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BROKER TO BROKER AGREEMENTS: RISK, REWARDS AND PROCEDURES

Presented by:



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Mr. Adleson has been a real estate attorney since 1976 and is a licensed California real estate broker. He is the senior shareholder in the law firm of Adleson, Hess & Kelly, a Professional Corporation. He graduated with a Juris Doctor, Cum Laude, from University of Santa Clara School of Law, 1976. Mr. Adleson and his firm are rated "AV" (the highest rating available for both legal ability and ethics) by Martindale-Hubbell, Inc., the oldest and most respected attorney information publication in the country. He is listed in Northern California Super Lawyers magazine in the area of real estate, a designation conferred upon him by San Francisco magazine and by nomination of his peers.

Mr. Adleson is corporate counsel for both the California Mortgage Association ("CMA") and for the United Trustee's Association ("UTA"; a multi-state association for the default services industry). Mr. Adleson is a past President and Legislative Chairman for UTA's predecessor, the California Trustees Association ("CTA") and currently he serves as a director of UTA. Mr. Adleson has represented numerous lenders, trustees, purchasers, sellers, title companies and others in trials, arbitrations, DRE licensee administrative hearings, appeals, amicus curiae briefs, class actions, unfair business practices action and in many other areas involving real estate, lending and foreclosure. Mr. Adleson is a past instructor of real estate and foreclosure classes at DeAnza Community College and San Jose State University and has taught numerous DRE and CLE approved continuing education classes throughout the world. He has also presented legal update programs for CMA, UTA, the National Business Institute, and bar associations and has been a speaker for CMBA, REOMAC, as well as for numerous other groups. Mr. Adleson is a former attorney for the California Court of Appeal and has testified before the judiciary committees of both the California Assembly and California Senate, in addition to drafting proposed legislation that has ultimately become law in California. He has frequently been called upon to testify as an expert witness throughout California.

JOFFREY G. LONG (Speaker)

Joffrey has been a in the mortgage industry since 1980, and a licensed real estate broker since 1978. He is the President of Southwestern Mortgage in Granada Hills, California. His focus is on the origination, underwriting, and servicing of privately funded real estate loans. Southwestern Mortgage funds and accepts broker submissions for residential, commercial, and mixed use loans.

A member of the CMA Board of Directors since 2001, Joffrey has co-chaired the education committee for the past 3 years. He is the author of the DRE approved course, "Making Money with Reverse Mortgages," and holds the Certified Mortgage Consultant (CMC) designation. He is an instructor for the National Assn. of Mortgage Brokers and the California Association of Mortgage Brokers training courses.

Funding Loans Originated by Other Brokers

I. INTRODUCTION (10 Min.)

Traditional Model.

For many years the traditional model for licensed real estate brokers (“REB”) acting as mortgage brokers (“Mortgage Brokers”) was to solicit borrowers and investors and to make, arrange, negotiate or resell loans secured by junior liens.¹ The mortgage broker would often solicit borrowers and lenders. Much of the Real Estate Law² has developed around the model where the Mortgage Broker was a broker (i.e., arranger not a direct lender or maker) of loans between two principals (i.e., the borrower and the lender). Generally, under the traditional model, Mortgage Brokers were dual agents, with all of the risks and obligations that go with dual agency including the difficulty of trying to serve two masters (i.e., the borrower and investor each as principals).

The Institutional Invasion.

With deregulation of institutional lenders (banks, savings associations, credit unions, etc.) they began to invade the territory previously the domain of mortgage brokers: subprime and equity lending. In addition, institutional lenders were no longer restricted (at least to the same extent) as to the type of products they offered and as to taking only senior liens. In addition, the creation and expansion of Government Sponsored Entities (“GSEs”; e.g., FannieMae and FreddieMac) that would buy up billions of dollars of loans originated by institutional lenders, gave these lenders an unbelievable amount of capital resources to continue lending. The threat to the traditional mortgage broker model was clear.

Evolving and Expanding Models.

To respond to this threat, which could have easily destroyed traditional mortgage brokering, many diverse models were developed. For example:

1. **Mortgage Bankers/Loan Correspondents.** Mortgage Brokers increasingly began acting as packaging brokers or correspondents for institutional lenders on loans secured by residential or commercial real property. While this type of relationship originally involved primarily “A” paper institutional loans, it now extends to A to D paper loans

¹ **Legend:** A licensed California real estate broker shall be referred to as an “REB”; a licensed consumer finance lender shall be referred to as a “CFL”, a licensee under the Residential Mortgage Lending Act shall be referred to as an “RML” and a broker providing services within the meaning of Business and Professions Code §§ 10131(d)&(e) and 10131.1 shall be called a “Mortgage Broker”.

² “Real Estate Law” as used in these materials means the laws relating to real estate licensees under the Cal. Business and Professions Code and by the regulations of the Cal. Real Estate Commissioner.

including a substantial portion of the subprime market. These loans are generally written pursuant to the institutional lender's underwriting standards or those required by the secondary purchasers who normally purchase these loans from the institutional lender. The Mortgage Broker, under such an agreement with the lender, solicits borrowers, takes loan applications and otherwise packages a loan for the lender or the lender's broker to consider for funding. The nature of the relationship is generally defined by a written agreement between the lender or Lender's Broker and the Packaging Broker (also called herein "Borrower's Broker"). In many such agreements the Lender attempts to disclaim that the Packaging Broker is, in fact, the Lender's agent or subagent of the Lender's broker. A court may well come to a different conclusion.

2. **Specializing Brokers.** In response to the threat to the traditional model, many Mortgage Brokers have turned to specialization. That is, they may only act as a loan correspondent for institutional loans secured by residential properties; only do consumer loans regardless of the funding source; only make loans secured by commercial property; make construction or remodeling loans; make loans, but only funded by pools rather than individual investors or under the multi-lender rule; or emphasize the making of Section 32 or Financial Code §§ 4970 loans (i.e., high cost mortgages). Others attempt to bifurcate the traditional model only representing Lenders or only representing Borrowers.

Breakdown of Course.

As is often the case, there is far more latitude and flexibility in non-consumer loans than there are in consumer loans. Regardless of the type of loan a Mortgage Broker makes or arranges, certain procedures and laws must be followed. This course will cover following:

- Relationship with the Borrower and with the Lender as well as with Other Mortgage Brokers Packaging Loans.
- Dual or Bifurcated Agency: Can You Only Represent One Side Of the Loan Transaction?
- Using a Packaging Broker in Consumer Transactions Subject To RESPA.
- Using a Packaging Broker in Non-RESPA transactions.
- Due Diligence In Selecting, Screening and Retaining a Packaging Broker.
- Form of Agreement and Common Provisions.

II. Relationship between Mortgage Brokers and the Borrower or Lender and Other Mortgage Brokers. (11 Min.)

The relationship between the Mortgage Broker, the Lender, the Borrower and other Mortgage Brokers participating in making or arranging loans secured by real property is generally defined by "agency law." The Mortgage Broker acts either a loan arranger (negotiating between a borrower and a lender) or as a loan maker (originating a loan as a principal with his/her own funds, potentially for resale to the public. Therefore, the

Mortgage Broker is generally an agent for someone or acting as a principal. The Mortgage Broker cannot act as a “conduit” or “independent contractor” acting on his/her own behalf as a middle man between Lender and Borrower.

Historically, under the traditional model, the Mortgage Broker was an agent (i.e., fiduciary) for both the Borrower and the Lender in arranging a loan secured by real property (i.e., a dual agent). In addition, the Mortgage Broker often continued after the close of the loan escrow to act as a servicing agent for the Lender.³ Particularly as Mortgage Brokers expand and diversify business models or specialize in more complex loan products, the risk of being a dual agent increases.

One reason former REBs obtain Consumer Finance Lender’s (“CFL”) licenses is because CFL’s are direct lenders using its own money (not brokers for private investors)⁴ and, as such, do not have fiduciary duties to investors or to borrowers. (See, *Barry v. Raskov* (1991) 232 Cal.App.3d 447, 458-459, and *Nymark v. Heart Fed. Savings & Loan Assn.* (1991) 231 Cal. App. 3d 1089.)

For many who wish to remain as REBs, exploring bifurcated agency (where the borrower and lender are represented exclusively by different brokers) may be a good solution where permitted by the fact and law.

A. The Broker’s Role: Agency and Fiduciary Duties

The Principal’s Misconception. Many Borrowers and private lenders confuse the responsibilities and duties of a REB (particularly of a Mortgage Broker) with that of a parent, guardian, personal financial adviser, and/or guarantor of his/her business decisions. That is, borrowers, buyers and sellers retain REBs for a number of diverse tasks (e.g., assistance in sales, purchase, exchanges, business opportunities, lending or leasing of real property). Many plaintiffs in lawsuits testify at trial that they expected their REB to take care of everything relating to the real estate and loan transactions involved in the particular case even though the agreement creating the agency was very narrow. Each of the principal’s business decisions should be shown to have been made with full knowledge (and understanding) of the material facts (where possible.) Principals often confuse an REB with someone that will insure the result or guarantee against the known risk of the investment.

The Industry’s Response. The California Association of Realtors (“CAR”) has done a very good job of disclosing the nature and scope of sales agents’ agency and to standardize disclosures that assure that it is difficult for a principal to assert that they were not aware of the material facts in a real estate sales situation. For example, mandatory agency relationship disclosures setting forth whether an agent in a 1-4 residential transaction is a dual agent or simply the agent of one of the parties to the transaction. (See, Civil Code §§ 2079 et seq.) Similarly, the development of extensive disclosures and

³ For this reason, the Mortgage Broker who has represented the Borrower in any capacity in making or arranging the loan should document that the relationship with the Borrower is terminated at the close of the loan escrow and that as servicing agent, the Mortgage Broker solely represents the Lender.

⁴ While this is technically true, a CFL may well obtain its money through various security offerings which are sold to the public (or a certain segment of the public) and, therefore, will have duties as the “issuer”. The purchasers of these securities, are buying a security other than a specified note secured by a deed of trust.

third party inspections has greatly reduced the liability of sales agents. (Civil Code §§ 1102 et seq.)

Mortgage Broker Industry Response. The short answer: “Little to None”. (See discussion of bifurcated agency below).

Mortgage Brokers have a more difficult task as bifurcated agency is not widely recognized (i.e., where the Mortgage Broker represents only the Borrower or only the Lender). While logically (and in many cases legally) there should be no difference between the agencies that apply to a REB listing and selling real properties and to a REB making and arranging loans secured by real properties, the cases, laws and regulations relating to mortgage brokering have developed with a greater emphasis on the broker being a dual agent or at least having duties to both the borrower and the investor. (*Wyatt v. Union Mortgage Company* (1979) 24 Cal.3d 773.) The case law should be read very carefully because customarily Mortgage Brokers have been retained by the borrower to arrange (or negotiate) a loan with a Lender. (*Id.*, at 782). ***As such, the Mortgage Broker who advertises for borrowers will usually be the agent of the borrower or a dual agent.***⁵ Mortgage brokers negotiating loans funded by private lenders may well be viewed as the agent for the private lender particularly where there is only one broker arranging the loan. However, there is no specific statute or regulation that prohibits the private lender from being represented exclusively by his/her own REB.

It is important that the roles of the various REBs (as well as their associate licensees) be reviewed as to the **purpose** of their agencies and their duties so that the **scope** of their respective agencies in each transaction can be determined.

A common business plan that has developed over the years is that one Mortgage Broker solicits borrowers wishing to obtain a loan and, in attempting to arrange the loan, the arranging broker solicits funds through another Mortgage Broker representing private Lenders or mortgage pools of some sort. This type of relationship may be viewed in two different ways: (1) bifurcated agency; or (2) as a subagency. Bifurcated agency is generally preferable for both REBs in the loan transaction as it focuses their duties on one client rather than two and limits (but does not eliminate) duties to the person in the transaction who is not the REB’s principal. Most loan document packages or programs fit best with the traditional dual agency model but are not set up very well to handle bifurcated agency. Typically, these loan packages have a loan procurement agreement with the Borrower which, if entered into between the Lender’s Broker and the borrower, is likely to

⁵ However, from a consumer’s standpoint, it is hard to see the difference between an ad placed by a Mortgage Broker advertising a particular loan and one placed by a direct lender advertising the exact same loan. While these direct lenders (i.e., Banks, Savings Banks, Credits Unions or CFLs) may be subject to a number of laws relating to their advertising (e.g., Federal Truth-In-Lending), they are generally viewed as a principal lender advertising for borrowers and not as an agent of the borrowers solicited by such ads. While addressing the issue, the B&P Code and DRE Commissioner’s regulations do not adequately distinguish between a REB making a loan versus his/her arranging a loan. This is due to the fact that many loans made by a broker with his/her own money are made with the intention of immediately reselling them to the public. Where a licensee really wants to “make” loans with his/her own money, as a principal, it may be best for licensees using their own money to do so as a CFL. This is not to say that a direct lender may never be found to have created an agency or confidential relationship with a borrower, but the general rule is that they are not agents of the Borrower.

make the Lender's Broker the agent of the borrower.

B. Definition: What Is An "Agent? (3 Min.)

An "agent" is a person who represents another, called a PRINCIPAL, in dealings with third persons. (Civ. Code § 2295.) In real estate sales, the principal is the "client" (usually the seller), the agent is the broker and his/her salespersons. The third person (usually buyer) was historically called the "customer". With Mortgage Brokers the principal is often the Borrower or the Lender, or both. As discussed in more detail later, identifying and disclosing the nature and extent of the agency relationship not only defines what the principal can reasonably expect but it may limit (or expand) the agent's responsibilities and liability in the transaction.

C. Special vs. General Agents.

"An Agent for a particular act or transaction is called a special agent. All others are general agents." (Civ. Code § 2297). Generally, REBs are special agents whose authority is limited to specific acts and transactions. (Civ. Code § 2297; *Rhode v. Bartholomew* (1949) 94 Cal.App.2d 272, 278.) Care has to be taken in drafting agreements with Borrowers or Lenders to make sure that the "specific acts" are limited (e.g., making or arranging a loan) while making sure the agreement gives the agent sufficient authority and leeway to perform the subject matter of the agency.

