THE PRESENT STATUS OF CONSUMER FRAUD LITIGATION

Thomas J. Methvin, Managing Shareholder
Beasley, Allen, Crow, Methvin, Portis & Miles, P.C.
Montgomery, Alabama

INTRODUCTION

The two main areas of consumer fraud that will be addressed in this paper are the victimization of consumers by the financial services industry, more commonly referred to as predatory lending, and the types of fraud perpetrated on consumers in the sale of insurance. This paper will also discuss both industries attempt at immunity by requiring pre-dispute, binding arbitration.

I. What is *Predatory Lending* ?

Although no statute or regulation defines the term "predatory lending," industry observers generally describe this type of behavior to include the theories discussed below. It has been estimated that predatory lending costs consumers nationwide $9.1 billion, annually.[1]

1. Equity-Stripping: The making of unaffordable loans based solely upon the home value rather than a borrower's ability to pay.[2] Predatory Lenders often loan money to consumers in amounts

[1] Coalition for Responsible Lending. 10/30/2001.

[2] Household International, Inc., SEC Filings, *Form 8-K*, January 21, 2003.

 Copyright © 2007 Beasley Allen, et al. All rights reserved.

larger than what they would normally qualify, and for which they cannot easily pay back. Lenders do this because they know with someone's house as collateral, they can essentially extort any amount of money they want by threatening foreclosure. Similarly, many lenders also loan homeowners money well in excess of their "loan to value" ratio of their home. This means that if the home is worth $100,000, they may loan you $125,000. This type of loan typically locks the borrower into a high-interest loan and makes it almost impossible for them to refinance. Often times, even if a person is forced into foreclosure as a result of defaulting on one of these loans, the borrower is still hassled for the remaining deficiency on the mortgage.

2. Flipping: The inducement of the borrower to refinance a loan repeatedly in order to charge higher points, fees and credit insurance premiums. This constant refinancing keeps the borrower paying back more and more interest and less of the principal.[3] In a consumer loan context, it is not uncommon for predatory lenders to

---

[3] Id.; *See also* Prepared Statement of the Federal Trade Commission before the House Committee on Banking and Financial Services, *Predatory Lending Practices in the Subprime Industry*. May 24, 2000.

www.beasleyallen.com Copyright © 2007 Beasley Allen, et al. All rights reserved.

require a borrower to refinance their loans when they are simply looking for a smaller, separate loan. In many cases, the borrower gets little or no money, but is still charged exorbitant fees and credit insurance premiums.

3. Insurance Packing: The requirement that a borrower purchase credit-insurance as a prerequisite to obtaining the requested loan.[4] This predatory act directly violates many state and federal banking and insurance regulations.[5] It is commonly known throughout the industry that the insurance that is forced upon the borrowers is grossly inflated and often useless.[6] If a borrower were allowed to purchase insurance from a legitimate insurance agent, they would more than likely be able to buy significantly more coverage at a cheaper price.

---

[4] Testimony of "Jim Dough" before the United States Senate Special Committee on Aging Hearing. *"Equity Predators: Stripping, Flipping and Packing Their way to Profits."* March 16, 1998. *See also* In the Matter of The Money Tree, Inc., 123 F.T.C. 1187 (1997).

[5] 65 FR § 75822 ("(4) The depository institution may not condition an extension of credit on the consumer's purchase of an insurance product or annuity from the depository institution or from any of its affiliates, or on the consumer's agreement not to obtain, or a prohibition on the consumer from obtaining, an insurance product or annuity from an unaffiliated entity. These disclosures must be made *orally* AND *in writing* before the completion of the sale of insurance product or annuity, in the case of paragraph (4) above, at the time the consumer applies for an extension of credit."(emphasis and bold facing added)).

[6] *Credit Insurance overcharges consumers $2.5 billion dollar annually*. A Report by The Consumer Federation of America and The Center for Economic Justice. November 2001. *See also* "Consumer groups accuse credit insurance companies of overcharging." http://www.insure.com/life/creditinsurance1101.html <last visited November 1, 2003>.

www.beasleyallen.com Copyright © 2007 Beasley Allen, et al. All rights reserved.

To make matters worse, it is common for many unsuspecting borrowers to be sold credit insurance containing exclusionary provisions that prevent them from ever being able to collect on the insurance in the event they wanted to use it. In terms of credit life insurance, one scam on elderly borrowers is to require the purchase despite the fact that the underwriting criteria will not allow the policy to be issued to persons older than 65. Another, perhaps even more egregious scam, is when persons with preexisting disabilities, and/or who are unemployed, are sold credit disability insurance. This also allows the insurance company to deny their claim, if one is ever made. Many of the individuals that we have seen in this category suffer from particularly severe mental disabilities and/or levels of retardation.

