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IN THE UNITED STATES DISTRICT COURT
FOR THE EASTERN DISTRICT OF VIRGINIA
Richmond Division

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Evelyn Anderson, et al.

Plaintiffs,

vs. Civil Action No: 87-0236-R

The Federal National Mortgage Association, et al.,

Defendants

- - - - - - - - - - - - - - - - -

PLAINTIFFS' MEMORANDUM OPPOSING MOTION TO DISMISS

Dated: June 8, 1987

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I. Introduction

This class action by defrauded Virginia mortgage borrowers was commenced in the wake of the unprecedented failure and bankruptcy of the mortgage-lending company, Landbank Equity Corporation. The action fundamentally seeks to save the homes of the up to 5,000 members of the plaintiffs' class who were victims of a massive scheme and enterprise of fraudulent and unconscionable loans. The borrowers were victimized by loans which included, inter alia, all or some of the following common elements: hidden charges for up to forty (40) points for each loan; fraudulent charges for non-existent appraisals; illegal inflated charges for mortgage guarantee insurance and appraisals; deceptive and misleading lending practices; disclosure violations of the Truth in Lending Act, and usurious interest rates.

Landbank Equity Corporation had as its indispensible "partners" in this enterprise the financial institutions across the nation that "aided and abetted" the Landbank Equity enterprise by knowingly financing this fraudulent operation through provision of warehousing lines of credit, or through the knowing purchase of large portfolios of these fraudulent loans in knowing and intentional disregard of established prudent banking practices, regulatory proscriptions and their fiduciary duties.

This action bases its causes of actions on various provisions of the: Racketeer Influenced and Corrupt Organizations Act, 18 U.S.C. §§ 1961, et seq.; Truth in Lending

II. Procedural History

The present action was filed in the Richmond Division in March, 1987 as a related case to a pending action, AmericanTrust Federal Savings Bank, et al. v. Certain Subscribers and Underwriters at Lloyds of London, etc. et al., Civ. Act. No. 86-0537-R. The AmericanTrust litigation also had its germination in the Landbank lending fraud. Thirty one financial institutions in AmericanTrust have brought an action against the mortgage guarantee insurance (MGI) companies who underwrote the MGI on the Landbank loans, and who have refused to pay out claims of the financial institutions. These thirty-one financial institutions are included among the named defendants and the members of the putative defendants' class in the instant case. On June 3, 1987, the Hon. Robert R. Mehrige, denied defendants motion to transfer venue of this action to Norfolk. While the venue motion was pending, the defendants filed this motion to dismiss.

This action had first been filed as an adversary proceeding related to the Landbank Equity Corporation bankruptcy now pending in the Bankruptcy Court in Norfolk, In re Landbank Equity Corporation, Case No. 85-01541-N. Plaintiffs chose to file the case as an adversary proceeding in the bankruptcy under the assumption rejected by the court, that it made sense to have all the defendants, including Landbank, together in the bankruptcy forum which was already conducting substantial factual inquiries into the Landbank operation.

The parties in the adversary proceeding were nearly

III. Defendants Have Failed to Show That No Set of Facts Exists Under Which Plaintiffs Could Prove Their Causes of Action

The ensuing discussion will demonstrate the Complaint sufficiently alleges causes of action and supporting facts to defeat a motion to dismiss on the failure to state a claim upon which relief can be granted. The Court must deny the motion to dismiss unless it appears beyond a doubt that the plaintiffs can prove no set of facts in support of their claim upon which they can obtain relief. Conley v. Gibson, 355 U.S. 41, 45-46, 78 S.Ct. 99, 2 L.Ed.2d 80 (1957). Defendants' motion fails to meet that burden, and should be denied.

The allegations discussed infra, specifically refute the contentions of Defendants that plaintiffs have alleged the circumstances constituting fraud with insuffucient particularity to meet the requirements of Fed. R. Civ. P. 9(b), and have failed to allege that each defendant shared Landbank's intent to defraud or that plaintiffs failed to allege that Landbank participated in the fraudulent scheme of Landbank. Defendants' Memorandum, pp. 6-8.

The plaintiff need not plead evidence and prove the a RICO case in the Complaint. American National Bank and Trust Company v. Haroco, 747 F.2d 384, 404 (7th Cir.), affirmed, 476 U.S. -, 105 S.Ct. 3291, 87 L.Ed 2d 437 (1985) (per curiam). Under the liberal pleading requirements of the Fed. R. Civ. P., even in RICO case, the courts are guided by the liberal pleading policy which prevents dismissal of the complaint for purely formal or technical reasons, and the requires the

IV. Plaintiffs Have Alleged Facts Sufficient to State a Claim Under RICO

There can be no doubt that as a result of their Landbank loans, plaintiffs have suffered substantial injury to their property. The loan agreements which impose a lien on their homes contain allegedly fraudulent and illegal charges for: excessive discount points of between 20 and 40 points; illegal overcharges for mortgage guarantee insurance above that authorized by filings with the Virginia Superintendent of Insurance; illegal and fraudulent charges for non-existent or inflated appraisals; and charges for an illegal "risk management fee" not authorized by statute. Complaint I-1(c).

A. Plaintiffs Have Suffered Injury As a Result of a Pattern of Activity Founded on Mail Fraud

The First Cause of Action alleges that plaintiffs have suffered injury to their property as a result of defendants' violation of 18 U.S.C. § 1962(a). Complaint I-49. A violation of this section occurs when: 1) a person receives income derived directly or indirectly, income from a pattern of racketeering activity; 2) in which such person has participated as a principal pursuant to 18 U.S.C. § 2; 3) and the person uses or invests this money directly or indirectly to acquire any interest in or the establishment or operation of any enterprise; 4) where the enterprise is engaged in or whose activities affect interstate commerce.

Plaintiffs allege that Landbank individually and as agent for the defendants, and the financial institutions, both

their notes were stated to all be between 17 and 18% (Complaint H-1 to H-12) while pursuant to the servicing agreements the defendants received a guaranteed return of only 14 to 15 1/2% (Complaint H-78). On information and belief, part if not all of the difference went to paying a "servicing fee" to Landbank. In this manner, the defendants directly and indirectly used income derived from a pattern of racketeering activity in the operation of the Landbank enterprise, which was engaged in interstate activity by making loans in five different states and selling loans to financial institutions throughout the United States. Complaint (generally).[4]

Plaintiffs have thus sufficiently pled the required elements of the violation of § 1962(a) by the investors based upon the predicate acts of mail fraud.

B. Plaintiffs Have Equally Suffered Direct or Indirect Injury As a Result of a Pattern of Racketeering Activity Founded on Fraud in the Sale of Securities

Plaintiffs also allege that Landbank acting individually and as agent for the defendants and the financial institutions,

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4. Plaintiffs therefore do not claim that the individual defendants were both the "person" engaging in the racketeering activity and the "enterprise" in which the income thus derived was invested, as suggested in Defendants' Memorandum, pp. 17-18. Plaintiffs clearly allege that for purposes of their § 1962(a) claims, the "enterprise(s)" in which the income from racketeering activitiy was invested or used to conduct business were both Landbank itself or the business "customers" of the financial institutions in whom the proceeds from the racketeering activity are invested. Therefore, _United States v. Computer Sciences Corp._, 689 F.2d 1181, 1190-91 (4th Cir.), _cert. denied_, 459 U.S. 1105 (1983) cited in Defendants' Memorandum, p 17, does not bar plaintiffs' causes of action under 18 U.S.C. § 1962(a).

§ 77e (a)(2). Finally Landbank offered to sell unregistered securities by making use of means or instruments of transportation or communication in insterstate commerce or in the mails, in violation of 15 U.S.C. §§ 77e (c). While the defendant lending institutions may be held liable as principals in the aforesaid examples of fraud in their previously described roles as aiders and abettors ("Discussion," infra, pp. 27-40), they may also be liable in their own right. Oppenheim, Appel, Dixon & Co., 3 RICO L. Rep. 683 (S.D.N.Y. 1986) (Aiding and abetting securities fraud is a predicate act).

Any person is prohibited from indirectly, as well as directly, causing unregistered securities to be carried through the mails or in interstate commerce, for the purpose of delivery after sale. Presumably the defendants here directed Landbank to send these unregistered securities to them through the mails or in interstate commerce for the purpose of sale and for delivery after sale. Such an illegal activity would constitute fraud in the sale of securities.

It is also unlawful for any person directly or indirectly to offer to buy any security unless a registration statement has been filed. 15 U.S.C. § 77e(c). The offer of the sophisticated defendant financial institutions to purchase these unregistered securities without inquiring whether they had been registered violated this provision and constituted fraud in the sale of securities. Also the purchase of these securities by the defendant financial institutions with the direct knowledge or the implicit knowledge of one who relies on "deliberate ignorance" of the underlying illegal and fraudulent

18 U.S.C. § 1961 (1)(D). The repeated acts of fraud in the sales of securities would constitute a "pattern of racketeering" as defined in 18 U.S.C. § 1961(5). Plaintiffs allege that but for the sale of the securities, Landbank would have been unable to engage in its fraudulent and illegal lending activities.