D. When and How Sub-Agency Applies. (2 Min.)

When more than one REB represents the same principal, the issue of whether a sub-agency exists arises. The REB initially engaged by the borrower (whether orally or by contract) to procure a lender is the actual agent of the borrower. To the extent a second broker becomes involved to perform some of the activities within the purpose and scope of the actual agency created between the borrower and the first broker, the second broker is either the agent of the first broker or the sub-agent of the Borrower. This distinction in status is based upon whether the borrower is aware of the appointment of the second agent.

Civil Code § 2349 provides that:

"An agent, unless specially forbidden by his principal to do so, can delegate his powers to another person in any of the following cases, and in no others:

1. When the act to be done is purely mechanical;
2. When it is such as the agent cannot himself, and the subagent can lawfully perform;
3. When it is the usage of the place to delegate such powers; or,
4. When such delegation is specially authorized by the principal."

If one REB employs a second REB without the principal's authority, the second broker is the agent of the first and not of the principal. (Civil Code § 2350.) On the other hand, if the first broker appoints the second broker with the principal's authority, the latter is the sub-agent of the principal. (Civil Code § 2351.) For this reason, knowledge and consent of the principal is critical to the creation of a true sub-

agency or for a dual agency. To avoid confusion the nature of the agency and all principal's consent should be obtained.

III. How Is the Agency Created? (8 min.)

An agency relationship is generally created by an express or implied agreement. While agreements creating an agency may be oral or in writing, many such agreements must be in writing for the real estate agency to recover any compensation. However, an agency **may be implied by actions**, e.g., consulting an attorney and requesting services be performed.

Confirmation Of Agency with Principal. For this reason, the best practice is for the Mortgage Broker, regardless of the type of agency being created (i.e., dual agency, sub-agency or bifurcated agency) to have an agreement with his/her principal expressly confirming the nature of the agency and evidencing the principals consent.

Address In Broker-To-Broker Agreement. Once REBs attempt to bifurcate the agency between two REBs, one exclusively representing the Borrower and one exclusively representing the Lender, the Lender's Broker may not want to have a direct agreement with the Borrower (i.e., an exclusive agreement to procure a loan would be only between the Borrower and the Borrower's Agent). The Lender's Broker or Lender can require as a term of its Broker-to-Broker Agreement that the Borrower's Broker obtain a Borrower's confirmation of agency and consent and that it be delivered to the Lender or the Lender's Broker as a condition of the loan package being complete.

A. No Consideration Required To Create An Agency.

No consideration is required to create an agency relationship. (Civ. Code § 2308). The volunteer will be held liable as an agent notwithstanding that his services are provided without consideration. A gratuitous agent cannot be compelled to act; however, if the gratuitous agent does act he/she will have the same fiduciary duties as a compensated agent. (2 Witkin, Summary of Cal. Law (9th Ed.), Agency and Employment, § 62, p.68 and cases cited therein.) **Be careful what you volunteer to do for free as you may still have liability as an agent. If a Mortgage Broker starts giving a Borrower advice on his purchase agreement for the secured property, he/she may have expanded his special agency and duties to include those that a buyer's REB may have even though no additional consideration is paid.**

B. Payment Of Commission Alone Does Not Create An Agency.

Conversely, receipt or splitting a commission does not automatically make him/her the agent of the person who paid the commission. (e.g, a REB acting as a principal buyer does not become a fiduciary merely because he split the commission with the seller's listing agent; see, *Cook vs. Westersund* (1981) 127 Cal.App.3d 154). **The court stated that "[t]he principal must in some manner indicate that the agent is to act for him, and the agent must act or agree to act on the principal's behalf and subject to his control."** In *Cook*, the buyer allegedly breached his fiduciary duty by failing to disclose to the seller that the imminent development of nearby properties had increased the value of the property. This case can be distinguished from prior cases in that, other than sharing the

commission, ***there were no facts to support an understanding between the parties that there was an agency.*** A principal does not normally become an agent simply because he is a licensee and collects a commission for representing his own interests.⁶

However, a writing promising to pay a commission, setting forth terms of the listing (in abbreviated form), initialed by the seller and performed by the broker has been held to be sufficient to meet the requirements of the statute of frauds. (Discussed below and see, *Seck v. Foulks*, (1972) 25 Cal. App. 3d 556, 562.) This is the problem with “Borrower-Broker agreements” that are not specifically drafted with bifurcated agency in mind.

The best practice is to have an agreement that specifies the nature of the agency as well as the nature and amount of the compensation.

IV. Scope of Agency (10 Min.)

Civil Code § 2315 states that “An agent has such authority as the principal, actually or ostensibly, confers upon him.” Generally, REBs are special agents whose authority ***is limited to specific acts and transactions.*** (Civ. Code § 2297; *Rhodes v. Bartholomew* (1949) 94 Cal.App.2d 272). As stated in *Charles B. Webster Real Estate v. Richard* (1971) 21 Cal.App.3d 612: “A real estate listing creates an agency between the broker and the owner (Cts. Om.). The broker's authority is fixed by the terms of the listing and is to negotiate with third parties for the sale of the property on behalf of the owner.” (Id.. at p.614, also see, Bus. & Prof. Code §§ 10131; *Lyne v. Bonner* (1954) 129 Cal.App 2d 743 746; *Walter v. Libby* (1945) 72 Cal.App.2d 138). A real estate broker's authority is limited to that actually or ostensibly conferred by the principal. (Civ. Code § 2315; California Real Property Sales Transactions, (CEB. 2d Ed. 1993).) These principals apply equally to broker-to-broker agreements and to agreements to procure.

A. Time And Services Should Be Narrow As Possible To Fulfill The Principal's Needs.

The scope of the agency in terms of what services are to be provided, when, and to whom can have a significant impact on the duties owed by the agent. Obviously, an agency where an REB says to a principal, “I’ll represent you in all matters requiring a REB license” would create expansive duties and related liability. On the other hand, an agreement to arrange a loan on specific terms secured by a specific parcel of real estate (or on the best terms available not to exceed certain limits) creates a much narrower agency, limited to arranging a loan and specified terms.

B. Clear Designation Of The Term Of The Agency Can Avoid Principal or Borrower Confusion Over Representation.

Some agency agreements under Real Estate Law require a definite termination date. For example, a licensee can be disciplined by the DRE for “[c]laiming, demanding, or receiving

⁶ Expanding on the common law rule, Civil Code § 2079.19, which applies to 1-4 residential properties, provides that “...The payment of compensation or the obligation to pay compensation to an agent by the seller or buyer is not necessarily determinative of a particular agency relationship between an agent and the seller or buyer.”

a fee, compensation or commission under any exclusive agreement authorizing or employing a licensee to perform acts set forth in Business and Professions Code § 10131 for compensation or commission where the agreement does not contain a definite, specified date of final and complete termination.” (BP § 10176(f)).

V. Certain Agency Agreements Employing A Broker Must Be In Writing. (10 Min.)

A. Statute of Frauds.

While an agency may be created orally, in writing, with or without consideration, a contract employing a real estate broker is invalid unless it is in writing and subscribed by his principal. (Civ. Code § 1624(a)(4); 2 Miller and Starr, Cal. Real Estate (3rd Ed.), Broker’s Compensation, § 5:6, p. 23; and Agency, § 3:5, p. 18.) Civil Code § 1624 provides in pertinent part:

(a) The following contracts are invalid, unless they, or some note or memorandum thereof, are in writing and subscribed by the party to be charged or by the party’s agent:

(1)

(2) A special promise to answer for the debt, default, or miscarriage of another, except in the cases provided for in Section 2794. [e.g., **Guarantees** or sureties];

(3) An agreement for the leasing for a longer period than one year, or for the sale of real property, or of an interest therein; such an agreement, if made by an agent of the party sought to be charged, is invalid, unless the authority of the agent is in writing, subscribed by the party sought to be charged. [e.g., purchase agreements]

(4) An agreement authorizing or employing an agent, broker, or any other person to purchase or sell real estate, or to lease real estate for a longer period than one year, or to procure, introduce, or find a purchaser or seller of real estate or a lessee or lessor of real estate where the lease is for a longer period than one year, for compensation or a commission. [e.g., listings]

(5)

(6) An agreement by a purchaser of real property to pay an indebtedness secured by a mortgage or deed of trust upon the property purchased, unless assumption of the indebtedness by the purchaser is specifically provided for in the conveyance of the property. [e.g., **an assumption agreement**].

(7) **A contract, promise, undertaking, or commitment to loan money or to grant or extend credit, in an amount greater than one hundred thousand dollars (\$100,000), not primarily for personal, family, or household purposes, made by a person engaged in the business of lending or arranging for the lending of money or extending credit. For purposes of this section, a contract, promise, undertaking or**

commitment to loan money secured solely by residential property consisting of one to four dwelling units shall be deemed to be for personal, family, or household purposes. [e.g., a commercial loan commitment]

B. Purposes Of The Statute Of Frauds And The Type Of Agreement That Meets Its Requirements. (5 min.)

As stated by the California Supreme Court in *Phillippe v. Shapell Industries, Inc.* (1987) 43 Cal.3d 1247:

“. . . , the primary purpose of section 1624(d) [now 1624(a)(4)] is to protect the real estate sellers and purchasers from the assertion of false claims by brokers for commissions. (*Pac. Etc. Dev. Corp. v. Western Pac. R. R. Co.* (1956) 47 Cal.2d 62, 67,)

(*Phillippe v. Shapell Industries, Inc.*, supra at 1257.) As stated by the Supreme Court in the *Phillippe* case, “[t]he writing must unequivocally show on its face the fact of employment of the broker seeking to recover a real estate commission.” (Id., emphasis added; citing *Franklin v. Hansen* (1963) 59 Cal.2d 570, 573 and other cases.) As noted by Miller and Starr:

“To satisfy the statute of frauds and the requirements for an enforceable contract, the broker’s agreement must: (1) be made between competent parties, (2) result from an offer and acceptance that manifests an objective mutual assent to be bound by these terms, (3) provides for consideration to each of the parties, (4) contains a property description that is sufficiently accurate and complete to identify the property, and (5) evidence the fact that the broker has been employed by the owner or a promise by the owner to pay compensation to the broker.”

(Emphasis added; 2 Miller & Starr, Calif. Real Estate, 3d Ed., Broker’s Compensation, § 5:6, p. 24; citing *Woodbridge Realty v. Plymouth Dev. Corp.* (1955) 130 Cal.App.2d 270, 273-274; and § 5:11, pp. 42-43; § 5:12, pp. 45-47). A writing promising to pay a commission, setting forth terms of the listing (in abbreviated form), initialed by the seller and performed by the broker has been held to be sufficient to meet the requirements of the statute of frauds. (See, *Seck v. Foulks*, (1972) 25 Cal. App. 3d 556, 562.)⁷

⁷ The signed business card stated on the back side: "Sitten 310 M/L 2000 per acre 1/2 down bal 5 years 5% int quarterly with int "keep taxes up to date 1/2 mineral rights 6% comm. 10/1/65 "GWF". The broker testified that the meaning of the note was: ""310 M/L" meant there were 310 acres "more or less" that were to be sold. The "2000 per acre" meant that "we were offering the property at \$ 2,000 per acre." "1/2 down" meant that one-half of the amount of the principal was to be paid into escrow; "bal 5 years" indicated that the balance was to be payable "over a period of five years on a deed of trust." The "5%" was the interest to be charged on the deed of trust. The line "quarterly with int" meant that quarterly payments were to be made on the deed of trust, with interest at 5 percent. "1/2 mineral rights" was intended to reserve one-half of the mineral rights on the property to the seller. The symbol "6% comm." meant that Foulks would pay Seck a 6 percent commission, and the date "10/1/65" fixed the termination date (rounded off) of the six months' period given Seck to handle the sale. The first word, "Sitten" (a misspelling of "Sitton") was an indication that "the documents had to be presented to [Mr. Sitton, Foulks' attorney] for legal interpretation on "any deal" that Seck brought to Foulks.

However, the better practice is to have an agreement that creates the agency, states the compensation, defines the scope of the agency, and sets forth the means and time of termination of the agency.

The courts are so strict on Brokers complying with the statute of frauds that when Brokers fail to have a proper signed writing, **when required**, the Broker is not only prohibited from suing to enforce the contract (even if he/she has fully performed), but the courts will not allow the Broker to recover compensation through other means generally allowed in other contexts, such as quantum meruit (i.e., suing for the value of services received) or for estoppel. For public policy reasons neither equitable estoppel, quantum meruit nor other equitable remedies can be asserted to avoid the provisions of Civil Code § 1624(a)(4) relating to real estate broker compensation. (*Phillippe v. Shapell Industries, Inc.*, supra at 1259-1260, 1263-1264.) The rationale for this is that real estate brokers are licensed and regulated after demonstrating knowledge of the law relating to real estate transactions. (Id.) They are presumed to know that a commission agreement is unenforceable unless the statute of frauds is complied with. (Id.) Brokers performing pursuant to agreements that do not meet all of the requirements of the statute of frauds, act unreasonably and they assume the risk of relying on unenforceable promises. (*Phillippe v. Shapell Industries, Inc.*, supra at 1262.)

C. While Generally No Writing Is Required To Make Or Arrange A Loan, There Are Notable Exceptions. (20 Min.)

1. No Writing Required to Make or Arrange a Loan and to Receive Compensation.

Except for a non-consumer loan commitment to make or arrange a loan over \$100,000 (Civ. Code § 1624(a)(7)), nothing in Civil Code § 1624 requires a written agreement for a real estate licensee providing services requiring a license under BP Code § 10131(d) & (e) [making or arranging loans, selling loans or servicing loans]. However, certain exceptions exist either based upon the statute of frauds or based upon other statutes or case law.

2. Best Practice Is To Have An Express Written Agreement with Lender, Borrower and Packaging Broker.

Even if not required by law, a written agreement provides a number of benefits for both the broker and the principal including: (1) it expressly creates the agency; (2) it clarifies whether the agency is exclusive or non-exclusive; (3) it defines the scope of the agency (i.e., only to arrange a certain type of loan); (4) it can disclose dual agency and obtain both parties' consent; (5) it can disclose that the broker is acting as a principal (although it may not be able to abrogate all of the broker's statutory or other duties to the borrower; (6) it can provide for compensation and the times when the compensation is earned; and (7) it can provide for when the agency is terminated (mandatory in exclusive agencies).