Lastly, another credit product that is sold in conjunction with predatory loans is credit-property insurance. This is insurance sold to cover the collateral securing the loan. It is not mortgage insurance. The abuse comes in the type of property that is required to secure the loans. The collateral that is required is literally household "junk" such as silverware, alarm clocks, exercise equipment, fishing poles, VCR's, etc. Many ex-employees have testified under oath that if a borrower defaults on a loan, the lender has no intention of ever repossessing any

www.beasleyallen.com Copyright © 2007 Beasley Allen, et al. All rights reserved.

of this junk. In fact, many branch managers will say that it is cost prohibitive to even pay someone to attempt to repossess these household items. The only reason the lenders require this type of collateral is so they can then sell the overpriced insurance to cover this collateral. In contrast to credit life and credit disability insurance, a lender can require that a borrower purchase insurance to protect the collateral securing the loan. The lender can't require the borrower to buy the insurance from any specific insurance company. In practice, however, lenders do require borrowers to buy from an insurance company that is paying the lender a hefty commission.

4. Pre-Payment Penalty: A fee charged to the borrower if they refinance with another lender, or sometimes even the same lender. This fee is designed to keep the customer "locked-in" to a high interest rate and/or predatory mortgage. Often, the pre-payment penalty incurred in paying off a high-interest loan takes away any savings associated with refinancing a mortgage at a lower interest rate.

 Copyright © 2007 Beasley Allen, et al. All rights reserved.

5. Hidden Balloon Payments : A system set up where the lender typically hides or fails to inform the borrower that her scheduled payments are primarily being applied to interest and very little on principal. When the borrower goes to pay off the debt, much to her amazement, she still has the majority of the principal remaining. At this point the homeowner either loses the house through foreclosure, or is forced to refinance the remaining balance at even more unfavorable terms.

6. Steering: Where lenders take borrowers with good credit and "steer" them to a subprime lending subsidiaries allowing the loan to be issued a loan with a higher-interest rate. In some cases, applicants with qualifying credit are denied loans, and then told that if they apply with a subprime lender, they are more likely to be approved. Of course, the subprime lender will do the deal at a much higher interest rate.

7. Paying Points to Buy Down the Interest Rate: Paying points to buy down an interest rate on a conventional mortgage can be a good way to reduce the amount of interest paid out over the life of

www.beasleyallen.com Copyright © 2007 Beasley Allen, et al. All rights reserved.

the loan. However, it is not much of a deal when the "buy down" points that are paid do not equal a comparable rate reduction. Unfortunately, with some predatory lenders, there is no interest rate reduction at all.

II. Who are the *victims* of predatory lending ?

It has been reported that as many as 12 million households in the United States do not have any type of relationship with a traditional banking institution.[7] This means that no one in those households has a checking account, savings account or even cashes their paychecks at a mainstream institution. More and more, these households are traditionally inhabited by the elderly, poor and are minority.[8] In a 1995 Federal Reserve Survey of Consumer Finances, 1/3 of African-American households and 29 % of Hispanic households did not use traditional banking services.[9]

The lack of actual banking institutions in predominately poor and minority communities is one reason for the lack of access to

---

[7] James Carr, Jenny Schuetz & Lopa Kolluri, *Financial Services in Distressed Communities: Issues and Answers*. Fannie Mae Foundation. August 2001.

[8] Association of Community Organizations for Reform Now ("ACORN"), *Separate and Unequal, Predatory Lending in America*. November 2001.

[9] See footnote 6.

 Copyright © 2007 Beasley Allen, et al. All rights reserved.

mainstream financial alternatives. However, another barrier is the minimum fees and requirements imposed on the customers who use, or try to use those services.[10] More and more, banks are charging very high minimum fees for checking and banking services. These are services that use to be free, or at least provided at a nominal charge.

In contrast to the lack of mainstream, prime lending institutions, there are no shortages of subprime lenders operating in the poor and minority communities. Unfortunately, these “fringe” financial service providers do not offer checking accounts or savings accounts and therefore have long-term, destabilizing effect on the borrowers. The services the “fringe” lenders offer are associated with higher fees and higher penalties. Even in situations where a borrower does have access to traditional mortgage or banking products, those products are also offered at an excessive rate. For example, late fees, overdraft charges, NSF charges, and minimum balance requirement penalties are more than what a prime customer would have to pay.

The lack of adequate financial savings products keeps people in an unforgiving “cash-economy.” This situation has long-term consequences on a borrower’s ability to accumulate assets, minimize

[10] See footnote 6.

