

Client Alert.

November 1, 2010

Interim Final Rule on Real Estate Appraisals

By Joseph Gabai

BRIEF SUMMARY

On October 18, 2010, the Federal Reserve Board (“Board”) issued an interim final rule to implement the appraisal independence provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank Act”). The interim final rule also implements the provisions of the Dodd-Frank Act that require creditors and their agents to pay customary and reasonable fees to fee appraisers. This client alert summarizes the Board’s rule and discusses its ramifications for mortgage lenders.

HISTORY AND SCOPE

- Section 1472 of the Dodd-Frank Act added a new Section 129E to the federal Truth-in-Lending Act (“TILA”) to impose appraisal independence requirements for a consumer credit transaction secured by the principal dwelling of the consumer. A detailed discussion of Section 1472 is found in our Dodd-Frank Residential Mortgage User Guide. See <http://www.mofo.com/files/Uploads/Images/ResidentialMortgage.pdf>.
- Regulations, interpretive guidelines, and statements of policy under Section 129E of TILA relating to appraiser independence ultimately may be jointly issued by the Board, Comptroller of the Currency (“OCC”), Federal Deposit Insurance Corporation (“FDIC”), National Credit Union Administration, Federal Housing Finance Agency (“FHFA”), and Bureau of Consumer Financial Protection. In the meantime, Section 129E directed the Board to issue interim final regulations within 90 days following the enactment of the Dodd-Frank Act (i.e., by October 19, 2010) to define the acts and practices that violate appraisal independence. These interim final regulations are deemed to be regulations issued by the larger group of federal agencies noted above.
- A number of existing provisions of law mandate appraisal independence, including Title XI of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (“FIRREA”); the appraisal regulations of the various federal banking agencies (e.g., 12 C.F.R. §34.41, *et seq.*, in the case of the OCC); and the Uniform Standards of Professional Appraisal Practice (“USPAP”). Section 129E itself, as well as the Board’s interim final regulation, are modeled on, and expand upon, the Board’s existing regulation at Section 226.36(b) of Regulation Z (12 C.F.R. §226.36(b)), which took effect on October 1, 2009. Section 226.36(b) applies to any closed-end consumer credit transaction secured by the consumer’s principal dwelling. In contrast, the Board’s interim final regulation applies to *all* consumer credit transactions secured by the consumer’s principal dwelling, both closed-end and open-end (collectively, “Covered Transactions”). Covered Transactions include, among others, purchase loans, refinancings, closed-end home equity loans, home improvement loans, debt consolidation loans, reverse mortgages, and home equity lines of credit.
- The appraisal independence provisions of the Board’s interim final regulation apply to all creditors and settlement service providers (collectively, “Covered Persons”) that are involved with a Covered Transaction.
 - Covered Persons include creditors, appraisal management companies (“AMCs”), appraisers, mortgage

Client Alert.

brokers, real estate brokers and agents, title insurers, and other settlement service providers (as defined in the Real Estate Settlement Procedures Act (“RESPA”) and HUD’s Regulation X)

- Covered Persons do not include the consumer him/herself, a guarantor, or a person residing in the consumer’s home who is not liable on the loan
 - In contrast, the provisions of the interim final regulation requiring the payment of customary and reasonable fees to fee appraisers, and the provisions requiring the reporting of certain compliance failures, are limited to appraisers subject to state agencies’ jurisdiction
- The valuations (“Valuations”) covered by the appraisal independence provisions of the new regulation include formal appraisals performed by licensed or certified appraisers, broker price opinions (“BPOs”), or any other estimate of value prepared by a natural person. Pictures and other information included with the estimate of value are treated as part of the Valuation.
 - A Valuation does not include an estimate of value prepared solely by an automated valuation model (“AVM”)
 - However, an estimate of value prepared by a natural person that is based, in whole or in part, on information from an AVM will be a Valuation
 - The Home Valuation Code of Conduct (“HVCC”) was announced by the FHFA on December 23, 2008. The HVCC imposed additional appraisal independence requirements for loans purchased by Fannie Mae and Freddie Mac. The HVCC also had a variety of unintended consequences. Section 129E(j) of TILA states that the HVCC will have no force or effect on the date that the Board’s interim final regulation is promulgated. Note that Section 1476 of the Dodd-Frank Act requires the General Accounting Office to prepare a study on the HVCC, leaving open the possibility that elements of it may return at some point.
 - The Board’s interim final regulation was published in the Federal Register on October 28, 2010, and will be effective on December 27, 2010. Comments regarding any aspect of the regulation may be submitted to the Board through that date.
 - Compliance with the interim final regulation is optional through March 31, 2011. Compliance becomes mandatory on April 1, 2011
 - The Board’s existing appraisal independence regulation at Section 226.36(b) of Regulation Z is removed effective on April 1, 2011. Parties subject to Section 226.36(b) may comply with either Section 226.36(b) or new Section 226.42 (discussed below) through March 31, 2011, and if those persons comply with Section 226.42 they will be deemed to comply with Section 226.36(b)
 - The Board’s interim final regulation does not address other appraisal matters governed by the Dodd-Frank Act, such as appraisal report portability under Section 129E(h) of TILA. This will await subsequent rulemaking.
 - A violation of Section 129E of TILA subjects the violator to the “enforcement provisions” referred to in Section 130 of TILA. In addition, violators are subject to a civil penalty of up to \$10,000 per day for the first violation, and up to \$20,000 per day for subsequent violations. The civil penalties are to be assessed by the federal agencies with administrative enforcement authority under TILA.

