

MELTDOWN PUSHES More Fiduciary Duties ON BROKERS

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Whether mortgage brokers have a fiduciary duty to borrowers was already a heated topic before the mortgage crisis hit. In the wake of the meltdown, many new laws and court cases have made the answer to that question even more complex.



Attempts to pinpoint the causes of the housing crisis and prevent a recurrence have focused on mortgage brokers and home loan origination practices. Legislators have taken steps to impose fiduciary duties on residential mortgage brokers, and courts sympathetic to distressed borrowers have recently decided, in a number of cases, that mortgage brokers owe fiduciary duties to borrowers. An escalating legal trend toward recognition of the fiduciary duty of residential mortgage loan brokers is apparent. ● While there is little uniformity or predictability in this area, a review of the law reveals that mortgage brokers can no longer persuasively claim to be mere intermediaries in the home loan origination process. ● The question of whether mortgage brokers have fiduciary obligations to prospective borrowers was reviewed in an October 2007 article in this magazine written by Andrea Lee Negroni and Joya K. Raha, titled “Mortgage Brokers—What Fiduciary Duties Exist?” The handful of cases and state statutes discussed in that article predicted a trend favoring such an obligation. Requests for updates on the law of mortgage broker fiduciary duty have been so frequent, and changes in the law so rapid, that *Mortgage Banking* and that article’s authors felt a sequel was needed. ● This article identifies legal developments since 2007, which reinforce the authors’ view that in the context of loan origination, mortgage broker fiduciary duty may eventually be the rule rather than the exception. The discussion of the theories and principles of fiduciary duty and the fiduciary relationship between principals and agents is derived from the 2007 article.

Theories and principles of fiduciary duty of mortgage brokers

The law of fiduciary duty can be divided into the following general categories: 1) express fiduciary duty imposed by statute; 2) fiduciary duty based on an agency relationship; and 3) fiduciary duty based on the special relationship of the parties (e.g., mortgage broker and would-be borrower). Within these general categories, there is some overlap. For example, some statutes impose fiduciary duty on mortgage brokers when an agency relationship exists between them and their borrower clients.

Fiduciary duty is the highest standard of care under the law. It traditionally includes the duty of loyalty and the duty of care.

The duty of loyalty is the obligation undertaken by the fiduciary 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 fiduciary to act in good faith, as one believes a reasonable person would act, in becoming informed and exercising the power of a fiduciary.

Other fiduciary duties that may fall on mortgage brokers include the duty to disclose all loan information to the borrower (e.g., loan fees, interest rates, prepayment penalties and yield-spread premiums [YSPs]), and the duty to act in good faith and to deal fairly (e.g., avoiding secret fees or undisclosed fee-splitting arrangements).

Fiduciary duty may be enhanced when a mortgage broker has special skills or experience. A mortgage broker with extensive knowledge and experience will likely be held to a higher standard of duty and care than a novice broker. The broker's duty will also be elevated to a higher standard if a consumer has limited knowledge of the complexities of the mortgage transaction, if the consumer relies exclusively on the broker's knowledge and expertise, or if the consumer is elderly or otherwise vulnerable.

Federal legislative reform

Recent federal legislation has helped to spur legal reform of mortgage brokerage at the state level. The Secure and Fair Enforcement for Mortgage Licensing Act of 2008 (SAFE Act), enacted on July 30, 2008, sets minimum licensing and registration standards for individual mortgage loan originators and encourages the states to adopt similar provisions, with the goals of enhancing consumer protection and reducing fraud.

The SAFE Act tasks the Nationwide Mortgage Licensing System and Registry (NMLSR) with streamlining the mortgage loan originator licensing and registration process, tracking originators through a comprehensive licensing and supervisory database, and increasing originator accountability.

In implementing the SAFE Act, every state has passed legislation instituting individual mortgage broker licensing

requirements. While the federal SAFE Act does not address fiduciary duties of mortgage brokers, several states have passed laws that go beyond the SAFE Act's minimum requirements and impose fiduciary (or fiduciary-type) duties on mortgage brokers.