Copyright © 2007 Beasley Allen, et al. All rights reserved.

their debt, and use their limited resources in such a way as to break the cycle of dependence on these subprime agents. When borrowers are faced with real world needs such as child rearing expenses, medical needs and other bills it takes to live day-to-day, the choice between borrowing money at exorbitant rates, or doing without, really isn't a choice at all.

As many publications have made clear, the disparity associated with predatory lending practices is most evident in its application along racial lines.[11] One study reports that in African-American neighborhoods, high-cost subprime loans accounted for 51 percent of home loans in 1998, compared with 9 percent in white areas.[12] Even more shocking is that customers in high-income African-American communities are six times more likely to have a subprime loan than homeowners in high-income white neighborhoods.[13]

III. The efforts to stop predatory lending.

---

[11] Paul Beckett, Critics Scrutinize Citigroup's Lending Practices to Minorities. Wall Street Journal. November 17, 2000 (online edition).

[12] See footnote 6.

[13] *Id.*; see also *Citigroup: Reinventing Redlining, An Analysis of Lending and Branch Disparities for Citigroup's Prime and Subprime Lending Affiliates*. National Training and Information Center. June 2002.

www.beasleyallen.com Copyright © 2007 Beasley Allen, et al. All rights reserved.

Predatory lenders come in all shapes and sizes - from local pawnshops that double as a quick cash marts, to rent-to-own stores, to multinational financial conglomerates whose stock is traded on the major exchanges. Let there be no misunderstanding, predatory lending is a big and profitable business. Although the number of credit unions, banks, and thrifts has been decreasing over the last few years, the number of check-cashing outlets has doubled.[14] In April 2000, a report commissioned by the United States Treasury Department revealed that there were over 11,00 check-cashing outlets servicing more than 180 million checks, worth roughly $60 billion.[15] In 1999, there were over 8,000 payday-lending operations nationwide, compared to just 300 stores, seven years prior.[16] In the subprime lending market, the profits being made are so enormous that the larger prime lending institutions are buying up all of the smaller operations in an effort to boost their coveted market share.[17]

---

[14] *Id*.

[15] *Id*.

[16] *Id*.

[17] Michael Hudson, *The New Loan Sharks*, Southern Exposure. Summer 2003.(Describes what he calls the "poverty industry". Also describes Citigroup's efforts to maximize their market share in the predatory lending industry by purchasing or acquired accounts from several other predatory lending companies.)

www.beasleyallen.com Copyright © 2007 Beasley Allen, et al. All rights reserved.

Although it has been a long-time in coming, several government entities have cracked down on the major predatory lenders and hit them where it hurts, their pocket books. In 2001, the Federal Trade Commission ("FTC") sued Citigroup, Inc. and The Associates for its predatory lending practices and fined them $215 Million. Similarly, the Insurance Commissioner of the State of Georgia fined The Associates Financial Life Insurance Company, a subsidiary of the lending company, $147,000 for issuing credit-life insurance policies that were contrary to state law.[18]

More recently, in 2002 Household International, Inc. has settled charges related to its predatory lending practices in its mortgage line of business to the tune of $484 Million.[19] This settlement entered into with the states attorneys general only deals with the company's mortgage and equity line products, and does not deal with their smaller consumer loans. Household International, Inc. also settled a smaller class action, containing similar allegations as the attorney's

---

[18] www.insure.com/states/ga/life/assocfinancial1099.html <last visited November 1, 2003>.

[19] www.household.com/corp/hi_pr_press_release180.jsp <last visited November 1, 2003>; see also www.household.com/corp/hi_pr_press_release135.jsp <last visited November 1, 2003> (In addition to the nationwide settlement, in 2002, the State of California fined Household $8.9 million for overcharges on fees).

www.beasleyallen.com Copyright © 2007 Beasley Allen, et al. All rights reserved.

general action, that included various forms of relief such as the restructuring of some mortgages, all totaling more than $32 million.

In January 2003, the State of California sued Wells-Fargo for $38.8 million in overcharges that the company collected from California residents.[20] In that lawsuit, the California Department of Corporations described Wells-Fargo's conduct as "willful." This characterization was based upon the fact that the state had fined Wells-Fargo for the same predatory actions in both 2001and 2002. In February 2003, the State of California went after Wells-Fargo again for separate predatory lending violations stemming from the company's refusal to make proper refunds to its mortgage customers.[21]

In 2000, a lawsuit was filed against Wells-Fargo[22] over an appalling incident involving information they was being disseminated about various racial and ethnic groups. The underlying action stemmed from a "community calendar" that Wells-Fargo placed on its

---

[20] www.corp.ca.gov/pressrel/03/corp/nr0302.htm <last visited November 1, 2003>.

