

## MINNESOTA STATUTES CHAPTER 325N: A MODEL FOR SUBSTANTIVE CONSUMER PROTECTION

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### I. INTRODUCTION

Why do so-called consumer protection laws provide so little actual protection?

In this article, we will first examine the current state of most consumer protection legislation, exploring some reasons why the laws have developed in this manner, and considering why disclosures alone often do not – and cannot – provide meaningful protection for consumers who most need it. We will then discuss Minnesota Statutes Chapter 325N, a progressive law enacted in 2004 that substantively regulates foreclosure reconveyances, a transaction often abused in a scam commonly known as “equity stripping.” Finally, using Chapter 325N as a model, we will consider other Minnesota consumer protection laws that could be strengthened by the addition of similar substantive protections.

We hope that this article will cause readers to think about

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those consumers most deserving and needing of protection from scams, how our free market “caveat emptor” philosophy is failing those consumers, and how we can provide stronger protections while making the market a safer and fairer place for all consumers.

## II. CONSUMER PROTECTION: CAVEAT EMPTOR

Governments have recognized the need to protect consumers from abusive practices since before the time of Shakespeare.<sup>1</sup> Usury laws prohibiting unfairly high interest rates are perhaps the oldest consumer protection laws, dating back to medieval times.<sup>2</sup> The heyday of consumer protection was in the 1960s and 1970s when legislators passed numerous consumer protection laws at both the state and federal levels.<sup>3</sup> Minnesota currently has over seventy-five consumer protection laws on its books,<sup>4</sup> including a usury law prohibiting interest above 8% on certain loans.<sup>5</sup> Yet despite all these protections, predatory practices abound.<sup>6</sup> With so much legislation, why are consumers still so vulnerable?

Very few consumer protection laws actually prohibit abusive contract terms or exorbitant prices. Rather, the majority of these laws simply mandate disclosures. For instance, Congress enacted the federal Truth in Lending Act (TILA)<sup>7</sup> “to assure a meaningful disclosure of credit terms so that the consumer will be able to compare more readily the various credit terms available to him and avoid the uninformed use of credit . . . .”<sup>8</sup> To that end, TILA

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1. See Elaine S. Tan, *An Empty Shell? Rethinking the Usury Laws in Medieval Europe*, 23 J. LEGAL HIST. 177, 177 (2003). For a Shakespearean view of money lenders, see WILLIAM SHAKESPEARE, *THE MERCHANT OF VENICE* act 1, sc. 3.

2. See Tan, *supra* note 1, at 177.

3. See, e.g., Drug Amendments of 1962, Pub. L. No. 87-781, § 1, 76 Stat. 780 (1962) (enacting sections 358–60, amending sections 321, 331, 332, 348, 351–53, 355, 357, 372, 374, 376, and 381, and enacting provisions set out as notes under sections 321, 331, 332, 352, 355, 360, and 374); Fair Housing Act, 42 U.S.C. §§ 3601–19 (2000) (effective Apr. 11, 1968); Equal Credit Opportunity Act, 15 U.S.C. § 1691 (2000) (effective Oct. 28, 1974).

4. See, e.g., MINN. STAT. ch. 325F (2004), ch. 70A (2004), §§ 47.59–60 (2004), 144A.4605 (2004), 155A.01 (2004), 184.33 (2004), 216B.098 (2004), 325G.17–20 (2004), 325G.23–28 (2004), 336A.02–.14 (2004), 386.375 (2004).

5. MINN. STAT. § 334.01 (2004).

6. See, e.g., STEVE TRIPOLI & ELIZABETH RENUART, NAT’L CONSUMER LAW CTR., *DREAMS FORECLOSED: THE RAMPANT THEFT OF AMERICANS’ HOMES THROUGH EQUITY-STRIPPING FORECLOSURE “RESCUE” SCAMS* (June 2005), <http://www.consumerlaw.org/news/ForeclosureReportFinal.pdf>.

7. 15 U.S.C. §§ 1601–67 (2000).