Client Alert.

HIGHLIGHTS OF THE INTERIM FINAL RULE AND ANALYSIS

- *Use of Coercion to Affect Valuations (Section 226.42(c)(1) of Regulation Z)*
 - A Covered Person may not directly or indirectly cause, or attempt to cause, a Valuation to be based on any factor other than the independent judgment of the person preparing the Valuation
 - This prohibits the use of coercion, extortion, inducement, bribery, intimidation, compensation, or collusion to influence the person who performs the Valuation or performs the valuation management functions described below. Paragraph 226.42(c)(1)-1 of the Federal Reserve Commentary to Regulation Z (“Commentary”) states that the terms “coercion,” etc., are to be defined by applicable state law or contract
 - The interim final regulation provides the following examples of violations:
 - Seeking to influence a person that prepares a Valuation to report a minimum or maximum value
 - Withholding, or threatening to withhold, timely payment because the value does not come in at or above a certain amount
 - Implying to a person that prepares a Valuation that current or future retention of the person will depend on the amount of the Valuation of a particular property
 - Excluding a person that prepares a Valuation from consideration of future engagements because the amount of the Valuation of a particular property did not come in at or above a certain level
 - Conditioning payment to a person who prepares a Valuation on whether the transaction is consummated
 - Applying any coercion or other prohibited act against an AMC or other person that performs valuation management functions, or any of their affiliates. In this regard, it is irrelevant whether the AMC or any such other person falls within the definition of an “appraisal management company” under Section 1473 of the Dodd-Frank Act
 - Threatening to withhold future business from a title company affiliated with an AMC unless the AMC’s appraiser values a property at or above a certain level
 - These examples are illustrative, not exhaustive. For example, the following acts also are prohibited:
 - Agreeing to employ a relative or friend in return for having the Valuation come in at a particular value
 - Providing gifts of money or other consideration in return for having the Valuation come in at a particular value
 - It is irrelevant whether the coercive act is designed to cause the person who prepares a Valuation to come in at or above a specific value, below a specific value, or within a certain range of values. All of these are impermissible

Client Alert.

- *Mischaracterization of Value (Section 226.42(c)(2) of Regulation Z)*
 - A person who prepares a Valuation may not materially misrepresent the value of the property.
 - The Commentary provides the following example: An appraiser estimates a value of \$250,000 when applying USPAP, but then assigns a value of \$300,000 for the property in the Uniform Residential Appraisal Report
 - A misrepresentation is “material” if it is likely to significantly affect the value assigned to the property. This means that a misrepresentation is “material” even if it does not affect the creditor’s decision to make the loan or the credit terms
 - In practice, it will be prudent to regard virtually any misrepresentation of value as material
 - A bona fide error is not regarded as a misrepresentation
 - A Covered Person may not falsify a Valuation, and a Covered Person other than the preparer of the Valuation may not materially alter a Valuation
 - See discussion above regarding what is “material”
 - Practice Point: Any alterations to a Valuation should be made by the person who prepared the Valuation
 - A Covered Person may not induce any other person to violate any of the foregoing rules relating to misrepresentations, falsifications, or alterations
- *Exceptions (Section 226.42(c)(3) of Regulation Z)*
 - Actions that are not prohibited by the rules against coercion and mischaracterization include the following, so long as they are not done in a manner that would cause, or attempt to cause, a Valuation to be based on any factor other than the independent judgment of the person preparing the Valuation:
 - Asking the preparer of the Valuation to consider additional and appropriate property information, including other comparable properties
 - Asking the preparer of the Valuation to provide further detail, substantiation, or explanation for the Valuation
 - Asking the preparer of the Valuation to correct errors in the Valuation
 - Obtaining multiple Valuations of the property in order to select the most reliable Valuation
 - Withholding compensation for breach of contract or substandard performance
 - Taking action permitted or required by applicable federal or state statute, regulation, or agency guidance

Client Alert.

