

Consumer Lending/Retail Banking Update

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Latest RESPA Developments

Title Insurance Probes; Who Will Be The Subject Of An Investigation Next?

Title reinsurance practices have come under increased scrutiny by state insurance departments. Recently, the California Insurance Commissioner issued nine subpoenas to six companies, including LandAmerica and Fidelity National Title, in its investigation of alleged illegal kickbacks in the title insurance industry. Mortgage lenders named in the subpoenas include United Home Mortgage Corp. and Wells Fargo Home Mortgage. The California Commissioner has been working with the Colorado and Washington state insurance regulators to investigate reinsurance contracts between title companies and subsidiaries of real estate firms, developers and lenders. Under the reinsurance schemes, title

insurers agree to give some portion, e.g., half, of the insurance premium on title insurance policies to the captive reinsurance companies to reinsure a portion of the insurer's risk. The parent companies of those captives refer business to the title insurers. These arrangements allegedly kick back a large share of the title insurance premium in exchange for referral of the customer to the title company in violation of RESPA.

The Colorado Department of Insurance has also recently alleged that nine title insurance underwriters, including Fidelity National, have paid kickbacks to homebuilders, lenders and real estate agents. The kickbacks, like in California, involved captive reinsurance transactions. Fidelity National has terminated all of its captive reinsurance treaties.

As a result of the title reinsurance investigations, some states intend to examine the title insurance industry as a whole, as well as other practices in which lenders take part, such as work share, marketing arrangements and joint ventures in the title area.

Both the Department of Housing and Urban Development ("HUD") and the Wisconsin Department of Insurance are reportedly investigating a Wisconsin title company for alleged violations of the anti kickback provisions of RESPA. Chicago Title Insurance Co. and Wisconsin Title Insurance Co. have formally complained to HUD that another Wisconsin title company is overcharging consumers.

Mortgage insurers are following the title probes but feel relatively safe that mortgage reinsurance deals, which were the focus of industry attention some years ago, will not be the subject of action by state and federal regulators as mortgage reinsurance deals are backed by actuarial analyses that show appropriate risk sharing and because HUD has addressed such arrangements in the past.

How far the title insurance probes will reach and what entities may be adversely affected by the probes remains to be seen.

In addition to more state investigations of business practices involving affiliated entities in the area of title insurance, the federal government is also increasing and widening the scope of its investigations into similar practices. HUD has tripled its RESPA enforcement staff in recent years and other federal regulatory agencies have also been involved in similar investigations. Chicago Title Company recently settled for \$5,000,000 claims brought by HUD, the Office of the Comptroller of the Currency and the Office of Thrift Supervision for alleged violations of RESPA. Chicago Title also settled with the Texas Department of Insurance for \$1,200,000. That investigation involved Chicago Title's purchase and sale of homes on the same day or soon thereafter with inflated property values. Regulators alleged that Chicago Title failed to properly complete the HUD-1 and diverted the proceeds from the sales to bank officers in the form of kickbacks. In addition to paying the

penalties, Chicago Title agreed to implement policies to ensure that HUD-1 settlement statements were properly prepared.

Although neither confirmed nor denied by HUD, there appears to be an ongoing HUD investigation in Oklahoma involving affiliated business arrangements among builders, a real estate broker and an Oklahoma title company. The allegation is that the profits of the joint venture were not being shared based on the amount of ownership interest in the joint venture but on the amount of business being referred.

Illinois Court Analyzes RESPA Employee Exemption

Under RESPA, one way to ensure that a mortgage lender will not be liable for failure to give disclosures regarding a lender's payment of fees to a loan originator is for the loan originator to be an employee of the lender, as opposed to an independent contractor.

In *Novakovic v. Samutin*, 820 N. E. 2d 967 (Ill. App. 2004), the plaintiff brought an action in Illinois against a mortgage lender (Guaranteed Financial Mortgage Services, Inc.) and a mortgage loan originator, alleging improper payment of fees to the loan originator by the lender and failure to make required disclosures under RESPA. At issue was whether the loan originator was an independent contractor or an employee of the lender, in which case his compensation is exempt from disclosure under RESPA.

The loan originator arranged a refinance between the borrower and mortgage lender. The loan originator worked approximately 35 hours per week for the lender, had an employment contract with the lender, was paid a commission based on the loans he originated for the lender, and received annual W-2 forms detailing

his compensation. The loan originator worked out of a Coldwell Banker office, pursuant to an agreement between Coldwell and the lender, and operated a separate commercial lending business in addition to arranging residential mortgage loans. In connection with the refinance at issue, the mortgage lender funded the loan with

In addition to HUD guidance regarding affiliated business arrangements, keep in mind that many states have laws forbidding or restricting affiliated businesses.

its line of credit, sold the loan on the secondary market and paid the loan originator a commission after deducting fees incurred in connection with the loan.

