

MORTGAGE BROKERS— What Fiduciary Duties Exist?

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A

debate is simmering in the mortgage industry about whether mortgage brokers who arrange loan transactions act as agents of potential borrowers, or whether they are merely middlemen without agency responsibilities. The compensation structure by which mortgage brokers are paid fees by both borrowers (origination fees) and lenders (yield-spread premiums) has fueled the fire of this debate. ● When brokers are paid commissions by both parties to a loan transaction, confusion results about whom the brokers actually “work for.” Unfortunately, there is little legal guidance to answer the question “Whom do mortgage brokers work for?” There is some case law, and a few states have enacted laws on the issue, but for the most part, the law is unclear about whether mortgage brokers represent borrowers, lenders, or neither. ● As a result of the ambiguity in this area, mortgage bankers, brokers and mortgage industry regulators (including lawmakers) should familiarize themselves with the existing laws and cases that have considered brokers’ duties and responsibilities. Understanding the law is crucial in light of recent economic events in the mortgage market (e.g., the spike in foreclosures and subprime market meltdown). It is also important because of increasing media criticism of mortgage brokers, (see, for example, James Hagerty, “Mortgage Brokers: Friends or

The debate has been long brewing over whether mortgage brokers owe a fiduciary duty to their borrowers. Here’s an update drawn from case law and newly enacted measures.

Foes?," *The Wall Street Journal*, May 30, 2007; and Ruth Simon and James R. Hagerty, "Debt Bomb: Inside the 'Subprime' Mortgage Debacle—The Middlemen: Mortgage Mess Shines Light on Brokers' Role," *The Wall Street Journal*, July 5, 2007).

Finally, greater understanding is needed in light of the high number of consumer complaints about the activities of mortgage brokers (see, for example, the State of Maryland's Regulatory Guidelines for Mortgage Lender Licensees, dated June 2005, which cites noncompliance with the state-mandated broker agreement as being the No. 1 regulatory violation).

This article compiles and describes cases and statutes placing fiduciary duties on mortgage brokers, and suggests an emerging trend toward increasing the duties owed by mortgage brokers to their borrower customers.

Are mortgage brokers middlemen or agents?

Currently, few laws on the books specifically outline the fiduciary duties of mortgage brokers. Independent mortgage brokers occupy a somewhat undefined space in the commercial world, being positioned between lenders and borrowers while usually maintaining that they represent neither.

The National Association of Mortgage Brokers (NAMB), McLean, Virginia, insists that "the consumer is the decision-maker, not the mortgage broker"—implying that fiduciary duty should not and cannot be owed to the borrower by the broker. Despite NAMB's position, the law of principal-agency relationships, as it has been applied to mortgage brokers by various courts, has often imposed fiduciary duties on brokers.

Agency creates a fiduciary relationship

Agency is a fiduciary relationship that results from the consent by one person (the principal) to another (the agent) that the other (the agent) act on his/her behalf or subject to his/her control. An agency relationship can be created either expressly by oral or written agreement, or it may be implied through conduct.

For a practical example, when a mortgage broker tells a prospective borrower that he will obtain the best loan or the best rate and the borrower relies on him to do so, an agency relationship may result from the broker's conduct.

Fiduciary duties accompanying the agency relationship include the duty of loyalty and the duty of care. The duty of loyalty is the obligation undertaken by the fiduciary (the agent) to exercise his power in a manner that he believes in good faith will best advance the interests or purposes of his principal, and conversely, not to exercise his power for personal benefit. The duty of care requires the agent to act in good faith, as one believes a reasonable person would act, in becoming informed and exercising the power of a fiduciary or agent.

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Fiduciary duties that may fall on mortgage brokers include the following: 1) the duty to disclose all loan information to the borrower (i.e., loan fees, interest rates, prepayment penalties and yield-spread premiums), and 2) the duty to act in good faith and to deal fairly (i.e., avoiding secret fees or undisclosed fee-splitting arrangements).