8. *Id.* § 1601(a).

requires lenders to make certain disclosures depending on the type of credit extended, such as the annual percentage rate (APR),<sup>9</sup> the right to rescind,<sup>10</sup> or the finance charge amount.<sup>11</sup> The Home Ownership and Equity Protection Act (HOEPA)<sup>12</sup> amends TILA and provides additional protection for certain high-cost home mortgage loans. While HOEPA prohibits a few especially abusive terms,<sup>13</sup> its primary effect is to require additional disclosures.<sup>14</sup>

Most state consumer protection laws operate in a similar way. They limit very few practices and rely primarily on disclosure of essential terms. For instance, although lenders making short-term unsecured loans under \$350 are limited in their charges, the permitted charges are astronomical when expressed as APRs.<sup>15</sup> Although the lenders must post notices informing borrowers that they will pay high charges, nothing requires them to disclose these charges as an APR.<sup>16</sup> There is no limit on the amount a hotel may charge its guests to make a local call, but the hotel must post a notice “on or near each telephone” that states the amount of the charge.<sup>17</sup> While there are a few exceptions,<sup>18</sup> consumer protection laws typically boil down to *caveat emptor*—let the buyer beware.

Federal preemption of the area has stymied attempts by states, including Minnesota, to impose more safeguards. States may not pass laws that interfere with or weaken a federal regulatory scheme. At one time, the preemption doctrine was interpreted as a floor. States could add to, but could not take away from, protections that federal regulations provided. But more recently, especially with the rise of national banking, commercial interests have successfully argued that it is too burdensome to comply with fifty different state laws. States may attempt to regulate consumer areas, but if the federal government steps in, typically much weaker regulations will

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9. See, e.g., *id.* § 1637(c)(1)(A)(i).

10. *Id.* § 1635(a).

11. See, e.g., *id.* § 1638(a)(3).

12. *Id.* §§ 1602(aa), 1610, 1639–40.

13. See *id.* §§ 1639(c), (e)–(h) (prohibiting prepayment penalties, balloon payments within five years of origination, negative amortization, prepaid payments, and extending credit without regard for the consumer’s ability to pay).

14. *Id.* §§ 1639(a), (b).

15. See MINN. STAT. § 47.60(2) (2004). For example, a one-month loan of \$50 may have a charge of \$5.50 added to it, which equals an APR of 132%. *Id.* at subdiv. (2)(a)(1).

16. *Id.* at subdiv. 4(e).

17. MINN. STAT. § 325F.99 (2004).

18. See, e.g., MINN. STAT. § 325F.91 subdiv. 3 (2004) (limiting late fees in rent-to-own agreements).

preempt state legislation. Minnesota has attempted to protect borrowers against usurious interest rates, but it can only do so for loans not made by banks or other federally regulated lenders.<sup>19</sup> Minnesota formerly prohibited prepayment penalties on mortgage loans but now generally allows them within certain parameters and with certain disclosures.<sup>20</sup> Because most consumer legislation touches on areas of interstate commerce, federal preemption of state laws presents a huge bar to substantive regulation of consumer transactions.

The primary reasons why consumer protection legislation relies so heavily on disclosures instead of making substantive limits are the American faith in the free market and Americans' equal distrust of big government regulation and paternalism. When consumers are well informed, they supposedly have equal bargaining power with other market participants, such as lenders or merchants. The consumers can shop around, compare prices or interest rates, and make the best decision, choosing to do business with one merchant and not another. This comparison shopping will influence lenders to compete for the consumers' business by offering lower rates and reduced fees and will entice merchants to lower their prices. The market will fairly allocate risks and rewards. Further, consumers are free to make choices. Unfortunately, various factors can interfere with the free market's regulatory influence.

Those who see the market as an effective regulatory tool assume that parties on both sides of the transaction – seller and purchaser, or lender and borrower – make rational decisions. A seller will not ask for more than a purchaser can afford, and a lender will not loan more than a borrower can repay. But when the impetus to make a rational decision is removed from one side of the equation, that regulatory effect is removed. This may seem farfetched, but it is exactly what has happened in mortgage lending due to the influence of the secondary mortgage market.

Historically, the institution originating a mortgage loan serviced it until the borrower paid off the loan. This meant that the lenders had real incentive to underwrite their loans properly and to ensure that borrowers could meet their obligations – if

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19. See MINN. STAT. § 334.01 (2004) (“No person shall directly or indirectly take or receive in money, goods, or things in action, or in any other way, any greater sum, or any greater value, for the loan or forbearance of money, goods, or things in action, than \$8 on \$100 for one year.”).