[21] *Id.*

[22] The case was originally filed against Norwest Financial and subsequently amended to add Wells-Fargo as a defendant.

www.beasleyallen.com Copyright © 2007 Beasley Allen, et al. All rights reserved.

internet website.[23] The alleged purpose of this "community calendar" was to provide data on neighborhood demographics, sorted by zip codes. The lawsuit claimed that negative aspects of predominately Latino and African-American neighborhoods were emphasized while positive aspects of those areas were down played. In white neighborhoods, just the opposite was true.[24]

In reviewing the information said to be on the website, it easy to see how several individuals were offended. In Wells Fargo's description of neighborhoods that received the designation "low income," the website stated that those communities were "distressed," that 86 % of the residents tended to be black, and "tend to purchase fast food and takeout from chicken restaurants." Other information appearing on the website describing "distressed neighborhoods" was that 40% of the residents received some type of public assistance and 25% were unemployed.[25]

Without even discussing the appropriateness of the information on the website, or analyzing the methodology in which it was

---

[23] USA Today. *"Loan site accused of ghettoizing minorities."* June 22, 2000.; *See also* Carl D. Holcombe. *"Wells Fargo faces lawsuit: Racial steering, lending discrimination claimed."* Inman News Features. June 22, 2000.

[24] *Id.*

[25] *Id.*

www.beasleyallen.com Copyright © 2007 Beasley Allen, et al. All rights reserved.

extracted, or even the accuracy of the information, this raw display of statistical data proves that predatory lenders look at racial and ethnic information when deciding on how and where to offer their lending products. These predatory lenders obviously want to know the source of the incomes of their "target market," and that target market's spending habits. Today's economy is information driven as evidenced by the courtroom and congressional battles over the national "do-no-call" lists, privacy act disclosures and internet spamming. It is not only the acquisition of this information that is big business, but the practical use of the information. It is the use of the information that allows predatory lenders to develop and create the lending products borrowers desperately need, at exorbitant prices and fees they cannot reasonably afford. And, because they know they "need" the access to the lending products, they can demand that they pay top dollar for them.

So far, Washington Mutual Finance[26] and American General Finance have escaped the regulatory grasp of any particular agency. Those experienced in the industry would argue that their escape is

[26] Washington Mutual did buy Long Beach Mortgage Company who was previously sued and entered into a settlement with the Department of Justice, Civil Rights Division. www.usdoj.gov/crt/housing/documents/longbeachsettle.htm <last visited November 1, 2003>.

www.beasleyallen.com Copyright © 2007 Beasley Allen, et al. All rights reserved.

more a function of a lack of resources and budgetary constraints facing the regulators and oversight agencies that must track the guilty parties. However, Washington Mutual and American General have not been so lucky in avoiding lawsuits brought by private litigants.

In 2001, Washington Mutual Financial was hit with a jury verdict of $71 million for allegations of "flipping" and "packing" consumer loans.[27] In 1999, American General Finance was ordered by a judge, sitting without a jury, to pay over $167 million concerning allegations involving predatory practices in a door-to-door financing scheme.[28] Presently, both of these companies are defending thousands of cases around the country wherein their customers have alleged many of the same predatory acts described herein. Sadly, because of arbitration agreements inserted into the loan documents the borrowers were forced to sign, a jury or any members of the public will never hear many of those claims. Even worse, many claims will never even be asserted because the borrowers will not be able to pay the up front filing fees associated with starting an arbitration.

[27] www.mfep.org/Noteworthy.htm <lasted visited November 1, 2003>.

[28] *Id.*

Copyright © 2007 Beasley Allen, et al. All rights reserved.

IV. What else can be done to stop predatory lenders ?

The answer to this predatory lending question involves the same answer as to most of our social problems … education, education, education…regulation. Financial literacy, or the lack thereof, has been recognized by some of the stalwarts of the financial industry as being public enemy number one.[29] In one defining speech, before a United States Senate Committee, Federal Reserve Chairman Alan Greenspan stated that,

> In considering means to improve the financial status of families, education can play a critical role by equipping consumers with the knowledge required to make wise decisions when choosing among the myriad of financial products and providers. This is especially the case for populations that have traditionally been underserved by our financial system. In particular, financial literacy education may help to prevent vulnerable consumers from becoming entangled in financially devastating credit arrangements. In the quest to stem the occurrence of abusive, and at times illegal, lending practices, regulators, consumer advocates, and policymakers all agree that consumer education is essential to combating predatory lending. An informed borrower is simply less vulnerable to fraud and abuse. Financial literacy can empower consumers to be better shoppers, allowing them to obtain goods and services at lower cost. This effectively increases their household budgets, providing more opportunity to consume and save or invest. In addition, comprehensive education can help provide individuals with the financial knowledge necessary to create household budgets, initiate savings plans, manage debt, and make strategic investment decisions for their retirement or their children's education. Having these basic financial planning skills can help families to meet their

[29] Alan Greenspan, Chairman of The Federal Reserve Board. *Financial Literacy*. Testimony before the United States Senate Committee on Banking, Housing and Urban Affairs. February 5, 2002.

www.beasleyallen.com Copyright © 2007 Beasley Allen, et al. All rights reserved.

