The Risk of Vicarious Liability *for* BROKER MISCONDUCT

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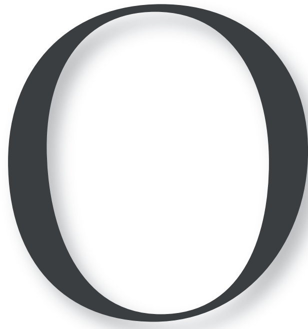


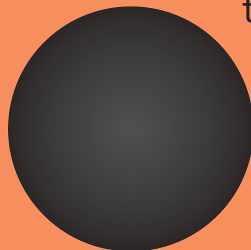
ne offshoot of the mortgage crisis that began in 2008 has been the rise in lawsuits by borrowers challenging both mortgage brokers and mortgage lenders for alleged misconduct in the origination or refinancing of home loans. In many cases, these lawsuits are based on distinct theories of liability, depending on whether the defendant is a mortgage broker or a mortgage lender, but some plaintiffs seek to hold lenders liable for alleged broker wrong-doing. ● Private plaintiffs have not typically prevailed in this attempt to impose vicarious liability based on basic agency theory, because the mortgage broker is generally an agent of the borrower and not an agent of the lender. As such, vicarious liability generally is not imputed to lenders. ● Nevertheless, this general principle has not prevented borrowers from looking to recover from deeper-pocketed lenders for mortgage brokers' alleged misdeeds. ● While the results for private plaintiffs have been unspectacular so far, with cases frequently dismissed at the pleadings stage, some cases have advanced past the motion-to-dismiss stage and other borrowers have settled their claims. In rare cases, courts have awarded vicarious liability judgments against lenders, particularly where lenders exerted a significant degree of control over the brokers or became actively involved in the transaction. ● This article analyzes the precedent established in private litigation where lenders have escaped liability for brokers' misconduct and, alternatively, where

This review of case law reveals steps lenders can take to avoid vicarious liability for the misconduct of mortgage brokers.

lenders have not been as fortunate, highlighting how lenders can avoid vicarious liability for the missteps of brokers.

Although the Department of Justice (DOJ) has been increasingly aggressive in asserting third-party liability against lenders in connection with race-discrimination claims, those cases have not been litigated and are not a focus of this article.

Most existing authority holds that a lender does not owe a borrower a fiduciary duty beyond those set forth in the loan documents.



Vicarious liability does not follow if the broker is not an agent of the lender

Most existing authority holds that a lender does not owe a borrower a fiduciary duty—or any duties, for that matter—beyond those set forth in the loan documents. Following this reasoning, misconduct by a mortgage broker remains with the broker, and does not create liability for the lender that makes loans arranged by the errant broker.

This general rule is illustrated in *Zimmerman v. Logemann* (Wisconsin, 2011). The *Zimmerman* plaintiffs claimed they were deceived into accepting a mortgage they could not afford and that both broker and lender conspired to induce them to accept the loan based on the broker's misrepresentations about their income and future refinancing.

The lender sought summary judgment, disclaiming an agency relationship with the broker. The court agreed, finding that neither a broker's compliance with a lender's process for obtaining a loan nor the lender's reference to the broker as a "partner," standing alone, were sufficient to bind the lender to the broker's actions or give the lender a right to control the broker's acts.

The Eastern District of California reached a similar result in *Sandry v. First Franklin Corporation* (2011), where the plaintiffs claimed lender liability based on fraud. They asserted that the broker promised a lower interest rate than was ultimately reflected in their mortgage, and that the loan terms resulted in negative amortization and a stiff prepayment penalty.

The lender successfully moved to dismiss the case, based on the court's ruling that the complaint did not allege facts sufficient to establish more than an arm's-length loan transaction or a fiduciary relationship between the borrower and the lender.

Similarly, in *Keen v. American Home Mortgage Servicing Inc.* (California, 2009), the court held that a lender owed no duty to a borrower or third party beyond those expressed in the loan agreement, absent special circumstances. Such special circumstances would have required the lender to "actively participate in the financed enterprise beyond the domain of the usual money lender," stated the *Keen* opinion.

