8.[5]

Bad underwriting practices like Fremont's decision to ignore borrowers' payment obligations after the teaser rate expires are a large cause of the recent surge in foreclosures. See Drivers, supra, at 2 (pinpointing "weak underwriting," along with home value drops, as "the main drivers of defaults and losses in the subprime sector"); Office of the Comptroller of the Currency, Survey of Credit Underwriting Practices 2 (2008), available at http://www.occ.treas.gov/cusurvey/2008UnderwritingSurvey.pdf ("[T]he relaxed underwriting standards of the

[4] Fifty and fifty-five percent were Fremont's standard nationwide limits, as explained in a publicly filed disclosure to the parties involved in a 2006 securitization of 4,728 Fremont mortgages. See Fremont Home Loan Trust 2006-1, Prospectus and Prospectus Supplement (Form 424B5) (Apr. 10, 2006), available at http://www.sec.gov/Archives/edgar/data/1357374/000088237706001254/d486451_all.htm ("Fremont's underwriting guidelines . . . generally require . . . debt to income ratios of 55% or less on mortgage loans with loan-to-value ratios of 90% or less, however, debt to income ratios of 50% or less are required on loan-to-value ratios greater than 90%.").

[5] Considering only the teaser rate payments also was Fremont's standard nationwide policy according to the filed disclosure. See Fremont Home Loan Trust 2006-1, supra ("Once all applicable employment, credit and property information is received, a determination generally is made as to whether the prospective borrower has sufficient monthly income available to meet the borrower's monthly obligations on the proposed loan, generally determined on the basis of the monthly payments due in the year of origination . . . ." (emphasis added))

past, coupled with current economic weaknesses, will result in increased credit risk and losses over the next 12 months."). Accordingly, federal regulators have specified that "[a]n institution's analysis of a borrower's repayment capacity should include an evaluation of the borrower's ability to repay the debt by its final maturity at the fully indexed rate" because "[q]ualifying consumers based on a low introductory payment does not provide a realistic assessment of a borrower's ability to repay the loan according to its terms." Interagency Statement on Subprime Mortgage Lending, 72 Fed. Reg. 37,569, 37,571, 37,573 (July 10, 2007); see also Fed. Reserve Sys., supra, 73 Fed. Reg. at 44,603 (to be codified at 12 C.F.R. § 226.34(a)(4)(iii)(B)) (presuming that a lender considered a borrower's ability to repay only when it "[d]etermines the consumer's repayment ability using the largest payment of principal and interest scheduled in the first seven years following consummation" (emphases added)). Underwriting based on the payments after the teaser rate expires is part of federal regulators' longstanding commonsense requirement that lenders must consider "[t]he capacity of the borrower . . . to adequately service the debt." 12 C.F.R. pt. 365, app. A, Interagency Guidelines for Real Estate Lending Policies (1993).

By understating borrowers' monthly payment obligation, the Federal Reserve has observed that lenders like Fremont are "in effect often extending credit based on the value of the collateral, that is, the consumer's house." Fed. Reserve Sys., supra, 73 Fed. Reg. at 44,541. Extending credit "based on the assets of the borrower rather than on the borrower's ability to repay" has long been a canonical sign of unfair predatory lending. Interagency Expanded Guidance for Subprime Lending Programs 10 (2001), available at http://www.federalreserve.gov/Boarddocs/SRletters/2001/sr0104a1.pdf; see also 15 U.S.C. § 1639(h) (prohibiting lending based on the value of the collateral without regard for a borrower's repayment ability for certain high-cost mortgage loans); Hargraves v. Capital City Mortgage Corp., 140 F. Supp. 2d 7, 20-21 (D.D.C. 2001) (listing "lending based on the value of the asset securing the loan rather than a borrower's ability to repay" as a sign of predatory lending).