> near-term obligations and to maximize their longer-term financial well-being.

Many of the governmental regulatory agencies are doing their part to educate the public on predatory lending and how to properly manage the family's personal finances. In 1994, Congress attempted to address some of the problems by passing the Home Loan Protection Act. Since that time, Congress has also held numerous hearings wherein they have listened to industry insiders and ex-employees describe the terrible effects that predatory lending has on the country's most vulnerable citizens. In addition to Congressional action, the Federal Reserve Board and the Office of the Comptroller of Currency ("OCC") have proposed banking regulations that cover "flipping" and "packing" activities. Even more locally, many states and cities have begun to see the value in enacting predatory lending laws. However, there is a caveat here.

Recently, the OCC has issued a troubling opinion wherein it has taken the position that its new regulations preempt all state laws that impose more restrictive requirements on lending. This preemption applies to National Banks who may have subprime lending subsidiaries. As discussed above, some of the largest banks are

www.beasleyallen.com Copyright © 2007 Beasley Allen, et al. All rights reserved.

involved in predatory lending via their subsidiaries. Although it is perhaps too early to tell, these new regulations will at times hurt consumers by limiting what state banking departments can do to these national banks. One thing is obvious, these predatory lenders will no longer have to answer to as many government regulators, or allow them to inspect their books. That is certainly not good for consumers.

On the private front, associations such as the Social Investment Forum Foundation, Co-op America, The National Consumer Law Center, the American Association of Retired Persons ("AARP"), the Association of Community Organizations for Reform Now ("ACORN") and various other consumer-oriented groups are developing programs and dispersing literature on these predatory lending topics. One organization, ACORN, has started raising awareness and trying to change predatory lending practices by organizing protests at the annual shareholder meetings of some of the largest predatory lenders.

Research has shown that community based organizations are the best equipped to deliver financial education services because they understand the particular financial education needs of their communities and have staff who can communicate comfortably with

 Copyright © 2007 Beasley Allen, et al. All rights reserved.

individuals.[30] These two groups, both public and private, are integral in protecting the public at large from predatory lending practices. However, what is essentially required, which should come as no surprise, are curriculum changes in America's schools and a focus on the way we teach personal financial decisions.[31]

Beyond education, the only thing that predatory lenders understand is "bottom-line' profit. Therefore, it is imperative to make it "unprofitable" to abuse the most vulnerable members of our society. In some instances, that can be achieved by better enforcement of the laws that are already on the books. Better enforcement typically means allocating the necessary resources to get the job done properly. Similarly, the granting of more regulatory authority for governmental

---

[30] John P. Caskey. *"Reaching Out to the Unbanked."* Center for Social Development, Washington University in St. Louis. September 22, 2000.

[31] Paul O'Neil, Secretary of the Treasurer, *"The State of Financial Literacy and Education in America."* Testimony before the United States Senate Committee on Banking, Housing and Urban Affairs. February 5, 2002.

Secretary O'Neil stated, in pertinent that,

> No better venue exists for us to reach such a large segment of the population than through our schools. No better mechanism exists for providing our nation's youth with the educational building blocks they will need to become competent consumers and managers of household wealth. By beginning the financial education process early, we can equip our youth with a foundation for making sound financial decisions throughout their lives. Indeed, in those states that have begun requiring personal financial education in high school, research shows that high school graduates have higher savings rates and higher levels of net-worth.

Copyright © 2007 Beasley Allen, et al. All rights reserved.

agencies assigned to oversee these corporations can empower those departments to question company executives, hold hearings and examine corporate records for abuse.

The last way to remove the profitability of predatory lending is to make the specific actions "illegal". Most people are surprised to learn that many of the actions of predatory lenders are perfectly legal. It is true that although there are maximum rates and fees that many lenders can charge for certain items, some of those caps depend on the type of loan. Moreover, many of the "limits" on fees are so high, and bear no association to the actual "risk" involved, that the government is essentially sanctioning the victimization of the most vulnerable segments of its population. As such, more consumer protection legislation must be passed that does not give lenders *carte blanche* authority to charge whatever they want. Instead, the charges should bear a reasonable relationship to the "risk" the company is actually assuming.

V. THE INSURANCE SCAMS

Similar to the predatory lending industry, many insurance companies seek to victimize the most vulnerable citizens in our

Copyright © 2007 Beasley Allen, et al. All rights reserved.

society. Through these scams, insurance companies extract hard earned money from responsible individuals whose only desire is to take care of their loved ones in a time of need.