20. MINN. STAT. § 58.137 subdiv. 2 (2004).

borrowers' monthly payments were too high, they would default, and the lender would be forced to foreclose on the property securing the loan to recover any of its funds, an expensive proposition. In the past twenty years, the emerging secondary mortgage market has removed much of that incentive. Few mortgage originators still service loans. Now, the originating lender quickly sells the loans on the secondary mortgage market, often to the Federal National Mortgage Association (Fannie Mae). Then, Fannie Mae pools and packages these loans into mortgage-backed securities.<sup>21</sup> Finally, investors buy these securities, and Fannie Mae uses the income from the sale of the securities to purchase more loans from originators.<sup>22</sup>

In theory, the resale of the loans benefits borrowers. Because this practice quickly replenishes the lenders' funds, especially in rapidly growing areas, they are able to make more loans without waiting thirty years for mortgagors to repay the funds; this should keep costs and interest rates low, which will encourage borrowing.<sup>23</sup> However, the securitization of mortgages on the secondary mortgage market has had a negative side effect. Instead of making realistic predictions about a borrower's ability to repay the loan, the originator now encourages the borrower to take out the largest amount for which it has approved him. The originator will be repaid almost immediately when the loan has been packaged and sold to Fannie Mae or another agency that issues mortgage-backed securities. Instead of considering the borrower's long-term ability to repay the loan, the originator now hopes only to make as much money as possible in the short-term. Any incentive to make a realistic loan – as opposed to pushing the consumer to borrow as much money as she possibly can – has been removed by the planned resale of the loan on the secondary mortgage market. Put another way, a profitable and therefore commercially reasonable loan for a mortgage originator can now include a loan anticipated to fail from the beginning. Thus, the effect of risk for the lender has lost any meaningful regulatory impact. To avoid abuses and

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21. JEAN CUMMINGS & DENISE DiPASQUALE, CITY RESEARCH, A PRIMER ON THE SECONDARY MORTGAGE MARKET 5 (June 4, 1997), <http://www.cityresearch.com/pres/smm.pdf>. The process of pooling mortgages and packaging them into mortgage backed securities is called "securitization." See U.S. SECURITIES AND EXCHANGE COMMISSION, MORTGAGE-BACKED SECURITIES (Feb. 11, 2003), <http://www.sec.gov/answers/mortgagesecurities.htm>.

22. CUMMINGS & DiPASQUALE, *supra* note 21, at 5.

23. *Id.* at 4, 8.

unreasonable loans, the borrower must rely heavily on disclosures when deciding whether to accept or reject offered terms. However, these disclosures do not work.

For disclosures to be meaningful, the consumer must be able to read, understand, and appreciate the information disclosed. A real problem occurs when individuals receiving the disclosures do not understand them. This can happen for a number of reasons – for example, everyone is familiar with the credit card disclosures printed in a font size almost too small to be legible. And disclosures are often written in complicated legalese. For instance, many individuals do not understand the difference between a simple interest rate and an APR.<sup>24</sup> Other disclosures are vague or not written in a way that is meaningful. Although Minnesota payday lenders must post notices informing borrowers that they will pay high charges, the law does not require that these charges be disclosed as interest or as an APR.<sup>25</sup> While tiny fonts and terms of art can ruin a disclosure's effectiveness, they are not the only problem.

A consumer's poor English language or reading skills can also render disclosures meaningless and prevent him from understanding the warning. Few consumer protection laws require disclosures in languages other than English, even if the parties conduct the transaction in another language. Some statutes intending to provide clearly written, easily understood disclosures mandate the content of the disclosure, along with font size and prominent display. However, mandating the content could reduce its effectiveness for non-English speakers by prohibiting language access. For instance, some lenders solicit loans by mailing live checks to individuals; endorsing and cashing the checks constitutes acceptance of the loan terms. Minnesota Statutes Section 47.605

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24. "Interest rate" typically refers to simple interest, computed on the original face amount of the loan. A \$100 loan with a 5% interest rate would result in \$5 of interest charges in the specified time period. APR is intended to express the true cost of credit, and includes finance charges and fees as well as interest charges. 12 C.F.R. § 226.22(a)(1) (2006). One way to calculate APR is the Newton-Raphson method. Loan amount = C, extra costs = E, interest rate = r, months of the loan = N. First, figure the monthly loan payment (P) as follows:  $P = [(C+E)r(1+r)^N] / [(1+r)^N - 1]$ . Then using that figure, solve for APR A ( $a = A/1200$ ) as follows:  $[a(1+a)^N / (1+a)^N - 1] - P/C = 0$ . Got it? Different formulas apply depending on whether the credit is open-end (as in a revolving line of credit) or closed-end (as in a mortgage loan), and can be found in Regulation Z, 12 C.F.R. section 226 appendices F, J (2006).