Other federal district courts have followed similar reasoning. The following examples are illustrative.

In *Harmon v. Bank United* (Maryland, 2009), the court held that misleading preliminary disclosures prepared using lender-generated standard forms did not establish a lender's control over a broker's actions and therefore did not result in an agency relationship between lender and broker.

In *Morilus v. Countrywide Home Loans Inc.* (Pennsylvania, 2008), the court found that the broker's conduct in 1) suggesting to the plaintiffs that they engage a "straw buyer" due to their poor credit and 2) misrepresenting the plaintiffs' income was not subject to the control of the lender.

In *Garczynski v. Countrywide Home Loans Inc.* (Pennsylvania, 2009), the court dismissed the plaintiff's complaint because an agency relationship between the lender and broker was not supported by the facts.

These cases demonstrate that when lenders maintain arm's-length relationships with borrowers and do not influence or control mortgage broker dealings with borrowers, lenders usually avoid liability for broker misconduct.

Wearing two hats or switching sides can lead to vicarious liability

Despite the general rule in the majority of cases on lender liability for broker conduct, courts have not adopted a "bright line" rule on the issue, nor held that a broker never can be the lender's agent. Indeed, some mortgage lenders have been unable to avoid liability—either court-imposed or implicitly via settlement—when actively engaging with brokers in disputed transactions.

Other risky situations include those where a single party acts as both lender and broker in the same transaction. Lenders should pay careful attention to this line of cases to avoid vicarious liability.

Smith v. Home Loan Funding (California, 2011) illustrates the risk of liability where a mortgage broker fails to inform the borrower that he or she is acting as both a broker and lender in a loan transaction.

As the court stated: "The mortgage lender who also acts as a mortgage broker must keep in mind the differences between the two when speaking to a prospective client. A mortgage broker has a fiduciary duty to a borrower. A mortgage lender does not. This case teaches that a mortgage lender should take care not to convey to a prospective client that it is acting as a broker when in fact it is acting as a lender."

In this case, the plaintiff proved that the broker, an employee of the lender, promised to "shop [for] the best loan" but instead referred the loan to his employer, resulting in an excessive interest rate and broker commission. The broker was found to have breached his fiduciary duty to the borrower by engaging in acts

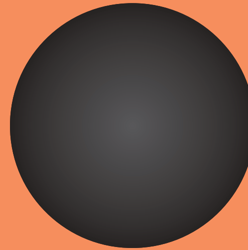
amounting to self-dealing.

The court expressly rejected the lender's defense that disclosure of the lender's identity in the loan documents was sufficient notice to the borrower of the broker's dual role.

A lender that wishes to maintain a close relationship with a mortgage broker should be mindful of the decision in *Poskin v. T.D. Banknorth NA* (Pennsylvania, 2009). Such a relationship can lead to a finding of agency between the lender and broker even if they both disclaim such a relationship.

In *Poskin,* the broker and lender had a pre-existing business relationship in which they shared operating bank accounts. The plaintiffs claimed that the broker falsified their employment status, income and race on loan documents in order to self-fund the loan and later assign it to the lender. The lender claimed it had "a generic working arrangement" with the broker and noted a disclaimer of agency in the loan assignment agreement.

Avoiding legal liability for broker misconduct is not an exact science, but the risks can be minimized.



The court denied the lender's motion for summary judgment because "express disclaimers of agency do not necessarily negate the existence of the agency relationship." The parties' joint operating account and four-year exclusivity agreement for the broker's handling of mobile home loans suggested a relationship "more akin to an agency relationship than an arm's-length transaction."

The parties ultimately reached an undisclosed settlement. This outcome puts lenders on notice that mere contractual disclaimers of agency may not be effective to overcome factual circumstances demonstrating the contrary.

The plaintiffs in *Whitley v. Taylor Bean & Whitaker Mortgage Co.* (Illinois, 2009) asserted that their broker used an inflated home value and false income, education and ethnicity data to obtain their mortgage, resulting in increased commissions, fees and interest. They claimed the lender knew or should have known they could not afford the payments and fraudulently or negligently represented otherwise.