See, the attached "Agreement to Procure a Lender". This Agreement has been recently modified to provide for options other than dual agency (e.g., bifurcated agency). However,

The date of the conversation and notation "3-24-65" and the initials "GWF" were placed on Seck's business card by Foulks, as we have emphasized.

at first, the Borrower's Broker may not know whether there will be a dual agency (he represents the Borrower and the Lender) or whether there will be a bifurcated agency (with the Lender and the Borrower each having difference exclusive agents). The disclosure in the modified "Agreement to Procure a Lender" leaves open the precise agency relationship of the Borrower's Broker, but obtains advanced consent to dual agency. Therefore, the precise agency relationship should be disclosed before the Borrower become obligated on the loan.

The sample "Agreement to Procure a Lender" is not intended to be a form for standard use by CMA members. It is merely a sample for the purpose of discussion. Many forms used in the industry are inadequate for use by each broker because their goals and method of doing business differ (e.g., a mortgage broker always acting as a dual agent, using only private investors to fund loans vs. a broker who primarily solicits Borrowers and relies on other brokers to provide Lenders. **This form is not suitable for CFL members because they are direct lenders.**

3. Where the Agency Agreement Is Exclusive.

BP Code § 10176(f) provides:

"Claiming, demanding, or receiving a fee, compensation or commission *under any exclusive agreement authorizing or employing a licensee to perform any acts set forth in Section 10131* for compensation or commission *where the agreement does not contain a definite, specified date of final and complete termination.* [Emphasis Added]"

Since making, arranging, buying, selling, exchanging and servicing loans secured by real property are acts requiring a licensee under Section 10131(d)&(e), BP Code § 10176(f) applies to any exclusive agreement to provide services for compensation. While there is no parallel provision of the statute of frauds (i.e., preventing enforcement of an oral exclusive agreement for such services), violating of BP Code section 10176(f) by failing to obtain a written exclusive agreement will, at a minimum, subject the licensee to DRE discipline.

Many procurement agreements purport to be exclusive and, as such, they must contain a definite, specified date of final and complete termination. The best way to avoid a dispute over when the final termination date is, would be to have it contained in an agreement signed by the principal.

4. Multi-Lender Servicing Agreements Must Be In Writing.

The statute of frauds does not require a loan servicing agreement to be in writing. However, the multi-lender rule does require that there be a written servicing agreement in a multi-lender loan. (BP § 10238(k).) While the broker may be compensated for making, arranging a loan or servicing a loan without an executed, written agreement under the statute of frauds, it is not entirely clear what the remedy is for failure of have a written servicing agreement under the multi-lender rule. However, the remedy could be anything from the servicing agreement not being enforceable to collect the broker's compensation to invalidating the multi-lender exemption under the securities law (which could make the loan an illegal security in the absence of another valid exemption or a permit). This is particularly problematic if the broker is deemed to be the securities issuer, and results in

the full range of penalties under the securities laws applying to the Broker. (See, Corp. Code § 25102.5.) **AS SUCH, A WRITTEN MULTI-LENDER SERVICING AGREEMENT SHOULD BE OBTAINED IN EVERY MULTI-LENDER LOAN AND SHOULD BE SIGNED BY EVERY INVESTOR.**

5. Disclosure of full amount of the licensee's compensation.

BP Code § 10176(g) provides:

“The claiming or taking by a licensee of any secret or undisclosed amount of compensation, commission or profit or the failure of a licensee to reveal to the employer of the licensee the full amount of the licensee's compensation, commission or profit under any agreement authorizing or employing the licensee to do any acts for which a license is required under this chapter for compensation or commission prior to or coincident with the signing of an agreement evidencing the meeting of the minds of the contracting parties, regardless of the form of the agreement, whether evidenced by documents in an escrow or by any other or different procedure.

While Section 10176(g) may simply be a disclosure statute, it is problematic because it anticipates “the signing of an agreement” or escrow documents evidencing the meeting of the minds (agency or commission agreement) between the broker and his principal. While each loan transaction should have some agreement, escrow instruction etc., a written agency agreement may be preferable so that the licensee knows when these disclosures must be made. (See discussion below regarding disclosure).

VI. Mortgage Brokers Are REBs Subject To Both Common Law Agency Rules And A Unique Statutory And Regulation Overlay. (10 Min.)

Real estate brokers (REBs) are regulated by the general provisions of agency law as well as by special provisions of Real Estate Law which regulates licensed real estate brokers and salespersons.⁸ A Mortgage Broker is merely a licensed REB performing certain tasks for which a broker's license is required. (BP § 10131(d)(e) & 10131.1). BP Code § 10131 provides, in pertinent part:

“A real estate broker within the meaning of this part is a person who, for a compensation or in expectation of a compensation, regardless of the form or time of payment, does or negotiates to do one or more of the following acts for another or others:

[(a) -(c) omitted].

⁸ All references to the Business & Professions Code and to the Regs are to those provisions as they existed in 2006 (except where referenced in quotes from cases), as these provisions are constantly changing. In fact, after the *Wyatt* case, the mortgage loan disclosure form was changed to disclose in writing most of the things which were improperly disclosed or misrepresented in *Wyatt*. That form has been changed on a number of occasions since *Wyatt*.

(d) Solicits borrowers or lenders for or negotiates loans or collects payments or performs services for borrowers or lenders or note owners in connection with loans secured directly or collaterally by liens on real property or on a business opportunity.

(e) Sells or offers to sell, buys or offers to buy, or exchanges or offers to exchange a real property sales contract, or a promissory note secured directly or collaterally by a lien on real property or on a business opportunity, and performs services for the holders thereof.”

(Emphasis added.) Most of the activities of mortgage brokers are covered under BP § 10131(d) & (e).

A. REB Acting As a Principal In Buying, Selling, Exchanging and Servicing Promissory Notes. (2 Min.)

An REB who acts as a principal in the making of loans for re-sale to the public, depending upon the facts, may be subject to the provisions of B&P § 10131.1. The DRE adopted a policy in 1985-86 distinguishing how mortgage brokers would be regulated when acting as principals. B&P Code § 10131.1 provides:

“A real estate broker within the meaning of this part is also a person who engages as a principal in the ***business of buying from, selling to, or exchanging with the public***, real property sales contracts or promissory notes secured directly or collaterally by liens on real property, ***or who makes agreements with the public for the collection of payments or for the performance of services in connection with real property sales contracts or promissory notes secured directly or collaterally by liens on real property.***

As used in this section, "in the business" means any of the following:

(a) The **acquisition for resale to the public, and not as an investment**, of eight or more real property sales contracts or promissory notes secured directly or collaterally by liens on real property during a calendar year.

(b) **The sale to or exchange with the public of eight or more real property sales contracts or promissory notes secured directly or collaterally by liens on real property during a calendar year.** However, no transaction negotiated through a real estate licensee shall be considered in determining whether a person is a real estate broker within the meaning of this section.

As used in this section, "sale," "resale," and "exchange" include every disposition of any interest in a real property sales contract or promissory note secured directly or collaterally by a lien on real property, except the original issuance of a promissory note by a borrower or a real property sales contract by a vendor, either of which is to be secured directly by a lien on real property owned by the borrower or vendor.”

This statute is designed to prevent individuals without an REB license from avoiding the licensure requirements by simply claiming to act as a principal. At the same time, it

attempts to exclude true principals who may, for personal investment, buy and sell promissory notes. It should be noted that the investor can acquire as many notes secured by real property as he/she wants without having a license as long as the acquisition is not for the purpose of resale to the public. However, on the other side of the coin, the investor cannot sell or exchange more than 8 notes secured by real property without either a REB license or by having the sale negotiated through a licensed REB (which is excluded from the counting of "8 or more").

VII. Duties of Brokers (To Principal And To The Other Party).

A. Source of Broker's Duties. (10 Min.)

The Agreement.

The context in which this fiduciary duty applies may depend on "the agreement between the broker and client." (*Carleton v. Tortosa* (3d Dist. 1993) 14 Cal.App.4th 745, 751.) Notwithstanding the holding in *Carleton v. Tortosa*, a real estate broker may not contract away duties to which the broker is subject as a matter of statute or regulation, whether constituting federal or state law.

Statutes, Regulations and general Agency Law.

The REBs duties come from two sources: (1) statutes and regulations (usually Real Estate Law); and, (2) general agency law. (Id., 14 Cal.App. 4th at 755.) Whether or not a duty exists is a question of law. (Id.) "The existence and extent of the duties of the agent to the principal are determined by the terms of the agreement between the parties, interpreted in light of the circumstances under which it is made . . ." (Id., citing Rest.2d Agency, § 376.)

Standard of Care from a number of sources.

In addition to the foregoing sources, real estate brokers are also subject to the duties and obligations that occur within the standard of care applicable to such licensees. Included when considering the appropriate standard of care is the custom and practice of mortgage brokers, statutes and regulations to which they are subject, any canons of ethics or standards of conduct recognized by the industry which are applicable to the subject conduct, and the statements contained regarding the standard of care within authoritative works (e.g., California Real Estate Law by Miller, Starr & Regalia and the California Department of Real Estate reference book), and case law.

Clarity of the Agency Relationship Is Often Difficult In Mortgage Broker Transactions.

Generally the Mortgage Broker is not a party to the listing or purchase agreements in the real estate sales transaction for which the loan may be sought. Thus, the duties of the Mortgage Broker may be much narrower than those of the sales and listing brokers because the purpose and scope of the agencies are different. That is, the Mortgage Broker is generally retained only to make or arrange a loan.

However, particularly where a Mortgage Broker wishes to bifurcate his/her agency (i.e., one representing the Borrower and one representing the lender), the Packaging Broker deals

only with the Borrower (takes the loan application and gathers information), packages the borrower's information, and then forwards it to a Lender's Broker who believes he/she is only the Lender's agent. Normally, this would appear to be an ideal situation for a bifurcated agency. The problem is that commonly the Borrower's Broker prepares (or controls the preparation) of the loan documents including the Agreement to Procure a Loan. Those documents may inadvertently make the Lender's Broker a dual agent (e.g., borrower agrees to pay a commission if the broker agrees to use diligence to obtain a lender directly or through sub-agents).

A broker attempting to represent only Lenders may want to review the Borrower loan documents (and request revisions, where necessary); require the Borrower and Lender to sign a separate agreement disclosing the nature of the agency relationship and obtaining their consent thereto; and/or, including a representation in the broker-to-broker agreement that the Borrower and the Borrower's Broker have complied with the Lender's or the Lender's Brokers policies and procedures (i.e., underwriting standards). Furthermore, in loan transactions to be funded by institutional or licensed lenders, the Mortgage Broker has typically executed a wholesale agreement contractually establishing that the mortgage broker is not the Lender's agent, or that he/she is only the Lender's agent for very limited, defined purposes, e.g., obtaining the appraisal report. When two brokers are involved in such transactions, it is likely that a sub-agency relationship is being created. In a consumer loan, it also should be noted that HUD, in implementing the regulations (24 CFR 3500 et seq.) for the Real Estate Settlement Procedures Act (RESPA), 12 U.S.C. §§1601 et seq., does not appear to have contemplated two mortgage brokers in the same loan transaction.

As mentioned above, a different approach (and documentation) will be needed if the loan is a CAL-32 covered loan or is a transaction subject to RESPA.

B. Common Law Duties of REB to Principal And To The Other Party To The Transaction. (5 Min.)

Each broker has a fiduciary duty to his principal and a duty to be honest and truthful in dealings with the other party in the transaction. (*Ward v. Taggart* (1959) 51 Cal.2d 736, 741; 2 Miller & Starr, Calif. Real Estate, 3d Ed., Agency, § 3:48, p. 277.) For this reason, even in a totally bifurcated agency, the Lender's Broker must keep this duty of "honest and truthful dealing" in mind when dealing with the Borrower.

The fiduciary duty imposed on an REB is aptly summarized in *Roberts v. Lamonto* (2003) 112 Cal.App.4th 1553, as follows:

"The law imposes on a real estate agent 'the same obligation of undivided service and loyalty that it imposes on a trustee in favor of his beneficiary.' [Citations.] This relationship not only imposes upon him the duty of acting in the highest good faith towards his principal but precludes the agent from obtaining any advantage over the principal in any transaction had by virtue of his agency. [Citation.] 'Such an agent is charged with the duty of fullest disclosure of all material facts concerning the transaction that might affect the principal's decision.' [Citations.]" (*Batson v. Strehlow* (1968) 68 Cal.2d 662, 674-675; see also *Field v. Century 21 Klodden-Forness Realty* (1998) 63 Cal.App.4th 18, 25; *Jorgensen v. Beach 'N' Bay Realty, Inc.* (1981) 125 Cal. App. 3d 155, 161-162; *Ford v. Cournale* (1973) 36 Cal. App. 3d 172, 180.)"

C. General Fiduciary Duties Applied To The Mortgage Broker (5 min.)

These various duties and the role of a Mortgage Broker are best summarized in *Wyatt v. Union Mortgage Company* (1979) 24 Cal.3d 773, 782, 157, where the California Supreme Court stated:

"A mortgage loan broker is customarily retained by a borrower to act as the Borrower's agent in negotiating an acceptable loan. All persons engaged in this business in California are required to obtain real estate licenses. (Bus. & Prof. Code §§ 10130 and 10131, subd. (d).) Thus, general principles of agency (Civ. Code, §§ 2228 and 2322, subd. 3) combine with statutory duties created by the Real Estate Law (see Bus. & Prof. Code, § 10176, subds. (a), (i)) **to impose upon mortgage loan brokers an obligation to make a full and accurate disclosure of the terms of a loan to borrowers and to act always in the utmost good faith toward their principals. 'The law imposes on a real estate agent "the same obligation of undivided service and loyalty that it imposes on a trustee in favor of his beneficiary." (Citations.) This relationship not only imposes upon him the duty of acting in the highest good faith toward his principal but precludes the agent from obtaining any advantage over the principal in any transaction had by virtue of his agency. (Citation.)' (Batson v. Sterehlow (1968) 68 Cal.2d 662, 674-765 [sic], 68 Cal.Rptr. 589, 597-598, 441 P.2d 101, 109-110.) A real estate licensee is 'charged with the duty of fullest disclosure of all material facts concerning the transaction that might affect the principal's decision. (Citations.)' (Rattray v. Scudder (1946) 28 Cal.2d 214, 223; see also *Realty Projects, Inc. v. Smith*, (1973) 32 Cal.App.3d 204, 210,; *Smith v. Zak* (1971) 20 Cal.App.3d 785, 792-793.)"**

(Emphasis Added).