Similarly, lending with the knowledge that a borrower cannot repay is an established sign of unfair and unconscionable conduct that violates consumer protection laws. For example, both the Uniform Consumer Sales Practices Act and the Uniform Consumer Credit Code include the creditor's knowledge that the consumer had no reasonable probability of repaying the obligation in full when codifying indicia of unfair lender practices.[6] Aside from states that have adopted these uniform codes, several consumer protection acts specify that lending with knowledge that a borrower cannot repay signals an unfair practice.[7]

Accordingly, Chapter 93A should be interpreted to prohibit lending with knowledge that a borrower cannot repay. See Darviris v. Petros, 442 Mass. 274, 279 (2004) (interpreting Chapter 93A in light of other states' consumer protection statutes); Baldassari v.

[6] See, e.g., Ohio Rev. Code Ann § 1345.03(B)(4) (requiring consideration of "[w]hether the supplier knew at the time the consumer transaction was entered into that there was no reasonable probability of payment of the obligation in full by the consumer" in determining unconscionablity under the Uniform Consumer Sales Practice Act); Me. Rev. Stat. Ann. tit. 9-A, § 6-111(3)(A) (requiring consideration of "[b]elief by the creditor at the time consumer credit transactions are entered into that there was no reasonable probability of payment in full of the obligation by the consumer" in determining unconscionability under the Uniform Consumer Credit Code).

[7] See Okla. Stat. tit. 15, § 761.1(B) (requiring, under the Oklahoma Consumer Protection Act, that "[i]n determining whether an act or practice is unconscionable the following circumstances shall be taken into consideration by the court: . . . whether, at the time the consumer transaction was entered into, the violator knew or had reason to know that there was no reasonable probability of payment of the obligation in full by the consumer"); Or. Rev. Stat. § 646.605(9)(c) (defining "unconscionable tactics" under the Oregon Unlawful Trade Practice Act to include "actions by which a person [p]ermits a customer to enter into a transaction with knowledge that there is no reasonable probability of payment of the attendant financial obligation in full by the customer when due"); D.C. Code § 28-3904(r)(1) (requiring, under the District of Columbia Consumer Protection Procedures Act, consideration of "knowledge by the person at the time credit sales are consummated that there was no reasonable probability of payment in full of the obligation by the consumer").

Pub. Fin. Trust, 369 Mass. 33, 45-46 (1975) (interpreting Chapter 93A in light of the Uniform Consumer Sales Practices Act and the Uniform Consumer Credit Code). Fremont therefore violated Chapter 93A by lending to borrowers who its own standards recognized would face unsustainable mortgage payments once the teaser rate expired.

C. The Unfairness of Making Loans for a House's Full Value Without Careful Origination Practices.

Subprime loans made for the full value of borrowers' collateral have a substantial risk of default and require careful underwriting and property appraisal. Research shows that the chance of default for subprime loans increases as the loan-to-value ratio rises. See Roberto G. Quercia et al., The Impact of Predatory Loan Terms on Subprime Foreclosures: The Special Case of Prepayment Penalties and Balloon Payments, 18 Housing Pol'y Debate 311, 337 (2007). When the amount of a loan equals the collateral value, the borrower cannot exit the loan because she will lack sufficient equity to refinance. Consequently, lenders must ensure through careful origination practices that such loans are sustainable. See Interagency Guidelines for Real Estate Lending Policies, supra ("[I]t may be appropriate in individual cases to originate or purchase loans with loan-to-value ratios in excess of the supervisory loan-to-value limits, based on the support provided by other credit factors." (emphases added)).

Fremont's origination practices, however, were woefully insufficient when it originated loans for the collateral's full value to Massachusetts borrowers. Instead, Fremont sought to make as many loans as possible by paying mortgage brokers for each completed loan, requiring little information from borrowers, and creating products with inexpensive but vanishing initial terms and ever-relaxing qualification standards. See, e.g., Super. Ct. Opinion at 22 (noting the growth of securitization incentivized Fremont to "take a quick profit" by "assign[ing] large quantities" of subprime mortgages).