- The foregoing examples are illustrative, not exhaustive. However, it would be prudent to limit behavior to actions that are consistent with those examples
- Comment: Creditors would be well advised to develop policies and procedures relating to the circumstances and manner in which these exceptions, and other exceptions allowed by the interim final regulation, may be properly exercised. Compliance with such appropriate and well-defined policies and procedures will go a long way in demonstrating the credible use of these exceptions
- *Prohibition on Conflicts of Interest (Section 226.42(d) of Regulation Z)*
 - A person who prepares Valuations, or performs valuation management functions (“Valuation Management Functions”), may not have a direct or indirect interest, financial or otherwise, in the property or transaction in question.
 - A “Valuation Management Function” includes recruiting, selecting, or retaining a person to prepare a Valuation; contracting with or employing a person to prepare a Valuation; managing or overseeing the process of preparing a Valuation; or reviewing or verifying the work of a person who prepares Valuations. The term is broadly defined to include services performed by traditional AMCs—which manage appraisals but not other types of Valuations—as well as persons who manage BPOs and other types of nonappraisal Valuations
 - Example: A person who has applied for a mortgage loan to buy a home may not perform the Valuation for that loan transaction because he/she has an interest in the property
 - Example: A person whose compensation depends on whether the transaction is consummated may not perform the Valuation for that loan transaction
 - Section 226.42(d) builds on existing regulations and guidance of the federal banking agencies that prohibit conflicts of interest with respect to the appraisal function. See, e.g., 12 C.F.R. §34.45 (OCC regulation) and the Interagency Appraisal and Evaluation Guidelines (FDIC FIL-74-94, November 11, 1994). The HVCC, issued in December 2008, imposed severe prohibitions on perceived conflicts of interest
 - The prohibition on conflicts of interest naturally raises a question whenever the person who prepares Valuations, or performs Valuation Management Functions, is employed by the creditor or an affiliate of the creditor. The Board has made clear that the fact of this relationship, by itself, does not necessarily result in a conflict of interest in violation of Section 226.42(d).
 - The term “affiliate” is defined by reference to that term in Federal Reserve Regulation Y. In general, an affiliate is a company that controls, is controlled by, or is under common control, with another company. See 12 C.F.R. §225.2(a)
 - Similarly, there are instances in which the person who prepares Valuations, or performs Valuation Management Functions, also performs some other settlement service (as defined in RESPA) in the transaction, or whose affiliate performs another settlement service in the transaction. Once again, the Board has made clear that the performance of other settlement services, by itself, does not necessarily result in a conflict of interest in violation of Section 226.42(d)

Client Alert.

- The principle underlying the interim final regulation is that sufficient firewalls and safeguards can ensure the integrity of the Valuation process. Accordingly, the regulation provides a series of “safe harbors” that can be used in both the employee and multiple services contexts.
 - If the appropriate safe harbor has been complied with, then the fact of the employee relationship, or the performance of other settlement services, will not, by itself, result in a violation of the conflict of interest provisions of Section 226.42(d)
 - If the appropriate safe harbor has not been complied with, then the question of whether there is, in fact, a conflict of interest in violation of Section 226.42(d) will depend on all of the facts and circumstances
 - Comment: While the use of the appropriate safe harbor is, technically speaking, optional, it would be extremely prudent to do so. In practice, failure to comply with the appropriate safe harbor can be expected to result in considerable scrutiny of—or, more likely, paint a target on—these types of relationships
 - Even if the appropriate safe harbor is complied with, any other actual conflicts of interest will result in a violation of Section 226.42(d). For example, if the person performing a Valuation for his/her employer falls within the safe harbor for employees, but the person owns an interest in the property in question, then he/she has a direct conflict of interest and has violated Section 226.42(d). The fact that he/she also fell within the safe harbor will not provide any protection
- Safe Harbor for Employees and Affiliates of Creditors with Assets of More than \$250 Million as of 12/31 for Both of the Past Two Calendar Years (“Larger Creditor Safe Harbor”). A person who prepares Valuations, or performs Valuation Management Functions, and is employed by such a creditor or an affiliate of the creditor will not, by that fact alone, have a conflict of interest in violation of Section 226.42(d) if:
 - The person’s compensation for preparing the Valuation or performing the Valuation Management Functions is not based on the value arrived at. For example, the fee paid to an in-house appraiser cannot be reduced if the appraised value comes in at less than the selling price of the property;
 - The person reports to a person (i) who is not part of the creditor’s loan production function, and (ii) whose own compensation is not based on the closing of the transaction. For example, an in-house appraiser cannot report to a loan officer, or a person supervised by a loan officer. Another example: A person engaged in Valuation Management Functions and who is an employee of an AMC that is an affiliate of the creditor cannot be supervised by a person who earns compensation based on the percentage of closed transactions for which the AMC provides Valuation Management Functions; and
 - No employee, officer, or director in the creditor’s loan production function is directly or indirectly involved in selecting, retaining, recommending, or influencing the selection of the person to prepare a Valuation or perform a Valuation Management Function, or to be included or excluded from a list of approved persons to perform those tasks. The Commentary provides the following example: A person who selects in-house appraisers to perform appraisals cannot be supervised by a person who also supervises loan officers

Client Alert.