State legislative reform

Since 2007, some states—including California, Nevada, New Mexico and Washington—have enacted laws expressly providing that a mortgage broker enters into a fiduciary relationship with or owes a fiduciary duty or obligation to a borrower.

California's law is illustrative: "A mortgage broker providing mortgage brokerage services to a borrower is the fiduciary of the borrower, and any violation of the broker's fiduciary duties shall be a violation of the mortgage broker's license law. This fiduciary duty includes a requirement that the mortgage broker place the economic interest of the borrower ahead of his or her own economic interest."

While the California Real Estate Broker Law included some fiduciary-type duties for licensees, the new statute extended additional fiduciary duties to them as well as to "licensed persons" under other California laws. The other states' laws enumerate specific duties that a mortgage broker owes to a borrower, including, for example: the duty to act in the borrower's best interest; the duty to act with reasonable care; the duty to fully and fairly disclose any facts that might affect the borrower's decisions, rights or interests; and the duty to act in good faith and engage in fair dealing.

Some states—such as Colorado, Maryland, North Carolina and Virginia—enacted laws that do not expressly impose a "fiduciary duty" on a broker,

but instead statutorily apply the duties of loyalty, care, disclosure and/or good faith and fair dealing to the mortgage broker-borrower relationship.

Other states—such as South Carolina and Wisconsin—have enacted laws that designate a mortgage broker as the agent of the borrower. Agency is a type of fiduciary relationship that results from one person (the principal) consenting to another person's (the agent's) acting on his behalf or subject to his control. In California, a mortgage broker's express fiduciary duty to a borrower is premised upon the agency relationship between the mortgage broker and the borrower.

Some of the new state laws imposing fiduciary-type duties on mortgage brokers—such as those in Nevada, Washington and Wisconsin—specify that a mortgage broker is not required to obtain a residential mortgage loan for a borrower with terms or conditions not available to the broker at the time. Even though these laws require a mortgage broker to use his or her best efforts on behalf of the borrower, the broker is not obligated to find the best product in the marketplace beyond the broker's usual course of business.

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Case law finding fiduciary duty based on agency relationship

In states whose laws do not impose fiduciary duties on mortgage brokers, some courts have nonetheless concluded that a fiduciary relationship may exist based on an agency theory. An agency relationship can be created either expressly by agreement, or it may be implied through conduct. Courts have recently found, under California (prior to and notwithstanding the statute codifying the fiduciary duty), Connecticut, Delaware, Illinois, Missouri and Virginia laws, that mortgage brokers owe fiduciary duties to borrowers because there is an agency relationship between them.

If no fiduciary duty is imposed on a mortgage broker by statute or other legal precedent, a finding of fiduciary duty based on an agency relationship may be avoidable if the borrower expressly waives any claim that the broker acts as his agent. Theoretically, a borrower and broker may agree that there is no principal/agent relationship between them, as one cannot be the agent of another without the other's consent.

In other words, absent a law to the contrary, an agency relationship is a voluntary relationship. However, while courts in some states may allow a borrower to waive his right to have a mortgage broker act as a fiduciary, other states may not permit such a waiver. For instance, in Wisconsin, statutory law provides that the duties a mortgage broker owes to a borrower cannot be waived.

Often, the significant facts that underlie the finding of an agency relationship relate to the broker's disclosures to the borrower. Allegations of breach of the duty of disclosure have been leveled against mortgage brokers even where borrowers have signed detailed disclosures acknowledging the actual loan terms. Despite accurate written disclosures, a mortgage broker may be found liable to his or her client for breach of duty if he or she provides incomplete or otherwise misleading information or the borrower does not read the written documents provided.

For example, a California court in *Zimmer v. Nawabi* (2008) held that a mortgage broker's duty to disclose material terms, such as the true interest rate and penalty fees, may go *beyond* written documents to include oral disclosure and counseling if the borrower is of "modest means and limited experience in financial affairs." The mortgage broker's employer may also be liable to the borrower on the theory of vicarious liability if the broker breaches his fiduciary duties.