25. See MINN. STAT. § 47.60 subdiv. 4(e) (2004).

regulates these loan solicitations, mandating certain disclosures with the intent of helping consumers understand the effect of cashing the check. But a translated notice advising “ESTA ES UNA SOLICITUD PARA UN PRÉSTAMO – LEA LAS SIGUIENTES CLÁUSULAS ADJUNTAS ANTES DE FIRMAR Y CAMBIAR ESTE CHEQUE” would likely better serve Spanish speakers, responding to a letter written in Spanish, than would the English statement “THIS IS A SOLICITATION FOR A LOAN – READ THE ENCLOSED DISCLOSURES BEFORE SIGNING AND CASHING THIS CHECK” that the current law requires.<sup>26</sup>

The market’s regulatory influence depends on well-informed consumers who shop around in order to make the best choice possible. Consumers may enter into less than optimal agreements because they do not know that they have other options or because meaningful options are not available to them.

The Center for Responsible Lending recently released a study analyzing the effect of race and ethnicity on home mortgage loan rates. This study, using data that lenders released under the Home Mortgage Disclosure Act,<sup>27</sup> showed that African-American borrowers are significantly more likely to receive a high-rate, sub-prime home mortgage loan than white borrowers, even controlling for credit scores and other factors legitimately affecting interest rates.<sup>28</sup> Similarly, the study found that Latino borrowers were also far more likely to receive higher interest rates than white borrowers – in the case of fixed-rate purchase loans without prepayment penalties, 142% more likely.<sup>29</sup> The free market is not working for these borrowers to provide the best loans possible because discriminatory underwriting and pricing practices have intervened.

Similarly, the free market disserves the borrower who does not have the time or collateral to avail herself of conventional lending. Small, short-term, unsecured loans, often called “payday” loans, are subject to only minimal regulation and disclosure requirements,<sup>30</sup> but these disclosures often do not matter. Consumers entering into these transactions must be aware that the interest rates are high, but these are not loans for those with good credit and

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26. See MINN. STAT. § 47.605 subdiv. 3(b) (2004).

27. 12 U.S.C. §§ 2801–10 (2000).

28. DEBBIE GRUENSTEIN BOCIAN ET AL., UNFAIR LENDING: THE EFFECT OF RACE AND ETHNICITY ON THE PRICE OF SUBPRIME MORTGAGES 16 (May 31, 2006), *available at* [http://www.responsiblelending.org/pdfs/tr011-Unfair\\_Lending-0506.pdf](http://www.responsiblelending.org/pdfs/tr011-Unfair_Lending-0506.pdf).

29. *Id.* at 18.

30. See MINN. STAT. § 47.60 (2004).

collateral. Individuals teetering on the edge of financial crisis, who need the money to pay the rent or buy food, are often the ones who obtain these loans. With few, if any, real options available, disclosures do not make a difference. If a person has no collateral and faces a choice between taking out a payday loan at an APR over 100% or being evicted for nonpayment of rent, the loan will be the clear choice. Although these loans typically have small principal amounts, their effect on an individual's or family's finances can be huge. Consumers in tight financial circumstances often cannot afford to pay the loan off in just two weeks and will either roll the loan over or pay off the loan with another; one study found that the average payday loan borrower has eleven loans per year.<sup>31</sup> A Minnesota borrower would pay \$23 in fees for a \$300 payday loan.<sup>32</sup> Rolled over eleven times, the fees would total \$253, and the borrower would still owe the original \$300. The Center for Responsible Lending estimated in 2003 that predatory payday lending costs consumers \$3.4 billion annually.<sup>33</sup> Given that the payday lending industry more than doubled between the years 2000 and 2003 and has shown no signs of slowing its growth,<sup>34</sup> it stands to reason that 2006 borrowers will pay far more than \$3.4 billion to payday lenders.

Disclosures are not enough. Legal terms are too abstruse even for most literate Americans. The risk/reward system that would regulate some lender behavior has become unhinged, providing reward for commercially unreasonable loans with virtually no risk to the lender. And the free market premise that consumers have full knowledge and free choice is seriously flawed because of economic realities and discrimination. Vulnerable consumers need more protection to give them equal footing with merchants and lenders in the marketplace.