- For purposes of the Larger Creditor Safe Harbor, the creditor's "loan production function" means an employee, officer, director, department, division, or other unit of the creditor with responsibility for generating Covered Transactions, approving Covered Transactions, or both.
 - This includes retail sales staff, loan officers, and anyone else who takes loan applications, offers or negotiates loan terms, or whose compensation is based on loan processing volume. The term is broader than the term "loan originator" as defined in the Board's recent regulation that governs loan originator compensation practices. See our earlier memo at <http://www.mofo.com/files/Uploads/Images/100831FinalRule.pdf>
 - A person is not considered part of the loan production function solely because part of his/her compensation includes a bonus not tied to specific transactions or a specific percentage of transactions closing, or a profit-sharing plan that benefits all employees. However, if a person is part of the creditor's profit-sharing plan, but also receives compensation based on the number or percentage of loans closed, he/she will be part of the loan production function
 - The term does not include a person whose only responsibility is for credit administration or risk management, such as loan underwriting, loan closing, preparing loan documentation, disbursing funds, collections, servicing, monitoring loan performance, or foreclosure processing. However, if a person who performs any of these functions (e.g., loan underwriting) also performs loan production functions (e.g., offers loans), he/she will be treated as part of the loan production function
 - Comment: For creditors that have assets of more than \$250 million in each of the past two calendar years, it is recommended that policies and procedures be developed to identify with specificity exactly which positions are, and are not, part of the loan production function. It may be necessary to revise the duties of some back office employees in order to keep them out of the loan production function. While the adoption of these policies and procedures will not necessarily be determinative, adherence to well-drafted policies and procedures may go a long way in establishing credibility to a creditor's position that a particular category of positions is not part of the loan production function, particularly in the context of a regulatory examination
- Safe Harbor for Employees and Affiliates of Creditors with Assets of \$250 Million or Less as of 12/31 for Either of the Past Two Calendar Years ("Smaller Creditor Safe Harbor"). A person who prepares Valuations, or performs Valuation Management Functions, and is employed by such a creditor or an affiliate of the creditor will not, by that fact alone, have a conflict of interest in violation of Section 226.42(d) if:
 - The person's compensation for preparing the Valuation or performing the Valuation Management Functions is not based on the value arrived at. For example, the fee paid to an in-house appraiser cannot be reduced if the appraised value comes in at less than the selling price of the property; and
 - The creditor requires that any employee, officer, or director who orders, performs, or reviews Valuations for Covered Transactions abstain from participating in any decision to approve, not approve, or set the terms of the transaction. For example, if a loan officer reviews an appraisal prepared by an in-house appraiser, the loan officer may not participate in the loan approval decision

Client Alert.

or participate in the setting of the loan terms

- Comment: For creditors that have assets of \$250 million or less in either of the past two calendar years, it is recommended that policies and procedures be developed to make sure that any employee, officer, or director who orders, performs, or reviews Valuations for Covered Transactions abstain from participating in any loan approval or credit terms-setting decisions
- Comment: Although safe harbors are available, the new regulation presents a creditor with risk of a conflict of interest should the creditor use an in-house employee to prepare Valuations or perform Valuation Management Functions. This risk is avoided if the creditor uses outside fee appraisers or engages a third party to perform Valuation Management Functions. However, the use of outside fee appraisers and engagement of a third party to perform Valuation Management Functions raises other risks, given the duty under Section 226.42(f) (discussed below) to pay reasonable and customary compensation to fee appraisers
- Safe Harbor for Providers of Multiple Settlement Services. A person who prepares Valuations or performs Valuation Management Functions and, in addition, performs some other settlement service for the transaction, or whose affiliate performs some other settlement service, will not, by that fact alone, have a conflict of interest in violation of Section 226.42(d) if:
 - The creditor had assets of more than \$250 million as of 12/31 for both of the past two calendar years, and the conditions for the Larger Creditor Safe Harbor (described above) are met. The Commentary provides the following example: If an AMC and title company are providing services for the same transaction, and the AMC employee who performs Valuation Management Functions is supervised by the title insurance agent in the transaction (and whose compensation depends on whether title insurance is sold at loan closing), the safe harbor will not be available; or
 - The creditor had assets of \$250 million or less as of 12/31 for either of the past two calendar years, and the conditions for the Smaller Creditor Safe Harbor (described above) are met
- Comment: Even if the safe harbor for providers of multiple settlement services is available, it is still necessary to comply with other applicable laws and regulations. For example, the referral of title business by an AMC to its affiliated title company also must comply with the Affiliated Business Arrangement rules under Section 3500.15 of HUD's Regulation X. Similarly, a bank's receipt of title services from an affiliate must meet the standards of Section 23B of the Federal Reserve Act and Federal Reserve Regulation W (12 C.F.R. Part 223)
- *Prohibition on Extension of Credit If Creditor Has Knowledge of Violation of Independence or Conflict of Interest Rules (Section 226.42(e) of Regulation Z)*
 - If the creditor knows, at or before the consummation of a Covered Transaction, that there has been a violation of any of the above Valuation independence or conflict of interest rules, Section 226.42(e) states that the creditor is not permitted to extend credit. There is an exception, which allows the creditor to extend credit, but only if the creditor documents that it has acted with reasonable diligence to determine that the Valuation did not, in fact, materially misstate or misrepresent the value of the property.