In deriving income from the purchase of the Landbank loans, which were originated pursuant to fraud in the sale of the Landbank securities or the "portfolios of Landbank loans," the defendant financial institutions derived income from a "pattern of racketeering" activity. The continuing sale of new portfolios of Landbank loans, and the income generated thereby, through new occurences of fraud, was essential to insure that Landbank could abide by its guarantee to forward monthly remittances to the defendants even if the underlying loans were in default. Complaint H-18(c). The financial institutions again, have received money derived from a pattern of racketeering activity in which they have participated as a

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7. (cont'd)

from making such premature offers to buy. 15 U.S.C. § 77e. While the legislative history of this section may show that the impetus for its inclusion was to prevent dealers from succumbing to premature solicitations from underwriters (H.R. Report No. 85, 73 Cong., No. 1st Sess. (1983), p. 11), the language "any person" did not limit its reach to that situation alone. As with RICO, the language refers to breadth, not ambiguity. _Spencer Companies_, _supra_. Even while it may be unfair to extend such coverage to an unsophisticated individual investor who mistakenly offers to buy an unregistered security, no reason exists to exempt sophisticated financial institutions from the natural consequence of their own knowing actions in supporting a massive securities fraud in pursuit of unusually high _guaranteed_ rates of return.

C. Plaintiffs Have Standing to State A Cause of Action Under RICO for Indirect or Direct Injury Proximately Caused by Fraud in the Sale of Securities

Pursuant to the seminal rulings of the United States Supreme Court in Sedima, S.P.R.L. v. Imrex Co. (hereafter, "Sedima")[9] and Haroco, supra, Landbank borrowers have standing under RICO to plead an "indirect" injury proximately caused by fraud in the sale of unregistered securities, in violation of the Securities Act of 1933, §§ 5 and § 17a, 15 U.S.C. §§ 77e and 77q. The recently decided International Data Bank Ltd. v. Zepkin[10] was decided by the Fourth Circuit under SEC Rule 10b-5 and does not apply to the securities fraud alleged in this case, pursuant to 15 U.S.C. §§ 77e and 77q.

The RICO language is explicit. Any plaintiff may bring an action pursuant to RICO whenever that plaintiff suffers an injury as a result of a violation of 18 U.S.C. § 1962. 18 U.S.C. § 1964(c). A violation occurs whenever a person engages in any activities set forth in four subsections, which as a common element require a "pattern of racketeering" activies. 18 U.S.C. § 1962. "Racketeering activity" is defined to

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9. 473 U.S. 479, 105 S.Ct. 3275, 87 L.Ed 2d 346 (1985)

10. 812 F.2d 149 (4th Cir. 1987). Zepkin proscribed RICO causes of action founded on securities fraud to anyone other than an actual seller or purchaser of securities. However, this holding is specifically limited to cases where the RICO predicate act is pled under SEC rule 10b-5, 17 C.F.R. § 240.10b-5. The Court explicitly declined to decide whether the same limitation applies to securities fraud alleged under 15 U.S.C. §§ 77e, 77q, et seq., 812 F.2d, at 151, Note, even in the face of its dicta discussion of considerations that apply to all security frauds. 812 F.2d, at 153.

U.S.C. §§ 77e and 77q.

<u>Zepkin</u> relies on precedent under Rule 10b-5 and § 10b of the Securities Act of 1934, 15 U.S.C. § 781. <u>Zepkin</u> turned not to RICO precedent, but a securities' case, <u>Blue Chip Stamps v. Manor Drug Stores</u>, 421 U.S. 723, 95 S.Ct. 1917, 44 L. Ed. 539 (1975) in support of its holding. 812 F.2d, at 151.

<u>Blue Chip Stamps</u> was concerned to restrict the limits of a judicially-created, implied private cause of action under SEC Rule 10b-5. After cataloguing the potential difficulties of proof, discovery, and "nuisance" litigation for "indirect" injuries, <u>Blue Chip Stamps</u> concluded that the "implied" cause of action under 10b-5 would be limited to direct injuries suffered by actual "purchasers" or "sellers" of securities.

In reaching its conclusion, <u>Blue Chip Stamps</u> adopted the twenty-three year old holding of <u>Birnbaum v. Newport Steel Corp.</u>, 193 F.2d 461 (2d Cir.), <u>cert. denied</u>, 343 U.S. 956, 72 S.Ct. 1051, 96 L.Ed 1356 (1952). 421 U.S. at 543. The Court acknowledged that: "The Birnbaum rule undoubtedly excludes plaintiffs who have in fact been damaged by violations of Rule 10b-5, and to that extent it is undesireable." 421 U.S. at 743. However, even in barring these non-purchasing and non-selling plaintiffs from invoking an "implied" cause of action under 10b-5, the <u>Blue Chip Stamps</u> Court recognized that:

> ". . . if Congress had legislated the elements of a private cause of action for damages, the duty of the Judicial Branch would be to administer the law which Congress enacted; the Judiciary may not circumscribe a right which Congress has conferred because of any disagreement it might have with Congress about the wisdom of creating so expansive a liability.

421 U.S. at 748.

as a result of a violation of § 1962 (§ 1964(c)); 2) they allege, _inter alia_, that any of the violations enumerated was founded on a pattern of racketeering activity; and 3) they allege one of the listed "racketeering activities" which includes, both mail fraud, and any offense involving fraud in the sale of securities, punishable under any law of the United States. § 1961 (1)(A), (D).

> . . . Where the plaintiff alleges each element of the violation, the compensable injury necessarily is the harm caused by the predicated acts sufficiently related to constitute a pattern, for the essence of the violation is the commission of those acts in connection with the conduct of an enterprise. . . Any recoverable damages occuring by reason of violation of § 1962(c) will flow from the commission of the predicate acts.

Sedima, 87 L.Ed.2d at 359.

Even the _Blue Chip Stamps_ decision acknowledged that under 10b-5, non-sellers and non-purchasers of securities could suffer damages, and the need to exclude them was an undesireable result dictated by the limitations of a judicially created private right of action. 421 U.S. at 743. The injuries suffered here fall into that category, and Congress through its enactment of § 1964 (private cause of action) has eliminated the undesirable result identified by Chief Justice Rehnquist in _Blue Chip Stamps_.

Defendants argue that the _Zepkin_ decision would bar plaintiffs' cause of action based on securities fraud, because plaintiffs were neither sellers nor purchasers of securities and therefore lack the necessary standing to raise this issue. This argument ignores the fact that _Zepkin_ is self-limited to predicate acts violating SEC Rule 10b-5, and does not extend to

D. Plaintiffs Have Also Sufficiently Alleged They Have Suffered Injury As a Result of Defendants' Direct or Indirect Participation in the Conduct of Landbank's Affairs Through a Pattern of Racketeering.

Plaintiffs have sufficiently alleged elements of a cause of action against the defendant financial institutions pursuant to 18 U.S.C. § 1962(c) and supporting facts, necessary to withstand a motion to dismiss. The elements which must be alleged are that: 1) a person associated with any enterprise; 2) the enterprise engages in interstate commerce; 3) the person conducts or participates, directly or indirectly in the conduct of the such enterprise's affairs through a pattern of racketeering activity.

For purposes of the Third Cause of Action, plaintiffs alleged that the defendant financial institutions were "associated" with an "enterprise" known as Landbank. Complaint I-51. The Complaint is suffuse with indicia of this association, which is summarized in the Third Cause of Action: 1) the financial institutions entered sales and servicing agreements with Landbank; 2) the financial institutions appointed Landbank as their agent for purposes of orginating and servicing loans; 3) the financial institutions continued their relationship with Landbank after they discovered, or should have discovered the nature and extent of the illegal and fraudulent activities of the Landbank enterprise. Complaint I-51. It is not disputed that Landbank engaged in interstate commerce. Complaint I-52.

Notwithstanding the plaintiffs' substantial allegations,

(7th Cir. 1986) is misplaced. (Defendants' Memorandum, p. 19). The court concluded that the Lipin plaintiffs had not even alleged that the defendants had even participated in the conduct of the enterprises affairs through a pattern of racketeering activities. 625 F.Supp. at 1100. The conclusion of the court was based on its finding that: ". . . it is not clear that any of the defendants, particularly the banks, conducted or participated in the direction or management of the companies' affairs." Id.

Plaintiffs here have alleged a continuing ongoing relationship between the financial institutions and the Landbank enterprise. See eg. Complaint: I-14; I-15; I-17; I-19. Also alleged are substantial indicia of the financial institutions direct and indirect participation in the conduct of Landbank's affairs which is far more pervasive than the single transfer of one company's stock alleged in Lipin. 625 F.Supp. at 1100. See, "Discussion," infra, pp. 28-40.