Wyatt does not say that a Mortgage Broker cannot have a lender as a principal. Rather it is based upon the customary fact pattern where the broker is retained by the Borrower to arrange financing secured by real property. Nothing in agency law or real estate law prevents the broker from having the deed of trust investor as a principal or having a dual agency. While bifurcated agency is common for real estate brokers acting in sales transactions, it is less clear in mortgage brokering transactions although there are few reasons, under state law, supporting the conclusion that there should be a distinction between how sales brokers and Mortgage Brokers are treated under the law.

D. Statutory Disclosures. (15 min.)

1. Mortgage Loan Disclosure Statement (in Multiple Languages)

Except where expressly exempt, the mortgage broker must give the borrower the Mortgage Loan Disclosure Statement (“MLDS” DRE Form # RE 992) or the alternate form Mortgage Loan Disclosure Statement/Good Faith Estimate (“MLDS/GFE”, DRE Form # RE 883; See, BP Code §§ 10240 and 10241; 10 CCR §§ 2840 and 2840.1.) Among other things the MLDS or MLDS/GFE disclose material facts regarding the loan transaction including, but not limited to, costs, fees and commissions.

“Every real estate broker, upon acting within the meaning of subdivision (d) of Section 10131,, who negotiates a loan to be secured directly or collaterally by a lien on real property shall, ***within three business days after receipt of a completed written loan application or before the borrower becomes obligated on the note, whichever is earlier, cause to be delivered to the borrower*** a statement in writing, containing all the information required by Section 10241. It shall be personally ***signed by the borrower and by the real estate broker negotiating the loan or by a real estate licensee acting for the broker in negotiating the loan.*** When so executed, an exact copy thereof shall be delivered to the borrower at the time of its execution. The real estate broker negotiating the loan shall ***retain on file for a period of three years*** a true and correct copy of the statement as signed by the borrower.”

Spanish, Chinese, Tagalog, Vietnamese, or Korean, DRE approved translated versions of the MLDS and MLDS/GFE are available on the DRE’s website. (<http://www.dre.cahwnet.gov/default.htm>.) Where the loan is negotiated primarily in one of these languages, the broker can comply with Civil Code § 1632 by giving the borrower the MLDS or MLDS/GFE in the language in which the loan was primarily negotiated. Giving the translated MLDS or MLDS/GFE substitutes for having to translate the loan documents into the language in which the loan was negotiated. CURRENTLY: THESE MLDS IN FOREIGN LANGUAGES LACK THE MANDATORY LANGUAGE THAT STATES: ”Department of Real Estate License information telephone number: (916) 227-0931, or check license status at www.dre.ca.gov”. Unfortunately, before using the foreign language translated version, this language (translated) should be added to the bottom of the last page. (See, Reg. 2840(a).)

2. Impact of MLDS on Bifurcated Agency.

Bifurcation of agency in a Mortgage Broker transaction is more difficult because of the statutory duties of disclosure that are imposed on the REB in addition to those imposed by common law (i.e., statutory duties of disclosure). Many of the statutes and regulations relating to mortgage brokering are not well adapted to a bifurcated agency in a mortgage broker context. (See, Bus. & Prof. Code § 10240 regarding mortgage loan disclosure statements (“MLDS”).) Part of the DRE’s reason may be to make sure that a consumer Borrower is always represented some licensee (e.g., avoiding the situation where a broker represents a direct lender and no one represents the consumer Borrower where a broker indeed solicits Borrowers.)

As noted above, the MLDS is required of “[e]very real estate broker, upon acting within the meaning of subdivision (d) of Section 10131, who negotiates a loan to be secured directly or collaterally by a lien on real property . . .” (And see, Regs. § 2840.) However, BP §

10131(d) and (e) are very broad and include real estate licensees who solicit or negotiate loans for lenders (or sales to purchasers) as well as those who solicit or negotiate loans for borrowers. Both § 10240 and the Regs provide little clarity on which broker is responsible to provide the MLDS. (See, Reg. §§ 2840 et seq.) However, looking at § 10240 in light of certain subparagraphs in that section and in light of other required statutory disclosures to the lender (Lender Purchaser Disclosure Statement “LPDS”), a good argument can be made that it is the broker who solicits and negotiates with a borrower who must prepare and give the MLDS to the borrower. BP §10240(b) provides:

“(b) For the purposes of applying the provisions of this article, a real estate broker is acting within the meaning of subdivision (d) of Section 10131 if he or she solicits borrowers, or causes borrowers to be solicited, through express or implied representations that the broker will act as an agent in arranging a loan, but in fact makes the loan to the borrower from funds belonging to the broker.”

While this provision is directed to loans ultimately made with broker controlled funds, it specifically defines the general conduct to which this exception applies (i.e., where a broker solicits borrowers for the purpose of “arranging” [not making] a loan.) Logically, the MLDS should be given to the Borrower by the Broker who solicited them for the purpose of making or arranging a loan for that borrower.

While attempting to use a bifurcated agency, the Lender’s Broker, out of an abundance of caution, may want to make sure that the Borrower has received a proper, timely and complete MLDS, even if the Borrower’s Broker promises to handle the disclosure. Even though there may be two licensed brokers who technically may be obligated to give the borrower a MLDS, a second MLDS is probably not necessary and may just create conflicts. Instead, the lender’s broker (acting exclusively for the lender) may prefer to have underwriting requirements or a procedural check list to verifies that the borrower’s broker has fulfilled his/her obligation to give a a complete, accurate and timely MLDS to the borrower within 3 business days of receiving a completed loan application or before the borrower becomes obligated on the note, whichever is earlier.

3. Lender Purchaser Disclosure Statement.

BP Code §§ 10232.4 and 10232.5 requires that a Lender Purchaser Disclosure Statement (“LPDS”) be delivered by the broker to the investors or purchaser. BP Code § 10232.4 provides that the LPDS shall be delivered to the investor/purchaser “as early as practicable before he or she becomes obligation to make the loan or purchase and, except as provided in subdivision (c), before the receipt by or on behalf of the broker of any funds from that person.”⁹ Versions available from the DRE are: RE 851A (Rev 2/04) Lender/Purchaser

⁹ BP Code § 10232.4(c) provides that: “When the broker has custody of funds of a prospective lender or purchaser which were received and are being maintained with the express permission of the owner and in accordance with law, and the broker retains the funds in an escrow depository or a trust fund account pending receipt of the owner’s express written instructions to disburse the funds for a loan or purchase, the broker shall cause the disclosure statement to be delivered to the owner and shall obtain the owner’s written consent to the proposed disbursement before making the disbursement. Unless the broker has a written agreement with the owner as provided in Section 10231.1, the broker shall transmit to the owner not later than 25 days after receipt, all funds then in the broker’s custody for which the owner has not given written instructions authorizing

Disclosure Statement (Loan Origination); RE 851B (Rev 2/04) Lender/Purchaser Disclosure Statement (Sale of Existing Note); RE 851C (Rev 9/01) Lender/Purchaser Disclosure Statement (Collateral Loan) and RE 851D (Rev 2/04) Lender/Purchaser Disclosure Statement Multi-Property (Cross-Collateralization) Addendum.

4. Impact of LPDS on Bifurcated Agency.

Similarly, the LPDS should be prepared and given by a broker soliciting a Lender or Purchaser to fund or acquire an interest in a private money loans secured by real property. In fact, Business and Professions Code § 10232.4 provides, in pertinent part:

“(a) In making a solicitation to a particular person and in negotiating with that person **to make a loan secured by real property** or to purchase a . . . note secured by a deed of trust, a real estate broker shall deliver to the person solicited the applicable completed [LPDS] . . .”

Thus, the language relating to the LPDS is clear. While one could employ semantics and argue that a Borrower’s broker will always be soliciting a Lender, in reality, the Borrower’s broker packages a loan and forwards it to a Lender’s Broker who already has (or will) solicit Lenders to fund the loan.

E. Impact of Financial Code § 4970 et seq. (a.k.a. AB 489 or Cal-32) may include lending and conduct standards to be imposed on both lenders and brokers as well as the method of repayment issue. (5 min.)

Financial Code §§ 4970 et seq. enacted in 2001 (a.k.a. AB 489 or Cal-32 and euphemistically called the Predatory Lending Law), creates numerous standards when the transaction is a “covered” loan. Among the standards of conduct are: limits on prepayment penalties; presumptions regarding debt to income ratios; controls on how home improvement loan proceeds are to be disbursed; the mandated use of a Consumer Caution and Home Ownership Counseling Notice; and limits upon refinancing by the same “originator” unless a demonstrated benefit has been achieved by the borrower, among others.

Since mortgage brokers are typically agents and fiduciaries of the borrowers, caution must be exercised in all loan transactions, even if the transaction is not a “covered loan.” Brokers may very well face the challenge of establishing a disclosure to be completed by the Borrower describing a reasonable payment method for the loan. Refinancing the Borrower, whether the transaction is a “covered loan”, *should be based upon some identifiable benefit to the Borrower.* Also, the loan product presented to the borrower should bear some relationship to the borrower’s financial needs and abilities. Brokers may want to reexamine their “hard money” mortgage policies and procedures in light of this legislation and consider whether it is worth offering “covered loans”.

F. Special Rules Under Financial Code § 4970 et seq. (aka AB 489 or Cal-32).

As of July 1, 2002, for covered consumer loans under Financial Code §§ 4970 et seq. (CAL-32 or the predatory lending law), attempts by a Mortgage Broker to bifurcate his/her

disbursement.”

agency may be prohibited as to covered loans based upon Financial Code § 4979.5(a) which provides:

“A person who provides brokerage services to a borrower in a covered loan transaction by soliciting lenders or otherwise negotiating a consumer loan secured by real property, is the fiduciary of the consumer, and any violation of the person's fiduciary duties shall be a violation of this section. A broker who arranges a covered loan owes this fiduciary duty to the consumer regardless of who else the broker may be acting as an agent for in the course of the loan transaction.”

(Emphasis Added). Section 4979.5(a) is not clear whether only a broker retained by the Borrower to solicit a lender or negotiate a loan is covered (i.e., and is the Borrower's fiduciary) or whether a broker attempting to represent only the Lender (bifurcated agency) becomes the Borrower's fiduciary merely by negotiating the loan (albeit exclusively for the Lender) or soliciting Lenders for a loan even though that Lender's Broker has no contact or contract with the Borrower. However, some commentators argue that under § 4979.5(a), any licensee who acts in a Cal-32 loan is the fiduciary of the Borrower, even where the Borrower is exclusively represented by his own broker,

Comment: Because of the potential liability involved for brokers, the best practice would be to refrain from making or arranging Financial Code §§ 4970 et seq., covered loans allowing the market place to create an environment where this vague legislation is amended, clarified, or is repealed. For Borrower's Brokers § 4970 et seq. is going to apply in any case. For Lender's Brokers, there is no down side to attempting to bifurcate agency as long as in doing so the Lender's Broker acts under the assumption that he/she may still be viewed as a fiduciary of the Borrower. In such a case, if the bifurcated agency is not recognized, the Lender's Broker still has conducted himself/herself in a fashion sufficient to satisfy duties he would have had if he/she were the Borrower's Broker.

G. Fiduciary Duty Includes Duty To Investigate And Advise Principal. (3 min.)

In *Field v. Century 21 Klownen Forness Realty* (1998) 63 Cal.App.4th 18, 21, 25 26, the court of appeal held that:

"The broker as a fiduciary has a duty to learn the material facts that may affect the principal's decision. He is hired for his professional knowledge and skill; he is expected to perform the necessary research and investigation in order to know those important matters that will affect the principal's decision, and he has a duty to counsel and advise the principal regarding the propriety and ramifications of the decision. The agent's duty to disclose material information to the principal includes the duty to disclose reasonably obtainable material information. [¶] ... [¶] The facts that a broker must learn, and the advice and counsel required of the broker, depend on the facts of each transaction, *the knowledge and the experience of the principal, the questions asked by the principal, and the nature of the property and the terms of sale.* The broker must place himself in the position of the principal and ask himself the type of information required for the principal to make a well informed decision. This obligation requires investigation of facts not known to the agent and disclosure of all material facts that might reasonably

be discovered.' [Citation.] [¶] Thus, depending on the circumstances, **a broker's fiduciary duty may be much broader than the duty to visually inspect and may include a duty to inspect public records or permits concerning title or use of the property, a duty which is expressly excluded from section 2079.**"

(Id. at pp. 25 26, Emphasis added; and see, *Assilzadeh v. California Federal Bank* (2000) 82 Cal.app.4th at 414-4166.) The Mortgage Broker representing the Lender should take the same care to investigate the Borrower and the secured property. Many of the same issues that are relevant for a broker to investigate and disclose to a buyer would also be relevant to a Lender making a private money loan. While it may be beyond the scope of a loan broker's duty to investigate the terms of the sale transaction and the condition of the property for the Borrower (i.e., that's the duty of his real estate broker involved in the purchase), the Mortgage Broker may well have a duty to the private Lender to investigate and disclose material facts with respect to the Borrower, the Borrower's ability to pay and the security for the loan.

Where there is litigation involving the property, the broker must disclose the fact of the lawsuit-which would put the buyer on notice that any defects not repaired would obviously have an impact on value. (*Pagaon v. Krohn* (1997) 60 Cal.App.4th 1; *Assilzadeh v. California Federal Bank*, supra.) As a licensee, however, what would be the harm in so advising the buyer of what the court of appeal views as an obvious fact?

A broker should recommend some form of title search or investigation of title and encumbrances on property. (See, *Wilson vs. Hisey* (1957) 147 Cal.App.2d 433.) Consideration should be given to the fact that a title company preliminary report is not an abstract of title and does not guarantee any of the information contained therein. It merely is a statement of the condition to which a title company will issue a title policy. Reliance on a preliminary report can be dangerous. (See, *Little v. Community Bank* (1991) 234 Cal.App.3d 355.) For a Mortgage Broker investigating and making recommendations on items not removed from the preliminary report and with respect to the proper type of title insurance and/or endorsements may well be a material disclosure. This is not only relevant in the original loan transaction but also when the loan is modified (i.e., recommending the obtaining of a modification or other applicable endorsement).

