

## Current Developments In Risk Management For Mortgage Brokers

By: John L. Hosack, Esq. and Jason E. Goldstein, Esq.\*

Whether a mortgage broker is acting as the agent of a borrower in negotiating a loan from a wholesale lender, or arranging a loan by bringing together a proposed borrower and lender, or acting as a lender and originating the loan directly to the borrower, there are many risks which must be managed effectively. This article is designed to provide the reader with some of the current developments in risk management as it relates to loans which involve mortgage brokers.

### The Mortgage Broker's Tool Box

Every mortgage broker has a proverbial "tool box" which it uses to conduct its business. But not every mortgage broker uses the same tools or has the same tool box. Tools which may be, or should be, in a mortgage broker's tool box include, but are not limited to: an appropriate license, forms, advertising and errors and omissions insurance. Whether you are the mortgage broker, the borrower or the lender, it is a critical part of risk management to know, before the loan is originated what tools are contained in the mortgage broker's tool box.

Licensing. In California, a real estate broker's license is required in order to perform mortgage loan activities. *Business & Professions Code* §§ 10130 and 10131(d). If a mortgage broker delegates the task of soliciting or negotiating loans secured by real property, it must delegate those tasks to a person with a valid real estate license. *Business & Professions Code* § 10132. A Mortgage Loan Originator (MLO) endorsement is also required if a mortgage broker wants to perform residential mortgage loan origination activities. *Business & Professions Code* § 10166.01(b)(1) and 10166.02(b)(2).

Does the mortgage broker involved in your transaction have the required license? This should be determined at the front end of the transaction.

Loan Forms. Mortgage brokers generally have form documents which they use in connection with specific loan transactions. Forms cannot be treated as sacrosanct. Forms which were once "tried and true" may have become obsolete or unenforceable over time. For example, if a mortgage broker uses an arbitration provision, is it now too one-sided to be enforced? If so, the mortgage broker or lender which worked with the mortgage broker may have a borrower's claims litigated before a jury instead of an arbitrator.

If a mortgage broker works in the residential mortgage field, are the mortgage broker's forms compliant with the ever evolving requirements of the Truth-In-Lending Act ("TILA"), Real Estate Settlement Procedures Act ("RESPA") and their hybrid requirement of TRID (TILA/RESPA Integrated Disclosure)? If not, the mortgage broker and lender may subject themselves to regulatory issues, damages, statutory damages, penalties, attorneys' fees and rescission of the loan. See, e.g., 15 U.S.C. § 1635.

Risk is minimized when a mortgage broker's forms are reviewed by a qualified professional on a regular basis to ensure that they continue to comply with the applicable law for which they were created.

Advertising. Mortgage brokers are in the business of soliciting, negotiating and arranging loans or submitting application packages to wholesale lenders for review and consideration for possible funding. What the mortgage broker advertises that it can offer, as opposed to what it actually provides or obtains for borrowers or lenders, may result in lawsuits or regulatory issues. Reviewing advertising on a regular basis to confirm it is accurate and compliant will minimize risk.

Errors and Omissions Insurance. Borrowers and lenders cannot presume that a mortgage broker has errors and omissions insurance. In California, mortgage brokers are not required to have errors and omissions insurance. Working with a mortgage broker who does not have insurance is a risk. Not inquiring about whether a mortgage broker has insurance or not before a loan is originated is an additional risk. The existence of sufficient insurance or the mortgage broker's financial ability to pay a claim is critical when issues with a loan arise. Future risk will be minimized if a mortgage broker has sufficient insurance or assets to pay a claim if an issue arises with a loan.

### Defining The Mortgage Broker's Relationships

A mortgage broker can represent a borrower in connection with obtaining a loan from a lender. A mortgage broker can also represent a borrower and a lender at the same time. A mortgage broker can also represent a borrower and be the lender. *Business & Professions Code* § 10131. However, things get more complicated when a finder, middleman or co-broker is involved. At a minimum, the additional parties require additional attention.

A mortgage broker's relationship to the parties involved in a loan transaction varies based upon the type of loan transaction at issue. The type of relationship and its scope should be clearly defined in writing, before the loan is originated so that the relationships of the parties and their respective duties, if any, are clearly understood. Defining the mortgage broker's relationship in writing to the parties involved in a loan transaction, before the loan is originated, minimizes risk and avoids confusion about the roles and duties of those involved in the loan transaction.

### The Mortgage Broker's Duties—General

A mortgage broker retained by a borrower to act as the borrower's agent in negotiating an acceptable loan has a fiduciary duty to the borrower. *Civil Code* § 2923.1(a). That fiduciary duty requires the mortgage broker to disclose all material facts to the borrower which may affect the borrower's decision to enter into the loan transaction. See, e.g., *Fuller v. First Franklin Fin. Corp.* (2013) 216 Cal.App.4th 955, 965.

In contrast, a mortgage lender does not have a fiduciary duty to a borrower. *Rufini v. Citimortgage, Inc.* (2014) 227 Cal.App.4th 299, 311. Based on the fact that the mortgage broker has a fiduciary duty to a borrower, but the lender does not, "a mortgage lender should take care not to convey to a prospective client that it is acting as a broker when in fact it is acting as a lender." *Smith v. Home Loan Funding, Inc.* (2011) 192 Cal.App.4th 1331, 1332.