In this case, plaintiffs have also alleged that the defendants "aided and abetted" Landbank in the operation and conduct of its affairs through a pattern of racketeering activity, thereby becoming chargeable as "principals." "Discussion," infra, pp. 27-39. This is far beyond "mere participation" in the predicate offenses, an activity which the court in Bennett v. Berg suggested would be insufficient to sustain a cause of action based on § 1962(c). 710 F.2d 1361, 1364 (7th Cir. 1983) (en banc), cert. denied, 464 U.S. 1008

worth noting that post-Sedima, the Mandel-Bennett "participation in the operation or management" standard has been rejected as too strict and in conflict with Sedima:

> This court rejects the stringent standard. That requirement goes beyond the "self-consciously" expansive language and overall approach" of RICO, Sedima, - U.S. at -, 105 S.Ct. at 3286, particularly section 1962(c), which merely requires that a person employed by or associated with the enterprise conduct or participate, either directly or indirectly, in the conduct of the enterprise's affairs through a pattern of racketeering activity. The statute does does not require that the defendant participate in the operation or management of the enterprise. Furthermore, such a requirement would frustrate RICO's broad remedial purposes. See id.

Virden v. Graphics One, 623 F.Supp. 1417, 1428 (D.C. Cal. 1985).

The Virden court reviewed the decisions of the other circuit courts of appeals that have developed a standard in harmony with Sedima:

> Other federal courts, however, merely require that the predicate acts be related to or have an effect on the enterprise's affairs. E.g., United States v. Carter, 721 F.2d 1514, 1525-28 (11th Cir. 1984) (holding that "proof of an effect upon the common everday affairs of the enterprise" is "clearly sufficient to support the required nexus between the enterprise and the racketeering activity"), cert. denied sub nom., Morris v. United States, - U.S. -, 105 S.Ct. 89, 83 L.Ed.2d 36 (1984); United States v. Cauble, 706 F.2d 1322, 1333 & n. 24 (5th Cir. 1983) (holding that a defendant conducts or participates in the conduct of a RICO enterprise's affairs merely if "the predicate acts [have] some effect on the lawful enterprise[;] [t]he prosecution need prove only that the racketeering acts affected the enterprise in some fashion"), cert. denied, 465 U.S. 1005, 104 S.Ct. 996, 79 L.Ed.2d 229 (1984); United States v. Welch, 656 F.2d 1039, 1060-62 (5th Cir. 1981) (rejecting the requirement that the racketeering activities benefit the enterprise and holding that § 1962(c) requires only "a sufficient nexus between the racketeering activities and the affairs of the enterprise"), cert. denied, 456 U.S. 915, 102 S.Ct. 1767, 72 L.Ed.2d 173 (1982); United States v. Scotto, 641 F.2d 47, 54 (2d Cir. 1980) (holding that a defendant participates in a RICO enterprise through a pattern of racketeering

plaintiffs have shown that defendants participated directly, or at worst, indirectly, in the conduct of Landbank's affairs. The motion to dismiss the Third Cause of Action should therefore be denied.

E. Defendants' Participated With Knowledge or Deliberate Ignorance and Thereby Aided and Abetted the Pattern of Racketeering Activity

Plaintiffs have generally alleged several instances in which the defendants have aided and abetted Landbank in violating various subsections of 18 U.S.C. § 1962 (a). If plaintiffs succeed in proving the defendants aided and abetted the illegal acts of Landbank, then the defendants will be liable as prinicpals. 18 U.S.C. § 2. Plaintiffs allege as well that through "aiding and abetting" Landbank, the defendants participated at least indirectly, if not directly in the conduct of Landbank's affairs as required *inter alia*, to show a violation of 18 U.S.C. § 1962(c). The illegal acts of Landbank are alleged to include mail and securities fraud. Complaint H-146 to 149, First Cause of Action, Second Cause of Action.

For purposes of discussing aiding and abetting, the defendant financial institutions are divided into two separate groups in order to reflect factual differences in the nature of their aiding and abetting. Thus, Perpetual Savings Bank which provided a warehousing line of credit to Landbank and which was not pled as a defendant class represenative is considered separately from the remaining named representative defendants

culpable role in the Landbank fraud. Perpetual's role can most accurately be analogized to "micro-management" of Landbank's business operation. Perpetual required Landbank to send a complete set of loan documents to its D.C. office for complete review before agreeing to fund and warehouse individual loans. Perpetual also strictly regulated Landbank's ability to make loans in the first place by manipulation of the level of credit available to Landbank through its warehousing line. Complaint H-139.

Perpetual was uniquely well-positioned to know of the fraudulent and illegal activities of Landbank. Revealing of its actual knowledge, is an April 19, 1985 letter from Perpetual Vice President Deborah Wenner complaining in part that: she had been "displeased" with the handling of Perpetual's loan relationship with Landbank since June, 1984; Landbank was making substantial numbers of loans to affiliated companies, which practice was prohibited by the loan agreement; Landbank had failed to notify Perpetual that it had received oral notice in February, 1985 that the Insurance Exchange of the Americas was cancelling its mortgage guarantee insurance policy with Landbank; Bill and Marika had borrowed $100,000 from Landbank in January, 1985 for a deposit in order to become partners in the Insurance Exchange of the Americas. Complaint H-118.

All the other defendants contracted with Landbank to purchase portfolios of loans. Generally, the loans had not been orginated by Landbank at the time of these contracts, but were made and delivered after the contract was entered,

of documentation violates standards set by Federal Home Loan Bank Board).

Pursuant to its duties as servicing agent, Landbank was responsible to collect all monthly payments from borrowers and to forward the collective monthly proceeds to individual financial institutions. Complaint H-18. Landbank was further responsible to continue forwarding the accrued collective monthly payment due to each individual financial institution, regardless of whether any underlying individual loans were overdue or in default. Ibid. Further, Landbank was given full authority to manage the individual loan portfolios and to default and foreclose loans as necessary. Complaint I-19.

The Fourth Circuit has further explained the proof necessary to establish the elements of "aiding and abetting:"

> To prove the crime of aiding and abetting the [plaintiff] must show that the defendant knowingly associated himself with and participated in the criminal venture . . . To prove the element of association, the [plaintiff] must show that the defendant shared in the prinicpals' criminal intent. . . This requires evidence that the defendant be aware of the principals' criminal intent and the unlawful nature of their acts.

Winstead, supra, 708 F.2d at 927. Accord, Flowers v. Tandy Corp., 773 F.2d 585 (4th Cir. 1985). In addition to direct evidence of knowlege, circumstantial evidence of knowledge is sufficient. Cf. Nye, supra, 336 U.S. at 619. In this case, the knowledge of the financial institutions was actual or implied, or a combination of both.

Actual knowledge of the financial institutions may be ascertained from example, from analzying a number of red-flags contained in the original commitment letters between Landbank

which would be triggered upon discovery by the purchasing financial institutions of any violations of the terms of the commitment letters. Complaint H-18 (f). Often, though not always, an inspection period of 30 to 90 days after delivery of the loans was imposed against the purchaser for exercising the repurchase option. Id. It is interesting to note that in the AmericanTrust case pending in this court, 31 financial institutions who have brought action against the mortgage guarantee insurers for failing to pay any claims on the Landbank loans, have stated that they never looked at the notes, all they looked at was the existence of mortgage guarantee insurance.[16]

Actual knowledge of a fact can also be imputed to a party which attempts to found their innocence on "deliberate ignorance." Deliberate ignorance and positive knowledge are equally culpable. United States v. Jewell, 532 F.2d 697, 700 (9th Cir.), cert. denied, 426 U.S. 951, 96 S.Ct. 3173, 49 L.Ed.2d 1188 (1976). Jewell explained the historical foundation of the concept of "deliberate ignorance:"

> The legal premise . . . is firmly supported by leading commentators here and in England. Professor Rollin M. Perkins writes, "One with a deliberate anti-social purpose in mind . . . may deliberately 'shut his eyes' to avoid knowing what would otherwise be obvious to view. In such cases, so far as the criminal law is concerned, the person acts at his peril in this regard, and is treated as having 'knowledge' of the facts as they are ultimately discovered to be." J. Ll. J. Edwards, writing in

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16. AmericanTrust Federal Savings Bank, et al. v. Certain Subscribers and Underwriters at Lloyds of London, et al., Civ. Act. No. 86-0537-R (E.D.Va. 1986). Complaint ¶¶ 132, 144, 182 (without MGI, the financial institutions would not have purchased these loans from Landbank).

that the financial institutions failed to abide by the duties imposed upon them by the Federal Home Loan Bank Board (FHLBB) and/or the Federal Savings and Loan Insurance Corporation (FSLIC) to conduct their business in a prudent and responsible fashion, and in accordance with the rules and regulations promulgated by those agencies as well as applicable statutes. Complaint, I-4 thru I-6.[17] Defendants could have only violated such duties through the invocation of a "deliberate ignorance."