RESPA prohibits referral fees or kickbacks in connection with real estate settlement services unless services are actually performed. However, bona fide salaries and payments from lenders to their bona fide employees for generating business are permitted under RESPA and do not require disclosure to the borrower.

As the term "employee" is not defined under RESPA, the Illinois appellate court examined the definition of employee in the Illinois Wage Payment and Collection Act. Under that Act, the term employee does not include an individual (1) free from control and direction under its contract for service with its employer and is actually free from such control; (2) that performs work outside of the usual course of business or outside of all places of business of the employer; and (3) that works in an independently established trade, occupation, profession or business.

With respect to the first exception, the Illinois appellate court found that there was an issue of fact as to whether the loan originator was controlled by the lender because, while the lender did not set a schedule or impose assignments or quotas, the loan originator attended weekly meetings with the lender and was employed under an employment contract on an exclusive and permanent basis. The court also found that an issue of fact existed as to the third exception because the loan originator operated his own commercial lending business separate from the lender but it was unclear whether the loan originator operated the business at the same time he performed services for the lender and whether he invested capital in the other business.

The case was remanded for further determination of these issues. As this case illustrates, lenders should not be cavalier about categorizing loan officers as W-2 employees and must exercise sufficient control over a loan originator so that it is considered a bona fide employee and not an independent contractor. Employers need to understand their state laws on bona fide employee attributes (as well as IRS guidelines). ■

New Jersey Department Of Banking And Insurance To Define Suitable Office Locations

The New Jersey Department of Banking and Insurance requires that applicants for a mortgage lender, mortgage broker or secondary lender license list an in-state office location in their applications. Although the application instructions state that an executive suite is not a suitable office location, staff at the Department had previously advised informally that an executive suite could be a suitable office location under certain conditions. Now the Department has issued a bulletin describing what types of executive suite and similar office

arrangements would be acceptable and has stated that it is considering amending the current regulations regarding suitable office locations.

In the bulletin the Department suggests that before entering into lease agreements for executive suites, shared office suites or virtual offices, a licensee or applicant submit a written request to the Department's Licensing Services Bureau for a review of any proposed office arrangement. The request for review must include a floor plan, the lease, interior and exterior photographs and must indicate where signs will be placed.

The Department will not approve a location as a main or branch office if it does not have, among other things:

- Space that may only be used by the licensee, enclosed by floor-to-floor ceiling walls and a door;
- an area in which the confidentiality of files and records of the licensee may be maintained and which prevents access to those files by persons unaffiliated with the licensee;
- signage that clearly identifies the licensee and the private work area of the licensed operation;
- at least one employee of the licensed entity working at the location; and
- space that is reasonably accessible to the public.

If you would like further information on New Jersey office requirements, please contact us. ■

Court Grants Summary Judgment In FCRA Class Action Based On Verbal Notice Of Adverse Action

A federal court in Philadelphia granted summary judgment to a lender in a putative consumer class action that alleged violation of the "adverse action" notice requirements of the federal Fair Credit Reporting Act. In *Barnes v. DiTech.Com*, No. 03-6471, 2005 WL 913090 (April 19, 2005 E.D. Pa.), the court held that the lender met FCRA's requirement by providing oral notice that the consumer had been offered a higher interest rate due to information in his credit report and by advising the consumer to continue disputing information in the report. FCRA "allows written, electronic, or verbal notice, and so evidence of a policy regarding written notice does not, taken alone, raise a genuine issue of material fact," the court stated (emphasis original). "Neither party has provided evidence as to the company policy, if any, on verbal disclosures in such circumstances. Absent proof of a company policy, the question of willfulness becomes a case-by-case issue of material fact."

The consumer alleged that he had not received a written adverse action notice after he contacted DiTech and was not offered the best available rate. The court agreed with two previous decisions holding that FCRA's "catch-all" provision (15 U.S.C. § 1681a(k)(1)(B)(iv)) applies to credit situations, notwithstanding a more specific provision covering credit transactions at § 1681a(k)(1)(B)(i), and that a lender who fails to offer the "best available rate" is required to provide notice of "adverse action." Although the lender argued that the transaction was governed by the credit-specific definition at § 1681a(k)(1)(B)(i), which defines "adverse action" in terms of ECOA's "completed application" requirement, the court disagreed, holding that a "completed application" is not

necessary, and relied on the "catch-all," which defines "adverse action" more broadly as "an action taken or determination that is (I) made in connection with an application that was made by, or a transactions that was initiated by, any consumer ... and (II) adverse to the interests of the consumer."