### III. MINNESOTA STATUTES CHAPTER 325N

Minnesota Statutes Chapter 325N is unusual in that few other states regulate the transactions that the codes define as "foreclosure

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31. KEITH ERNST ET AL., *QUANTIFYING THE ECONOMIC COST OF PREDATORY PAYDAY LENDING* 3–4, 8 (Dec. 18, 2003), *available at* <http://www.responsiblelending.org/pdfs/CRLpaydaylendingstudy121803.pdf>.

32. *See* MINN. STAT. § 47.60 subdiv. 2(4) (2004).

33. ERNST, *supra* note 31, at 7–8.

34. *Id.* at 2.

reconveyances.”<sup>35</sup> And it is also unusual, however, when compared to other consumer protection laws in that it actually provides substantive protections – limiting consumers’ losses and capping purchasers’ profits from these transactions.

Prior to the Minnesota State Legislature’s enacting Chapter 325N, the foreclosure reconveyances were unregulated and easily abused. Although they can take several forms, there is a basic pattern that most of these transactions follow.

First, a homeowner with a significant amount of equity in the home misses one or more mortgage payments, and the lender begins the foreclosure process. One of the first steps of this process is publication of a notice of the lender’s intent to foreclose.<sup>36</sup> This notice, which the lender must publish for at least six weeks, must include the mortgagor’s name, the address of the mortgaged property, the original principal amount, the date of the loan, and the amount that the lender claims is due.<sup>37</sup> When an investor cross-references these publications against public property records listing such things as other recorded liens or judgments and county-assessed market value, it is easy to determine which homeowners facing foreclosure have substantial equity in their homes.

Once the investor has found homeowners with significant equity remaining, the investor will approach them offering various types of assistance. Offers of help may range from a quick purchase of the home for cash to refinancing the homeowner’s mortgage. If the homeowner wants to try to keep the home, as is often the case, the investor may enter into a reconveyance with the homeowner. The homeowner temporarily sells the home to the investor, allegedly for the purpose of securing financing to pay off the foreclosing lender. The investor allows the homeowner to stay in the property and buy it back at a price that covers the loan, the investor’s fees, and other costs.

As an example, assume a homeowner purchased her home ten

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35. California (CAL. CIV. CODE §§ 1695–1695.17, 2945–2945.11), Georgia (GA. CODE ANN. § 10-1-393 subdiv. (b)(20)(A)), Maryland (MD. CODE ANN., REAL PROP. § 7-301-321), and Missouri (MO. ANN. STAT. §§ 407.935–.943) are the other states that regulate some aspect of foreclosure reconveyance transactions. Maryland’s law is the most similar to Minnesota’s Chapter 325N.

36. See MINN. STAT. § 580.03 (2004) (requiring that “[s]ix weeks published notice shall be given that such mortgage will be foreclosed by sale of the mortgaged premises, or some part thereof, and at least four weeks before the appointed time of the sale a copy of such notice shall be served upon the person in possession of the mortgaged premises, if the same are actually occupied.”).

37. *Id.* §§ 580.03–.04 (2004).

years ago and owes \$70,000 on her mortgage. Her home has appreciated over time, and it is now worth \$200,000, giving her \$130,000 in home equity. The homeowner loses her job and falls behind on her \$600 monthly mortgage payment as she searches for new employment. If she sold the home for a fair price, she could expect to walk away from the closing with over \$100,000 after realtor fees and closing costs. But she may not want to move, or she may not be able to find suitable housing that is less expensive than the mortgage payment she could not meet. These situations lead homeowners to enter into foreclosure reconveyances.

In a straightforward foreclosure reconveyance transaction, the investor first purchases the home, paying off the foreclosed loan and any other liens. The purchase price may be set slightly higher than the total amount owed on the home to cover closing costs and to allow the homeowner to receive some cash at the closing. Then, typically in the same transaction, the investor conveys an interest in the home back to the homeowner, often either with a contract for deed or a lease with a purchase option. If done fairly, this arrangement allows the homeowner to make affordable payments to the investor and repurchase the home after a set amount of time, with the investor receiving a higher price than she paid for the home as a return on her investment. In our hypothetical, the homeowner could sell her home to the investor for \$80,000. This would pay off her foreclosed loan, cover closing costs, and even give her some cash from the transaction. The homeowner would continue to live in the home, making payments for a year or two to the investor, while she finds new employment and cleans up her credit. Then, at the end of the predetermined time period, she could repurchase the home from the investor for \$100,000. This would allow the investor almost \$20,000 profit after closing costs.