A mortgage broker must not obtain material benefits (e.g., compensation) from third parties in transactions where he or she represents the borrower, without full disclosure to, and consent from, the borrower. The rule against self-dealing is based upon the assumption that when a fiduciary pursues material benefits from third parties in his role as agent for his principal, the fiduciary's desire to gain those benefits may dissuade him from obtaining the best terms for his principal because he is no longer disinterested in the transaction.

Not only would a mortgage broker's undisclosed or unconsented self-dealing be a violation of the duty of loyalty, but a third party who induces the fiduciary to breach his or her duty may also become liable to the principal. In the Illinois case *Whitley v. Taylor Bean & Whitaker Mort-*

STATE LAWS ADDRESSING MORTGAGE BROKER FIDUCIARY DUTY

California: Cal. Civ. Code § 2923.1 (West 2010) (effective Jan. 1, 2010)

Colorado: Colo. Rev. Stat. § 12.61.904.5 (2009) (effective Aug. 5, 2009), to be amended by H.B. 10-1141, 2010 Colo. Legis. Serv. Ch. 280 (West) (approved May 26, 2010)

Maryland: Md. Code Regs. 09.03.06.20 (2010) (effective Nov. 3, 2008)

Nevada: Nev. Rev. Stat. § 645B.0147 (2009) (effective Oct. 1, 2009)

New Mexico: N.M. Stat. § 58-21B-20 (2009) (effective July 31, 2009)

North Carolina: N.C. Gen. Stat. § 53-244.109 (2009) (effective July 31, 2009)

South Carolina: S.C. Code Ann. § 40-58-78 (2009) (effective Jan. 1, 2010)

Virginia: Va. Code Ann. § 6.1-422 (2009) (effective July 1, 2009), to be amended by S.B. 295, 2010 Va. Legis. Serv. Ch. 794 (West) (approved April 21, 2010) (effective Oct. 1, 2010)

Washington: Wash. Rev. Code § 19.146.095 (2009) (effective June 12, 2008)

Wisconsin: Wis. Stat. § 224.79(3) (2010) (effective June 1, 2010)

gage Corp. (2009), the court found that an allegation of a lender policy "of paying YSPs to brokers in exchange for the broker's cooperation in unnecessarily inflating plaintiffs' interest rates" was sufficient to state a claim for inducing a breach of fiduciary duty. The court subsequently dismissed the case without prejudice due to the parties' tentative settlement.

A Delaware court, in *Ramsey v. Toelle* (2008), found that a fiduciary relationship arose where the mortgage broker was the agent of a borrower who placed her confidence in the broker and relied on the broker's special knowledge. The court held that the mortgage broker breached her fiduciary duty through self-dealing by using the client's confidential information to take advantage of a business opportunity and gain an interest for herself in a real estate transaction.

The court noted, "[W]hile the relationship of agent to principal, under Delaware law, does not of itself give rise to fiduciary duties, where an agent represents a principal in a matter where the agent is provided with confidential information to be used for the purposes of the principal, a fiduciary relationship may arise."

Because self-dealing by mortgage brokers is thought to have contributed to the mortgage crisis, legislative reforms have been proposed to restrict the ability of mortgage brokers to benefit at the expense of their borrower clients. For example, the financial reform legislation passed this summer—the Dodd-Frank Wall Street Reform and Consumer Protection Act—prohibits YSPs because of the perceived

risk that lender-paid fees may induce mortgage brokers to steer borrowers to higher-cost loans, or to the lenders offering the highest YSPs.

Prior to the legislation, *Mayoral v. WMC Mortgage LLC* (2009) suggested that failure to disclose the purpose and effect of a YSP could constitute a breach of fiduciary duty.

Self-dealing can take many forms for mortgage brokers. “Flipping,” or frequently refinancing loans to maximize brokerage fees, may be a breach of the broker’s fiduciary duty, as discussed in *Ware v. IndyMac Bank FSB* (2008). Courts have noted that a mortgage broker’s acceptance of excessive compensation is a breach of fiduciary duty (*Perez v. First Option Mortgage Corp.*, [2008]), as does obtaining “secret profits” (*Brewer v. IndyMac Bank* [2009]).