Certainly, the existence of senior liens or junior tax liens is critical when one purchases property at trustee sales or other distressed property sales. A REB breaches his/her fiduciary duty (to a buyer) by failing to disclose existence of and advise as to the effect of "due on sale" clause in deed of trust taken subject to by buyer. (*Pepitoni vs. Russo* (1976) 64 Cal.App.3d 685.) .

H. Open Your Mouth, Expand Your Duties. (5 Min.)

The REB should not attempt to provide or give advice beyond the scope of the agency (e.g., do not give advise or assistance on the purchase of a piece of real property or on the tax consequences of that purchase when the broker is only retained to arrange a loan pursuant to a procurement agreement; see, *Santos v. Wing* (1961) 197 Cal.App.2d 678 [giving tax advice]). Because of the fiduciary duties which are imposed on an agent, he/she cannot be burdened with the obligations against his/her will. (See, *Schmidt v. Beckelman* (1960) 187 Cal.App.2d 462.) That is, a principal cannot, after the fact, come in and pick

one special agent in the transaction and attempt to charge him/her with the duties of other special agents or of a general agent (e.g., to advise him/her as a financial adviser, sales broker and/or as to the purchase and sale aspects of the transactions she/he had already entered).

A broker can breach his/her duties when he/she volunteers information about the property (or loan) or about the other party (buyer or borrower) which is later proven to be factually incorrect or where he represents that he will investigate or verify information. Examples: Where broker recommends a sale to a prospective purchaser based upon the financial ability of buyer where such financial information is incorrect. *Timmsen vs. Forest E. Olson, Inc.* (1970) 6 Cal.App.3d 860; value of security or financial strength of payor of note, *Banville vs. Schmidt* (1974) 37 Cal.App.3d 92. Similarly, where the agent has reason to suspect the information provided by buyer (or Borrower) is incorrect but does not investigate or recommend the principal investigate. *Alhino v. Starr* (1980) 112 Cal.App.3d 158. In *Alhino* the agent for seller was told by the buyer that he wanted the seller take-back note taken as part of the purchase price to be an *unsecured* note with no late charge, attorney' fees or acceleration clauses, so that he would have no difficulty making late payments. The agent did not disclose this information or its effect to the seller and represented, based upon buyer's unverified financial statement, that the buyer's financial condition justified the unsecured note. No disclosure was made as to the deletion of these standard promissory note clauses. (i.e., breach of fiduciary duty). Also see, *Pepper vs. Underwood* (1975) 48 Cal.App.3d 698 and with respect to the reliability of information supplied by the seller on net rental income. *Ford vs. Cournale* (1973) 36 Cal.App.3d 172.

I. Generally A Competent Principal Who Fails To Read Documents When Given An Opportunity To Do So May Not Avoid Their Legal Effect. Except . . . (3 Min.)

In *Carleton v. Tortosa, supra*, the principal was given a number of standard form documents and disclosures and the real estate broker defendant ***admittedly did nothing to prevent him from reading the documents in their entirety.*** The principal in *Carleton* stated he glanced through the documents. The court of appeal noted that the "failure to read the documents does not permit him to avoid their legal effect . . ." (Id., 14 Cal.App.4th at 755, citing *Bolanos v. Khalatian* (1991) 231 Cal.App.3d 1586, 1590.) However, the REB must not dissuade the principal from reading the documents or disclosures, and must not misrepresent what the documents or disclosures mean. Further, a REB must exercise a great deal of caution when the documents or disclosures contemplate conduct potentially adverse to the principal, e.g., the mediation and arbitration provisions within some standard real estate purchase agreements. REBs when acting as fiduciaries of a principal to whom disclosures and representations are being made, ***must discuss the significance and consequences of the disclosures and representations and offer advice and recommendations within the scope of the agency.*** (See, *Field v. Century 21 Klowden Forness Realty* (1998) 63 Cal. App. 4th 18, 21, 25 - 26).

J. Duties Of A Mortgage Loan Broker To Explain Loan Terms And To Make Accurate Oral Disclosures. (3 Min.)

Wyatt v. Union Mortgage Co., supra, is most favorable to the Borrowers dealing with a Mortgage Broker. *Wyatt* pointed out that merely having a large pile of otherwise accurate documents that the Borrower is given an opportunity to read, may not be sufficient to fulfill

the broker's duty to the Borrower. It may be necessary to explain the significance of the documents, particularly if they differ from prior oral or written representations of the broker (e.g., ads, sales calls etc.)

In *Wyatt*, the Mortgage Broker advertised specific loans on television when, in fact, no such loans existed. In response to the ads, the Borrowers sought to have Union Home Loan (herein "Union") arrange a loan with private, non-institutional lenders. The Borrower agreed in writing to specific terms. (Id. 24 Cal.3d at 779-780.) Union verbally advised the Borrower that there would be a "small balloon payment" due in the 37th month. (Id.) The Borrower specifically asked the broker about the interest rate and payment grace period. The broker told the Borrower he would have a 10-day grace period and a seven or eight percent interest rate. (Id., 24 Cal.3d at 780.) At the closing, the Borrower was shown a pile of loan documents and was not given an opportunity to read them. In fact the terms of the loan actually made had only a five-day grace period, a late charge which was in excess of 50 percent of the monthly installment and a provision that allowed pyramiding¹⁰ of late charges. The actual balloon payment, in relation to the loan, was over 70 percent of the original loan balance, if all installments were paid on a timely fashion. The pyramiding of late charges was never explained to the Borrower. The Borrower was late several times, causing the pyramiding of loan charges to occur resulting in a balloon payment as large as the original loan. Union refused to extend the loan and the Borrower was forced to refinance with Union, as the Borrower could not obtain financing elsewhere. The second loan involved similar misrepresentations about the loan and included the same type of late charge. Late charges were assessed even though the borrower was not delinquent on the second loan. There was evidence that the company (which was quite large) had a known policy of pushing late charges very hard as a source of income (i.e., it kept the late charges).

The court of appeal noted in *Wyatt* that, while the documents may have been accurate, the Borrower asked questions about the loan terms and the answers were materially misleading and incomplete. Based on this, the court found a breach of fiduciary duty. The duty, however, had only to do with accurately disclosing the material terms of the loan. (Id. 24 Cal.3d at 782-783.) ***The court of appeal did require that the broker orally and accurately disclose the material terms of the loan being made.*** (Id. 24 Cal.3d at 783-784).

The *Wyatt* case is the source of the oral disclosure forms used by many Mortgage Brokers today. There is nothing in the *Wyatt* decision that requires the disclosure by the Mortgage Broker of matters beyond the material terms of the loan being made. There is no case requiring a Mortgage Broker to give business advice to the Borrower, tell the Borrower whether his/her real estate purchase transaction is a good or prudent one, give tax advice etc. In fact, to do so may expand the broker's liability (see discussion above). This should be distinguished from giving advice on the subject matter of the agency (i.e., the terms of the loan and whether the loan being arranged is the best one available for the Borrower).

¹⁰ Pyramiding is where subsequent payments are first applied to accrued late charges, rendering the subsequent payment deficient which can result in the borrower almost continually accruing new late charges.

The facts in *Wyatt* occurred between 1966 and 1970, well before the current statutorily required disclosures mandating extensive written state and federal disclosures of all of the material terms of the loan (discussed supra). Since *Wyatt*, there have been extensive state and federal laws enacted, requiring written disclosures and outlawing bait and switch loan practices and features such as late charge pyramiding.

The *Wyatt* decision was made in the context of the tradition Mortgage Broker model and little in that opinion would lead one to believe that a bifurcated agency is not possible or that the Lender's Broker would take on duties to the Borrower other than those always owed by an agent to a third party in a transaction with his/her principal (i.e., a duty of honest and fair dealing.)

K. Duty to Disclose Dual Agency. (5 min.)

Any real estate licensee is subject to discipline where he/she, in performing or attempting to perform any of the acts within the scope of his license, has been guilty of “[a]cting for more than one party in a transaction without the knowledge or consent of all parties thereto.” (BP Code § 10176(d).) While the phrase is written in the disjunctive, “...knowledge *or* consent...”, it must be interpreted in the conjunctive, “...knowledge *and* consent...”. It should be obvious that if one acts with knowledge that consent is implied, and one cannot consent to that which one has no knowledge. The *principal's consent should be obtained in each transaction*. Nothing in § 10176(d) excludes Mortgage Broker's from these rules although few standard form loan documents clearly disclose dual agency and obtain both principals consent. (See, the recently modified “Agreement to Procure Lender”.)

L. Brokers are not middlemen. (2 min)

Brokers are independent contractors acting as agent of the borrower, the lender, or both. While Mortgage Brokers may act as a direct lender (depending upon the facts), they are not “middlemen” when arranging a loan on behalf of another. Mortgage Brokers must be the agent of the Borrower or of the Lender, or of both (i.e., a dual agent).

Mortgage Brokers by definition are licensed to act on behalf of a principal in dealings with third parties. BP Code § 10131 describes real estate brokers acting on behalf of another for compensation, or expectation of compensation, regardless of form, time (or implicitly, source) in certain defined transactions to solicit or negotiate on behalf of a principal. (See, discussion above.) The language clearly describes an agent for a particular purpose and scope and for a particular transaction, i.e., a special agent. The agency with the Borrower typically arises when the broker undertakes to procure a lender for the loan that the Borrower requested.

Mortgage Brokers are required act within the course and scope of their license when issuing securities to deed of trust investors, whether pursuant to the “whole” note exemption (Corp. Code § 25100(p)) or pursuant to the “multi-lender” note exemption (Corp. Code § 25102.5 [exemption but REB is the issuer]; BP Code § 10237 et seq.) Some commentators view Mortgage Brokers as de facto broker dealers with the fiduciary duties and due diligence required of such dealers under the Corporate Securities Law of 1968 and the Corporations Commissioner's regulations pertaining thereto. (See, 10 C.C.R. § 260.240.1; and see, BP Code § 10131.3, Corp. Code § 25004, 25100(e) and 25206.)

Note: Some argue that Mortgage Brokers may not act as a de facto dealer when the total

number of investors exceeds 100 persons.

Accordingly, real estate brokers acting as mortgage brokers must be agents and fiduciaries of private deed of trust investors to whom securities are being issued by the broker. (See, 10 C.C.R. 260.115.)¹¹ Therefore, the mortgage broker may be in the unenviable position of being both the issuer and the de facto broker dealer through whom the security is being issued.

M. Disclosure Of Secret Profits Or Compensation. (3 min.)

Various situations arise in sales and loan transactions where the broker makes a secret profit and/or undisclosed compensation. For Mortgage Brokers, all broker commissions and lender origination fees should be disclosed on the Mortgage Loan Disclosure Statement ("MLDS" DRE Form # RE 992) or on the alternate form Mortgage Loan Disclosure Statement/Good Faith Estimate ("MLDS/GFE", DRE Form # RE 883)(See, BP Code § 10240 and 10241; 10 CCR §§ 2840 and 2840.1.) Where a yield spread premium is paid by the lender after the close of escrow, that fact should be disclosed on the MLDS or more appropriately on the MLDS/GFE under "Compensation to Broker (Not Paid Out of Loan Proceeds)." Proper use of the statutory disclosures required in loan broker transactions, reduces the likelihood of hidden commissions and/or of undisclosed compensation. However, unless the Lender is copied with the MLDS, the Lender may not have the full amount of the Mortgage Broker's compensation disclosed as the LPDS does not set forth all of the potential compensation being received by the Mortgage Broker from the Borrower.

As aptly summarized in *Roberts v. Lamonto* (2003) 112 Cal.App.4th 1553:

"The law imposes on a real estate agent 'the same obligation of undivided service and loyalty that it imposes on a trustee in favor of his beneficiary.' [Citations.] This relationship not only imposes upon him the duty of acting in the highest good faith towards his principal but precludes the agent from obtaining any advantage over the principal in any transaction had by virtue of his agency. [Citation.] 'Such an agent is charged with the duty of fullest disclosure of all material facts concerning the transaction that might affect the principal's decision.' [Citations.]" (*Batson v. Strehlow* (1968) 68 Cal.2d 662, 674-675; see also *Field v. Century 21 Klowden-Forness Realty* (1998) 63 Cal.App.4th 18, 25; *Jorgensen v. Beach 'N' Bay Realty, Inc.* (1981) 125 Cal. App. 3d 155, 161-162; *Ford v. Cournale* (1973) 36 Cal. App. 3d 172, 180.)

¹¹ 10 CCR § 260.115 provides: "A licensed real estate broker, a licensed finance lender, or licensed industrial loan company who engages in the offer and sale of notes secured by real property of various makers, which are a series of notes or notes in which undivided interests are offered and sold, is the issuer of such notes and undivided interests if the notes of the various makers are offered and sold pursuant to a plan or arrangement which is common as to the various makers with respect to documentation and loan standards and which includes provisions for servicing such notes on behalf of the purchasers."

"When a broker is engaged by an owner to market the owner's property, an agency relationship is created. The agent has fiduciary duties to the seller to disclose all material facts. *If the agent, or a relative or associate of the agent, purchases the property, the agent's fiduciary duties continue even though he or she may be a principal in the transaction.*" (2 Miller & Starr, Cal. Real Estate (3d ed. 2000) § 3:17, pp. 86-87 (Miller & Starr) italics added, footnotes omitted.) In other words, "[o]nce an agency relationship has been created between the agent and the seller, the agent is not absolved of fiduciary duties merely because he or she is also buying or selling as a principal." (Id., § 3:28, pp. 161-162; italics added.) **Thus, "[o]ne who acts as an agent and also deals with his principal as to the subject matter of the agency cannot take advantage of his principal by withholding from him information secured by means of the agency."** (*Ratray v. Scudder* (1946) 28 Cal.2d 214, 224 (*Ratray*); see also *Steve Schmidt & Co. v. Berry* (1986) 183 Cal. App. 3d 1299, 1313-1314.)"