In a typical equity skimming transaction, the unscrupulous investor sets the purchase price as high as possible and then obtains a mortgage for nearly the full value of the home. The homeowner receives no proceeds, which instead go to the investor to pay the investor's fees and to pay costs in the future. The investor also sets the lease or contract payments much higher than the homeowner can afford. When this happens, the homeowner will inevitably default on the payments. The investor can then evict the homeowner in a summary housing court proceeding and resell the home for fair market value – pocketing the homeowner's equity and leaving the homeowner with nothing.

In our hypothetical, imagine an unscrupulous investor who, instead of purchasing the property for \$80,000, purchases it for \$200,000 and places a \$160,000 mortgage on the property. The homeowner sees no proceeds from this sale, which allegedly should net the homeowner \$130,000. Why not? The investor uses the proceeds of the \$160,000 to pay off the \$70,000 loan in foreclosure and inflated closing costs of \$30,000. The investor is paid a fee of \$36,000. The investor puts the remaining money into an “escrow account,” where questionable costs and management fees quickly drain the balance. Imagine if our hypothetical investor then required monthly payments hundreds of dollars more than those on the foreclosed loan. What options would be available to the homeowner? How could she possibly hope to complete the reconveyance and regain full title to her home?

This clear potential for abuse led to the Legislature’s regulation of foreclosure reconveyances. In addition to its typical consumer protection provisions, such as requiring written contracts<sup>38</sup> and a five-day right to cancel,<sup>39</sup> and even strengthening its disclosures by requiring language access,<sup>40</sup> Chapter 325N also sets substantive limits on several terms of the reconveyance transaction. First, before entering into the transaction, the purchaser must verify the homeowner’s ability to complete the reconveyance – both by making the monthly lease or contract payments and by making the final re-purchase.<sup>41</sup> The statute creates the presumption of affordability if the monthly payments, along with other listed housing expenses, do not exceed 60% of the homeowner’s monthly gross income.<sup>42</sup> If the homeowner is unable to complete the reconveyance despite these provisions, the statute requires that the investor pay the homeowner 82% of the fair market value of the home, minus expenses, within 150 days of the homeowner’s eviction or voluntary move-out.<sup>43</sup> In addition to limiting the investor’s fee to 18% of the fair market value, this

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38. MINN. STAT. §§ 325N.03, .11 (2004).

39. MINN. STAT. §§ 325N.02, .13 (2004).

40. MINN. STAT. §§ 325N.03(c), .11 (2004).

41. MINN. STAT. § 325N.17(a)(1) (2004).

42. *Id.* Housing expenses in the 60% calculation include “payments for regular principal, interest, rent, utilities, hazard insurance, real estate taxes, and association dues.” *Id.*

43. MINN. STAT. § 325N.17(b)(2) (2004). For accounting forms showing how to calculate the payment to the homeowner and what expenses she may deduct from that 82% figure, see <http://www.ag.state.mn.us/consumer/housing/HomeOwnerPaymentAccountingForms.htm> (last visited Sept. 27, 2006).

provision also ensures that homeowners do not lose the entire value of the equity that they worked to build prior to foreclosure.

Compliance with Chapter 325N would dramatically change the outcome of our second hypothetical above. The investor would be required to verify the homeowner's income before entering into an agreement with her. A contract, written in the same language used by the parties when negotiating the deal, would memorialize the terms of their agreement, and the homeowner would have five business days after signing the contract to change her mind. If she were unable to complete the reconveyance, she would receive 82% of fair market value, \$164,000, less reasonable costs such as satisfying her mortgage and paying closing costs. She would take away at least \$64,000 in equity, and the investor would still receive her fee of 18% of fair market value, \$36,000. Both parties benefit from the transaction, instead of one party – the original homeowner – receiving practically nothing.

Foreclosures and foreclosure reconveyance transactions are not unique to Minnesota, but Chapter 325N is an unusual law that passed under unusual circumstances. Since 1980, the prevalent mood favoring deregulation and reliance on market forces has thwarted new consumer protection legislation. But events in 2004 converged to allow the passage of this new law.

