CLAIMS AGAINST BAD BROKERS

Pursuing the Predators

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The Oregon Mortgage Broker Act prohibits untrue statements and material omissions by mortgage bankers and brokers and further prohibits schemes that would operate as a fraud or deceit. With the current crisis in mortgage loans, the Act now has unanticipated significance. However, there is little case law interpreting the Act and few written industry standards to guide compliance.

Fraudulent mortgage sales practices have injured consumers and helped to feed the collapse in mortgage-based investment products that threatens the economy. For example, borrowers have been induced to enter into sub-prime mortgages when their credit ratings qualified them for loans with lower interest rates and better terms. Additionally, brokers have convinced borrowers to enter into loans they could not repay when adjustable rates reset upwards. Motivated by yield spread premiums from lenders, brokers also have sold borrowers high interest loans when they would have qualified for lower rates.

Suitability standards

One idea that has gained traction is the codification of a suitability standard, similar to that applicable to securities brokers, that would apply to mortgage lenders and brokers. On a federal level, there are incipient attempts to promulgate suitability standards. House Bill 3195 ("The Mortgage Reform and Anti-Predatory Lending Act of 2007"), which proposes to modify sections of the federal Truth in Lending Act, passed the House on November 15, 2007. The legislation would require that loans "benefit the borrower" and that residential loan refinancing result in a "net tangible benefit" for the consumer. Section 201 of the proposed bill states that a residential mortgage loan "shall be based on consideration of the consumer's credit history, current income, expected income the consumer is reasonably assured of receiving, current obligations, debt-to-income ratio, employment status, and other financial resources other than the consumer's equity in the dwelling or real property that secures repayment of the loan." Proponents of a federal suitability standard also have suggested other elements that might be included in a suitability standard of care, including the number of dependents, borrower's age, anticipated expenses, and objectives in obtaining the loan.

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See Brokers p 30

Brokers
Continued from p 29

Too little, too late

The Federal Reserve Board has proposed changes to Regulation Z, which implements the Truth in Lending Act. For "higher-priced mortgage loans" the proposed rule would prohibit creditors from extending credit without delving into borrowers' ability to repay and require creditors to verify income and assets when making a loan. Consumer groups have characterized the Fed's action as "too little, too late."

In the securities context, the standard of care to determine whether a security is "suitable" is set forth in NYSE Rule 405 (the know-your-customer rule) and the Financial Industry Regulatory Authority (FINRA) Rules of Fair Practice. FINRA Rule 2301 states that the broker should have reasonable grounds for believing that a stock recommendation is suitable for the customer, based upon information concerning the customer's financial status, tax status, investment objectives, etc. Rule 405 requires "due diligence," and suggests items to be included in a New Account Form, such as age, occupation, estimated income and net worth, marital status, number of dependents, and investment objectives.

State law

Ideally, the Oregon Legislature will clarify the situation for consumers and the industry by enacting a written standard for the mortgage industry, although lawmakers failed to do so during the recent (Feb. 2008) special session. However, the similarities between the existing mortgage broker and securities statutes give rise to the question whether the mortgage broker statute already allows for suitability claims. Section 59.925 of the Oregon Mortgage Brokers Act parallels the Oregon Securities Laws, which in turn parallel Rule 10b-5. Thus, the same type of claims available under Rule 10b-5 against securities brokers may be available against mortgage brokers and lenders.

In the federal securities context, an injured plaintiff may bring a suitability claim under Rule 10b-5, promulgated under Section 10(b) the Securities Exchange Act of 1934. The basis of a suitability claim is that the broker has omitted telling the investor that his or her recommendation was unsuitable for the investor's interests. A suitability claim also can be based on negligence, although that has become a complicated issue in Oregon.

The brokers

The mortgage and securities industries are similar in that brokers hold themselves out as professionals who will find the "best" product suitable for the consumer's objectives and needs. The drafters of the mortgage broker statute acknowledged this similarity when they lifted parts of the mortgage broker statute directly from the securities statute. One category of problems reported by the Financial Fraud Section of the Oregon Justice Department in its testimony before the Legislature was mortgage brokers promising to get loans for consumers with bad credit or who lacked the income to qualify for the loan, or in other words, promising loans unsuitable for the borrower.

The mortgage industry will fight a suitability claim on the basis that there are no widely accepted written standards from the Legislature or regulatory authorities. However, the lack of a written standard does not necessarily signify that there has been no misstatement or material omission.

The Mortgage Bankers Association also has contended that the mortgage and securities industries are not analogous. The MBA asserts that the federal government has had a policy of making as many loans available to as many viable borrowers as possible (citing the Fair Housing Act, etc.), and that a suitability standard would impede that goal. According to the MBA, the only consequence of a suitability standard in the securities industry is lost commissions for brokers, but, in the mortgage industry, such a standard might cause lenders to become overly cautious, thereby violating the "letter of federal anti-discrimination laws and the spirit of community reinvestment laws."

Protecting consumers

Putting aside the question of why caution in large consumer financial transactions would be harmful, this argument overlooks the fact that a primary purpose of the federal securities laws is the maintenance of free and open capital markets that encourage suitable investments after full disclosure. Certainly, the current predatory lending crisis serves as a lesson about the harmful consequences that can arise from unregulated markets. Fair lending policies developed during the 60s and 70s were meant to ensure that loans were extended to all qualifying borrowers and to prevent lending bias due to factors such as race, age, and disability. The policies were not intended to shield the mortgage industry from liability for unscrupulous lending practices.

The mortgage industry itself should embrace formal suitability standards as a way to legitimize the industry in the face of ongoing scandal. In the meantime, Oregon practitioners should consider alleging a suitability claim under the mortgage broker statute as one recourse against unethical mortgage brokers and lenders. While the claim will be hotly contested, the courts are the only recourse until the Legislature takes further action.

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