Consumer Financial Services LAW REPORT

Focusing on Significant Caselaw and Emerging Trends

Route to:

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HELOC reduction class actions: What is a 'significant decline' in a home's value under TILA/Reg Z?

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The sudden decline in home prices when the subprime mortgage bubble burst in mid-2008 caused most lenders to seek ways to limit risk of loss exposure to the home equity line of credit, a second-mortgage product that was aggressively marketed back in the days when housing values were considered immune from falling. Various methodologies were utilized to either cancel HELOCs or reduce loan limits significantly.

Plaintiff's attorneys recently filed several putative nationwide class actions in California federal courts challenging the rollbacks as illegal under Truth in Lending Act/Regulation Z and unfair business practices concepts, among other theories. Reg Z allows credit-line reductions if there's a "significant decline" in property value, which historically has meant a loss in value of 50 percent from the unencumbered equity when the loan was made.

Three of the suits were filed by the same firm (Kamber Edelson LLP), and all four target the practices of JPMorgan Chase and the recently acquired Washington Mutual. What follows is a detailed look at three of these cases (with a weather eye to a fourth) and a discussion of their potential significance in the current context of the emerging new world of consumer protection involving financial services.

Kimball v. Washington Mutual

In the first lawsuit filed by Kamber Edelson, Michell Kimball sued JPMorgan Chase Bank and WaMu for freezing the HELOC on her Escondido, Calif. home which took effect on March 26, 2009. (*Kimball v. Washington Mutual*, No. 3:09-cv-01261 (S.D. Ca. 06/10/09).)

Kimball seeks to be class representative for two classes: 1) all persons who had their HELOCs reduced or suspended by Chase/WaMu "without a sound factual basis that the reduction was due to a substantial decline in the value of the property securing the account"; and 2) a subclass of all persons who received from Chase/WaMu a "HELOC Reduction Notice Form Letter" utilized by the banks.

Kimball asserts eight separate claims: 1) a Declaratory Judgment Act (27 USC § 2201) class claim that TILA and Reg Z are violated by the banks' process/policies in HELOC reductions; 2) a class claim for TILA actual damages (increased price of credit, appraisal fees, adverse effects on credit scores, loss of interest, NSF fees, etc.) and statutory damages; 3) a notice-subclass claim under 12 CFR § 226.9(c)(3)) for untimely/inadequate form notices that were devoid of valuation data or of the threshold value for credit line reinstatement; 4) breach of contract for the class; 5) breach of implied covenant of good faith/fair dealing on behalf of class and the notice-subclass; 6) unjust enrichment (as an alternative claim) for both the class and the notice-subclass if no contract is found to exist; 7) a California unfair competition claim for the class; and 8) a California UCL claim for the notice-subclass.

The crux of Kimball's case is her contention that she was told WaMu's "computer models" indicated that she needed a current appraised value of at least $752,221 to reopen her HELOC – allegedly with no explanation for the $60,501 difference in the reinstatement figure from the one given to plaintiff by WaMu just three days earlier. Kimball says that Chase/WaMu refused to explain why the values changed.

Following the bank's appeal process, Kimball obtained a new appraisal of her property using a WaMu-approved appraiser, who valued the residence at $1,150,000 — a whopping $418,929 more than the $731,071 value WaMu assigned to the property. Kimball was able to get her HELOC reinstated, but she still sued.

Kimball challenges the "significant decline" in home value and calls into question the HELOC rollback methodology pursuant to TILA/Reg Z. Kimball complains

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that Chase/WaMu failed to: "1) validate the models on a periodic basis to mitigate the potential valuation uncertainty; 2) properly document the validation analysis, assumptions and conclusions; 3) appropriately back-test representative samples of the valuation against market data on actual sales; 4) account fairly for improvements, property type of geographic comparables; and 5) take other necessary steps to reasonably verify the accuracy of the valuations."

The complaint specifically references the TARP bailout money provided to Chase/WaMu, and cites the public statement made by Chase CEO Jamie Dimon in congressional testimony as evidence that the HELOC reductions on struggling consumers constituted "unconscionable" conduct. Kimball charges the banks with "knowingly and intentionally using faulty and dubious automated formulas, with unreliable and inaccurate analyses, formulas, equations and processes, vulnerable to manipulation, including but not limited to Automated Valuation Models, to unreasonably undervalue homes so as to falsely trigger Defendants rights to freeze or lower the credit limits."

Wilder v. JPMorgan Chase

The second lawsuit in the Kamber Edelson trilogy, Robert Wilder on behalf of himself and a putative nationwide class and a notice-subclass, sued JPMorgan Chase bank and First American Corelogic Inc. claiming violations of TILA/Reg Z and common-law claims based on HELOC line rollbacks. (*Wilder v. JPMorgan Chase, et al.*, No. 09-834 (C.D. Ca. 07/17/09).)