Fremont's slapdash origination process when lending the full value of the collateral was exacerbated by widespread appraisal inflation. Financial analysts reviewing the current foreclosure crisis have noted "widespread concern regarding the number and severity of inflated valuations used to determine [the loan-to-value ratio]." FitchRatings, The Impact of Poor Underwriting Practices and Fraud in Subprime RMBS Performance 7 (Nov. 28, 2007). Pressure on appraisers to facilitate a high volume of subprime lending created excessive valuations. Id.[8] Fremont knew about appraisal inflation and its consequences, as investors in its securitized loans were warned:

> The quality of the[] appraisals [used to underwrite Fremont loans] may vary widely in accuracy and consistency. Because in most cases the appraiser is selected by the mortgage loan broker or lender, the appraiser may feel pressure from that broker or lender to provide an appraisal in the amount necessary to enable the originator to make the loan, whether or not the value of the property justifies such an appraised value. Inaccurate or inflated appraisals may result in an increase in the number and severity of losses on the mortgage loans.

Fremont Home Loan Trust 2006-1, supra. These inflated appraisals rendered Fremont's loans for the collateral's full value even more unfair because many borrowers were consequently unable to escape the loan even if they responsibly tried to sell their house.

D. The Unfairness of Penalizing Borrowers Who Try To Escape Unsustainable Loans.

Not only did Fremont's loan terms trap many Massachusetts borrowers in unsustainable loans for which default was inevitable, it imposed a penalty on

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[8] The New York Attorney General has identified "rampant appraisal fraud" as one of the practices that "had gone so horribly wrong in the mortgage industry . . . . Again and again our industry-wide investigation found that banks were putting pressure on appraisers to drive up the value of loans just to make a quick buck." Press Release, New York Attorney General Cuomo Announces Agreement with Fannie Mae, Freddie Mac, and OFHEO (Mar. 3, 2008), available at http://www.oag.state.ny.us/media_center/2008/mar/mar3a_08.html; see also Fed. Reserve Sys., supra, 73 Fed. Reg. at 44,541 n.56 (noting a problem during the subprime lending boom of "the appraisal the lender relied on overstat[ing] borrower equity because the lender or broker pressured the appraiser to inflate the house value").

anyone who tried to escape by repaying the loan within the first several years. These fees, known as prepayment penalties, left borrowers further unable to free themselves from the unsustainable loans. Research indeed demonstrates that subprime loans with prepayment penalties are at a sixteen to seventy percent greater risk of foreclosure than those without such penalties. Quercia et al, supra, at 337; Schloemer et al., supra, at 21.

Penalizing someone who seeks to escape from a loan that Fremont has designed as an unsustainable ticking foreclosure time bomb epitomizes unfair conduct that Chapter 93A outlaws. The Federal Reserve's recent decision to ban prepayment penalties in subprime ARMs with teaser rates expiring in four or fewer years reinforces that such a penalty is unfair. See Fed. Reserve Sys., supra, 73 Fed. Reg. at 44,603-04 (to be codified at 12 C.F.R. § 226.35(b)(2)). Although the ban does not directly apply to the loans at issue in this case because they predate its adoption,[9] the Federal Reserve's comments about the rule should inform this Court's interpretation of "unfair" under Chapter 93A:

> [T]he fairness of prepayment penalty provisions on [subprime] loans depends to an

[9] "[N]othing in this rule should be construed or interpreted to be a determination that acts or practices restricted or prohibited under this rule are, or are not, unfair or deceptive before the effective date of this rule." Fed. Reserve Sys., supra, 73 Fed. Reg. at 44,523.

> important extent on the structure of the mortgage loan. . . . With respect to subprime loans [with a teaser rate lasting four or fewer years] designed to have shorter life spans, the injuries from prepayment provisions are potentially the most serious, as well as the most difficult for a reasonable consumer to avoid. For these loans, therefore, . . . the injuries caused by prepayment penalty provisions with subprime loans outweigh their benefits. . . .
> . . .
>
> Prepayment penalty provisions also exacerbate injuries from unaffordable or abusive loans. In the worst case, where a consumer has been placed in a loan he cannot afford to pay, delaying a refinancing could increase the consumer's odds of defaulting and, ultimately, losing the house.

Id. at 44,552.