In an "evolving transaction," such as when the roles of the parties, or the intent of the principals, changes during the deal, a mortgage broker's duties may change. For example, while underwriting is for the benefit of the lender, and not the borrower (*Perlas v. GMAC Mortg., LLC* (2010) 187 Cal.App.4th 429, 436), this may change when the mortgage broker changes its role from solely representing the borrower to also being a lender. Potential conflicts of interests may arise in the evolving transaction. When elderly persons are involved, additional duties may also arise.

Determining before a loan is originated what duties the mortgage broker has in a particular transaction will assist with minimizing risk.

### Loan Types & Issue Spotting

Issues that arise in mortgage brokering may depend on the type of a loan being arranged or originated. For example, if it is a residential mortgage transaction, were all of the proper disclosures given? If it is a business purpose loan which involves a residential property, is the borrower *really* not residing at the

property *or* is the borrower *really* living at the property and using it as his or her principal residence? If it is a construction loan, has there already been a commencement of the work of improvement at the property? Or in any loan transaction, has the mortgage broker sent an email which the mortgage broker does not feel comfortable being marked for identification as Plaintiff's *Exhibit T*? Exercising vigilance in all aspects of brokering mortgage loans will minimize future risk.

### Third Party Vendors

Mortgage brokers customarily select the third party vendors who assist with the loan origination process, such as the credit reporting agency, appraiser, escrow agent, title insurer and notary. However, these selections must be made carefully because the mortgage broker may be vicariously liable for the torts of the independent contractors which it selects and uses. *Barry v. Raskov* (1991) 232 Cal.App.3d 447, 454 ("These considerations support a rule of vicarious liability for the torts of an independent property appraiser employed by a mortgage broker").

For example, a mortgage broker may think that the information which is contained in a credit report which it obtained is innocuous, but the title insurance industry falsely argues when claims occur that the information contained in a credit report is material to determining whether to issue a title insurance policy (despite deliberately never asking for a copy of a credit report). The insurer then seeks to deny the claim and rescind the policy. The appraiser may lie about inspecting the interior of the subject property and may insert pictures from a different property into the appraisal report. This makes it appear to the mortgage broker and/or lender that the owner of the property is really applying for a loan or selling the property, when in reality a fraud is in the works. The escrow agent may not disclose to you all of the material facts of which it is aware and which would have affected the lender's decision to fund the loan. The notary may be living out of a car, have no insurance and may notarize any Deed of Trust presented to it without scrupulously verifying the identity of the person who is signing the Deed of Trust. The notary then conveniently "loses" his or her notary journal once a claim arises. Carefully choosing third party vendors will minimize risk.

### Post-Closing Issues

Risk is not eliminated after a loan is originated. Fraud, forgery and fund diversion are many times discovered after the lender's money has been disbursed. Appropriate claims should be made promptly to all potentially liable parties and their insurers. If the



loan is sold on the secondary market, repurchase demands may arise which must either be paid or rebutted. If a mortgage broker also services a loan, as is frequently done in the private mortgage lending space, a multitude of issues may arise, especially on residential mortgage loans. Modification requests will also require consideration, and if accepted, documented along with obtaining appropriate endorsements to the title insurance policy.

When any potential issue is spotted by a mortgage broker, lender, or borrower, either before the lender's money is disbursed or after, action must be taken to determine the scope and extent of the issue. If a mortgage broker, lender or borrower is unsure if a "real" issue actually exists, a second opinion should be sought. Hoping that nothing has happened, or will happen, can only make things worse. Depending on what issue is discovered, legal counsel should be engaged to protect the mortgage broker, lender or borrower in order to minimize any potential for exposure.

## Conclusion

Mortgage brokers provide a valuable service to borrowers and lenders. However, merely because a person is licensed as a mortgage broker does not mean that person is qualified to serve as a mortgage broker in a particular transaction. Therefore, appropriate due diligence by the broker, lender and borrower is recommended.

\*This article discusses issues which were discussed in a Buchalter Nemer webinar on March 22, 2016. Mortgage Broker and Expert Witness Joffrey Long was a member of the panel of speakers at that webinar. However, he is not an author of this article. The opinions expressed herein are that of the authors and should not be construed as Mr. Long's opinions on the standard of care for mortgage brokers.



*Jason E. Goldstein is a Shareholder in the Firm's Litigation Practice Group in Orange County and Chair of the Firm's Mortgage Banking Group. Mr. Goldstein is an experienced litigator in state and federal courts across the country. Mr. Goldstein specializes in prosecuting title insurance and escrow claims and defending lenders and brokers in court (negligence, fraud, TILA, RESPA, HBOR, wrongful foreclosure) and before government agencies. Mr. Goldstein also regularly prosecutes misappropriation of trade secret claims, judicial foreclosures and conducts general civil litigation. He is an Affiliate Member of the California Mortgage Association. He can be reached at 949.224.6235 or [jgoldstein@buchalter.com](mailto:jgoldstein@buchalter.com)*



*John L. Hosack is a Shareholder in the firm's Litigation Practice Group in Los Angeles and a member of the firm's Mortgage Banking Group. Mr. Hosack represents mortgage brokers, secured lenders and property owners at trial and on appeal in real property disputes including, broker liability, lender liability, fraud, breaches of contract, mechanic's liens, stop notices, judicial foreclosures, receiverships, escrow claims and title insurance claims. His transactional practice includes commercial real property loan documentation, loan workouts, REO sales and foreclosures. He is an Affiliate Member of the California Mortgage Association, a member of the Los Angeles Mortgage Association, a Fellow of the American College of Real Estate Lawyers and a Fellow of the American College of Mortgage Attorneys. He can be reached at 213.891.5080 or [jhosack@buchalter.com](mailto:jhosack@buchalter.com)*