1. Bad Faith/Refusal to Pay Cases – Perhaps the most common fraudulent and illegitimate insurance practice concerning insurance companies is the refusal to pay a claim that is clearly "covered" within the terms of the policy. It is amazing at the lengths some insurance companies will go to prevent having to pay honest claims. Our firm is presently pursuing a large number of cases against what is perhaps the worst company for paying honest claims.

Unum/Provident & Accident Insurance Company is the largest issuer of disability insurance policies in the United States. Through our efforts, and the effort of others, we have uncovered numerous ex-employees, including company doctors who actually reviewed and denied claims, which state management told them that they had to either deny claims and/or terminate existing claims, so that the company could make its profit goals.

Copyright © 2007 Beasley Allen, et al. All rights reserved.

This company has been featured on the investigative reporting show *60 Minutes*, where many of these same people were interviewed.[32]

Some ex-employees stated that in an exhaustive effort to deny claims, some were often reviewed as many as 20 times to find a way of not paying it. Similarly, when an employee could not find a reason to deny a claim, it would often be discussed in a group meeting to see if they could "brainstorm" about finding a way to deny the claim. One ex-employee estimated that they were denying anywhere from 7 to 14 million dollars a month in legitimate claims.

As you would expect, over the last couple of years, UNUM/Provident has had several multi-million dollar verdicts against it. One California jury awarded an optometrist $31 million dollars for the denial of his claim. Apparently, despite medical testimony to the contrary, UNUM/Provident believed that this physician could still perform delicate eye surgery while his hands shook from the Parkinson's disease.

In response to these lawsuits, UNUM/Provident has turned to another deceitful practice – they now insert mandatory binding arbitration clauses in their insurance contracts. This is a growing trend in all industries that will be discussed later in this paper.

---

[32] http://www.denied-disability-claim.com/ <last visited May 10, 2004> (click on hyperlink to 60 Minutes investigative report).

www.beasleyallen.com Copyright © 2007 Beasley Allen, et al. All rights reserved.

2. “Death-Spiral” / “Pricing-Out” of Health Insurance Policies cases[33] – This practice involves a complicated process where companies move their unhealthy policyholders from their original risk group to another risk group that has all, or a greater number of unhealthy policyholders. This higher risk group in-turn, justifies higher rates and/or rate increases. As the insurance company continues to pull unhealthy policyholders out of certain risk pools and joins them with other unhealthy policyholders, the company effectively “prices-out” the more risky policyholders and is left insuring only health policyholders who file little or no claims. This insidious practice has left thousands of people throughout this country without health insurance because they are unable to pay the artificially inflated premiums. Often, by the time they are priced out of their health insurance coverage, they are essentially uninsurable and cannot find replacement coverage.

A similar fraudulent practice often occurs with the sale of nursing home policies, home healthcare policies, and long-term care policies to the elderly. This “bait and switch” routine begins with an “actuarially defective” price that sets a premium too low to fund the term of the policy. This inevitable deficiency causes the need for a premium hikes later in the

[33] http://www.beasleyallen.com/cases/consumer fraud/death_spiral.htm <last visited May 10, 2004> (lists companies being pursued on death spiral theory).

 Copyright © 2007 Beasley Allen, et al. All rights reserved.

term of the policy, when the person is older, often on a more limited income, and often when they need the policy the most. Again, these actuarial games price out the risk for the insurance companies, ensuring large windfalls, at the expense of the loyal policyholder who always paid their premiums.

3. Insurance sales to Medicaid Recipients[34] –Several insurance companies are targeting and selling limited health insurance policies to citizens who are elderly and/or have a very low annual income and receive Medicaid benefits. These limited insurance products essentially provide the same benefits that Medicaid already provides. Therefore, the coverage is essentially worthless and never gets used. It is a windfall for the insurance companies with almost no risk.

4. "Vanishing Premium" cases[35] – These cases involve the customer being falsely told that if they make their premium payments for a specified term (for example 10 years), they will never have to make another premium payment after that date. What is often not told to the policyholder is that this benefit is interest rate sensitive and that the premium does not

[34] http://www.beasleyallen.com/cases/consumer_fraud/ins_sales_medicaid_recip.htm <last visited May 10, 2004> (lists companies being pursued under this theory).

[35] http://www.beasleyallen.com/cases/consumer_fraud/vanishing_premium.htm <last visited May 10, 2004> (lists companies being pursued under this theory).

Copyright © 2007 Beasley Allen, et al. All rights reserved.