Beyond trapping borrowers in unsustainable loans, prepayment penalties also unfairly increase their costs from the outset. One factor in a subprime borrower's initial interest rate is the amount of compensation the lender pays to mortgage brokers; lenders use a device called a "yield spread premium" ("YSP") to pay a mortgage broker more if he sells the loan at a higher interest rate than the rate for which the borrower qualifies. The highest YSPs are available only for loans that contain prepayment penalties. Indeed, the price quotations Fremont provided to mortgage brokers effective January 14, 2005 specify that brokers could not receive a YSP when they brokered a loan without a prepayment penalty. JA0087 ("Waive Prepay -- No YSP"). But when the loan included a prepayment penalty, the broker received a fee of up to two percent of the principal if he also increased the borrower's interest rate by 125 basis points. Id. ("2.0 YSP +1.25"). For twenty-five fewer basis points -- an increase of 100 basis points rather than 125 points -- the borrower could have received a loan with no prepayment penalty but that prevented the broker from hitting the fee jackpot provided by the YSP. Id. ("Waive Prepay -- No YSP +1.00").

This market-distorting relationship has made subprime prepayment penalties the glue for steering borrowers into higher-cost loans than those for which they qualify. The subprime mortgage market gives brokers the incentive to sell a loan that costs more at both ends -- the higher rate on the front end and the prepayment penalty on the back. See Fed. Reserve Sys., supra, 73 Fed. Reg. at 44,553 (noting "originators' incentives -- largely hidden from consumers -- to 'push' loans with prepayment penalty provisions and at the same time obscure or downplay these provisions" because "lenders pay originators considerably larger commissions for loans with prepayment penalties"). It also causes subprime borrowers to pay roughly two dollars in prepayment fees for every dollar of value they receive from interest rate reductions nominally created by including a prepayment penalty. See Michael D. Calhoun, Financing Community Development: Learning from the Past, Looking to the Future 5 (2007), available at http://www.responsiblelending.org/pdfs/remarks-of-michael-calhoun-crl-03-29-2007.pdf; see also Keith S. Ernst, Borrowers Gain No Interest Rate Benefit from Prepayment Penalties on Subprime Mortgages 5 (2005), available at http://www.responsiblelending.org/pdfs/rr005-PPP_Interest_Rate-0105.pdf (finding interest rates on subprime fixed rate refinance loans did not differ based on the inclusion of prepayment penalties and interest rates on subprime fixed rate purchase loans were higher for those that included prepayment penalties). In other words, Fremont borrowers with prepayment penalties not only are unfairly trapped in unsustainable loans, but they are also unfairly paying more for being put in a trap.[10]

Fremont's prepayment penalties undercut its argument about promoting wealth accumulation by low- and moderate-income borrowers. See Fremont Br. at 37. Instead, prepayment penalties serve as an exit tax that strips equity from borrowers who seek to use their subprime loans as a bridge to becoming prime borrowers.

[10] Almost no prime loans contain prepayment penalties. See Fed. Reserve Sys., supra, 73 Fed. Reg. at 44,553 (detailing that only six percent of prime mortgages originated between 2003 and 2007 had prepayment penalties versus three-quarters of subprime loans). This absence of prepayment penalties in the prime market belies any notion that subprime borrowers freely choose prepayment penalties. All things being equal, a borrower in a higher-cost loan would not choose to be inextricably tied to that product by a high exit tax. See id. (noting "a serious question as to whether a substantial majority of subprime borrowers have knowingly and voluntarily taken the very high risk of paying a significant [prepayment] penalty").

Because Fremont's prepayment penalty demands up to six months' interest for an early exit, borrowers whose teaser rates varied from 6.1% to 12.4% face penalties of up to 3.05% to 6.2% of their loan principal. See Super. Ct. Opinion at 10-11 (detailing that fourteen of the Fremont loans in foreclosure had prepayment penalties of up to six months' interest and that the teaser rates on the loans in foreclosure were 6.1% to 12.4%). The amount of equity lost from even a three percent penalty is significant: For example, a three percent prepayment penalty on a $200,000 loan costs the borrower $6,000 -- an amount more than the median net worth of this country's African-American households. See Census Bureau, Net Worth and the Assets of Households: 2002, at 13 (2008), available at http://www.census.gov/prod/2008pubs/p70-115.pdf.