The bank notice of decline in property value is attached to the complaint and is very similar to the notice sued upon in the *Kimball* case. The key differences in *Wilder* concern the class definition (all persons who had a HELOC reduced or suspended by Chase "based on faulty valuation models or insignificant declines in property values" where the reduction or freezing did not satisfy the "substantial decline" Reg Z trigger) and include the targeting of Corelogic as a codefendant – attempting claims against Corelogic for aiding and abetting and for civil conspiracy.

Walsh v. JPMorgan Chase

In apparent competition with Kamber Edelson, plaintiff's counsel David Parisi and Suzanne H. Beckman of Parisi & Havens filed a copycat putative class action on behalf of Michael Walsh against Chase/WaMu. (*Walsh v. JPMorgan Chase*, No. 2:09-cv-04387 (C.D. Ca. 06/18/09).)

The facts of the Walsh HELOC reduction are a different twist on the other cases. The complaint attempts the same claim lineup as *Kimball* and proposes a nationwide class and a separate notice-class of consumers who received the form Chase/WaMu notice letter.

In August 2003, Walsh purchased his residence, getting a first mortgage through WaMu of $293,000 and setting up a HELOC of $100,000. On the sole basis of the asserted decline in property value, WaMu notified Walsh on April 20, 2009 that the new AVM value for his residence in 2009 was $466,300. The HELOC credit limit had been lowered from $100,000 to $16,300 — just slightly above the outstanding loan balance.

When Walsh called WaMu to protest the decline in property value and to ask about WaMu's initial appraised value in 2003, as well as the April 2009 revaluation, he was given differing figures. Allegedly, WaMu inconsistently asserted that the original appraised value of the property was $490,000, which was later changed to $502,589.

Walsh's complaint walks through the math [albeit inaccurately] to allege that Reg Z's 50-percent-decline-in -unencumbered-equity trigger was not satisfied by WaMu before reducing the HELOC by $83,700. Walsh detailed that if the initial appraisal was $490,000 in 2003, then he had a $293,000 first and $100,000 HELOC totaling $393,000, or $77,000 [*sic* $97,000] of unencumbered equity protection in the original deal. A 50 percent reduction in this cushion would constitute a "substantial decline," but that would require a $38,500 [*sic* $48,500] decline in fair market value from $490,000 — or a trigger threshold of $451,500 [*sic* $441,500].

The WaMu AVM figure of $466,300 did not satisfy the Reg Z trigger. Similarly, even if the initial appraised value of Walsh's residence had been $502,589, then the initial unencumbered equity was $109,589 ($502,589 - $293,000 - $100,000). A 50-percent reduction would be $54,794.50 and thus the trigger threshold was still at $447,794.50 ($502,589 - $54,794.50), well below WaMu's AVM value.

Credit rollback processes under scrutiny

These putative class actions are still in the initial pleading stages and no significant rulings have yet been made. But they do raise some vexing challenges to TILA/Reg Z process methodology for cutting credit lines based on the "significant decline" in unencumbered equity test.

These cases could illuminate the policies and procedures banks should use when reducing credit based on drops in property value, and the appropriate form of notice/appeal procedure. They also will vet the need for lenders to substantiate property value declines before reducing credit, and the need to monitor valuation and appeal processes to ensure a result which can be defended as reasonable.

The cases all propose nationwide classes with arguably overlapping claims and face significant defense barriers. They seek the dubious application of California's UCL, as well as California common law, to a proposed national "class" which would include thousands of non-California consumers. While large TILA classes have been certified in the past, there is a $500,000 aggregate cap on TILA class claim exposure.

The cases may also fail certification because of the predominance of individualized issues — value, decline

in value, unencumbered equity and improvements made. The ability to bring a California UCL claim for conduct covered by TILA/Reg Z also raises preemption arguments.

Despite the significant hurdles these cases face, they do exemplify the litigation risks of credit line rollbacks after an unanticipated real estate market drop — and the pitfalls of using geographic-based valuation models. How lenders implement credit reduction standards, as well as their documentation of the "significant decline" trigger, notices, appeal procedures and reinstatement assistance, will be tested by these initial cases, and perhaps by other filings in the future.

To be sure, Chase/WaMu were not the only banks to implement recent HELOC-reduction programs. Other lenders have followed similar paths.

Keep an eye on these cases and watch for future rulings on the TILA compliance and Reg Z issues. For example, another case also bears watching: *Schulken v. Washington Mutual, et al.*, No. 5:09-cv002708 (N.D. Ca. 06/18/09).

The third of Kamber Edelson's recent filings in California is slightly different from the cases described above; in this case, the HELOC reduction basis at issue is not declining property values. Instead, it is about borrower loss of income and the reasonableness of the lender's belief that the borrowers could no longer meet their loan obligations — implicating 15 USC §1647 and 12 CFR §226.5(b)(f)(3)(vi), comment 7.

One has to believe that if the newly-proposed federal Consumer Financial Protection Agency is created by the Obama administration's promised financial institution regulatory reform legislation, then consumer advocates will add some legal gloss to the processes by which credit extensions can be reduced by lenders. ❑