Independent of the knowledge that would have inevitably flowed to the financial institutions had they properly observed their fiduciary and statutory duties, defendants should have been further put on notice by the uncommon nature of the purchase contracts that: the operations of Landbank; Landbank's

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17. The F.H.L.B.B. adopted a final rule effective October 28, 1986, on record-keeping requirements imposed on its supervised institutions, whose purpose " . . . was not to introduce a series of new underwriting concepts . . . but . . . to set forth in greater detail existing prudent lending requirements as required by the Board and the courts. "Loan Record Keeping Requirements," 51 Fed. R. 30848 (August 29, 1986) (emphasis added). "The Board agrees that each purchaser or participant must make its own underwriting decision, but it continues to believe that reviewing a copy of the originator's underwriting standards should be part of that decision. A lender may wish to consider whether to purchase a loan made by a seller whose underwriting standards are substantially different from its own." 51 Fed. R. at 30850. None of the defendant financial institutions made individual underwriting decisions, to the current knowledge of plaintiffs, but left those judgments entirely to Landbank. Complaint I-19. Some of the critical documents which the FHLBB requires such purchasing institutions to have, which the defendants here as a rule never acquired, were: 1) the application for the loan; 2) the borrower's financial statement evidencing an ability to repay the loan or a credit report; 3) documentary evidence of the validity of the lien on the security such as title insurance; 4) a copy of the originator's underwriting standards. 12 C.F.R. § 563.17-1(c)(3)(i). The defendants here did not require Landbank to send those documents. Complaint H-18(g).

taken exception to all the Landbank originated loans it had purchased as sub-standard and poorly underwritten. Complaint H-52.

Even before undertaking any discovery, plaintiffs have uncovered numerous instances where a number of the financial institutions realized at the outset that their were significant problems with the loan files they were receiving. For example, on March 9, 1983, Vincent Colleti, II, Associate Lender Representative of FNMA wrote to William Runnells to advise hime that the delinquency ratio of the loans purchase by Fannie Mae had increased significantly. Complaint H-28. The following month, an April 12, 1983 letter from FNMA complained that a spotcheck" had revealed "very alarming" results including: poor credit ratings of borrowers; inflated and unjustified appraisal values; no mortgage guarantee insurance; poor credit ratings of borrowers; unacceptable income-to-debt ratios; unexplained pay-offs at closings; and issuance of small first mortgages and large second mortgages to qualify the "seconds" for FNMA purchase. Complaint H-30. It was not until August 19, 1983 that FNMA cancelled its selling arrangements with Landbank. Complaint H-42.

After the cancellation of the agreement qualifying Landbank to sell loans to FNMA, on November 17, 1983, Sherri Reich, Senior FNMA Counsel requested a copy of a legal opinion as to whether there was a problem with usury when under Virginia law when amounts were charged which were not disclosed on the face of the note. Complaint H-48. However FNMA did not require Landbank to repurchase the loans it had purchased by that time

between Balboa and Landbank which included a letter in which Balboa's Corporate Counsel Stephen Brandon had charged: 1) the premium charged to the borrowers for mortgage guarantee insurance appeared to be twice the actual premium charged by the insurance company; 2) the Itemization of the Amount Financed was seriously misleading, in part, because it gave the impression that all of the amounts listed were paid on behalf of the borrower, whereas a certain number of them, such as mortgage guarantee insurance, discount points and the service charge are a prepaid finance charge; 3) amounts charged for additional charges appear to be well in excess of statutory limits under Virginia law, subject to court interpretation. Complaint H-79. This correspondence was sent as well to all the financial institutions who had purchased Landbank loans insured by Balboa. Complaint H-84.

It is therefore clear that genuine issues of fact have been shown which must be further fleshed out in discovery and determined at trial regarding the actual knowledge of the financial institutions with respect to the illegal and criminal activities of Landbank, as well as the extent to which their knowledge can be demonstrated either through circumstantial evidence or through the doctrine of "deliberate ignorance."

Having appointed Landbank their agent, the financial institutions were chargeable both with Landbank's culpability and knowledge:

> Under well-established principles of agency, a principal is bound by the knowledge of its agent concerning a matter upon which·is is the agent's duty to report. Restatement, Agency 2d § 272. It is no defense that the agent did not, in fact, communicate his knowledge to his principal. Bowen v. Mt. Vernon Savings Bank, 70 App. D.C. 273, 105 F.2d 769 (1939). United States v. Hanna Nickel Smelting Company, 253 F.Wupp 784, 793 (D.C.Ore. 1966) aff"d, 400 F.2d 944 (9th Cir. 1968).

United States v. Georgia-Pacific Co., 421 F.2d 92, 97 note 7 (9th Cir. 1970).

An exception to this general rule exculpates the principal when the agent is secretly acting adversely to the principal. United States Fidelity and Guarantee Co. v. State of Oklahoma, 383 F.2d 417, 419 (10th Cir. 1967. However this exception is not absolute. Presumably if the defendants knew or exercised "deliberate ignorance" sufficient to imply knowledge, then the exception would not apply since it could not be said that Landbank was operating in secret. Here, the illegal and fraudulent acts of Landbank were known to the defendants. See "Discussion," supra, pp. 27-39.

However, the exception is subject to a qualification which has application in this case. When the principal retains the fruits of the agent's acts after knowledge of the facts, it

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Note 19 (cont'd)

supports the conclusion that notwithstanding the self-serving contract provision, Landbank had been appointed as agent. At worst, it leaves an issue of fact as to whether Landbank was an agent.

any culpability for the massive damages suffered by the plaintiffs. Judicial ratification of such a radical interpretation of the financial, fiduciary and regulatory obligations of the defendants would substantially undermine the traditional responsibilities assigned to financial institutions and severely erode public confidence in this nation's financial industry.

Rather, the true position of the financial institutions can at best be more accurately analogized to that of a financier who solicits an unknown intermediary to make and manage suspiciously high-return investments for the principal with little or no supervision, and without regard to the ultimate risk. When it turns out the "agent" of the lender has been engaging in all manner of illegal and fraudulent activies in unsupervised pursuit of the principal's goals, it is more than disingenuous for the prinicpal to disclaim responsibility for the acts of their agent.

The targetting of a co-perpetrator by another does not relieve the so-called "vicitim" of culpability for having aided and abetted the illegal and fraudulent conduct of the co-actor. For example, a RICO case setting forth a street-gang as a single RICO enterprise is not defeated by intra-gang conspiracies or even attempted murders involving the individual gang members as both the perpetrators and the victims. _United States v. Louie_, _supra_, 625 F.Supp. at 1332. The financial institutions could escape liability under their "victim" theory only if the plaintiffs had not alleged that they they were both aware of and profitted from the Landbank scheme. _Banque Worms_

V. Plaintiffs Have Stated Viable Claims Under Truth-in-Lending

A. Plaintiffs' Claims are Not Barred by the Statute of Limitations

1. Any Limitations Have Been Equitably Tolled by the Fraudulent Concealment of the Hidden Finance Charges.

Whenever a creditor fraudulently conceals its failure to make the material disclosures required by the Truth In Lending Act, 15 U.S.C. §§ 1601, et seq., the one year statute of limitation set forth at 15 U.S.C. § 1640 (e) is equitably tolled until such time as the debtor discovers or has a reasonable time to discover the fraud involving the complained of TIL violation. Jones v. The Transohio Savings Association, 747 F.2d 1037, 1040-1043 (6th Cir. 1984). Accord, King v. State of California, 784 F.2d 910, 915 (9th Cir. 1986). The three year limitation on rescission should be tolled as well as a consequence of the fraudulent concealment of the fraudulent charges and fees alleged in this case.[20]

The overwhelming indicia of fraud which pervade the Landbank credit operation have been previously discussed. "Discussion," supra, pp. 27-39.. Plaintiffs have specifically asked the court to find that that Landbank and the defendant

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20. At least one case has suggested that notwithstanding the language of the recission statute which states that the right to rescind expires after three years, the limitation is not absolute and does not apply where recission is alleged defensively in a collection action under the theory of recoupment. Dawe v. Merchants Mortgage and Trust Corporation, 683 P.2d 796 (Col. 1984) (en banc). Plaintiffs in this case where applicable have alleged rescission as a defense to the defendants counterclaims.

Financed rather than the Finance Charge. 15 U.S.C. § 1605 (e)(5); 12 C.F.R. § 226.4 (c)(7)(iii). Unsually high rates for the appraisals and overcharges above the legally authorized premiums for MGI would have been apparent on the face of the loan documents.

While Landbank's manipulation of the Itemization of Amount Financed statement would have fraudulently concealed this from an inexperienced and unsophisticated borrower, it should have been obvious from the face of the assigned documents and the disclosure statement to experienced financial institutions who regularly make loans and are well-schooled in the requirements of TIL. Defendant financial institutions even as assignees, are accountable for violations apparent on the face of the disclosure statements. 15 U.S.C. § 1641(a). Therefore, any member of the plaintiffs' class whose loan exhibits TIL violations on the face of the assigned documents or the TIL disclosures, where the violation was deceptively concealed from the unsophisticated borrower, but not from the experienced financial institution, continued to enjoy the tolling of the statute of limitations against the financial institution through the additional tolling imposed from the commencement of the borrowers' litigation in the bankruptcy court through the current time.

Discovery may uncover additional similar types of violations systematically apparent on the face of the assigned documents or the disclosure documents for which the defendant financial institutions may be held accountable regardless of their status as assignees. 15 U.S.C. § 1641(a).

