

VICTOR O. SCHINNERER & COMPANY, INC. risk management reporter

Information and Risk Management Ideas for Real Estate Professionals

MORTGAGE BROKERS BEWARE

Understanding and Mitigating Risk Is Critical in Today's Marketplace

FROM any perspective, it's a tough time to be in the real estate business. In 2006 alone, an estimated \$600 billion in new subprime loans were originated, and more than \$1.3 trillion in subprime loans are currently pending. In addition, loan defaults and delinquencies have grown steadily, and numerous lenders have filed for bankruptcy or just ceased writing loans.

And that's just the business side. Individuals, many of them holders of subprime mortgages or creative financing premised on rising home values, aren't faring any better. A survey of home prices released in late April shows double-digit drops in home values in many large markets over the past year, and foreclosure filings for the first quarter rose more than 112 percent over last year. That translates to one in every 194 households—and a 23 percent increase over the previous quarter.

Losses often translate into both despair and anger, and that means looking for someone to blame. Federal and state regulators are pursuing criminal cases of mortgage fraud, many of them landing corrupt real estate lenders and brokers in jail on charges of wire fraud, conspiracy and money laundering. Meanwhile, the number of civil lawsuits filed by both lenders and borrowers is on the upswing. If you're a real estate broker, you could get swept up as each side looks for someone to be held responsible for their losses.

Indeed, mortgage brokers are increasingly at risk of being sued by both lenders and borrowers, Dale Forsythe, a partner at Pittsburgh-based Wayman, Irvin & McAuley, LLC, told *Risk Management Reporter*. "Lenders are more aggressively seeking recourse. As bad loans pile up, they're going after both brokers and appraisers," says Forsythe. "Meanwhile, borrowers who have lost their homes are seeking recourse from everyone in the process—lenders, appraisers and brokers."

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In addition, some lawyers are actively marketing their services to potential clients who feel they may have been defrauded by their lender or their broker.

Understanding Your Risk

To protect your business, it's important to understand what your exposures are and then take steps to mitigate them. The risks are there, whether or not there is a default or foreclosure involved.

Take, as an example, a lender who is preparing to resell one or more

loans in the secondary market. The potential secondary lender does its due diligence and discovers that there is a problem with an appraisal, the borrower's income, the borrower's credit situation or some other factor that increases the risk of a default. So the potential buyer backs out, and the lender is left with a loan that it can't resell. The lender then turns around and sues the mortgage broker, who has typically warranted the information provided by the borrower.

According to Forsythe, typical claims filed by lenders include:

- Contract claims, such as in the example above, based on the broker's certification to the lender that the information provided in the loan application was accurate.
- Breach of warranty claims, which are very similar to contract claims.
- Negligent misrepresentation, in which a lender claims a broker said something or included something in the paperwork that, while perhaps imparted in good faith, was nonetheless inaccurate.
- Intentional misrepresentation, in which there is an assertion that the broker intentionally misled the lender

Borrowers' claims, meanwhile, are often based on the premise that a broker falsified information, provided inaccurate information or steered the borrower to a poor loan option. Lawsuits by borrowers have also alleged that a broker did not provide a good faith estimate, was not clear on taxes and escrow payments or misled the borrower about its fees—all

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information that, at a minimum, may not have been adequately explained to the borrower.

"A broker's exposure often starts when they sign a lender's online business agreement," says Forsythe. "Brokers hit the 'click here' button and agree to all the terms. As a result, they are unwittingly signing contracts that are very one-sided in favor of the lender. Then, when they are brought into a lawsuit, they realize they are in a difficult situation."

The Limits of Incorporation

If your mortgage brokerage is incorporated, you may think that your risk is minimal. But you may not have the protection you thought, says Forsythe, who points out that incorporation doesn't necessarily mean you can't lose your home and other personal assets if you lose a lawsuit. Your risk increases if you are uninsured and your corporate assets are minimal.

"There are often ways to pierce the corporate veil," explains Forsythe. "Three common ways to do so are based on the theories of undercapitalization, alter ego and participation."

Most states require corporations to maintain a certain debt-to-asset ratio. Under the undercapitalization theory, if a company's debts are significantly greater than its assets, then the company may not offer the protection of a true corporation.

Under the alter-ego theory, a corporation is merely a sham and not really separate from the individual who owns it. The alter-ego case can be made if you're not holding board meetings and keeping minutes, or if the company's assets are being used to pay for dry cleaning or other personal expenses.

The participation theory holds that an individual owner who participates in wrongdoing or an act of negligence can be held personally responsible. So, for example, if you—rather than one of your employees—personally submit

data to a lender that later proves to be faulty, you can be named individually in a lawsuit.

The incentive to pierce the corporate veil is to find the money, which is why this risk tends to affect predominantly brokers who are uninsured. Brokers with solid insurance policies in place find themselves armed with both financial protection against unintended actions that may cause harm and the benefits of having their legal defense (and defense costs) paid by their carrier.

Mitigating Your Risk

"Beyond purchasing insurance, there are two other key actions that mortgage brokers should take to mitigate risk," says Forsythe. "First, it's important to try to negotiate more favorable contracts with lenders and incorporate more favorable language into the contract with the borrower. Second, documentation at every step of the process is critical."

Clearly, experienced brokers who have long-standing relationships with one or more lenders have the best shot at improving their contracts and making them less one-sided. With fewer borrowers out there, and increasing competition for the best of them, it's worth trying to improve that broker-lender contract before you sign away all your options. In addition, consider asking your attorney to review your contracts before you sign them. A good attorney can add language to the borrower's contract that warrants that the information provided to you, the broker, is correct. He or she may also be able to help you negotiate terms with your lending partners.

Regarding documentation, Forsythe stresses the importance of keeping information on every action and every conversation that you have with a lender, a borrower, an appraiser, or anyone else involved in a real estate transaction. He adds that "a strong electronic database with multiple searchable triggers can be invaluable in some situations."

Forsythe also advises brokers to invest in a documentation audit. A good expert will review your record-keeping methods and guide you in setting up strategies and systems to reduce your risk.

Finally, some good news. In response to the mortgage crisis, the industry is beginning to police itself. Professional associations, including state mortgage broker associations, are increasing their professional development requirements and looking to require members to become certified. Some states are also looking at legislative remedies to better ensure a professional, honest broker-borrower relationship.

As the bad actors leave the stage, the market will eventually start to settle down and mortgage brokers will become less of a target over time. Until that happens, and even after, it is and will remain important to understand your risks and take steps to mitigate them now and into the future.

Risk Management Reporter thanks Dale Forsythe, partner in the law firm of Wayman, Irvin & McAuley, LLC., for his assistance: 437 Grant Street, Suite 1624 Frick Building, Pittsburgh, PA 15219; tel: 412-566-2970; email: dforsythe@waymanlaw.com.

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