A market that has often touted its role as a "bridge to prime" should not impose a toll that makes the bridge uncrossable. Prepayment penalties in the subprime market have precisely that effect. See Fed. Reserve Sys., supra, 73 Fed. Reg. 44,553-54 ("2-28 and 3-27 ARMs were marketed to borrowers with low credit scores as 'credit repair' products, obscuring the fact that a prepayment penalty provision would inhibit or prevent the consumer who improved his credit score from refinancing at a lower rate."). In sum, the consumer is trapped, as many borrowers are unable to refinance with more responsible lenders because of these steep prepayment penalties. Ruth Simon, Mortgage Refinancing Gets Tougher: As Adjustable Loans Reset at Higher Rates, Homeowners Find Themselves Stuck Due to Prepayment Penalties, Tighter Credit Rates, Wall St. J., Feb. 8, 2007, at D1.

III. Fremont's Unfair Lending Was Not Permitted by Any Other Law.

No federal or state banking regulator or law has ever permitted the unfair lending practices covered by the injunction. To the contrary, federal regulators have warned lenders about the legal risk of violating "[s]tate laws, including laws regarding unfair or deceptive acts or practices" when they branch out beyond traditional mortgage products. Interagency Guidance on Nontradtional Mortgage Product Risk, 71 Fed. Reg. 58,609, 58,617 (Oct. 4, 2006). Moreover, federal regulators have traditionally declined to set a hard-and-fast line between permitted and "unfair or deceptive" subprime lending practices. See Letter from Alan Greenspan to Rep. John J. LaFalce 2 (May 30, 2002) [hereinafter "Greenspan Letter"], available at http://www.federalreserve.gov/boarddocs/press/bcreg/2002/20020530/attachment.pdf ("[T]he Board believes it is effective for the banking agencies to approach compliance issues on a case-by-case basis");[11] see also

[11] Federal banking regulators can prohibit "unfair or deceptive acts or practices" under federal law. 15 U.S.C. § 45(a); see also 12 U.S.C. § 1818(b)(1), (e)(1), (i)(2) (providing the Federal Reserve System and the Federal Deposit Insurance Corporation authority to enforce 15 U.S.C. § 45(a)).

Fed. Reserve Sys., supra, 73 Fed. Reg. at 44,523 ("[A]cts or practices occurring before the [October 1, 2009] effective date[] of these rules [that ban certain unfair subprime lending practices pursuant to the Federal Reserve's power under the Truth in Lending Act] will be judged on the totality of the circumstances under other applicable laws or regulations. Similarly, acts or practices occurring after the rule's effective dates that are not governed by these rules will continue to be judged on the totality of the circumstances under other applicable laws or regulations." (emphases added)).

Fremont's assertion that making loans with the features identified by the Superior Court had been permitted by the relevant regulators, thereby excepting them from the coverage of Chapter 93A is simply wrong. See Fremont Br. at 30-35 (citing Mass. Gen. Laws ch. 93A, § 3).[12] Although federal regulators have not banned all "risk layering" that combines loan features that increase the chances of default, they have done so in expectation that lenders will otherwise ensure

[12] The Federal Reserve has also rejected Fremont's argument that banks will stop lending if they are regulated through case-by-case reviews of their past conduct. See Fremont Br. at 37-39. Instead, it has stated that a "case-by-case" approach to determining unfair or deceptive practices is preferable to codified prohibitions. Greenspan Letter, supra, at 2. It reasoned that "it is difficult to craft a generalized rule sufficiently narrow to target specific acts or practices determined to be unfair or deceptive, but not to allow for easy circumvention or have the unintended consequence of stopping acceptable behavior." Id.

borrowers are not at risk of default. See, e.g., Interagency Statement on Subprime Lending, supra, 72 Fed. Reg. at 37,573 ("When risk-layering features are combined with a mortgage loan, an institution should demonstrate the existence of effective mitigating factors that support the underwriting decision and the borrower's repayment capacity.").