In American Pipe, the Supreme Court concluded that if class certification was denied, members of the putative class could intervene on their own behalf, taking advantage of the tolling of the statute of limitations until the denial of the class motion: " . . . the commencement of the original class action tolls the running of the statute for all purported members of the class who make timely motions to intervene after the court has found the suit inappropriate for class action status." 414 U.S., at 553. In an analogous situation, the amendment of a defendants' class action complaint to alter the status of an individual defendant to the status of a representative defendant has been approved would not be barred by the statute of limitaions. Kerney v. Fort Griffin Fandangle Association, 624 F.2d 717 (6th Cir. 1980).

In this action, when the class action was refiled in the District Court, several members of the plaintiffs' putative class were added as named plaintiffs: the Haysletts and the Hodges. At worst, this was equivalent to the Haysletts and the Hodges filing a new suit. In such a situation the Fourth Circuit has held:

> Thus we are persuaded that the correct reading of American Pipe is that the pendency of a putative class action tolls the running of limitations both for purpose of intervention and the filing of a new suit based upon a cause of action embraced within the putative class action until certification of the class is denied.

Parker v. Crown, Cork and Seal Company, Inc., 677 F.2d 391 (4th Cir. 1982).

No new causes of action were added peculiar to the Hayslletts or the Hodges. The named defendants (with the

B. Plaintiffs' Rescission Rights Against Assignees are Identical to their Rights Against Landbank Without Regard to Whether the TIL Violations Were Determinable from the Face of the Disclosure or Assigned Documents As Long as Defined "Material Violations" Have Occured

The limitation of liability of voluntary assignees to only disclosure violations determinable from the face of the disclosure statements or the assigned documents does not apply to the plaintiffs' right to rescind. 15 U.S.C. § 1641(c). Rather, the assignee are subject to recission whenever the disclosure statements fail to properly disclose any of the defined "material" disclosures.[21] In the absence of disclosure of any of the "material" items, the right to rescind may be exercised anytime up to the date the proper disclosure is finally, made with an outside limitation of three years. 15 U.S.C. § 1635(f). The one year statute of limitations for actions to recover damages under 15 U.S.C. § 1640 has no application to the right of recission.

Plaintiffs seek a declaration that all members of the plaintiffs' class who were obligated on a loan agreement with Landbank on or after May 27, 1983, three years prior to the date of filing of the original complaint in the bankruptcy

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21. "The term 'material disclosures' means the required disclosures of the annual percentage rate, the finance charge, the amount financed, the total of payments and, and the payment schedule." 12 C.F.R. § 226.23(a)(3) note 48. The facts cited in the Complaint allege the disclosure statements understate the Finance Charge and the A.P.R. The cases cited by defendants to define "material violations" (Defendants' Memorandum, p. 25) are superceded by TIL Simplification of October, 1982 and Revised Regulation Z (cited above) to the extent they are in conflict.

to pursue their Truth in Lending claims, at least through discovery, in order to identify any additional systemic violations. Other examples of material violations may exist such as the failure of Landbank or the financial institutions to disclose the payment schedule. Such a violation would also trigger a right to rescind. 12 C.F.R. § 226.23 note 48.

Defendants' argument that the term "bona fide" charge is somehow defined differently than "actual" charge, strains credulity. Defendants' Memorandum, p. 24. For example, under Virginia law lenders are prohibited from charging more than the actual amount paid for mortgage guarantee insurance and appraisal fees in a second mortgage transaction. Code of Virginia § 6.1-2330.24 A. Plaintiffs have also alleged facts which show that Landbank was charging fees for mortgage guarantee insurance in excess of that authorized under the insurance law. Complaint H-79 (b). It is hard to imagine how prohibited excess charges could therefore be considered "bona-fide."

Discovery is also necessary to determine whether or not the financial institutions were voluntary or involuntary assignees. If the financial institutions were actually involuntary assignees who received their assignments through order of the bankruptcy court, then they are liable for all TIL violations whether or not they are apparent from the face of the assigned documents or the disclosure documents. 15 U.S.C. § 1641(a). In November, 1985, the bankruptcy trustee applied to the Bankruptcy Court for an order approving a stipulation negotiated with the trustee in which over twenty of the

VI. PLAINTIFFS' STATE CLAIMS ARE PROPERLY BEFORE THE COURT UNDER THE DOCTRINE OF PENDENT JURISDICTION

A federal court may exercise pendent jurisdiction over state claims when the state and federal claims arise from a common nucleus of operative facts and are such that the plaintiff would ordinarily be expected to try them all in one proceeding. United Mine Workers v. Gibbs, 383 U.S. 715, 725; 16 L.Ed.2d 218, 228 (1966). It is discretionary with the court, and the factors to be considering in determining whether to exercise that discretion include the similarity of the state and federal issues, commonality of evidence, whether the state claims predominate in terms of factual development and proof, and the viability of the federal claim. Id., 383 U.S. at 726.

An examination of those considerations lead to the conclusion that the exercise of pendent jurisdiction is appropriate. The facts that give rise to plaintiffs' federal claims also give rise to their state claims. See Mason v. Richmond Motor Co., Inc. 625 F.Supp. 883, 887 (E.D. Va. 1986). At the core of plaintiffs' claims--the "umbra," not the penumbra, Id.--is the fraudulent and deceptive mortgage lending scheme which depended upon originating loans containing excessive, concealed charges and trafficking in those loans in order to originate more such loans and perpetuate the scheme.

Defendants posit that plaintiffs usury and consumer protection (UDAP) claims do not arise from the same group of operative facts as its RICO claims, Def. Br. 29. They further suggest that it is inappropriate to raise state credit law claims to TIL. Def. Br. 29-30. The former misapprehends the

wire fraud and security fraud. See Section IV, <u>supra</u>. The mail fraud alleged by plaintiffs involved use of the mails and telephone wires to actively seek to conceal the true cost of credit to borrowers and to charge and collect fictitious and excessive charges. Complaint ¶ H-147. Among the facts necessary to prove the commission of the predicate act of mail (and wire) fraud as alleged would include: concealing the true cost of credit by concealing points in the face amount of the note; concealing the true cost of credit by padding appraisal and mortgage guaranty insurance fees; imposing further excessive charges by padding the fees and by charging improper interest on a face amount of the note, which amount conceals improper, hidden fees. In addition to constituting evidence to establish one of the elements of the RICO claim, these facts are also common to the usury claim and the consumer protection claim, as well as the Truth in Lending claim.

Since the proof necessary to establish the commission of the predicate act of mail and wire fraud under the RICO claim are substantially the same as the facts necessary to establish the state claims, pendent jurisdiction is appropriate. <u>Morley v. Cohen,</u> 610 F. Supp. 798, 821 (D.C. Md. 1985).[23] <u>See</u> also

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[23]Defendants apparently would deny commonality merely because the predicate act is just one element necessary to establish a RICO claim. Def. Br. 29 n.10. Defendants' analogy to <u>Mason, supra.</u> 625 F. Supp at 888, where the only common fact was that the plaintiff was fired, is inapposite. It would only be a proper analogy if the only common operative fact was that each plaintiff had obtained a loan. <u>Compare Mason</u> (an Age Discrimination Act case) with <u>Taylor v. Home Insurance Co.</u> 777 F.2d 849, 861 (4th Cir. 1985), <u>cert. den.</u> 106 S.Ct. 2249 [state court claim of intentional infliction of emotional distress properly pendent to federal claim based on Age Discrimination Act.]

pursue an unwarranted construction to irrational conclusions. See Section VIII-A-2, *infra*. In *Campbell v. General Finance Corp. of Virginia*, 523 F. Supp. 989 (W.D. Va. 1981) the district court held plaintiff's usury claim under the Virginia Small Loan Act properly pendent to her TIL claim. One of Ms. Campbell's two TIL claims was that a required reaffirmation of a debt previously discharged in bankruptcy was a finance charge under TIL; she also alleged that the same requirement constituted a prohibited charge under the Virginia Small Loan Act. *Id.* at 991. The court ruled on both claims, despite the fact that there was no Virginia case law on the particular state law being interpreted, and voided the loan. *Id.* at 996.[25]

Defendants' reliance on *Mason*, *supra*, 625 F.Supp. 883, is inapposite in this context as well. Def. Br. 27. In *Mason*, the plaintiff sought relief for common law claims which the state has never recognized. There was no common law or statutory basis for the existence of such claims, irrespective of whether the facts of the case could lead to recovery under such theories. *Mason*, *supra*, 625 F. Supp. at 889-890. By contrast, as to Plaintiffs' Consumer Fraud claim, they are only

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[25]The Small Loan provision at issue specified what charges were permissible and provided that no other charges in addition to those authorized could be imposed. *Id.* This is similar to § 6.1-330.24, at issue herein, providing that "no other charges" may be imposed on second mortgage loans apart from those specified, which includes only the "actual cost" of appraisal and MGI fees.