Client Alert.

- For purposes of Section 226.42(e), a Valuation materially misstates or misrepresents the value of the property if there is a misstatement or misrepresentation in the Valuation that affects the credit decision or the credit terms
 - For example, if the creditor learns that a loan officer coerced an appraiser into assigning a particular value to the property, the creditor is prohibited from closing the loan unless the exception described above applies
 - The materiality standard under the exception in Section 226.42(e) is in contrast with the materiality standard that applies to mischaracterizations under Section 226.42(c)(2), discussed above, under which a mischaracterization of value is material if it significantly affects the value assigned to the property, even if it does not affect the credit decision or the credit terms
 - The Board's Supplementary Information states that if a creditor violates Section 226.42(e) by closing the loan, the Board's regulation does not void the consumer's loan agreement with the creditor. Whether the loan is void or voidable will depend upon state or other applicable law
- The Commentary states that a creditor can meet the terms of the exception (which allows it to close the loan) if the creditor makes the loan based on a different (clean) Valuation than the one that was tainted
 - The Commentary also states that a creditor need not necessarily obtain a second (clean) Valuation to meet the terms of the exception and close the loan. It provides an example where an appraiser reports an effort by a loan officer to cause a misstatement of the value of the property, where the creditor reasonably determines and documents that the Valuation did not materially misstate or misrepresent the value of the property
 - Comment: In practice, a creditor that learns of a material misstatement or misrepresentation in the value of the property will almost always need to obtain and rely on a different (and clean) Valuation. In these situations, the first Valuation will be tainted, and most creditors will not wish to take the risk associated with confirming that the exception permitted under Section 226.42(e) is applicable. This will be particularly true in the case of heavily regulated creditors
 - Comment: Creditors should make sure that they have policies, procedures, and infrastructures in place that will mandate and facilitate the internal reporting of acts that could lead to material misstatements or misrepresentations in the values of properties, as well as a mechanism that will preclude the closing of loans that have been so tainted
 - Comment: If the Valuation in question is an appraisal and the appraiser has violated certain duties, then, in addition to the prohibition against the funding of the loan under Section 226.42(e), the creditor has a duty to report the responsible appraiser in accordance with Section 226.42(g) of Regulation Z, discussed below
- *Duty to Pay Customary and Reasonable Compensation to Fee Appraisers (Section 226.42(f) of Regulation Z)*
 - In any Covered Transaction, the creditor and its agent must compensate a fee appraiser at a rate that is customary and reasonable for comparable appraisal services in the geographic market where the property is located.

Client Alert.