"vanish." Instead, after the specified term, additional premiums are needed to maintain the benefits of the policy. Although these cases seem like they have been around for years, there is still a good bit of litigation surrounding these cases. Many of the early policies that were sold are just now reaching the "vanish" date shown on the policy and therefore are causing the policyholders to pay additional premiums.

5. "Race-Based" Premiums set on insurance policies[36] – From the 1930s until late 1970s, at least 30 insurance companies engaged in the shameful practice of charging "race based insurance premiums" on so called "burial policies" and/or "industrial life policies." This involved a national scheme to unlawfully charge African-Americans higher insurance premiums based solely on the color of their skin. Many of these companies further compounded the problem when they took steps to cover this practice up. Some companies continued to charge this racist premium until the 1980s.

VI. ARBITRATION : An Attempt at Immunity from Lawsuits.

Although not a practice limited to lending and insurance industries, mandatory, binding arbitration agreements are the equivalent of

---

[36] http://www.beasleyallen.com/cases/consumer fraud/race_based_ins.htm <last visited May 10, 2004> (lists companies being pursued under this theory).

www.beasleyallen.com Copyright © 2007 Beasley Allen, et al. All rights reserved.

“privatizing” a consumer’s remedy that is typically his/her only defense against corporate wrong doing. This privatization process is considerably slanted in favor of the corporation and most often operates to protect the wrongdoer instead of punishing them. Many consumer activists have argued that arbitration agreements should not apply to disputes between consumer and businesses. The sound reasoning behind this suggestion is two fold.

First, in many cases the arbitration provider has an economic incentive to rule in the party’s favor that drafts the contracts. It is not a stretch of the imagination to presume that if an arbitration provider rules against a certain company too many times in consumer-related disputes, they will simply redraft their form contracts and insert another arbitration provider.

The second reasoning that consumers will almost never be on equal footing with a business in an arbitration context is that consumers cannot afford the outrageous cost associated with the start up the arbitration proceeding. In many instances the exorbitant “filing” fee is just that, it pays for the client to be able to “file” their claims in the form of a pleading. If the client wants a hearing on any matter, it is generally an extra charge each time. If the client wants the arbitrator to resolve a preliminary dispute, it is an extra charge. If a party wants to amend or supplement pleadings, extra

www.beasleyallen.com Copyright © 2007 Beasley Allen, et al. All rights reserved.

charge. And, if you want to actually try your case on the merits, and actually put on witnesses instead of submitting the issues on briefs, you guessed it . . .extra charge. In this type of system, it is easy to see how corporations who are already unscrupulous, can abuse the system and make it such that no consumer can come out ahead, or even be "made whole."

Amazingly, many arbitration provisions do not prevent the corporation from taking the cheaper alternative of going to court and enforcing their rights against the customer, *i.e.*, if the customer defaults on a loan and/or the business needs to repossess collateral. Many courts around the country have consistently upheld these "one-sided" arbitration agreements as valid and enforceable.

Another drawback of arbitration for consumers is that the preparation of their case is severely hampered by the extremely limited discovery allowed and the private nature associated with that discovery. This limited discovery is problematic for two main reasons. First, under recent U.S. Supreme Court precedent, due process concerns require a sufficient evidentiary showing to be made in order to sustain an award of punitive damages.[37] Traditionally the way to get this evidence, often evidence of

[37] *State Farm Mut. Auto. Ins. Co. v. Campbell*, 538 U.S. 408, 123 S.Ct. 1513, 155 L.Ed.2d 585 (2003); see also *BMW of North America, Inc. v. Gore,* 517 U.S. 559, 116 S.Ct. 1589, 134 L.Ed.2d 809 (1996).

www.beasleyallen.com Copyright © 2007 Beasley Allen, et al. All rights reserved.

other occurrences, is through discovery. Absent such an evidentiary showing, a court is more likely to reduce or vacate an arbitrator's award.

This new due process concern causes problem for plaintiffs. Typically, a court only reviews an arbitrator's award in cases of a manifest disregard for the law and/or a bias is shown on the part of the arbitrator. These are very difficult grounds to establish and almost always result in the award being affirmed. However, based upon the constitutional due process argument in *Campbell*, there is now an additional ground for review. This additional ground only operates to the defendant's benefit.

The second major problem with the limited discovery received in arbitration is that all of the information is traditionally private. The private nature of discovery means that if a corporation is ever punished for an illegal practice or admits a product defect, there is a good chance no one else will find out about it. The open nature of the court system has long been a way to check the abusiveness of corporations and protect lives by shedding light on dangerous products.

Although most of the news about arbitration is generally bad for consumers, not all of it is bad. In a recent development, two of the largest home loan giants, Fannie Mae and Freddie Mac, have stated that they will no longer invest in mortgages that force borrowers to sign arbitration clauses.

www.beasleyallen.com Copyright © 2007 Beasley Allen, et al. All rights reserved.