"A real estate licensee who "claim[s] or tak[es] ... any secret or undisclosed amount of compensation, commission or profit or fail[s] to reveal to the employer of such licensee the full amount of such licensee's compensation, commission or profit under any agreement authorizing or employing such licensee to do any acts for which a license is required," is subject to discipline by the Real Estate Commissioner. (Bus. & Prof. Code, § 10176, subd. (g).) **Such a licensee also violates his or her fiduciary duties toward the employer** and will not be allowed to retain the undisclosed profit: "[A] real estate licensee, while acting in his or her capacity as such, must not receive any benefit from the transaction of his or her agency other than that which is known and accepted by the principal. The agent will not be permitted to retain anything that might otherwise derive from participation in the transaction unless the agent fully discloses the nature and amount of the benefit and receives the **approval of the principal. It is totally immaterial that the transaction is otherwise fair to the principal, or that the principal receives exactly the price wanted for the property ...**" [Ct. Om.] '[T]he principal's right to recover does not depend on any deceit of the agent, but is based upon the duties incident to the agency relationship and upon the fact that all profits resulting from that relationship belong to the principal.'" (*Crogan v. Metz, supra*, 47 Cal.2d at pp. 404-405.)

(*Roberts v. Lamonto, supra* at 1562-1564; [bold emphasis added].)

Both BP § 10240(b) and the *Roberts* case, make it clear that just because a Mortgage Broker commences the relationship representing the Borrower or Lender, fiduciary duties and statutory disclosure duties are not avoided by the Broker later become a principal in the transaction.

As noted in 2 Miller & Starr, Calif. Real Estate, 3d Ed., *Agency*, § 3:17, p. 85-86:

“An agent owes his or her principal the duty to disclose factors regarding the property, such as an opinion of value or the possibilities of future appreciation, and also the duty to make a reasonable investigation of, to consult about, and to advise regarding matters that may affect the principal’s decision. [fn. om] An agent must disclose all factors regarding the desirability of the transaction from the viewpoint of the principal **and all profits that the broker will make, or anticipates making, on the transaction.**”

(Emphasis Added.)

While these rules related to undisclosed compensation or secret profits more frequently arise in cases involving the sale of property to an agent or an undisclosed, related buyer, they also apply to Mortgage Broker transactions. Awareness of the above rules increases the importance of *terminating the agency with the Borrower at the time the loan is closed*. If the broker were to be viewed as continuing to be the agent for the Borrower, it would make it very difficult for a broker to negotiate with the Borrower for himself or for the investors, particularly after default, regarding purchasing the secured property, obtaining a deed-in-lieu of foreclosure and/or forbearance agreements.

Other instances of undisclosed profits can be where the broker receives undisclosed referral fees in a transaction in which he is involved (also a RESPA violation where applicable). For example, a broker is involved in a purchase of commercial real property and does not disclose that an affiliated broker in his office is arranging the financing and that the broker receives the actual broker’s commission. (This example is from a real case, where the commercial loan documents listed an unknown salesperson as the broker to keep the borrower/buyer from knowing that the broker in the purchase transaction was actually the broker arranging the loan and receiving a commission from the new lender).

N. Broker may end up as both principal and agent and fiduciary of borrower, Business and Professions Code 10240(b). (4 min.)

BP Code § 10240(b) provides that:

“For the purposes of applying the provisions of this article, a real estate broker is acting within the meaning of subdivision (d) of Section 10131 if he or she solicits borrowers, or causes borrowers to be solicited, through express or implied representations that the broker will act as an agent in arranging a loan, but in fact makes the loan to the borrower from funds belonging to the broker.”

This section contemplates a Mortgage Broker commencing a relationship as an agent for the Borrower to procure a Lender for the loan the Borrower seeks, but where the broker later decides to make the loan out of the broker’s own funds. Section 10240(b) subjects the broker to subdivision (d) of 10131 and, therefore, the resulting fact situation is the Mortgage Broker is both the agent of the Borrower and the principal making the loan. The broker should be very careful when completing the “may”, “will” and “will not” disclosures in the MLDS or MLDS/GFE (10 CRC §§ 2840 or 2840.1) to ensure the Borrower is fully aware of the broker’s roles in the loan transaction. Further, BP Code § 10241(j) must also be kept in mind when considering the broker’s role as a Lender which also results from the use of broker controlled funds.

Beginning the loan transaction with a disclosure on the MLDS or MLDS/GFE that the broker “may” use his own or broker controlled funds may subject the broker to the provisions of BP Code § 10240(b).

O. Disclosure of Significant Relationship With A Party To The Transactions. (3 min.)

An agent must disclose to his principal material business or family relationship with the other party to the transaction. (*Jorgensen v. Beach ‘N’ Bay Realty, Inc.* (1981) 125 Cal.App.3d 155, 163.) In *Jorgensen*, the Court of Appeal held that where the real estate broker represented both the seller and buyer and disclosed this relationship to both of them, it was potentially a breach of the licensee's fiduciary duty not to disclose all material facts where the buyer was a wealthy investor who had numerous transactions with the broker and made substantial and continuing investments in the broker's area of business; where the broker failed to disclose that the purchaser intended to purchase for investment and mislead sellers into believing the purchasers wished to reside in the residence; where the agent highly recommended that seller accept a low purchase price with a quick close of escrow and where agent failed to disclose his personal substantial stake in winning the favor of the buyer. In this case, the buyer immediately listed and resold the subject property at a substantial profit. The court also held it may be negligent when a real estate agent lists a property, even at the instance of the seller, without a reasonable basis or investigation to support the listing price.

P. Disclosure of Agency in Sales Transactions.

Civil Code §§ 2079.12 – 2079.24 require that real estate agents representing both the buyer and the seller in a 1-4 residential transaction must provide a disclosure statement to both buyer and seller disclosing the nature of the various agency relationships. These are very important provisions which real estate agents must follow. In summary, they provide the declaration of the California Legislature when they passed these statutes (§ 2079.12), the definition of “agent”, “buyer”, “seller” and other important terms (§2079.13), the duty of the agent to provide the disclosure form and who must sign it (§ 2079.14), the agent's declaration of facts when the buyer or seller refuse to sign the disclosure form (§ 2079.15), the disclosure form itself (§ 2079.16), the agent's required disclosure of his/her relationship to the buyer or seller and the required confirmation (§ 2079.17), if the selling agent is the listing agent, they may not also act as agent for the buyer only (§ 2970.18), a party's payment of compensation to the agent is not determinative of his/her relationship to the party paying (§ 2970.19), the agent's ability to select another form of agency relationship (§ 2079.20), the dual agent's prohibition of disclosing the buyer's or seller's willingness to sell at a particular price (§ 2079.21), the selling agent may also be the listing agent (§ 2079.22), the parties may consent in writing to a modification of the agency relationship prior to performance of the act which is the object of the agency (§ 2079.23), and these sections do not limit the agent's liability for breach of fiduciary duty or the duty of disclosure (§ 2079.24).

While the statute does not provide specific remedies for failure to comply with the agency disclosure law by providing the required disclosure before taking the listing, the court in *Huijers v. DeMarrais* (2nd Dist. 1992) 11 Cal.App.4th 676 held that the agent's **failure to provide the required disclosures prior to entering into the listing agreement relieved**

the seller of any obligation to pay the agent's commission but did not allow them to rescind the purchase agreement with the buyers.

Q. Duty of Broker to Obtain Competitive Product in the Right Class of Loan For Borrower and to Establish Method of Repayment Upon Which Borrower is Reliant. See Draft Language for Duties of Agent and Terms of Agreement with Borrower. (2 min.)

Because Mortgage Brokers cover such a broad range of lending types, it is difficult to state precisely what the “duties are” and what is the “standard of care”, as to a particular loan. There certainly may be differences in the broker’s duties depending on the nature of the Borrower and the type of loan. In a commercial loan with a sophisticated Borrower, It may be possible to say, “I have a fixed group of investors who will make a loan on “x” terms.” This may be acceptable if it is clear that the broker is not going to shop for the best loan in the highest class available to the borrower. Example, a commercial borrower is willing to borrow at 10% for a 3 year term when he could get a 7% loan from the bank. His rationale is that banks take too long to process commercial loans and the process is too complicated. With these facts being known by the Borrower and/or disclosed by the Broker, does the broker have a duty to try to obtain the better bank loan at a lower rate? Probably not.

With respect to consumer loans subject to RESPA the answer is like to the contrary. HUD has repeatedly advanced the notion that mortgage brokers, when performing their role as an agent and fiduciary of the Borrower, have the obligation of delivering the “best available” or “best possible” loan. A non-fiduciary Lender is able to select from loan products being offered the particular loan product that most closely applies with the Borrower’s financial standing and credit-worthiness. A Mortgage Broker, as an agent and fiduciary of the Borrower should not be subject to the impossible standard of “best available” or “best possible” loan product. On the other hand, Mortgage Brokers will likely be subjected to a standard of arranging for the Borrower a “competitive product” in the right class of loan when considering the Borrower’s credit history, financial standing, income, financial needs, the loan terms requested at the time of the application, the time requirement the Borrower has imposed on loan funding, the type and location of the property, the market conditions where the intended security property is located, and the disclosed reasonable method of repayment. In short, current legislative and regulatory direction appears to be imposing the foregoing standards on mortgage brokers who act as agents and fiduciaries of the borrower.

Bifurcation may impact the Lender’s Broker’s liability while the Borrower’s Broker’s liability remains the same.

VIII. Termination of Agency Relationship. (5 min.)

A. Methods of Terminating Agency.

The agency relationship may be terminated by any of the following:

1. Acts of one or both parties (rescission, renunciation etc.).

The normal law and grounds for rescission of a contract apply to agency agreements. (Civ.

Code § 1688 et seq.) Unless the agency is coupled with an interest, an agent can always be terminated. However, termination by the principal may constitute a breach of contract depending on the listing, agreement to procure a loan or commission agreement between the agent and principal. In those cases where the agent was terminated for cause arising out of an “intentional” breach of the agent’s fiduciary duty, the courts have held that the agent is not entitled to compensation and that such termination does not result in an actionable breach of contract.

2. Expiration of agent's term (listing runs out or Agreement to Procure a Loan expires due to an express term in the agency agreement).

This termination occurs when the agency agreement is subject to a particular termination date. A specific termination date is required pursuant to BP Code §10176(f).

During the life of a loan, many things happen after the close of the loan escrow. ***The best practice is for any REB acting as the agent, dual agent or subagent of a borrower, to terminate the agency relationship in writing at the close of escrow or at a specified time if the loan does not close by a particular date.*** Generally, this should be done in writing in the agreement employing the agent or creating the agency and is mandatory if the REB is to act as an exclusive agent. This formal written termination of agency with the Borrower should be combined with an express statement that if the REB continues to service the loan it is solely as the agent for the lender. This helps eliminate any question that the REB servicing the loan does so exclusively as agent of the Lender. These provisions assist in heading off assertions that the REB, in taking actions to enforce the obligation for the Lender, has somehow breached a fiduciary duty to the Borrower.

Many brokers intend to exclusively act as the Lender’s Agent in servicing the loan after the loan is made. It could be dangerous for the Mortgage Broker who made or arranged the loan to continue to have a vague agency relationship with the Borrower. During the servicing of the loan, the situation can and, often does, change. For various reasons, the Borrower may want to refinance the loan being serviced. This situation is further complicated when the Borrower is in default. The Borrower will often call the servicing REB to attempt to obtain a workout agreement or to refinance. If the servicing REB had a clearly defined relationship at the close of the original loan, a new agency will have to be created by express or implied agreement (e.g., Broker agreeing to procure another loan). Therefore, unless the servicing REB intends to create a new agency relationship with the Borrower (e.g., arranging a refinance or representing the borrower in attempting to obtain a workout), his/her communications with the Borrower should make it clear that any actions he/she takes in negotiating a workout agreement is on behalf of the Lender. The servicing REB may not be able to avoid being a dual agent of the Borrower and Lender if the servicing agent is servicing an old loan for the Lender and, at the same time, making or arranging a refinance loan for the Borrower.

Continuing after the close of the loan as representative of any principal can impose continuing duties. In *Brown vs. Critchfield* (1st Dist.1980) 100 Cal.App.3d 858, the seller's real estate agent and the seller's attorney in a transaction involving an installment sale, blanket deed of trust, and partial releases were held liable for breach of fiduciary duty. ***Both the attorney and real estate agent had agreed to continue to represent the seller over a prolonged period of the installment sale and they did not immediately advise***

the seller that the property taxes were delinquent and that immediate foreclosure should have been instituted under seller's purchase money deed of trust. When the seller ultimately foreclosed for buyer's failure to make payments on the purchase money note and deed of trust, substantial property taxes were owed and had to be paid by the seller. Among other things, the *Brown* case likely would apply to REBs servicing loans and shows why retaining a tax service is wise. More importantly, however, the *Brown* case shows why it is important for a broker to terminate his agency relationship when the original purpose of the agency has been fulfilled (e.g., the loan escrow closes.)

3. Extinction of the subject matter.

For example, if the house to be sold burns down or is foreclosed prior to sale under the listing. Also, when the loan requested by the Borrower is unavailable and no alternative loan is acceptable to the borrower.

4. Revocation by principal.

A principal always has an absolute right to revoke the agency relationship but such action may make the principal liable to the agent for damages (e.g., the commission under the listing agreement). Again, agency relationships coupled with an interest may not be revoked except for the malfeasance, defalcation, or other "intentional" breach of fiduciary duty by the broker.

5. Death or incapacity of principal or agent.

This is the hard way to get out of an agency relationship. This rule raises some interesting issues however.

Since a loan servicing agreement is an agency contract, does it terminate when the broker dies or is incapacitated? What if the broker loses his/her license (e.g., suspension or revocation)? Can a servicing agreement be assignable at the election of the broker? If not, what happens under BP § 10238(k) which requires, as part of the multi-lender rule (securities exemption), that there be a written servicing agreement? A distinction has been drawn between a corporate broker and a mortgage broker functioning as a sole proprietorship or partnership. In the latter case, the courts have generally held that the contract with principals have been terminated as a result of the death of the agent. In the event of the principal, the issue turns on whether the probate court at the request of the personal representative would deem the contract to be executory and reaffirmed by the court.