Barnes is the latest in a series of recent decisions applying the "catch-all" in the credit context. See *Treadway v. Gateway Chevrolet Oldsmobile*, 362 F.3d 971 (7th Cir. 2004) and *Crane v. American Home Mortgage Corp.*, No. 03-5785, 2004 WL 1529165 (E.D. Pa. July 7, 2004) and *Thomas v. Cendant Mortgage*, No. 03-1672, 2004 WL 2600772 (E.D. Pa. Nov. 15, 2004). In agreeing with the earlier decisions, the *Barnes* court held that "Defendant's offer of a home equity loan at a higher interest rate because of Plaintiff's poor consumer credit score is an adverse action under the FCRA which requires adverse action notification." Notwithstanding its conclusion that FCRA required an adverse action notice, the court granted the lender's motion, based on the evidence of verbal notice provided to the consumer. Blank Rome served as co-counsel to the lender in the successful defense of the case. ■

Bankruptcy Court Rules That Equity Principles Allow Flexibility In Molding TILA Rescission Remedies

Consumer lawyers often plead a request for rescission under the Truth in Lending Act as one of the remedies that they seek against mortgage lenders in federal Truth in Lending Act complaints. Because rescission under TILA requires that the consumer "tender" back the "proceeds" of the loan (see 15 U.S.C. § 1635(b) and 12 C.F.R. § 226.23), the impact of the rescission remedy in the context of a chapter 13 bankruptcy case has raised difficult questions. These questions include whether the bankruptcy court can condition rescission on the

payback by the consumer of the proceeds; whether the lender receives a secured or unsecured claim against the bankruptcy estate for the proceeds; and, whether the court can rescind without requiring tender of the proceeds.

Cruz v. Household Finance Consumer Discount Co. (In re Cruz), No. 03-17888-SR, Adv. No. 03-1152 (Bankr. E.D. Pa. Nov. 1, 2004) provides one bankruptcy judge’s view on how TILA rescission works in the bankruptcy context and underscores the potentially harsh losses that may result. In that case, the court found violations of TILA, Pennsylvania’s Act 6 usury law, 41 P.S. § 101 *et seq.*, and the state Unfair Trade Practices and Consumer Protection Law (UTPCPL), 73 P.S. § 201-1 *et seq.* The court concluded that the lender had violated TILA’s requirements relating to notice of rescission by failing to complete the rescission notice form properly; violated Act 6 by charging an interest rate higher than that permitted by state law on second mortgage loans; and violated UTPCPL by falsely representing that credit insurance was required in order to obtain the loan.

The debtor contended that the court should void the lender’s secured interest and that the lender should receive an unsecured claim for the loan proceeds (the loan principal, less all closing costs, payments and statutory damages) in the chapter 13 plan. After reviewing the handful of decisions on TILA rescission remedies in bankruptcy and finding decisions going both ways on whether the court could void the mortgage without tender of proceeds, the court concluded that the cases “confirm ... that the analysis is grounded in equity. ... [T]he Court will condition rescission upon tender, but will take further evidence at a supplemental hearing to determine the amount the Debtor is able to pay over the life of her plan, or over some different span of time. In all

events, the Court’s Order will provide that Household shall retain its security interest until the Debtor completes payment of the tender sum; in other words, the rescission shall be effective only upon completion of the tender.”

Because the debtor successfully rescinded her loan, the Court ruled that she was not entitled to damages for her other claims, for violations of Act 6 and the UTPCPL. The court stated that, as a general principle, the rescission of an agreement precludes an award of actual damages. After a subsequent hearing, the court ordered that of the \$29,242.37 principal mortgage amount, the debtor was required to tender proceeds of \$15,044.37 (principal less \$12,198 payments made and \$2,000 TILA statutory damages). Exercising its equity powers, it ordered that \$10,000 of the tender amount was allowed as a secured claim and that the remaining \$5,044.37 would be unsecured and dealt with “in the same manner as other unsecured claims.” Upon payment of the secured claim in full, the lender would be required to release its mortgage. Although unreported, the slip opinion is available on the website for the United States Bankruptcy Court for the Eastern District of Pennsylvania at <http://www.paeb.uscourts.gov/pages/pubopins/pdf/03-1152-cruz,quetzy-opinion.pdf>. ■

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