"[t]o do otherwise would waste judicial resources, frustrate the convenience of the parties, and encourage piecemeal litigation." Meadow Limited Partnership v. Heritage Savings & Loan Ass'n, 639 F. Supp. 643, 651 (E.D. Va. 1986).

The Virginia Supreme Court has definitively ruled that the language now demoninated as subsection (i) covered home equity loans by unlicensed and unsupervised lenders in those aspects of the transaction not specifically the subject of regulation under Truth in Lending. Valley Acceptance Corp. v. Glasby, supra, 337 S.E. 2d at 295. Applying the Act to such a transaction was not troublesome to the Court, for from its initial passage, the Virginia statute evinced a clear intent to cover the sale of credit except to the extent the latter was specifically limited by § 59.1-199.[28] The intent to cover credit which was not regulated by other laws is evinced by the exclusionary language of § 59.1-199. Only "aspects" of a credit transaction covered by TIL were excluded, § 59.1-199(C), and only those "suppliers" who "sell" credit under the watchful eye of other regulatory and supervisory bodies § 59.1-199(D), are excluded from the Acts' coverage.

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[28]In interpreting UDAP language defining the scope of coverage as being "the sale of goods or services used primarily for personal, family and household purposes," as does Virginia's, other states have differed on whether real estate was a good or service (compare State v. First National Bank of Anchorage, 660 P.2d 406 (Alaska 1982) (not a consumer good or service) with People ex rel MacFarlane v. Alpert Corp., 660 1295 (Colo. Ct. App. 1983 (real estate is included). They have also differed on whether credit was a good or service. Compare State v. Grotherhood Bank & Trust, 649 P.2d 419 (Kan. Ct. App. 1982) and Lavinia v. Howard Bank, No. C400-75CncC, Clearinghouse No. 26,015 (Vt. Super. Ct. Jan. 9, 1976) with Lamm v. Amfac Mortgage Corp. 605 P.2d 429 (Ore. Ct. App. 1980) As is discussed, credit coverage under Virginia's Consumer Fraud Act is clear; and the inclusion of the sale of real estate "primarily for consumer, family and household purposes" was clear from the definition of "Goods" as real property. § 59.1-198(B).

purchases involving limited investment purposes. There is no suggestion whatsoever that the 1981 amendment in any way restricted pre-existing coverage.

The defendants' argument that non-purchase money loans secured by real estate are implicitly exluded as a result of the 1981 amendment, even if it made any sense in the context of the Act as a whole and in light of Glasby, should not be adopted without more explicit authority than they have presented. The court's analysis in State v. Brotherhood Bank & Trust, 649 P.2d 419 (Kan. Ct. App. 1982) demonstrates that restrictive readings of UDAP statutes are not to be undertaken without clear signals that that is what is intended. The Kansas UDAP statute had specifically included "money or credit" in the definition of its covered transactions. That language was deleted. However, the purpose of the deletion was unclear; it could have been considered redundant, since credit can be defined as intangible personal property; or they could have thought they had deleted credit from coverage by deletion of that language. The court said that, given the purposes of the UDAP statute and the need to interpret it liberally, they would not exclude credit transactions by implication. The legislature could have been specific if it intended that. Id. at 421-422.

Defendants further claim protection from the exclusions of §§ 59.1-199(C)[Truth in Lending] and 59.1-199(D)[regulated lenders.] This argument, too, comes to nought.

As to the Truth in Lending exclusion, the Virginia Supreme Court's decision on November 27, 1985 in Valley Acceptance

Secondly, the defendants cannot avail themselves of the exclusions of § 59.1-199(D)[regulated and supervised lenders]. The consumer transaction at issue was made by an unlicensed and unregulated lender not protected by that exclusion. Complaint ¶ D-1. (Cf: Valley Acceptance Corp. v. Glasby, supra, 337 S.E.2d 291). Thus this is precisely the kind of credit transaction which, absent UDAP, would have fallen through regulatory cracks; precisely the kind of credit transaction the Virginia Consumer Protection Act was designed to catch, p. 62, supra. The fact that the loans have been assigned does not alter that coverage. The consumer's rights under UDAP are fixed at the time the UDAP violation occurs; no privity between the plaintiff and defendant is required. The consumer's standing derives from his relationship to the transaction, not the defendant. Flenniken v. Longview Bank & Trust, 661 S.W.2d 705 (Tex. 1983). Unless defendants can establish that they are holders in due course, Section VIII-C, they took Landbank's liability for these transactions along with Landbank's rights.

Further, even if non-purchase money real estate credit is not subject to the Act, sales of services in conjunction with the loan, such as appraisal services and the purchase of insurance are. They are sales of services distinct from the credit, and are subject to the Act. Fortner v. Fannin Bank in Windom, 634 S.W.2d 74 (Tex. Civ. App. 1982). Consequently,

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(Cont.) Commissioners did not adopt the ALJ's recommended decision as to TIL, but his TIL position was effectively reinstated by the 5th Circuit, In Re USLIFE Corp., 599 F.2d 1387 (5th Cir. 1979)

VIII. PLAINTIFFS STATE A CLAIM UNDER THE VIRGINIA MONEY AND INTEREST STATUTE

A. The Enforceable Rate of Interest Must Account For Points and Excess or Fictitious Fees As Interest[31]

1. Computational Framework

Before considering whether the facts alleged in plaintiffs' complaint are sufficient to state a claim for usury, it is critical that all parties have a common understanding of exactly what the claim is. As both usury laws and Truth in Lending of necessity involve computational issues, it may be helpful in discussing the legal implications of the computational arguments to have an illustration of the way these different computational rules impact a specific transaction[32].

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[31]Defendants' brief deals separately with the issue of plaintiffs' claims as to points and to excessive MGI and appraisal fees. Because plaintiffs allege that both constitute interest, and are thus functionally indistinguishable in considering plaintiffs' usury claim, both are treated here. To the extent defendants deny any remedy is available against them, the discussions under Section VIII-B--D address those issues. (As to their claim that there is no usury penalty for excessive charges in violation of § 6.1-330.24 [hereinafter, all references will be to the subsections of § 6.1-330, unless otherwise specified], Def. Br. 38, plaintiffs would note that it is undermined somewhat by the express language of § 47, which nullifies loans with charges in excess of those permitted by § 16 and § 24. <u>See</u> also Shanks, "Practical Problems in the Application of Archaic Usury Statutes," 53 Va. L. Rev. 327, 336-339 (1967)[hereinafter Shanks]. With the main thrust of their contentions dealt with in the body of this Section, only one miscellaneous point need be addressed. They seek to graft the remedy from Article 6 for excessive late payments (§ 26) on to Article 5 as the remedy for excessive charges (§§ 23 & 24). Def. Br. 38 n. 14 That is not consonant with the statutory scheme nor the body of usury law in Virginia, and as to second mortgages, is specifically refuted by the language of § 47. See further discussion in this section generally.

[32]This loan is an example for illustrative purposes only, and is not intended to introduce facts as to any (Cont'd)

excluded from interest, and are not considered compensation for the loan[34] under the usury laws of Virginia. Consequently, under the Virginia usury scheme defining what is "interest" and what is not, only the points are interest, assuming the other charges conform to the statutory mandates. Therefore, to determine the allowable rate of return,[35] that portion of the face amount of the note which represents points must be excluded from principal. The statutes require that the amount of interest be derived by applying a rate to the "principal" of the loan. (§§ 16(E) and 37). While plaintiffs agree there is no statutory limit on the amount of points per se, they must be counted as interest in computing the rate of interest actually charged. Shanks, supra. at 337.[36]

(Note 33, cont'd) extent to which a borrower may be required to pay certain types of costs associated with loan closings clarifies for creditors that such costs, to the extent authorized, can be safely imposed and will not be considered interest. Id. at 337 n. 52. In view of traditional usury rules, applicable in Virginia, that no device or subterfuge is permitted to protect a lender where he takes more than the allowable interest, Carter v. Hook, 116 Va. 812 (1914); Bank of Radford v. Kirby, 100 Va. 498 (1902); Shanks, supra. at 335-339, the conditions set forth in such statutes define the allowable parameters for charges not denominated interest. (See also pp. 75, 77-78, infra.)

[34] Interest is compensation for the loan or use of money. Turner v. Turner, 85 Va. 379 (1885).

[35] See pp. 81-82, infra.

[36] See also Atlantic Trust & Deposit Co. v. Union Trust & Title Co., 110 Va. 286, 67 S.E. 182 (1909) [where a note stated that $70,000 was repayable at 6%, semiannually for 1 year, but where the actual agreement called for a commission of $1400 cash, the "legal effect of the actual contract (Cont'd).

loan, for example, while Virginia law permits a 2% service charge on second mortgages and the actual cost of mortgage guaranty insurance to be excluded from the computation of interest, TIL requires that they both be included in the TIL finance charge (and hence the TIL APR). Reg. Z. § 226.4(b)(2) & (3). Under TIL, appraisal fees may be excluded from the finance charge if they are "bona fide and reasonable" in amount, § 226.4(c)(7). Charges are reasonable if they are not inflated so as to conceal a hidden finance charge. Rohner, The Law of Truth in Lending, ¶ 3.03[2][a] at 3-30 -- 3-31.