IX. Broker Agreements and RESPA. (15 Min.)

A. Introduction.

RESPA is found in 12 U.S.C.S. § 2601 et seq. Substantial amounts of litigation raise issues about the application of § 8 of RESPA. In particular, challenges are frequently raised to lender charges and fees, markups, yield spread premium (YSP) and sharing of fees. Section 8 of the Real Estate Settlement Procedures Act ("RESPA") provides, in

pertinent part:

“(a) Business referrals. No person shall give and no person shall accept any fee, kickback, or thing of value pursuant to any agreement or understanding, oral or otherwise, that business incident to or a part of a real estate settlement service involving a federally related mortgage loan shall be referred to any person.

(b) Splitting Charges. No person shall give and no person shall accept any portion, split, or percentage of any charge made or received for the rendering of a real estate settlement service in connection with a transaction involving a federally related mortgage loan **other than for services actually performed.**” [Emphasis added].

B. RESPA and Fee Splitting.

Markups without providing services (e.g., charging a \$50.00 fee to the borrower for courier services although only part of that sum was paid to third party couriers and the balance retained by the lender) will likely violate RESPA § 8(b). (See, *Sosa v. Chase Manhattan Mortgage Corporation* (11th Cir. 2003).) In *Santiago v GMAC Mortgage Group, Inc.* (3rd Cir. Aug. 2005) 417 F.3d 384, the court of appeal held that § 8(b) does not cover overcharges, but held that a borrower may sue for markups of third-party fees. (Also see, *Kruse v. Wells Fargo Home Mortgage, Inc.* (2nd Cir, 9-30-2004) 383 F.3d 49). In the *Santiago* case, the court of appeal found that there is no “reasonableness” standard for fees in § 8(b).

C. Federal and State issues presented by bifurcation of agency relationships. (3 min.)

In a RESPA loan transaction, the ability for two mortgage brokers to be involved is difficult, at best. As previously indicated, HUD did not envision more than one mortgage broker in any loan transaction. When the loan transaction is subject to FHA or VA regulation, only one mortgage broker is permitted who performs as loan correspondent. Under federal rules loan correspondents are agents of the sponsor, the latter being the approved mortgagee.

BP Code § 10133.15 defines “loan correspondent”, stating:

“The provisions of Article 5 (commencing with Section 10230) and Article 7 (commencing with Section 10240) do not apply to any person whose business is that of **acting as an authorized representative, agent, or loan correspondent of any person or employee thereof doing business under any law of this state, any other state, or the United States relating to banks, trust companies, savings and loan associations, industrial loan companies, pension trusts, credit unions, or insurance companies or when making loans qualified for sale to any of the foregoing insofar as that business is concerned.**” [Emphasis added.]

In this statute, a “loan correspondent” is defined as agents or authorized representatives of banks, savings and loans and savings banks, credit unions, thrift and loans, and pension plans (generally viewed as those plans possessing at least \$15 million in assets). However, the statute is not clear regarding the size of the pension plans involved. What is

clear is that mortgage bankers (whether licensed under the Residential Mortgage Lending Act ["RML"s] or under the Real Estate Law) and finance lenders (licensed as California Financed Lenders "CFL"s) are not included within the list of lenders for whom mortgage brokers may act as loan correspondent pursuant to BP Code § 10133.15.

In 1994, the Independent Bankers Association (IBA) requested an opinion from HUD regarding the use of two brokers in a transaction subject to RESPA under the Fee Splitting portion of the regulation as compared to the limitations on broker cooperation as set forth in the same regulatory scheme. (See, 24 CFR §§ 3500 et. seq.) HUD responded, in effect, authorizing the presence of two brokers within RESPA transactions (other than FHA or VA) by providing a list of fifteen functions HUD believes brokers may perform. The bottom line is that for two brokers to be involved under federal rules **at least 6 of the items must be performed by any broker receiving compensation**. Merely taking the loan application is insufficient activity to warrant compensation. On March 1, 1999, HUD issued its Statement of Policy 1999 -1 "Regarding Lender Payments to Mortgage Brokers" (e.g., yield spread premiums), 64 FR 10080 which referenced and interpreted the 1994 HUD Opinion requested by IBA. The following is set forth on page 9 of the HUD 1999-1 Statement of Policy:

"C. Payments Must Be for Goods, Facilities or Services

In the determination of whether payments from lenders to mortgage brokers are permissible under Section 8 of RESPA, **the threshold question is whether there were goods or facilities actually furnished or services actually performed for the total compensation paid to the mortgage broker**. In making the determination of whether compensable services are performed, HUD's letter to the Independent Bankers Association of America, dated February 14, 1995 (IBAA letter) may be useful. In that letter, HUD identified the following services normally performed in the origination of a loan:

(a) Taking information from the borrower and filling out the application; [fn. 4 stated: In a subsequent informal interpretation, dated June 20, 1995, HUD stated that the filling out of a mortgage loan application could be substituted by a comparable activity, such as the filling out of a borrower's worksheet.]

(b) Analyzing the prospective borrower's income and debt and pre qualifying the prospective borrower to determine the maximum mortgage that the prospective borrower can afford;

(c) Educating the prospective borrower in the home buying and financing process, advising the borrower about the different types of loan products available, and demonstrating how closing costs and monthly payments could vary under each product;

(d) Collecting financial information (tax returns, bank statements) and other related documents that are part of the application process;

(e) Initiating/ordering VOEs (verifications of employment) and VODs (verifications of deposit);

- (f) Initiating/ordering requests for mortgage and other loan verifications;
- (g) Initiating/ordering appraisals;
- (h) Initiating/ordering inspections or engineering reports;
- (i) Providing disclosures (truth in lending, good faith estimate, others) to the borrower;
- (j) Assisting the borrower in understanding and clearing credit problems;
- (k) Maintaining regular contact with the borrower, realtors, lender, between application and closing to appraise them of the status of the application and gather any additional information as needed;
- (l) Ordering legal documents;
- (m) Determining whether the property was located in a flood zone or ordering such service; and
- (n) Participating in the loan closing.

While this list does not exhaust all possible settlement services, and while the advent of computer technology has, in some cases, changed how a broker's settlement services are performed, HUD believes that the letter still represents a generally accurate description of the mortgage origination process. ***For other services to be acknowledged as compensable under RESPA, they should be identifiable and meaningful services akin to those identified in the IBAA letter including, for example, the operation of a computer loan origination system (CLO) or an automated underwriting system (AUS).*** [Emphasis Added].

HUDs Real Estate Settlement Procedures Act Statement of Policy 2001 1: Clarification of Statement of Policy 1999 1 Regarding Lender Payments to Mortgage Brokers, and Guidance Concerning Unearned Fees under Section 8(b) issued on October 18, 2001 and cited as 66 FR 53052, provides, in part:

“The Secretary, therefore, interprets Section 8(b) of RESPA to prohibit all unearned fees, including, but not limited to, cases where: (1) Two or more persons split a fee for settlement services, any portion of which is unearned; or (2) one settlement service provider marks up the cost of the services performed or goods provided by another settlement service provider without providing additional actual, necessary, and distinct services, goods, or facilities to justify the additional charge; or (3) one service provider charges the consumer a fee where no, nominal, or duplicative work is done, or the fee is in excess of the reasonable value of goods or facilities provided or the services actually performed.”

The federal acceptance of splitting fees among brokers does not necessary solve the problems of addressing bifurcated agency or of even fee splitting. That is, a review of the list of services in the 1994 Opinion, as commented on in HUDs 1999-1 Statement of Policy, makes it difficult for one broker solely representing Lender to perform the required 6 items

because most of the items involved services customarily provided to or for the borrower in the transaction.

In addition, it does not address the state issue involving agency or sub-agency. As previously indicated, one broker could conceivably act as the agent of the borrower and the other as the agent of the lender. The issue becomes even more complex when the institutional or licensed lender refuses to allow either broker to act as its agent.

Therefore, "Conventional Broker Agreements" between an institutional lender and a broker are far easier to draft than a Broker-to-Broker agreement since there is only one broker to receive a commission.

In a RESPA transaction, the Broker-to-Broker agreement, by addendum, should attempt to allocated 6 or more of the required items to each of the brokers involved in the transaction. Since there are only 14 designated items in the 1999-1 Statement of Policy (although recognizing others are likely to exist), dividing a commission between more than two brokers is problematic.

While most of the services referenced in the 1999-1 Statement of Policy are services to the Borrower (not to the Lender), nothing in RESPA appears to expressly prohibit bifurcated agency. However, if, to meet the requirement of having 6 or more services from the list of services, the Lender's Broker selects items that provide services to the Borrower, it is possible a court would view the broker as a special agent for the Borrower for the purpose of those designated services. Out of an abundance of caution, the Lender's Broker may want to conduct himself/herself as if he/she were the agent of the Borrower.

X. Due Diligence In Selecting and Retaining a Packaging Broker (6 Min.)

The main risk of acting as a wholesale lender or broker arises from the conduct of the retail broker even if the Lender and Lender's Broker have attempted to disclaim or bifurcate the agency. As such, it is important that the wholesale lender and Lender's Broker adequately investigate the Packaging Broker. This process often starts with an application for a Broker-to-Broker agreement. Such applications are generally required before an institutional lender authorizes a broker to solicit borrowers and submit packages to the Lender. Unfortunately, such applications are less frequently used in the private lending business. However, since there is so much risk related to the honesty and competency of the Packaging Broker, the best practice is to get a completed application from the Packaging Broker and enter a Broker-to-Broker Agreement (contents discussed later) before funding any loan through that Broker. The next best practice is to engage in some level of due diligence to investigate the Packaging Broker before entering a Broker-to-Broker agreement.

A. The application for the broker-to-broker agreement might contain the following:

1. Broker name, Address, Phone, Fax and E-mail information;
2. Type of broker (individual or corporate);
3. Entity information (e.g., State of incorporation);

4. Federal Tax Identification Number (FID#) or social security number (SS#). This should be included in the IRS form W-9 (see, documents section).
5. DRE License information (e.g., corporate broker or individual and dba.)
6. Name and information of Primary Officer (contact information; license type and status; and social security number);
7. Main Processor's Name;
8. List of all officers and owners and all loan officers (preferably with an indication as to whether they are licensed and, if so, what type of license they possess).
9. Name of principals and percentage of ownership;
10. Disclosure of pending litigation or lawsuits; DRE complaints etc. in past 3 years (minimum).
11. Any license discipline or suspension by any wholesale broker or lender.
12. Representation of the nature and extend of any internal audit system to verify the information in their loan files (packages);
13. Whether or not the broker is a threshold broker or information about the amount and types of loans made or arranged within the past 3 full years.
14. Disclosure of any related businesses conducted on the premises or other licenses used on the property, particularly insurance licenses.
15. References or list of largest lenders or brokers (by dollar volume) with whom the broker has done business in the past.
16. The application should be signed, dated and contain a provision (preferably right above the signature) authorizing the Lender's Broker to obtain credit information as part of the approval process.

B. Supporting documents:

1. Resume of history of the Packaging Broker;
2. Resume of senior officer/principals;
3. Resume of senior processors;
4. Most recent balance sheet and profit and loss statement;
5. Copy of internal audit;
6. Processing fee. Institutional lenders often demand a processing fee. However, there is no requirement for such a fee and the concept may not work well outside of the institutional lender marketplace;
7. Copy of Annual Threshold Broker Report;
8. Disclosure of insurance coverage held (E&O; Fidelity Individual; Fidelity Blanket).
9. If the Packing Broker is a corporation, get a corporate resolution authorizing the corporation (and specific officers) to sign the Broker-to-Broker agreement; and,
10. Signed Broker-to-Broker Agreement.

C. Independent Review and Verification of Application.

The Lender's Broker should then do an independent review and verification of the application information and supporting documents. This can be done by the Lender's Broker or through vendors who specialize in such review and verification. Acts to verify the Retail Broker information include:

1. Verify Broker and other license information on the application. An informal check can be done at the DRE website at: <http://www.dre.cahwnet.gov/>. Verify:
 - a. Name, address and whether the license is Corporate or an individual.
 - b. If a d.b.a. is used, make sure it is listed on the DRE website, if not inquire as to whether the d.b.a. has been submitted to the DRE.
 - c. Check expiration dates for all relevant licensees.
 - d. If the REB is a corporate broker, name and license status of the designated officer.
 - e. Review former names. Some brokers change their d.b.a. every time they have a problem.
 - f. Review Affiliated Licensed Corporations.
 - g. Review list of salesperson;
 - h. Review any entries relating to discipline relating to Broker, Associate Brokers and Salespersons. Obtain applicant's explanation for any DRE discipline.
2. Assuming the Packaging Broker has signed an authorization to obtain credit information (contained in the application or other document), obtain a Credit Report on Packaging Broker. The Broker-to-Broker agreement will include representations and warranties, an indemnity provision and a repurchase provision obligating the purchasing broker to repurchase loans under certain conditions (e.g., failure to meet the Lender's underwriting requirements or failure to make more than one or two payments in the first 6 -12 months after the loan is funded.) The financial data submitted by the applicant may be phony, a credit report and a public records check will often smoke out phony information in the application.
3. Check references;
4. Run public records database check to verify lawsuits and other public record information. This will often be very revealing and smoke out bad brokers and borrower. Lexis-Nexus, Choicepoint, Merlin and numerous other services provide such information at a reasonable price. This can show an array of data including lawsuits, judgments etc. Generally, borrowers and brokers who are involved in multiple law suits are likely to be problem individuals with whom to do business. However, some care must be taken in reviewing the data. Some brokers who are involved in evictions or foreclosures may be named in numerous lawsuits but they, themselves, are not litigious.
5. Check the ***Specifically Designated Nationals ("SDN") List***. As stated on the US Treasury Department's website:

"As part of its enforcement efforts, OFAC [Office of Foreign Asset Control] publishes a list of individuals and companies owned or controlled by, or

acting for or on behalf of, targeted countries. It also lists individuals, groups, and entities, such as terrorists and narcotics traffickers designated under programs that are not country-specific. Collectively, such individuals and companies are called "Specially Designated Nationals" or "SDNs." ***Their assets are blocked and U.S. persons are generally prohibited from dealing with them.*** [09-10-02]". [Emphasis added]

The SDN list can be found at the US Treasury Department's website: <http://www.treas.gov/offices/enforcement/ofac/sdn/> and it is also combined with the EPLS List discussed below.