Case law imposing fiduciary duty based on a special relationship

Courts in Florida, Maine, Massachusetts, Mississippi, New York and Pennsylvania have held that a mortgage broker may owe a borrower a fiduciary duty based on a “special” or “confidential” relationship with a borrower. The existence of a special or confidential relationship often turns on the borrower’s experience and financial sophistication, on the one hand, and the mortgage broker’s specialized knowledge, experience and skills, on the other. The greater the inequality between the two and the greater the broker’s influence over the borrower, the more likely it is that a court will find a special relationship justifies the imposition of fiduciary duty.

In evaluating the broker’s duty, courts also consider whether the borrower relied upon the mortgage broker to act in his or her best interest, placed trust and confidence in the broker, and whether the broker was aware of or accepted a position of trust and confidence. Determining whether a fiduciary duty is owed based on a special relationship typically depends on the facts and circumstances in each case.

A mortgage broker’s oral representations to a borrower can create a special relationship leading to fiduciary duty. In *Perez v. First Option Mortgage Corp.* (2008), a broker’s representation that he could obtain a specific type of loan with a certain monthly payment (in this case, a fixed-rate mortgage with monthly payments of \$1,200) may have created a fiduciary duty if the borrower relied upon such representation.

Even in states where a mortgage broker does not generally owe a fiduciary duty to a borrower, such as New York, a court may conclude that a fiduciary relationship is created where the broker represents that he or she will perform services that go beyond those performed by a traditional, independent broker (see *Iannuzzi v. Washington Mutual Bank* [2008]).

A court may find that a mortgage broker has a fiduciary duty to the borrower who has limited English-language competency, particularly when the broker has explained the loan transaction to the borrower orally and/or the borrower places special trust in the broker. In *Amaral v. Crown*

Mortgage Group & Assoc. (2008), the court explained that the mortgage broker could have breached a fiduciary duty to the borrower because his oral explanations of the loan in the borrower’s native language did not disclose the availability of a lower interest rate and the broker’s receipt of a YSP (even though the interest rate and the YSP were disclosed on the federal disclosure statements).

In reviewing the law of fiduciary duty in the context of residential loan origination, one must distinguish between lenders and brokers. Lenders, unlike brokers, do not generally owe fiduciary duties to their borrower customers.

However, in *Mortensen v. Home Loan Center Inc.* (2009) and *Park v. M&T Bank Corp.* (2010), courts permitted claims of breach of lender fiduciary duty to survive motions to dismiss. Despite these preliminary decisions, mortgage brokers stand in a very different position *vis-à-vis* their clients than do lenders. At present, the heightened standard of responsibility for brokers generally does not apply to lenders in commercial, arm’s-length loan transactions with borrowers, absent unique circumstances that create special relationships between the lenders and the borrowers.

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An increasingly tough stance on brokers

In 2007, the tide of increased mortgage broker fiduciary duty began to rise, based on a handful of laws and court cases. This body of law has developed considerably since then, prompted by public officials’ desire to address the financial and housing crises and by homeowners’ challenges to a variety of loan origination practices.

In addition to statutes and court decisions, enforcement officials are taking an increasingly tough stance toward mortgage brokers believed to have used inappropriate loan origination methods. State attorneys general have actively pursued the mortgage industry, and initiatives such as the State-Federal Task Force on Mortgage Enforcement, created by the the National Association of Attorneys General [NAAG], Washington, D.C.; and the Financial Fraud Enforcement Task Force, established by President Obama, signal government’s intention to crack down on the industry for years to come.

Mortgage market behavior often drives legal developments as policymakers respond to perceived market dysfunction. Now it appears that the market-driven legislative response cycle may come full circle.

Higher-level legal duties and responsibilities imposed on mortgage brokers may eventually force brokers to take one side of the transaction or the other—the lender’s side or the borrower’s side—and abandon the argument that they stand independently between the parties to merely effectuate loans. In these times, mortgage brokers would be wise to heed a new twist on an old adage: “Broker beware.” **MB**

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