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November 3, 2009

## States Are Pondering Fraud Suits Against Banks

By [DAVID STREITFELD](#) and JOHN COLLINS RUDOLF

PHOENIX — Newly empowered by the [Supreme Court](#), the attorneys general of several states hit hard by the housing collapse are exploring consumer fraud suits against major mortgage lenders.

Frustrated by the banks' inability or unwillingness to stop an avalanche of foreclosures, the states are considering lawsuits over the creation and marketing of millions of bad loans as well as the dismal pace of mortgage modifications.

Such cases would have been impossible until recently, because federal regulators had exclusive oversight of national banks. But a 5-to-4 Supreme Court decision in June allowed the states to exercise their own supervision, giving them significant leverage.

"We tried to use the tool to be persuasive with the banks," Arizona's attorney general, Terry Goddard, said in an interview. "But their waterfall of excuses, the abysmal numbers of modifications, tells us persuasion is not working."

As a result, he said, "we're moving much closer to litigation."

While statutes vary, those of every state prohibit fraud in consumer lending. The attorneys general are considering the theory that the banks essentially perpetrated a vast fraud on consumers by marketing exotic loans that would prove impossible to pay back.

During the boom, the banks earned short-term fee income from generating the loans, then quickly resold most of them to investors or to [Fannie Mae](#) and [Freddie Mac](#), two government-sponsored housing agencies that eventually required costly taxpayer bailouts.

The Mortgage Bankers Association, a trade group, declined to comment on the possibility of state fraud lawsuits. A spokesman, John Mechem, warned that consumers would end up paying for any campaign of stepped-up legal activity.

"Lawsuits add to the patchwork of regulations that increases compliance costs for lenders, which in turn increases the cost of credit for borrowers," Mr. Mechem said.

The states' new power to sue banks arose from an effort in 2005 by [Eliot Spitzer](#), then the New York attorney general, to discover whether several banks had violated the state's fair-lending laws.

The banks balked at surrendering any information. The Clearing House Association, a consortium of national

banks, and the federal [Office of the Comptroller of the Currency](#) filed suit, asserting the states had no authority over national lenders.

Mr. Spitzer's successor, [Andrew M. Cuomo](#), took up the battle. Lower courts agreed with the banks, but the Supreme Court, narrowly, did not.

Already, the states' victory in *Cuomo v. Clearing House* is beginning to affect the legal landscape. "The handcuffs are off," said Ann Graham, a professor of banking law at [Texas Tech University](#). "The states can pursue justice now."

In July, the Illinois attorney general, [Lisa Madigan](#), filed a civil rights case accusing [Wells Fargo](#) of predatory lending. While the case was in the works for 18 months, Ms. Madigan said "it would have been much more difficult to bring" without the favorable Clearing House ruling.

The impact goes beyond housing issues. In West Virginia, a case brought by the state against [Capital One](#), charging deceptive marketing of credit cards, was blocked by a judge in June 2008. The judge said the state did not have authority to pursue the case. After the Clearing House decision, West Virginia filed a request to reinstate the case.

Other states say they are just beginning to explore their new powers.

"We're back on the field," said Iowa's attorney general, Tom Miller. "That's really important. Certainly there will be some litigation."

In Arizona, the number of state lawyers working on mortgage issues went from one to eight after Clearing House. "Before the court's decision, we wouldn't waste our time looking at national banks," said Robert Zumoff, senior litigation counsel for Mr. Goddard.

The Clearing House ruling rolled back an expansion of federal authority that began more than five years ago. In January 2004, the Comptroller of the Currency, the agency responsible for regulating national banks, issued two rule changes that had a far-reaching effect on the ability of state banking regulators and law enforcement to pursue violations of state law by large banks and their subsidiaries.

The rule changes broadened the protections afforded to national banks against prosecution for violations of state civil rights and predatory lending laws and other banking statutes. In a statement announcing the regulations, then-comptroller John D. Hawke Jr. said that his agency would take the lead on preventing lending abuses by the banks.

"Predatory lending is a very significant problem in many American communities, but there is scant evidence that regulated banks are engaged in abusive or predatory practices," Mr. Hawke said then. "Our regulation will ensure that predatory lending does not gain a foothold in the national banking system."

In the years that followed, as the housing market roared to a peak and then began to plunge, national banks repeatedly and successfully cited the new regulations to turn back lawsuits alleging violations of predatory lending statutes and other laws by state attorneys general and banking regulators.

At other times, they merely switched their charters. When Illinois first started investigating the branches of

Wells Fargo Financial Illinois for predatory lending in the spring of 2008, the branches operated under a state charter.

Initially, Wells responded to the state's subpoena. But on July 26, 2008, the branches were put under the control of Wells Fargo Bank, which is nationally chartered. Wells promptly informed the state of this new situation and ceased cooperation.

With such maneuvers, Ms. Madigan said, "it was much easier for people in the banking industry or any other industry to hide their misconduct."

While the attorneys general do not say they could have prevented all the shady deals that characterized the housing market at its worst, they believe they might have been able to stop enough of them to limit the scale of the crash.

"For the better part of eight years, the federal regulators were not being aggressive, and at the same time we were disabled," said the Ohio attorney general, Richard Cordray. "There was nothing holding back irrational and irresponsible practices."

The Clearing House decision was not a full-fledged victory for the states. The decision limits their subpoena power. While it is now easier to bring cases in court, it might be harder to develop them in the first place.

If the banking industry has its way, the victory will not be a permanent one.

In Washington, the banks are lobbying hard to try to block the states from becoming more aggressive. Lobbyists have urged lawmakers to pre-empt state rules that are more restrictive than federal laws. The Obama administration has opposed those changes.

Two weeks ago, the House Financial Services Committee voted to give the federal government the power to block states from regulating large national banks in some circumstances. Under the compromise, the Comptroller of the Currency would be able to override the states, but only after finding that the state law significantly interfered with federal regulatory policies.

In an interview in his offices here, Mr. Goddard and his top aides spoke repeatedly of their frustrations in dealing with the banks.

After the Clearing House decision, he said, there was "a virtual parade of national officers of national banks" coming through, ostensibly eager to find a common ground to help stanch foreclosures that are running as high as 7,000 a month in Arizona.

But Mr. Goddard, a former mayor of Phoenix, said the lenders were often unable or unwilling to provide him with elementary information, including how many and what kind of loans they have in the state.

The banks have been imploring Mr. Goddard to tell homeowners in default to get in touch with them, opening a dialogue. So he has. But the homeowners say they call and get no response.

"People call and get a runaround," Mr. Goddard said. "The paperwork gets lost. It's time to stop this absurd dance."

He would rather have a solution to the foreclosure problem today than a court victory in three years. But since he is not getting a prompt solution, that leaves only the hope of legal action, in his view. Any case will most likely be a major effort involving multiple states.

“Maybe the banks think we don’t have the gumption to pull the trigger,” Mr. Goddard said.

*Stephen Labaton contributed reporting.*

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