6. Check whether Packing Broker appears on the ***Excluded Person List System ("EPLS") List***. (See, <http://www.epls.gov/>). According to the EPLS website: "EPLS is the electronic version of the Lists of Parties Excluded from Federal Procurement and Nonprocurement Programs (Lists), which identifies those parties excluded throughout the U.S. Government (unless otherwise noted) from receiving Federal contracts or certain subcontracts and from certain types of Federal financial and nonfinancial assistance and benefits." Certainly this is not determinative of whether a private lender or broker would or should do business with the Packaging Broker, but it is another factor to consider. ***HOWEVER, YOU CANNOT DO BUSINESS WITH THE PERSON IF THEY APPEAR ON THE SDN LIST.***
7. Check the HUD, ***Limited Denial of Participation List*** ("LDP List"). The LDP List can be found at <http://www-domino5.hud.gov/ec/compliance/ldp2.nsf> or verification can be obtained from:

"A Limited Denial of Participation (LDP) is an action taken by a HUD Field Office or the Deputy Assistant Secretary for Single Family (DASSF) or Multifamily (DASMF) Housing which excludes a party from further participation in a HUD program area. The scope of the LDP is limited to the geographic area of the office which sent the notice to the party. DASSF & DASMF LDPs are effective nation-wide unless otherwise noted. An LDP generally expires in one year. A HUD "program area" is as broad as the programmatic jurisdiction of an Assistant Secretary. LDPs are issued to parties (individuals & companies) who fail to comply with HUD program standards. In most cases, the causes of an LDP action could be remedied by the party. LDP actions include provisions for an appeal process with a speedy conference at the HUD office which issued the LDP as the first step in that process."

Again, this is not determinative of whether a private lender or broker would or should do business with the Packaging Broker, but it is another factor to consider.

XI. Form of Agreement and Standard Provisions. (20 Min.)

A. Introduction.

The Broker-To-Broker agreement serves three main purposes: (1) Defines the agency relationship between the parties (discussed above); (2) it establishes the duties between the Borrower's Broker and the Lender and Lender's Broker (particularly important in RESPA transactions); (3) it establishes the criterion under which the Lender is willing to loan or the Lender's Broker are willing to act.

Because many brokers representing large pools are, in essence, principals in the pools or acting as broker for the lending pools, they often begin to look like a wholesale lending operation (never or rarely dealing with consumers or borrowers).¹² As such many of these lending operations want to emulate the institutional lender/Third Party Originator ("TPO") model where a broker or correspondent solicits borrower and arranges loans for (or for funding or sale to) the Lender. Other brokers are merely trying to match a borrower they have with a funding source they need (traditional model).

B. When and How?

Generally, this Agreement should be entered prior to the first transaction where two brokers cooperate in making or arranging a loan by one providing the borrower and the other providing the lender. Once that is done, the Agreement is designed to last until terminated by one of the parties.

C. Content of the Agreement.

There are many different variations to Broker-Lender Agreements and Broker-to-Broker agreements. The contents of the Agreements vary depending on whether the lender is an institution seeking agent or correspondents to solicit borrowers and package loan applications or where, as here, one broker has an investor for a loan and another has a borrower. The following will focus upon a Broker-to-Broker agreement.

1. Define the Parties and Date of Agreement.

Identification of the Lender's Broker, the Borrower's Broker, the date (or effective date) of the Agreement and DRE licensing number.

2. Recitals and Identification of General Purpose of the Agreement.

Recite that the parties are real estate licenses and the type of loans or representation they intend to do. For example, that the Borrower's Broker is a licensed real estate broker who will solicit Borrowers for loans and that the Lender's Broker is a licensed real estate broker who will solicit Lenders to fund completed and accepted loan applications if the Lending Broker's (or his/her Lender's) underwriting standards are met. These provisions may need to be revised where the two brokers intend to have interchangeable roles (i.e., one time the

¹² Even though they "look" like a wholesale lending operation, the REB should not forget that they are still acting as an agent for the lender and often as an agent conducting services requiring a REB's license.

Broker is the Lender's Broker and another time he/she is the Borrower's Broker).

3. Define Role: Agency, Non-Exclusive and Not Partners or Joint Venturers.

Defining the type of agency involved is critical for the reasons set forth in the agency discussion above and because the choice of agency relationship may dictate which loan documents are used. As mentioned above, most standard loan document packages designed for Mortgage brokered transactions are written for the traditional dual agency model and may destroy any attempt to bifurcate agency in the Broker-to-Broker agreement.

Most agreements will provide that the Borrower's Broker is the agent for the Borrower, an independent contractor of the Borrower and that the Borrower's Broker is not the agent of the Lender or of the Lender's Broker. In addition, the agreement will often provide that the Borrower's Broker has no authority to act on behalf of, or make representations for, either the Lender or the Lender's Broker. In addition, such agreements will often disclaim that any partnership or joint venture exists between the parties.

4. Taxes and Licenses.

It is wise to address that as an independent contractor there will be no withholding of any type (except for off sets) from compensation paid to the Borrower's Broker under the agreement. The agreement should provide that Borrower's Broker shall give the Lender's Broker a completed W-9 form setting forth his/her/its social security number and/or FIN #.

In addition, the agreement will generally identify the broker's REB license numbers and require that, at least, the Borrower's Broker provides true and accurate copies of his/her real estate license and those of principals and others working under the broker's license. Although not provided for in the sample agreement, the Borrower's Broker may want to require the same from the Lender's Broker (or at least check out the Lender's Broker's licensing status.)

5. Define Agency Relationship with Borrower and Lender (Dual Agency, Sub-agency or Bifurcated Agency).

The sample agreement is written for bifurcated agency. Other agency relationships would require a modification of the Agreement. In addition, any modification to the initial bifurcated agency may require a subsequent disclosure to both the Borrower and to the Lender (e.g., disclosure of a changed agency relationship and consent to any dual agency.)

It may be possible to disclose to the Lender that the Lender's Broker may act as a dual agent in the transaction and to get the Lender's consent in advance. However, if there is a change in the agency relationship after the transaction has begun, it may be the best practice to disclose the change of relationship and to obtain a written document confirming the Borrower's and Lender's knowledge and consent to the change in the agency relationship. A simple confirmation of agency relationship may be used although not mandated by law in Mortgage Broker loan transactions.

For the Lender's Broker's protection, he/she will want to obtain a Confirmation of Agency signed by the Borrower so that the Lender and the Lender's Broker have something signed by the Borrower that proves that the Borrower's Broker has properly advised the Lender of the agency relationship.

The sample agreement attempts to allocate the responsibilities for giving the MLDS, GFE and LPDS between the Borrower's Broker and the Lender's Broker. (See, discussion above). Depending on the type of loans made or arranged (e.g., consumer vs. commercial), each broker may want to refine or modify the language in the sample agreement.

6. Borrower's Broker to obtain Loan Application etc. (depending on RESPA Limitations).

In a non-RESPA transaction, the Borrower's Broker may be required to solicit the Borrower; provide all supporting documentation to the loan application (e.g., credit report, appraisal, VOE's, VOM's, etc.); and do everything else to have a turn-key loan package for the Lender's Broker and Lender to review. The sample agreement requires that the loan package be submitted in conformity with the Lender's policies and procedures. In addition, all appraisals should be done by appraisers approved by the Lender or Lender's Broker.

7. Representation and Warranties.

The Borrower's Broker is the first line of defense in fraudulent or bad loans. The Borrower's Broker is the person who has direct contact with the Borrower and who is directly involved in putting together a substantial amount of the Borrower's application and supporting documents. The Borrower's Broker often obtains the appraisal and the credit report which may be critical to the lending process. The more that is done directly by the Borrower's Agent in the making or arranging of the loan, the more representations and warranties the Lender or Lender's Broker will want in the Agreement, particularly if there is no repurchase agreement. Also, the representations and warranties serve as the substantive basis for the indemnity clause (discussed below).

The agreement should provide that the representations and warranties are made both when the Agreement is original signed and delivered to the Lender's Broker as well as each time a loan application is submitted. Therefore, as a matter of standard practice, the Borrower's Broker should update any information (e.g., new licensees) that has changes since the agreement was signed and delivered to the Lender's Broker.

Typical areas covered in representations are: licensing information, truthfulness of information supplied, authority and capacity to act, compliance with the law, disclosure of lawsuits, criminal convictions and administrative proceedings, allocation of duties under RESPA, agency confirmation; disclosure of commissions, no outside or undisclosed compensation, and no loans made or arranged subject to Fin. Code §§ 4970 et seq. and Section 32.

It is important to have a clause or a representation or warranty that the Borrower's Broker will not receive any outside or undisclosed compensation not listed on the MLDS or disclosed to the Borrower and to the Lender's Broker as such undisclosed compensation might make the TILA and MLDS disclosures inaccurate and ineffective and may affect whether the loans were in fact subject to the provisions of Fin. Code §§ 4970 et seq. or Section 32.

The sample agreement assumes that the Lender's Broker and Lenders do not want to make Fin. Code §§ 4970 et seq. or Section 32 loans. The sample agreement would have

to be changed to omit ¶ 4(h) if the Lender's Broker and its lenders are willing to make these types of loans.

That the Borrower's Broker has established procedures to assure that, and has undertaken all reasonable efforts to verify that, Borrowers read and understand English and that those Loans are negotiated primarily in English and not in any other language. An addendum should be created that establishes proper Lender and Lender's Broker standard for allowing loans subject to Civil Code § 1632 to be negotiated in any language other than English. Part of the procedures used by a Borrower's Broker should be a statement or declaration of the Borrower stating in English (as well as in the other languages set forth in Civil Code § 1632) that the loan was primarily negotiated in English or one of the other designated languages.

8. Commission Clause.

Limitations must be imposed here as to the type of loans the Lender and Lender's Broker is willing to arrange or fund. This can be negotiated on a deal-by-deal basis or a schedule of commissions and costs can be attached or incorporated into the sample agreement.

The Lender and Lender's Broker may want to include a provision in the commission clause (or in the representations and warranties) that the Lender's Broker will not make or arrange consumer loans subject to "Section 32" loans or that are covered loans under California's high cost mortgage law (Fin. Code § 4970 loans) and that the Borrower's Broker shall not present a loan for approval that would be covered by these statutes. If the Lender and Lender's Broker are willing to make Section 32 loans or high cost mortgages under Fin. Code §§ 4970 et seq., they may want to replace the prohibition against such loans in the sample agreement with the Lender's requirements for such loans.

It is important to provide a right to off set current commissions owed to Borrower's Broker against sums that may be owed by Borrower's Broker to Lender of Lender's Broker. Often the Lender's Broker may have an indemnity claim arising from a funded fraudulent loan and will not be able to get the Borrower's Broker to step up to the plate and provide indemnification and defense. The "off set" clause provides a possible way to recoup from current commissions money's owed for these closed loans that have gone bad because of some breach of the agreement with Borrower's Broker.

9. Termination Clause At-Will upon Notice/Post Termination Commissions.

The sample agreement provides one of many solutions to at-will notice of termination and how to handle work that is in the pipeline upon termination.

10. Trade Secrets and Proprietary Interest.

The sample agreement has one or many variations of a clause attempting to deal with trade secrets and proprietary interest. The significance of this type of clause will vary greatly depending on how much information, or access to information, is shared between the parties to the Agreement. This is frequently a more important issue between the Broker and his/her better salespersons or associate brokers who later decide to go elsewhere of set up a competing business.

The sample agreement does not have a prohibition against the Borrower's Broker contacting the Lender directly although such a clause could be built in although its impact may be limited to preventing the Borrower's Broker from interfering with the Lender's Brokers contract or prospective business advance.

11. Indemnity Clause for Lender and Lender's Broker.

An indemnity clause should be included both for the Lender's Broker and for the Lender although the latter is a third party beneficiary (i.e., not a direct party to the contract). There are many versions of indemnity clauses, some simple, some more complicated. The most important feature is that the clause provides that the indemnitor (here the Borrower's Broker) will "indemnify, hold harmless **and defend**". Some thought must be given to the nature of the "defense" feature. That is, who chooses the attorney and what approval of consent does the indemnitee have?

12. Rescission Provision/Repurchase Agreement

Broker Agreements will occasionally include a clause permitting rescission by the Lender or buy back if the Broker knew, or should have known, about false or fraudulent information or even if a loan is bad from the beginning (e.g., Borrower only made one or two payments in the first six months). These clauses may require that the Broker purchase or repurchase the loan. Repurchase generally accrues to the benefit of the Lender. [No included in Sample Agreement]. No repurchase provision has been included in the draft agreement because of the business model used in a bifurcated mortgage brokered loan (i.e., the Borrower's Broker never made and sold a loan as is typical in mortgage banking business model). Therefore, the Borrower's Broker would not be rescinding or effecting a repurchase. Instead, all that would be occurring is requiring the Borrower's Broker to repurchase the loan as a form of indemnity. Therefore, the indemnity provision is probably just as effective as the purchase/repurchase approach.

If the purchase/repurchase approach is used, the Lender and Lender's broker should insert provisions assuring the Borrower's Brokers assets and ability to pay. These would include insurance provisions (e.g., E&O and fidelity bonds or insurance). In addition, the Borrower's Broker's financial statement should indicate a financial ability to respond to requests to purchase/repurchase a loan.

13. Compliance with the Law. Often in representations and warranties.

14. No Liability for Lender Not Funding Unless Written Commitment Is Given or if gross negligence or willful conduct exists.

15. Survival of Indemnity, Repurchase and other clauses after Termination.

16. Forum Clause; Venue.

17. Alternative Dispute Resolution: Mediation/Arbitration.

This has been written in the draft agreement as an Exhibit because so many different broker's have different approached to alternative dispute resolution (e.g., reference, binding arbitration or mediation.)

18. Attorney's Fees and Cost Clause.

The draft agreement contains a fairly expansive attorney's fees clause. Each broker may decide to narrow or expand this provision.

19. Severability Clause.

20. Notice Clause.

21. Incorporation of Recitals.

22. Construction.

23. Non-Assignment Clause.

CONCLUSION

Lender-Broker or Broker-to-Broker agreements take many different forms. The form of the agreement and content is often more dictated by the business model being used by the brokers than by magical legal words. Before using any form of agreement careful thought should be put into the business plan, Lender's preferences and policies, loan types and business practices and policies of the respective brokers who are parties to the contract.