The court stated that in the broker-lender context, if the evidence indicates that "the broker has a close relationship or far more authority than that of simply bringing the borrower and lender together," the court may deem the broker to be an agent of the lender. The court concluded that the plaintiffs pleaded sufficient facts to support an agency relationship between the lender and mortgage broker.

These facts included the broker's arranging a significant number of loans for the lender, the lender paying kickbacks to the broker for obtaining high loan interest rates, and the broker using various lender documents to process the loan (e.g., rate sheets, product sheets, loan pricing software and closing documents). Following this unfavorable ruling, the parties reached a nonpublic settlement.

Lenders wishing to avoid vicarious liability should clearly delineate the levels of authority granted to employees compared with the authority of independent third-party brokers.

Where the context is unclear, a lender's failure to "maintain a watchful eye" over acts of brokers may subject it to liability, even if no agency relationship was intended.

The Ohio Court of Appeals suggested that a broker-lender may be subject to individual and corporate liability by "switching hats" in a mortgage transaction. In *Swayne v. Beebles Investments Inc.* (2008), the plaintiff approached a mortgage broker for home-improvement loan financing. The broker contacted an outside lender but failed to find financing because of the plaintiff's poor credit. The broker then switched hats and became the lender.

The switching of roles did not end the fiduciary relationship established when the defendants were brokering the loan; this fiduciary relationship "did not cease to exist once they brokered the deal to themselves," the *Swayne* opinion states. Because the defendants used information obtained from the plaintiff and relied on the trust established with her to broker an unconscionable deal for their own advantage, the court affirmed an award for the plaintiff on the grounds of unconscionability, fraud and violations of the Ohio Mortgage Brokers Act.

Two cautionary conclusions follow for lenders and brokers switching hats during a mortgage transaction: first, a mortgage broker is not absolved of his duty to act in the interest of the borrower when he becomes a lender in the same loan transaction; and second, a broker-lender may not abuse a position of trust with a prospective borrower that is created by a brokerage agreement.

Lessons learned

Avoiding legal liability for broker misconduct is not an exact science, but the risks can be minimized. Existing jurisprudence suggests that lenders are not vicariously liable for the acts of independent brokers in arm's-length broker-lender relationships. Ambiguity creeps in when lenders become more involved with the broker's role in loan transactions.

Lenders therefore should avoid over-involvement with brokerage activities and not attempt to manage the day-to-day conduct of independent brokers or control how they perform their duties. This does not mean that lenders should adopt a hands-off approach to dealing

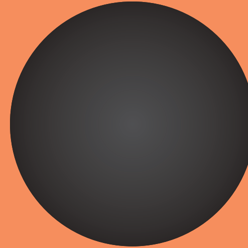
with mortgage brokers.

Indeed, this is especially true given the enhanced regulatory attention on vendor management and the March 19, 2010, Department of Justice fair lending settlement with several AIG subsidiaries, in which the DOJ had alleged that the subsidiaries' failure to "monitor" or "supervise" brokers in setting broker fees constituted a pattern or practice of discrimination against African-American borrowers.

In order to mitigate the risks of secondary civil liability for oversight of brokers—which regulators and enforcement agencies are now requiring—lenders should engage in 1) thorough evaluation of brokers before they are approved; 2) ongoing due diligence of their operations, policies and procedures; 3) regular quality control of their originations; and 4) enhanced compliance reviews.

By taking these preferred compliance and due-diligence steps, lenders can address their regulatory vendor-management requirements in a way that would not appear to control broker conduct vis-à-vis particular loan transactions and individual borrowers that would increase the risk of vicarious liability for broker actions.

Lenders should take care to monitor brokers' work and draw independent conclusions about that work.



Denying that a broker-lender relationship creates agent-principal status is an unavailing defense where the facts suggest otherwise. Lenders should take care to monitor brokers' work and draw independent conclusions about that work. In certain circumstances, courts may be loath to let lenders hide behind contractual disclaimers of agency when facing claims of vicarious liability if the broker's misconduct served the lender's interests and the conduct was performed at the lender's behest. MB

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