- This likely will be the most challenging provision of the Board's interim final regulation. Given the fact-intensive nature of ascertaining a customary and reasonable fee, creditors and their agents will need to do a fair amount of work to be comfortably assured that they are in compliance even if they use one of the presumptions of compliance discussed below
- Because Section 226.42(f) covers all "Covered Transactions," the duty to pay customary and reasonable fees applies to, among others, purchase loans, refinancings, closed-end home equity loans, home improvement loans, debt consolidation loans, reverse mortgages, and home equity lines of credit
- Section 226.42(f) is limited to appraisals performed by fee appraisers. It does not apply to other types of Valuations, such as BPOs
- For this purpose, a "fee appraiser" is either (i) a natural person who is a state licensed or certified appraiser and receives a fee for performing an appraisal, but who is not an employee of the person engaging the appraiser, or (ii) an organization (e.g., corporation, partnership, sole proprietorship, association, cooperative, or other business entity, but not a natural person) that, in the ordinary course of business, employs such appraisers, receives a fee for performing appraisals, but is not an AMC that is subject to Section 1124 of FIRREA. Section 1124, which was added to FIRREA by Section 1473 of the Dodd-Frank Act, regulates and requires the registration of certain AMCs. An example of an organization that will be treated as a fee appraiser is an appraisal firm that has a staff of employee-appraisers
- By definition, the customary and reasonable compensation requirement does not apply to a creditor's compensation of its own in-house employees who are appraisers. However, if the creditor's staff appraiser is not actually an employee of the creditor (e.g., he/she is an independent contractor), then, as literally written, the customary and reasonable compensation requirement will apply. Also, note that appraisers who are characterized as "employees," but who are not bona fide employees, will be subject to the customary and reasonable compensation requirement
- Section 226.42(f) applies both to the creditor and its "agents." The Board's Supplementary Information makes clear that a creditor's "agent" includes AMCs. For example, if a creditor engages an AMC to arrange for an appraisal by a fee appraiser, the AMC is subject to the duty to pay customary and reasonable compensation to the fee appraiser. However, the total fee paid by the creditor to its agent, the AMC, is not subject to the customary and reasonable compensation requirement because the AMC itself is not a fee appraiser. For this purpose, an AMC is defined as a person authorized to perform one or more of the following on behalf of a creditor: recruit, select, and retain fee appraisers; contract with fee appraisers to perform appraisal services; manage the process of having appraisals performed (including providing administrative services, submitting completed appraisal reports, collecting fees for services provided, and compensating fee appraisers); or review and verify the work of fee appraisers. This definition is the same as the definition of an "AMC" under Section 1124 of FIRREA, except that it does not require the person to oversee a network or panel of a certain minimum size

Client Alert.

- In contrast, a fee appraiser him/her/itself is not an agent of the creditor, and is not subject to the customary and reasonable compensation requirement. For example, if a creditor engages an AMC to arrange for an appraisal, the AMC in turn engages an appraisal firm (which is not an AMC under Section 1124 of FIRREA), and the appraisal firm has one of its appraisers perform the appraisal, then both the appraisal firm itself and the appraiser are “fee appraisers” under this rule. As a result, the AMC is required to pay a customary and reasonable fee to the appraisal firm, but the appraisal firm is not required to pay a customary and reasonable fee to the appraiser
- Comment: As literally worded, Section 226.42(f) prohibits paying compensation to a fee appraiser that is in excess of the customary and reasonable fee, as well as paying compensation that is less than the customary and reasonable fee. Ordinarily, appraisal fees paid by a consumer are excluded from the finance charge under Regulation Z, in a transaction secured by real property or in a residential mortgage transaction, so long as the fees are bona fide and reasonable in amount. See 12 C.F.R. §226.4(c)(7)(iv). If the compensation paid to a fee appraiser is more than the customary and reasonable fee, the excess amount will not qualify for this exclusion, and therefore will be part of the finance charge. This will affect a variety of disclosures in the Regulation Z disclosure statement, and will also impact the calculation of “points and fees,” which will have ramifications relating, among others, to the treatment of a loan as a “qualified mortgage” (see Section 1412 of the Dodd-Frank Act) and as a high-cost mortgage (see Section 1431 of the Dodd-Frank Act). Also, if the creditor charges the borrower a fee “in excess of the reasonable value of goods or facilities provided or the services actually performed,” HUD takes the position that this violates Section 8(b) of RESPA. See HUD Statement of Policy 2001-1
- The Commentary provides guidance regarding three aspects of the contractual relationship between the creditor or its agents on the one hand, and the fee appraiser on the other:
 - Section 226.42(f) does not prohibit the creditor or its agents from withholding compensation from a fee appraiser if he/she/it fails to meet contractual obligations, such as failing to deliver an appraisal report or for violating a federal or state appraisal law. However, any such claim must be genuine and not a pretext. Further, if any such claim were to be pretextual, this could serve as a basis for a violation of the prohibition on coercion discussed above
 - If the creditor or agent signs a contract with a fee appraiser agreeing that the fee paid is “customary and reasonable,” this does not mean that the creditor or agent has complied with the customary and reasonable compensation requirement. The Commentary states that such an agreement will not by itself create a presumption of compliance
 - Section 226.42(f) does not prohibit volume-based discounts, so long as the compensation is customary and reasonable. Note, however, that volume-based discounts could raise issues under Section 8(a) of RESPA. In addition, under rulings by some (but not all) courts, if the fee appraiser is paid a discounted fee, and the creditor upcharges that fee to the consumer, this could raise issues under Section 8(b) of RESPA. Also see HUD Statement of Policy 2001-1
- The duty of the creditor and its agents is to pay a customary and reasonable fee in the “geographic market of the property being appraised.”

Client Alert.