The Minnesota State Legislature passed Chapter 325N amid great publicity about the problem of equity stripping.<sup>44</sup> Much of this publicity was due to the actions of Attorney General Mike Hatch, who filed suit against three of the state's largest equity stripping scammers.<sup>45</sup> The Attorney General's suit against one of the companies, HJE Financial, LLC, helped provide the political pressure necessary for the bill's passage through the Legislature. Moreover, one of the company's principals, Ron Esau, had served as Governor Tim Pawlenty's campaign treasurer.<sup>46</sup> This created a unique political climate with pressure for both parties to support tougher laws.

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44. See, e.g., Sheila Mulrooney Eldred, *Stripped Clean*, CITY PAGES (Minneapolis-St. Paul), July 21, 2004, at 11; Neal Gendler, *Lender's License Suspended*, STAR TRIB. (Minneapolis), May 21, 2004, at 1D; Nolan Zavoral, *Rally Targets St. Paul Real Estate Firm*, STAR TRIB. (Minneapolis), Oct. 15, 2003, at 5B.

45. State v. Grant Holding, LLC, No. C6-03-12006 (Ramsey County (MN) D. Ct. filed 2003); State v. HJE Fin., LLC, No. 03-CV-5554-JNE/JSM (D. Minn. filed Oct. 2003); State v. Home Funding Corp., No. C4-03-7691 (Dakota County (MN) D. Ct. filed Apr. 28, 2003).

46. Pat Doyle, *State Fines Pawlenty Campaign Treasurer*, STAR TRIB. (Minneapolis), Sept. 24, 2005, at 7B.

At this point in time, it is impossible to tell what the long-term effects of Chapter 325N's substantive provisions will be. As of this writing, the statute has been in effect less than two years. No published case law on Chapter 325N exists, and few cases are proceeding. The only case dealing with Chapter 325N that has come before the Minnesota Court of Appeals presented the question of housing court jurisdiction over evictions with Chapter 325N counter-claims and defenses.<sup>47</sup> No analysis or commentary has been published addressing whether the statute's substantive restrictions would unreasonably chill the private investor market.

There is strong reason to believe that the substantive terms and limits in Chapter 325N will have a positive effect for all parties involved in the transaction. The statute recognizes that this type of financing arrangement is riskier than conventional loans. While not dictating terms or banning significant financial rewards to investors, the statute provides reasonable limits to curtail predatory practices. Because the statute limits a foreclosed homeowner's monthly payment to 60% of monthly gross income, individuals entering in to these transactions truly stand a chance of repurchasing their homes.<sup>48</sup> If the reconveyance fails and the foreclosed homeowner moves out, or if the investor evicts her from the home, both parties still benefit. Homeowners with significant equity will not lose everything. Investors' and brokers' profits are limited, but at 18% of fair market value, profits can be substantial while still complying with the statute.<sup>49</sup> If the parties later disagree about the fairness of the transaction, the statute removes discretion from the court and instead imposes clear guidelines to assist the court in deciding whether the terms are reasonable. Chapter 325N provides a model for a statute that offers objective guidelines to curb abuses while still allowing significant room for investors and homeowners to negotiate the terms and benefits of the transaction.

#### IV. CONSUMERS WOULD BENEFIT FROM ADDITIONAL SUBSTANTIVE PROTECTIONS

The substantive limits in Chapter 325N clearly benefit foreclosed homeowners, foreclosure purchasers, and foreclosure

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47. Real Estate Equity Strategies, LLC v. Jones, 720 N.W.2d 352 (Minn. Ct. App. 2006).

48. MINN. STAT. § 325N.17(a)(1) (2004).

49. See MINN. STAT. § 325N.17(b)(2) (2004). See also hypothetical *supra* Part III.

consultants. If legislators used this chapter as a model, they could make any number of other consumer protection laws stronger by the addition of similar substantive limits.

A. *Fees for Late Rent: Define and Limit "Reasonable."*

One area that could benefit from more objective guidelines and limits is late fees in residential leases. Minnesota Statutes Chapter 504B governs landlord-tenant relationships. This chapter addresses various rights and responsibilities, including mutual covenants against allowing unlawful activity,<sup>50</sup> a tenant's right to privacy,<sup>51</sup> and shared utility meters.<sup>52</sup> However, nowhere does the chapter discuss the issue of fees for late payment of rent. Over the years, Minnesota courts have determined that late fees are permissible when they take the form of reasonable liquidated damages, and not a penalty.<sup>53</sup> The fees must be reasonable and not disproportionate to actual damages.<sup>54</sup> Unfortunately, the failure to provide objective guidance has led to abuse.