These duties may be enhanced when the agent has special skills or experience that give him an advantage over his principal. In other words, a broker with much more knowledge and experience in mortgage loan transactions than his prospective customer is likely to be held to a higher standard of duty and care than a novice broker. The broker's duty is also likely to be higher if the customer has limited knowledge of the complexities of the mortgage transaction, or if the customer is relying exclusively on the broker's expertise and knowledge.

A broker's duty of loyalty to his principal incorporates the principle that there should be no self-dealing by the broker. In other words, the broker must avoid acquisition of material benefits from third parties in transactions where he represents the borrower.

The rule against self-dealing is based on the assumption that when an agent pursues material benefits from third parties in connection with actions taken on behalf of his principal, the agent's eagerness to acquire those benefits may override his commitment to obtain the best terms for his principal. Not only would a self-dealing mortgage broker be violating the duty of loyalty to his client, but a third party who assists or encourages an agent to breach a duty to his principal is also subject to liability to the principal.

The general principle of avoidance of self-interest in brokered transactions should sound a loud warning bell for the payment by lenders and receipt by brokers of yield-spread premiums in loan transactions, particularly if they are not expressly disclosed and agreed to by the borrower.

A mortgage broker's duties to the borrower depend on the borrower's experience and financial sophistication and the broker's specialized knowledge, experience and skills. The greater the imbalance between the two, the more likely the broker is to be deemed the agent of the borrower with the attendant fiduciary duties.

A mortgage broker's duty to disclose material facts about a loan transaction and to explain loan details is increased if the borrower has limited knowledge or is financially unsophisticated, according to the oft-cited California case *Wyatt v. Union Mortgage Co.* There, a mortgage broker was held to be in breach of his fiduciary duty based on his failure to disclose to the borrower the true rate of interest, the penalty for late payment and the amount of the balloon payment.

Wyatt suggests that under California law, where a borrower is unsophisticated and relies on the

expertise and knowledge of a mortgage broker, a high standard of fiduciary duty compels the mortgage broker to abstain from acts that are adverse to the borrower's interests.

Myer v. Preferred Credit Inc., et al., held that a mortgage broker breached his fiduciary duty when he failed to disclose to the borrower the receipt of a yield-spread premium from the lender. The yield-spread premium was compared to a "kickback," and the court found it adverse to the borrower's interests.

The court also determined that because the borrowers lacked knowledge of financial matters and mortgage lending negotiations, the mortgage broker had an even higher duty of explanation to them. The *Myer* decision is consistent with California's *Wyatt* case in holding that the level of a borrower's financial knowledge (or lack of it) may determine the fiduciary duty owed by the broker to the borrower.

Other reported cases address the issue of a broker's duty to act in the best interest of the borrower, including the Georgia case *McWhorter v. Ford Consumer Finance*, which addressed broker fees in the context of broker duty. In this case, the broker received a total 4 percent fee from both the lender and the borrower. Despite the broker's being paid by both sides, the court held that the broker had an agency relationship with the borrower and, as an agent, the broker was bound to loyalty and good faith in dealings with the borrower.

Under agency law, suggests *McWhorter*, a mortgage broker who accepts a fee from a lender acts adversely to the borrower; agency means that the mortgage broker or agent should deal exclusively in the best interests of the borrower (his principal).

The Missouri decision in *Armstrong v. Republic Realty Mortgage* held that a mortgage brokerage firm breached its fiduciary duty by acting adversely to the borrower's interest when the broker convinced the lender that the borrower would pay a higher prepayment penalty than the lender required. The broker split the compensation paid by the lender for selling a higher prepayment penalty as part of the loan, and then paid part of the broker's share (\$2,000) to its loan officer. This conduct by the broker was held to be contrary to the borrower's best interests, resulting in a punitive damages judgment of \$125,000.

While fee-splitting arrangements (such as existed in *Armstrong*) are subject to criticism, a broker has no fiduciary duty to disclose his or her own fees, under the Maryland decision in *Holzman v. Blum*, which drew a distinction between a mortgage broker's fiduciary duty in relation to his services and his duties vis-à-vis his fees. In fee arrangements with prospective borrowers, the Maryland court held that brokers and borrowers deal at arm's length; but with respect to a broker's services, the broker has a duty to act in the borrower's best interests.