- Unhelpfully, the Commentary states that this means the geographic market relevant to compensation levels for appraisal services. Accordingly, depending upon the facts and circumstances, the relevant geographic market can be a state, a metropolitan statistical area (“MSA”), metropolitan division, area outside an MSA, county, or other geographic area
- The Commentary provides the following examples, which demonstrate the fact-intensive process in identifying the geographic market:

“For example, assume that fee appraisers who normally work only in County A generally accept \$400 to appraise an attached single-family property in County A. Assume also that very few or no fee appraisers who work only in contiguous County B will accept a rate comparable to \$400 to appraise an attached single-family property in County A. The relevant geographic market for an attached single-family property in County A may reasonably be defined as County A. On the other hand, assume that fee appraisers who normally work only in County A generally accept \$400 to appraise an attached single-family property in County A. Assume also that many fee appraisers who normally work only in contiguous County B will accept a rate comparable to \$400 to appraise an attached single-family property in County A. The relevant geographic market for an attached single-family property in County A may reasonably be defined to include both County A and County B.”
- The interim final rule provides two separate presumptions of compliance with the customary and reasonable compensation requirement.
 - If the creditor and its agents comply with either of the two presumptions, then it is presumed that they are in compliance with the customary and reasonable compensation requirement
 - Both of the two presumptions of compliance are rebuttable. The presumption may be rebutted with evidence that the amount of compensation paid to a fee appraiser was not customary and reasonable for reasons that are unrelated to the conditions for the presumption. How this will be done remains to be seen. If a presumption relied upon is successfully rebutted, this means that the customariness and reasonableness of the compensation is determined based on all of the facts and circumstances (i.e., without a presumption of compliance or violation)
 - Comment: While the regulation does not require the creditor and its agent to comply with one of the two presumptions, in practice this is what most creditors ultimately are expected to do
 - Comment: Both presumptions contain a fact-intensive determination process, which suggests that there may not be an easy way of being comfortably assured that the customary and reasonable compensation requirement is being met
- First Presumption of Compliance. A creditor and its agents are presumed to be in compliance with the customary and reasonable compensation requirement if they conform to the following three-part process:
 - First, the creditor or its agents must determine the amount of the fee that is reasonably related to recent rates paid for comparable appraisal services performed in the geographic market of the property being appraised. This requires the identification of “comparable appraisal services” being

Client Alert.

performed, which overlaps somewhat with the second part of the three-part process, below. Also, it requires an identification of the “geographic market” (see discussion above). “Recent rates” depend on the relevant facts and circumstances, but the Commentary states that rates charged within one year of reliance on the information generally will qualify

The Commentary also states that the creditor/agent may gather the information using a reasonable method, including a fee survey. Unlike the second presumption of compliance discussed below, the first presumption of compliance does not prohibit the inclusion of fees paid by AMCs in any such survey. In fact, the Board’s Supplementary Information expressly confirms that the regulation and Commentary do not prohibit this. This borders on the incredible, given the Dodd-Frank Act’s express prohibition on the use of such information in what has become the second presumption of compliance. Keep in mind that the presumptions are rebuttable, and a survey used to support the first presumption that includes AMC-paid fees could be challenged. If a decision is made to accept this risk, and a survey used to support the first presumption includes AMC-paid fees, it would be advisable to determine that the overall results of the survey fairly represent the fees paid to fee appraisers in the relevant geographic market. Finally, nothing in the regulation or Commentary prohibits a creditor from delegating the tasks required by the first presumption to an AMC. However, because the AMC is the agent of the creditor, the creditor presumably will have exposure for the acts or omissions of the AMC in this regard, and creditors should take steps to protect themselves accordingly (e.g., by obtaining appropriate representations, warranties, and indemnities in their agreements with AMCs)

- Second, once this amount is determined, it must be adjusted, as applicable, based on certain factors (i.e., type of property, scope of work, turnaround time for performance of the work, appraiser qualifications, appraiser experience and professional record, and appraiser work quality)

The need to consider the appraiser’s qualifications does not override federal or state laws prohibiting the exclusion of an appraiser from consideration for an appraisal assignment solely by virtue of membership or lack of membership in any particular appraisal organization. See, e.g., 12 C.F.R. §34.46(a) (OCC regulation). Note that Section 1473 of the Dodd-Frank Act will allow membership in a nationally recognized appraisal organization to be considered, but lack of membership may not be the sole bar against consideration for a particular appraisal assignment

- Third, the creditor and its agents must not engage in any anticompetitive acts in violation of federal or state law. Examples of prohibited acts include: (i) entering into contracts or engaging in conspiracies to restrain trade through price fixing or market allocation, in violation of federal or state antitrust laws, or (ii) engaging in acts of monopolization, such as restricting entrants into the relevant geographic markets (e.g., if an AMC holds a dominant position in a particular geographic market, through that AMC’s use of exclusivity agreements in its contracts with creditors) or causing persons to leave those markets, in violation of federal or state antitrust laws

Client Alert.