Many leases have late fee policies that, on their face, bear no relation to actual damages and are therefore illegal penalties. Some leases have ratcheting fees – for example, \$5 a day for every day rent is late. A tenant who pays her \$800 rent twenty days late might owe \$100 in late fees. A landlord with a 10% mortgage would have incurred only \$4 in interest lost. The fee has no relation to the cost that the landlord actually bears from the late payment. Other leases charge large late fees regardless of how much money is late. A low-income tenant in subsidized housing whose portion of the rent is only \$41 could face a \$50 late fee when her rent is late. This situation can snowball when a lease requires that payments apply first to late fees, then to rent. So in the example of the subsidized tenant, if she pays her \$41 rent on time the next month, but has no money for the late fee, she incurs a second \$50 charge and now owes \$100. Such a situation can – and does – quickly lead to eviction and homelessness. Creating limits similar to those in Chapter 325N would curb abuse.

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50. MINN. STAT. § 504B.171 (2004).

51. MINN. STAT. § 504B.211 (2004).

52. MINN. STAT. § 504B.215 (2004).

53. See *Local 34, State, County & Mun. Employees v. County of Hennepin*, 310 Minn. 283, 288, 246 N.W.2d 41, 44 (1976); *Palace Theatre, Inc. v. Nw. Theatres Circuit, Inc.*, 186 Minn. 548, 553, 243 N.W. 849, 851 (1932).

54. *Gorco Constr. Co. v. Stein*, 256 Minn. 476, 481–82, 99 N.W.2d 69, 74–75 (1959).

Providing a dollar limit for late fees and an objective definition of a reasonable charge would not be excessive regulation. Therefore, limiting late fees to a set amount or to the landlord's actual damages, such as lost interest or administrative costs, would be a simple way to protect tenants against inflated fees that constitute a penalty without placing a heavy burden on landlords.

*B. Payday Loans: Disclose, and Limit, the APR.*

Minnesota state law regulates short-term, unsecured (often called "payday") loans, but only loosely. It caps APRs, but at an astronomical 390%.<sup>55</sup> And while the law requires various disclosures, it does not require the lender to disclose the loan's APR to the borrower.<sup>56</sup> California is currently working to cap interest rates on such loans at 36%.<sup>57</sup> A similar effort in Minnesota to cap APRs at a reasonable amount, combined with an APR disclosure requirement, would level the playing field without destroying the lender's profit incentive. Such requirements would help consumers understand the terms of their loans, dissuade borrowers who could do without the expensive loans, protect consumers with few options aside from the payday loans, and at 36% – more than four times the usury rate in Minnesota – still provide a substantial profit to investors. Setting limits would allow this market to continue to operate profitably, but with fewer incidents of abuse.

## V. CONCLUSION

Minnesota's Chapter 325N is an unusual consumer protection statute that provides substantive protections for homeowners entering into foreclosure reconveyance transactions. This legislation protects parties on both sides of the transaction – it provides foreclosed homeowners with genuine protection against foreclosure rescue scams, allowing them a real chance at

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55. See MINN. STAT. § 47.60, subdvs. 1, 2 (2004) (outlining the various fee levels that are permitted for loans of up to \$350). For calculation of APR, see *supra* note 24. See also Consumer Federation of America, *Safe Harbor for Usury: Recent Developments in Payday Lending* (Sept. 1999), available at <http://www.consumerfed.org/pdfs/safeharbor.pdf>; Wisconsin State Legislature, Legislative Reference Bureau, *Wisconsin Briefs* (July 2000), available at <http://www.legis.state.wi.us/lrb/pubs/wb/00wb7.pdf>.

56. See MINN. STAT. § 47.60, subd. 4 (2004). See also *supra* Part II.

57. Tony Perry, *Targeting "Predator Lenders,"* L.A. TIMES, June 17, 2006, at B6.

repurchasing their homes, all while giving foreclosure consultants and purchasers clear guidelines on how to structure the transactions. The chapter sets limits that allow for a substantial profit while still ensuring that the transaction is commercially reasonable for the consumer. If it can avoid federal preemption, this legislation could be a model for reforming other consumer protection statutes to provide meaningful protections.