Thus, in the instant transaction, assuming the appraisal fee is "bona fide and reasonable," the TIL finance charge would consist of the service charge, mortgage guaranty insurance, and points, in addition to the interest earned over time. A total of payments of $30,920.41, ($14,000 at 18% for 124 months) would break down into a TIL finance charge of $21,750.64, for a TIL-prescribed APR of 31.29%.[37]

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[37]However, it should be remembered that the disclosed TIL APR can be wrong, if, for example, the mortgage guaranty insurance was not included in its calculation, or if the appraisal fee contains a hidden finance charge. Under such circumstances, the use of a TIL-APR as an escape hatch is particularly troublesome. See pp. 86-88, _infra_.

Further, both the general usury statutes and special usury statutes are to be liberally construed, not strictly, "to avoid the mischief at which [they are] directed and to advance the remedy for which [they were] promulgated."[39]

The structure of the Virginia statute is important in applying it to a given transaction. A rate, which is the word use to describe the allowable compensation, by definition requires a calculation of the ratio between principal and interest. Black's Law Dictionary, 5th Ed. Words must be given their common meaning. Therefore, when compensation received is characterized by the law as interest, it as a mathematical necessity affects the ratio of principal and interest, and therefore the actual rate of return. Thus, a $70,000 note at 6% was not really a 6% return where it includes $1400 commission which the law at the time characterized as interest, Atlantic Trust & Deposit Co. v. Union Trust & Title Co., 110 Va. 286, 67 S.E. 182 (1901). A loan at 6% interest was not really a 6% loan, but in excess of that rate of return where the compensation involves 6% interest plus an option to buy land at 40% of its value, which the law considered further

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[39]Valley Accep. Corp. v. Glasby, supra, 337 S.E.2d at 295; Whitworth & Yancy v. Adams, supra. 26 Va. at 417. In the latter case, the court also notes that common law prohibited the charging of interest, which became legal only with the Statute of Henry VIII. Thus usury statutes are in derogation of common law only to the extent they allow interest, not to the extent they limit interest. Id. Thus, the general principle of strictly construing statutes in derogation of common law, Farish for Farish v. Courion, Inc., 754 F.2d 1111, 1115 (4th Cir. 1985) requires strict construction of the limits of allowable interest.

The "deregulation" merely replaced a statutorily prescribed rate with a contract rate. However, this was done in a statutory context which involves retaining the existing structure of the usury statute. There is still a statutorily defined rate "ceiling," though the numerical value of that rate is determined by reference to the agreement, rather than to a numerical rate set by statute; that agreed upon rate[41] nonetheless still is cast as a ceiling.

Notably, when "deregulating" the legislature also retained its provisions categorizing and quantifying other specific charges which are excludable from computation of interest, (i.e. principal). There is still a numerical limit on the amount of service charge which may be imposed, § 6.1-330.16(E) & § 6.1-330.23. Thus, if it is within that limit, such a service charge may still be excluded from computation as interest. The statute also retained limitations on those closing costs which a borrower could be required to repay, and provided that such charges as are authorized under the statute need not be considered as interest under the Money and Interest statute, § 23, § 24. Thus, while plaintiffs agree that prescribed charges may be excluded in determining the legality of a loan under § 23, they strongly take issue with defendants statement that "proscribed" charges, Def. Br. 38, may likewise be excluded.

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[41]As to what rate the parties agree upon, see pp. 81-82, <u>infra</u>.

the entire $14,000 face amount of the note is considered the principal to which the 18%-note rate is applied, the borrower's total of payments is $30,920.24. However, if the note rate is applied to the "principal" amount of the loan, as the law specifically states it must be, the interest earned over the 124 months is much less. Eighteen percent on a principal as defined by Virginia law of $9800 yields earned interest over 124 months of $11,844.28. When the 30 points ($4200) which the lender is free to charge, so long as he counts it as interest, is added to the earned interest ($11,844.28) and the principal ($9800), the borrowers' total of payments is $25,844.28. The difference between doing it according to the statutory scheme, and doing it in the manner in which plaintiffs allege these loans were done would, in this illustrative case, be a $5,075.96 overcharge over the full loan term, even without padded fees further increasing the overcharge.

The defendants urge the position that a disclosure on the TIL disclosure statement of an APR operates as a savings clause, or usury escape hatch. They apparently argue that the mortgage loan can be enforced at the TIL-APR, irrespective of what the interest rate on the note states.[42] See Def. Brief

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[42]The full text of the relevant statutes are as follows:

§ 6.1.-330.16(E): Any loan secured by a subordinate mortgage or deed of trust on such residential real estate with an initial maturity in excess of ten years and two months may be lawfully enforced at the interest rate stated therein on the principal amount of the loan forborne or contracted to be lent or forborne. Notwithstanding the foregoing, a service charge not exceeding two per centum of the amount of the loan may also be imposed. Disclosure of charges, not otherwise specified in the note, deed of trust, or mortgage, in an interest (Cont'd)

Virginia's first mortgage statute was "deregulated" in 1970 to authorize that such a mortgage could be enforced at the rate stated in the mortgage,[44] in an effort to alleviate a "drought in mortgage money." Edmonds, Virginia Law of Interest and Usury, 10 U. of Richmond L. Rev. 77, 82 (1975). In 1975, the Virginia legislature enacted a general rearrangement and recodification of the money and interest statutes. Va. Acts of Assembly 1975, ch. 448. By that time, five years after first mortgages were "deregulated" to allow for agreed upon interest, some uncertainty had arisen. As it was described by the Chairman of the Committee to the Code Commission responsible for the recodification at the time:

> Section 37 provides that a first deed of trust or first mortgage may be lawfully enforced at the interest rate stated in the contract. There has been some imprecision and perhaps indecision as to what constitutes the contract in which the interest rate must be stated. The contract for repayment is the note and while most prudent lenders insert the interest rate in both the note and deed of trust, it was thought that insertion of the rate in either the note or the deed of trust would comply with the statutes. A 1975 Senate amendment added the provision that disclosure of charges, which are not otherwise specified in the note, deed of trust or mortgage, in an interest disclosure statement pursuant to federal disclosure laws is sufficient compliance with section 37. Edmonds, supra. at 102-103.

When second mortgages later were deregulated the legislature adopted the same language already in use for first mortgages. Contrary to defendants assertions, in that historical context, the purpose of that language is very clear. Only if the note or security instrument does not state

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[44] Va. Acts of Assembly 1970, Ch. 38; codified at Va. Code § 6.1-319.1, recodified in relevant part at § 6.1-330.37.

(¶ H-147)[47]. To use the usury law, a remedial and protective law, to protect such deceptive and anticompetitive behavior is to turn both usury and TIL laws upon their head. Transactions under a usury statute permitting agreed-upon rates must be at least as strictly scrutinized as when there is a statutory numerical limit to assure that the borrower knew the rate to which he or she was agreeing. Usury statutes must be construed to effectuate their remedial purposes. Valley Acceptance Corp. v. Glasby, supra. 337 S.E.2d at 295.

It is especially proper to do so when the suggested counterinterpretation not only undermines the legitimate purposes, but leads to unacceptable and irrational results. Even a cursory examination of the distinctions between the Virginia Money and Interest statute and the Truth in Lending disclosure act shows the danger of comparing those apples and oranges in the manner in which defendants suggest. Further, an examination of the necessary implications of their suggested interpretation points out the implausible consequences of such an interpretation. To adopt the contortions which inherently flow from defendants' interpretation violates all rules of statutory construction, and the court should decline the invitation to twist the law into the knots suggested.

One problem with defendants' interpretation is that, given

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[47]As to the functional "inadequacy of federal disclosure rules to correct information imperfections," see Eskridge, One Hundred Years of Ineptitude: The Need for Mortgage Rules Consonant with the Economic and Psychological Dynamics of Home Sale on Loan Transaction," 70 Va. L. Rev. 1083, 1128 (1984).

It is not a favored construction to assume the legislature impliedly repealed all those long-standing elements of the usury scheme by that simple reference to the TIL disclosure statement. See R. Cross, Inc. v. City of Newport News, 217 Va. 202, 228 S.E.2d 113, 116 (1976). Further, it is a well-established rule that legistative enactments cannot be read "in a manner that will make a portion of it useless . . . [E]very act of the legislature should be read so as to give reasonable effect to every word and to promote the ability of the enactment to remedy the mischief at which it is directed." Jones v. Conwell, 314 S.E.2d 61, 64 (Va. 1984). The legislature also must be assumed to know, not only that they were leaving all that statutory language on the books, but that the law has always required that, in measuring the rate of charge a borrower is actually paying against the benchmark rate, all compensation which the law considers interest must be computed as such. See Wicks v. City of Charlottesville, 208 S.E.2d 752, 755 (Va. 2974), app. dis'd. 421 U.S. 901; Cape Henry Towers v. National Gypsum Co., 331 S.E. 2d 476, 479 (Va. 1985). All these rules of statutory construction lead to the eminently sensible conclusion that deregulation language merely changed the benchmark rate to an agreed rate, obtained by reference to the note or mortgage, unless it does not appear there. In that case, and only in that case, can the benchmark be obtained by reference to the TIL document.