- **Second Presumption of Compliance.** A creditor and its agents are presumed to be in compliance with the customary and reasonable compensation requirement if they determine the amount of compensation paid to the fee appraiser by relying on rate information that meets all of the following:
 - First, the information must be based on objective third-party information. This includes fee schedules, studies, and surveys prepared by independent third parties, such as government agencies, academic institutions, and private research firms
 - Second, the information must be based on recent rates paid to a representative sample of providers of appraisal services in the geographic market of the property being appraised, or the fee schedules of those providers. (See discussion above regarding the “geographic market.”) Thus, the fact that the information is derived from a government agency fee schedule is not, by itself, sufficient to get the benefits of the second presumption of compliance—it also is necessary to confirm that the information is based on recent rates actually paid to a representative sample of providers in the relevant market, or the fee schedules for those providers
 - Third, any information based on fee schedules, studies, and surveys must exclude compensation paid to fee appraisers for appraisals ordered by AMCs. For this purpose, an “AMC” is defined as set forth above. As noted above, this definition is the same as the definition of an “AMC” under Section 1124 of FIRREA, except that it does not require the person to oversee a network or panel of a certain minimum size
- **Mandatory Reporting to State Appraiser Certifying and Licensing Agencies (Section 226.42(g) of Regulation Z)**
 - A Covered Person has an affirmative duty to report an appraiser to the appropriate state appraiser certifying and licensing agency if:
 - The Covered Person reasonably believes that the appraiser has not complied with USPAP or ethical or professional requirements for appraisers codified under state or federal law or regulation (e.g., Section 226.42(c) and (d) of Regulation Z, discussed above); and
 - The failure to comply is material (i.e., it is likely to significantly affect the value assigned to the property). Note that the standard of materiality under Section 226.42(g) is the same as the standard of materiality under Section 226.42(c)(2), but different than the standard of materiality under Section 226.42(e)
 - The Commentary provides the following examples of reportable activities: mischaracterization of the value of the property in violation of Section 226.42(c)(2)(i) of Regulation Z; performing an appraisal in a grossly negligent manner in violation of USPAP; or accepting an appraisal assignment on the condition that the appraiser will report a value equal to or greater than the purchase price for the property. In contrast, the Commentary states that an appraiser’s disclosure of confidential information in violation of state law, or failure to maintain required errors and omissions insurance in violation of state law, will not trigger a reporting obligation under Section 226.42(g). However, these acts or omissions will have other ramifications for the appraiser

Client Alert.

- As noted above, “Covered Persons” include creditors, AMCs, appraisers, mortgage brokers, real estate brokers and agents, title insurers, and other settlement service providers (as defined in RESPA and HUD’s Regulation X). The term excludes the consumer him/herself, a guarantor, or a person residing in the consumer’s home who is not liable on the loan
- The duty to report under Section 226.42(g) is limited to misbehavior by persons required to be licensed or certified appraisers. This duty to report does not apply to misbehavior by persons who perform Valuations but who are not appraisers. For example, the duty to report does not apply to a real estate broker who performs a BPO
- If there is a duty to report, the Covered Person must do so within a reasonable time after he/she/it determines that there is a reasonable basis to believe that a failure to comply has occurred
- The report is to be made to the state appraiser certifying and licensing agency for the state in which the property in question is located
- Comment: Other federal and state laws may impose independent—and substantively different—obligations to report suspected misbehavior. For example, banks must file Suspicious Activity Reports where required by applicable regulations. See, e.g., 12 C.F.R. §21.11 (OCC regulation)
- Comment: A Covered Person that makes a report under Section 226.42(g) is not protected from defamation or other claims. This lack of protection emphasizes the need to develop detailed policies and procedures relating to reporting. The lack of protection under Section 226.42(g) is in contrast with other mandatory reporting rules that provide some level of protection against these types of claims. See, e.g., 12 C.F.R. §21.11(l), an OCC regulation that discusses safe harbor protection for national banks that file Suspicious Activity Reports

Contact:

Joseph Gabai
(213) 892-5284
jgabai@mofo.com

Andrew M. Smith
(202) 887-1558
andrewsmith@mofo.com

Sean Ruff
(202) 778-1665
sruff@mofo.com

About Morrison & Foerster:

We are Morrison & Foerster—a global firm of exceptional credentials in many areas. Our clients include some of the largest financial institutions, investment banks, Fortune 100, technology and life science companies. We’ve been included on *The American Lawyer’s* A-List for seven straight years, and *Fortune* named us one of the “100 Best Companies to Work For.” Our lawyers are committed to achieving innovative and business-minded results for our clients, while preserving the differences that make us stronger. This is MoFo. Visit us at www.mofo.com.

Because of the generality of this update, the information provided herein may not be applicable in all situations and should not be acted upon without specific legal advice based on particular situations.