Accordingly, federal regulations have never permitted combining loan terms in a way that places borrowers into an inescapable and unsustainable loan -- the result the Superior Court correctly found resulted from the combination of loan terms covered by the injunction. See, e.g., Interagency Expanded Guidance for Subprime Lending Programs, supra, at 11 ("Loans to borrowers who do not demonstrate the capacity to repay the loan, as structured, from sources other than the collateral pledged are generally considered unsafe and unsound.").[13] To the contrary, federal law and regulators have long declared that lending based on the value of residential real estate rather than on the borrower's ability to repay is a canonical sign of unfair predatory lending. See id. at 10; see also 15

[13] Fremont's argument about "a hyper-technical restriction to the 93A exemption" supposedly applied by the Single Justice of the Court of Appeals is a red herring. See Fremont Br. at 34. This Court need not decide whether federal regulators had to permit the specific combination of the four loan terms identified by the Superior Court in order for the Chapter 93A exception to apply. It is sufficient that federal regulators have never permitted a combination of loan terms that results in an inescapable and unsustainable loan.

U.S.C. § 1639(h) (prohibiting lending based on the value of the collateral without regard for a borrower's repayment ability for certain high-cost mortgage loans). The Superior Court correctly identified just such prohibitions on asset-based lending as notice to Fremont that the loans covered by the injunction were unfair. See Super. Ct. Opinion at 23-24 (citing Office of the Comptroller of the Currency Advisory Letter 2003-2); see also Fed. Reserve Sys., supra, 73 Fed. Reg. at 44,541 (noting during the subprime boom "creditors were in effect often extending credit based on the value of the collateral").

Finally, the Federal Deposit Insurance Corporation's ("FDIC") condemnation of Fremont definitively rejects the argument that its practices were permitted. A March 2007 FDIC Cease and Desist Order targeted, inter alia, the very practices at issue here. That Order stated that the FDIC "had reason to believe that [Fremont] had engaged in unsafe or unsound banking practices and had committed violations of law and/or regulations" through practices that included:

> [M]arketing and extending adjustable-rate mortgages ("ARM") products to subprime borrowers in an unsafe and unsound manner that greatly increases the risk that borrowers will default on the loans or otherwise cause losses to the Bank, including ARM products with one or more of the following characteristics:
>
> (i) qualifying borrowers for loans with low initial payments based on an introductory or "start" rate that will expire after an initial period, without an adequate

> analysis of the borrower's ability to repay the debt at the fully indexed rate;
>
> . . .
>
> (iii) containing product features likely to require frequent refinancing to maintain an affordable monthly payment and/or to avoid foreclosure;
>
> (iv) including substantial prepayment penalties and/or prepayment penalties that extend beyond the initial interest rate adjustment period;
>
> . . .
>
> (vii) approving loans or "piggyback" loan arrangements with loan-to-value ratios approaching or exceeding 100 percent value of the collateral;
>
> [M]aking mortgage loans without adequately considering the borrower's ability to repay the mortgage according to its terms;
>
> . . .
>
> [O]perating inconsistently with the FDIC's Interagency Advisory on Mortgage Banking and Interagency Expanded Guidance for Subprime Lending Programs.

Fremont Inv. & Loan, Docket No. FDIC-07-035b, at 3-4 (Mar. 7, 2007), available at http://www.fdic.gov/bank/individual/enforcement/2007-03-00.pdf.[14] This Court should accept the FDIC's position that federal law did not authorize Fremont's practices.

Conclusion

Fremont made loans in Massachusetts containing unfair terms -- whether viewed individually or in combination -- that would be unsustainable for

[14] The fact that Fremont did not admit to the allegations does not diminish the FDIC's view that such practices are impermissible. That position by Fremont's federal regulator -- regardless whether Fremont accepted it -- renders the Chapter 93A exception inapplicable.

borrowers. No regulator ever blessed Fremont's decision to make such unfair loans. The Superior Court's injunction preventing Fremont from immediately foreclosing on these unfair loans offers relief to the Massachusetts borrowers who received them and protects borrowers from being victimized by a similarly unfair product in the future. Accordingly, the injunction will provide much needed relief to Massachusetts borrowers suffering from the disastrous subprime foreclosure crisis now buffeting the country and will help to prevent such a catastrophe from again striking Massachusetts consumers.

Both public policy considerations and the relevant legal authorities side with the Commonwealth. This Court should affirm the Superior Court.

Respectfully Submitted,

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Dated:
September 22, 2008
Boston, Massachusetts