Such a construction is even more persuasive when the function of TIL and usury laws are compared. Truth in Lending,

defendants allows a real interest/principal ratio which is neither the rate stated on the note or on the Truth in Lending disclosure statement. Can the TIL-APR be an escape hatch if the real return is somewhere in between the note rate and the APR, though it is nowhere agreed upon? A construction leading to such an irrational result is not to be countenanced. F.B.C. Stones, Inc. v. Duncan, 198 S.E.2d 595, 599 (Va. 1973).

Perhaps most telling is the irrationality of this interpretation in the situation where, as here alleged, fees are fraudulently padded, though in fact disclosed. The TIL-APR disclosed on the documents will be understated by TIL computational rules if, for example, the mortgage guaranty insurance is included in the amount financed, or if the appraisal fees or other costs listed in § 226.4(c)(7) contain hidden finance charges and are therefore not "reasonable and bona fide,"[49] as indeed plaintiffs allege is the case with one subclass of borrowers. Complaint e.g.¶ ¶ E-7(e), ¶ H-1(c). Can a TIL disclosure be an escape hatch even if it is wrong under TIL rules?[50] Again, that is an irrational

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[49]See p. 72, supra.

[50]If the TIL document is allowed to be used as a alternative applicable rate, there may be implications for the secondary mortgage market. To be negotiable, an instrument must be a "courier without luggage." If state law defines something apart from the note, (which is the document containing all the language designed to make it a negotiable instrument), as an "integral part of the loan" Smith v. U.S. Credit, supra. 801 F.2d at 664, which may establish the validity or invalidity of the note, will it constitute bad faith for prospective purchasers not to seek and examine that "integral" document? See VIII-C, infra.

B. Relief Under Virginia Usury Laws May Be Sought Against Defendants

Defendants seem to argue that borrowers cannot bring affirmative actions, but must purposely default in order to lure the obligee into a collection action, which the borrower only then may defend against with his or her usury claims. Def. Br. at 34. (The notion is somewhat strained in Virginia, which has non-judicial foreclosures and thus requires an affirmative action to stop a foreclosure in any case.) Neither Virginia nor federal law requires such gamesmanship; that is the purpose in authorizing declaratory relief. See, eg. Va. Code § 8.01-191.

Defendants argument that they are not proper defendants because Landbank, not they, received the fraudulent overcharges is disingenuous. Def. Br. 38. While it may have merit where such front-end charges are paid in cash at closing, these fraudulent charges form part of the face amount of the notes defendants hold. Thus the borrowers are paying these charges to defendants--with interest. Thus in collecting and seeking to enforce these notes, it is defendants who are taking and receiving usurious charges. Each payment containing usurious charges is a usurious transaction.[51] Whether each payment contains excessive charges is a question of fact relating to

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[51] Baker v. Lynchburg National Bank, 120 Va. 208, 220 (1917). Thus the two year statute of limitations runs from each payment containing those charges, and whether that is so is a question of fact. Id. Incidentally, t should be noted that the two-year limitation on recovery of penalties for usurious first mortgage loans provided by § 6.1-330.46 would not constitute a bar to the equitable claim for reformation of the contracts to prevent further payment of usury.

C. Whether Defendants Are Holders In Due Course Is a Question of Fact Not Determentable On A Motion To Dismiss

Defendants claim that they became holders in due course (HDC) by allegedly purchasing the Landbank loans in the secondary mortgage market. Def. Br. 40. Whether defendants are holders in due course is a question of fact, and the complaint alleges sufficient facts to establish agency, notice, or a lack of good faith, any of which would deny the holder in due course statuts. See Section IV D-E, supra. Further, once a claim to an instrument is established,[52] the person claiming to be a holder has the "burden of establishing that he...is in all respects a holder in due course." § 8.3-307(3). That burden must be met by defendants, and must be established by facts. For example, the defendants cannot be holders in due course unless they are holding negotiable instruments.[53] The defendants further must establish that they are in possession of the notes, which, if order paper rather than bearer paper, must have been indorsed to the defendants "on the instrument itself or on a paper so firmly affixed thereto as to become a part thereof." § 8.3-202(1) & (2). Transfer of order paper by a separate assignment agreement, rather than by prescribed indorsement does not consitute negotiation, and those who possess documents under such circumstances cannot be

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[52]As to whether borrowers can establish their claims in an affirmative action, see Section VIII-B, supra.

[53]§ 8.3-302 uses the term "instrument," in turn defined as "negotiable instrument," § 8.3-102(e). The requirements for a negotiable instrument are set forth in § 8.3-104. See n. 50, supra.

Plaintiffs have pled ample facts, which, if proved, would constitute willful ignorance. Whether the standard necessary to establish the requisite willful ignorance for HDC purposes is the same as standard to establish "willful ignorance" for the purposes of RICO is unclear, but it is unlikely it would be a greater standard. Plaintiffs have discussed at length those facts alleged in the complaint which would establish willful ignorance, and there is no need to repeat that discussion. See Section IV, _supra_. Further, plaintiffs have alleged facts which, in proven, could establish that defendants had created an agency relationship with Landbank, which, of course had actual knowledge of all the facts surrounding these transactions. See Section IV-E, supra. The agent's knowledge would constitute actual knowledge. §8.3-304(7) The complaint is more than sufficient to state a usury claim, and to cast doubt upon the investors' status as holders in due course.

while making the penalty for violation harsher and a greater deterrent." Id. (emphasis added)

This legislative action occurred against the backdrop of the adoption of the Uniform Commercial Code two years earlier, Va. Acts of Assembly, 1964, ch. 285. The U.C.C. provides that even holders in due course do not take an instrument free of certain defenses, including "such ...illegality of the transaction, as renders the obligation of the party a nullity." Va. Code § 8.3-305(2)(b). In Westervelt v. Gateway Financial Services, 464 A.2d 1203 (N.J. Super. Ch. 1973), the court noted that the "void and unenforceable" language of New Jersey's Secondary Mortgage Loan Act was passed subsequent to the adoption of the UCC, and that in using such language, the legislature "must have had its eye on the Code provision that subjects even holders in due course to the defense that the transaction was a nullity." Id at 1206. The legislature thus, by using such language in the Secondary Mortgage Act intended that a noncomplying second mortgage would be a nullity as that word is used in the U.C.C. Id. Furthermore, as the court notes, such an interpretation clearly furthers the protective purposes of the Second Mortgage Act. Id. The New Jersey court's analysis is compelling precedent in the interpretation of the similar provisions in § 47.

The defendants seemingly try to avoid this result by citing cases which state that usurious contracts are "for illegal consideration." Def. Br. 34-35. However, the cases cited do not support that argument. Prior to 1873, Virginia's general

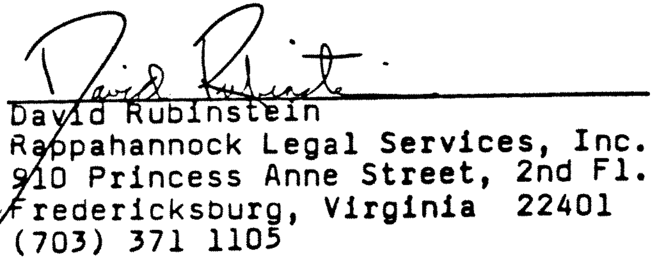
than "illegal" even a holder in due course cannot enforce it. Lynchburg, supra. at 659; Moore v. Potomac Savings Bank, 160 Va. 597, 602-603 (1933). See also Glassman v. F.D.I.C., 210 Va. 650, 652 (1970). As legislatures are presumed to know the law, Cape Henry Towers v. National Gypsum Co., supra, 331 S.E.2d at 479, this clear explication of Virginia usury laws, coupled with the enactment of the U.C.C. two years earlier, can only lead to the conclusion that the use of the phrase null and void was intentional and purposeful. Given the protective purpose of the Second Mortgage Act, the Virginia legislature, just like the New Jersey legislature in the same circumstances, did so to ensure the Act's ends were met.

The defendants attempt to further evade the effect of the nullifying provisions by stating that the penalty is "directed only at the lender and assignees 'who are agents or principals of the lender.'" Def. Br. 35. On a motion to dismiss, even assuming the interpretation is correct, this availeth defendants nothing, for whether they are "agents or principals" of Landbank is a question of fact. Plaintiffs complaint contains ample factual allegations, which, if proven, could establish the character of defendants as Landbank's principals for the purposes of these loans. See Section IV-E, supra

More importantly, the language is quoted out of context. The section reads in relevant part,

> Any contract, note, mortgage, or deed of trust made or received and providing for interest charges in excess of those permitted by §§ 6.1-330.16 and 6.1-330.24, except as hereinafter provided, shall be null and void and unenforceable by the lender or by his assignees, who are agents or principals of the lender.

Dated: June 8, 1987



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