Although a laudable move, many analysts believe this policy change is more of a response to recent accounting crises within these organizations. It has yet to be seen whether this move will cause other lenders to follow suit. We have yet to see any insurance company stand up and take the high road.

Because of recent arbitration rulings by the United States Supreme Court, the only immediate answer to the arbitration problem is with Congressional action. Unfortunately, that does not appear to be likely. With the enormous sums of money at issue, the predatory lenders and insurance lobby will spend whatever it takes to ensure that their "private" system of justice is not dismantled.

Over time, several notable people have expressed their sentiments about the right to trial by jury and the ever-increasing presence of arbitration:

> Without the right to trial by jury, people will be "ridden like horses, fleeced like sheep, worked like cattle, and fed and cloathed like swine and hounds."
>
> **- John Adams, January 27, 1766**

> Ask any reasonable man on the street, i.e., a consumer, if he thinks it is fair that he is barred from access to the courts when he has a claim based on a form contract which contains an arbitration clause and he will respond with a resounding "No!" Our system of justice leaves many issues that arise within the context of a judicial proceeding to the discretion of the trial judge. Oftentimes, this discretion is referred to as the "smell test." The reality that the average consumer frequently loses his/her constitutional rights and right of access to the court when he/she buys a car, household

Copyright © 2007 Beasley Allen, et al. All rights reserved.

appliance, insurance policy, receives medical attention or gets a job rises as a putrid odor which is overwhelming to the body politic.

***

When it comes to arbitration, we appear to have lost our sense of history…the Western legal system, evolved to cherish and delicately depend upon divided authority with an independent judiciary available to resolve the claims of the weakest members of our society. The decade of the Sixties bears ample witness to us that the availability of courts to the weak can help prevent violent upheaval and provide peaceful avenue of social change.

***

When introduced as a method to control soil erosion, kudzu was hailed as an asset to agriculture, but it has become a creeping monster. Arbitration was an innocuous when limited to negotiated commercial contracts, but it developed sinister characteristics when it became ubiquitous.

- United States Bankruptcy Justice James Sledge
***In re Knepp*, 229 B.R. 821, 827 (N.D. Ala. 1999).**

But there is one way in this country in which all men are created equal--there is one human institution that makes, a pauper the equal of a Rockefeller, the stupid man the equal of an Einstein, and the ignorant man the equal of any college president. That institution, gentlemen, is a court. It can be the Supreme Court of the United States or the humblest J.P. court in the land, or this honorable court which you serve. Our courts have their faults, as does any human institution, but in this country our courts are the great levelers, and in our courts all men are created equal.

- Atticus Finch
***To Kill a Mockingbird*, by Harper Lee © 1960**

More specifically, the courts generally refuse to lend themselves to the enforcement of a "bargain" in which one party has unjustly taken advantage of the economic necessities of the other. "And there is great reason and justice in this rule, for necessitous men are not, truly speaking, free men, but, to answer a present exigency, will submit to any terms that the crafty may impose upon them." *Vernon v. Bethell*, 2 Eden 110, 113. So wrote Lord Chancellor Northington in 1761.

Copyright © 2007 Beasley Allen, et al. All rights reserved.

> The fact that the representative of the Government entered into the contracts "with their eyes wide open" does not mean that they were not acting under compulsion. "It always is for the interest of a party under duress to choose the lesser of two evils. But the fact that a choice was made according to interest does not exclude duress. It is the characteristic of duress properly so called." *Holmes, J.*, in *Union Pac. R. Co. v. Public Service Comm.*, 248 U.S. 67, 70, 39 S.Ct. 24, 25, 63 L.Ed. 131.
>
> ***
>
> Underlying all these cases is the law's recognition of a basic psychological truth. In *Atkinson v. Denby*, 7 Hur1st. & N. 934, 936, Cockburn, C.J., said that "Where the one person can dictate, and the other has no alternative but to submit, it is coercion". See, also, Abbott, C.J., in *Morgan v. Palmer*, 2 Barn. & C. 729, 735: "But if one party has the power of saying to the other, 'that which you require shall not be done except upon the conditions which I choose to impose,' no person can contend that they stand upon anything like an equal footing." And these were decisions in days when law was supposed to be much more rigid and more respectful of forms than we now ordinarily deem just.

- United States Supreme Court Justice Frankfurter
Dissenting in *U.S. v. Bethlehem*, 315 U.S. 289 (1942).

The use of mandatory binding arbitration is perhaps the most insidious and open assault on consumers' rights today. Arbitration is without question protecting corporate wrongdoers and preventing the public from attaining information that may be used to save lives.

www.beasleyallen.com Copyright © 2007 Beasley Allen, et al. All rights reserved.