In addition to the duty to act in the borrower's

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best interest and to fully disclose all facts pertinent to the loan, a mortgage broker has a duty to act in good faith in dealings with borrowers.

In the Missouri case *Jefferson v. American Financial Group Inc.*, the court held that Mortgage Source failed to act in good faith and with reasonable skill, care and diligence for the benefit of the borrower, and breached its fiduciary duty in a number of ways: It obtained an appraisal that was unreasonably inflated, obtained a loan on terms it knew the borrower could not repay, failed to keep the borrower informed about the terms of refinancing and made false representations that the borrower could refinance in six months.

In Texas, a broker was held to be in a fiduciary relationship with a borrower in *Rauscher Pierce Refsnes Inc. v. Great Southwest Savings FA*. The broker was supposed to issue seasoned loans (existing loans, more than 6 months old, with no defaults), of grade-A investment quality. The broker breached his fiduciary duty of reasonable investigation and proper delivery of all information when he delivered loans that were "not insured, not seasoned and of poor quality," stated the *Rauscher* decision.

Rauscher cited *Magnum Corp. v. Lehman Brothers Kuhn Loeb Inc.*, stating that "the relationship between a broker and its customer is that of principal and agent."

In states whose courts have not considered mortgage brokers' agency or fiduciary roles vis-à-vis prospective borrowers, statutes governing mortgage brokerage, including broker license laws, may (but will not always) shed light on the issue. In *Koch v. First Union Corp.*, a Pennsylvania court found that a fiduciary duty exists even though the Pennsylvania Mortgage Bankers and Brokers Act imposes no fiduciary duty on mortgage brokers.

The *Koch* decision cites *Frowen v. Blank*, stating that "[a confidential relationship] appears when the circumstances make it certain the parties do not deal on equal terms, but, on the one side there is an overmastering influence, or, on the other, weakness, dependence or trust, justifiably reposed." Thus, in Pennsylvania, notwithstanding the mortgage broker licensing law, the confidential nature of broker-borrower relationships may impose fiduciary duties on brokers.

Supplementing case law and mortgage broker licensing laws, some state statutes contain express "good faith" requirements applicable to mortgage brokers, including several enacted in 2007. Colorado H.B. 1322 and S.B. 216 establish a statutory duty of good faith and fair dealing for mortgage brokers in all communications and transactions with borrowers, including a duty to take into consideration a borrower's financial condition when brokering a loan.

On June 11, 2007, Maine Governor John Baldacci signed L.D. 1869, an anti-predatory-lending bill that

imposes a duty on loan brokers to “act in good faith and with fair dealing” toward borrowers. (Most of the provisions of L.D. 1869 become effective Jan. 1, 2008.)

Minnesota H.F. 1004 specifies that a residential mortgage loan originator has an agency relationship with the borrower unless he expressly disclaims such a relationship in writing within three business days of accepting a residential mortgage loan application. If a loan originator accepts or solicits an advance fee for obtaining a Minnesota residential mortgage loan, he automatically creates a fiduciary relationship with the borrower.

With enactment of H.F. 1004, Minnesota raised the bar for mortgage broker duties to prospective borrowers statewide. (Prior to adoption of H.F. 1004, Minnesota law was undecided about whether brokers owed a fiduciary duty to borrowers. See, for example, *Brancheau v. Residential Mortgage*, 182 F.R.D. 579 [D. Minn. 1998], a case rejecting the notion that a fiduciary relationship exists between all brokers and borrowers.)

Current law demonstrates that mortgage brokers are likely to be deemed agents of prospective borrowers in the context of loan origination. This is especially true when borrowers lack knowledge of financing transactions, when brokers have special knowledge or skills, and when borrowers rely on the brokers’ expertise and counsel or are otherwise at a disadvantage in obtaining information from other sources.

As agents, certain legal duties are required of mortgage brokers—i.e., the duty of fairness and honesty, the duty of good faith and the duty to disclose all material facts. Failure of mortgage brokers to embrace and abide by these general and well-established duties will likely lead to enactment of a complex patchwork of non-uniform state statutes defining with precision the duties of mortgage brokers to the borrowing public. **MB**

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