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Lender Not Responsible For Misconduct of Its Mortgage Broker

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In shopping for a mortgage loan, most potential borrowers do not deal directly with mortgage lenders. Rather, these potential borrowers usually retain the services of an independent mortgage broker, who, in turn, steers them to one of his preferred mortgage lenders.

In *Hawthorne v. American Mortgage Inc.*, the U.S. District Court for the Eastern District of Pennsylvania recently decided whether a mortgage lender that was recommended by a mortgage broker could be held liable under agency principles for the broker's misconduct during the mortgage loan approval process.

In 2004, Judson and Stayce Hawthorne had entered into an agreement of sale to purchase their dream home. To finance the purchase of the property, Mr. Hawthorne submitted a mortgage loan application to American Mortgage.

American Mortgage subsequently issued a letter to Hawthorne certifying that he was pre-approved for a mortgage loan.

As part of the mortgage loan application process, Hawthorne also signed a written agreement describing the nature of the relationship between him and American Mortgage: "We [American Mortgage] are acting as an independent contractor and not as your agent. . . . We have entered into separate independent contractor agreements with various lenders."

Soon thereafter, Hawthorne received a letter from American Mortgage stating: "Congratulations, your mortgage application on the above referenced property has been conditionally approved with Countrywide funding terms and conditions." One of the conditions was that "all conditions to be finalized by underwriting."

Hawthorne informed American Mortgage that if closing did not take place as scheduled, the Hawthornes would lose the right to purchase the property.

Eight days prior to the scheduled closing, Countrywide received Hawthorne's completed mortgage loan application for underwriting purposes.

Hawthorne contacted American Mortgage and informed them that another interested buyer of the property had offered the Hawthornes \$350,000 to walk away from their contract to purchase the property or to assign their rights under the contract to him. The Hawthornes rejected that offer because they were assured that their deal would close.

On the eve of closing, however, Countrywide determined that Hawthorne's application did not meet Countrywide's underwriting conditions primarily due to his questionable credit history.

No one from Countrywide or American Mortgage informed the Hawthornes of their failure to obtain underwriting approval, and they proceeded to closing the following day. After delaying for several hours, American Mortgage finally admitted to the Hawthornes that it could not provide financing for the scheduled closing and needed additional time. When the sellers refused to reschedule the closing, the sellers terminated the agreement of sale and the Hawthornes lost the right to purchase their dream home. The sellers ultimately sold the property to the interested third party for \$150,000 above the price the Hawthornes agreed to pay.

The Hawthornes then filed a lawsuit against American Mortgage and Countrywide for breach of contract, fraud, violations of Pennsylvania's Unfair Trade Practices and Consumer Protection Law, and negligent misrepresentation.

Countrywide then moved for summary judgment on all claims in the complaint.

District Court's Ruling

The district court first discussed whether American Mortgage was Countrywide's agent in the truest sense.

In Pennsylvania, "[t]he basic elements of agency are 'the manifestation by the principal that the agent shall act for him, the agent's acceptance of the undertaking and the understanding of the parties that the principal is to be in control of the undertaking.'"

The district court ultimately concluded that an agency relationship did not exist between American Mortgage and Countrywide. Among other things, the district court pointed out that American Mortgage had the financial wherewithal to be able to fund their mortgage loans and American Mortgage and Countrywide specifically agreed that their relationship was non-exclusive in that American Mortgage was not obligated to submit all loan funding requests that it brokered to Countrywide.

A significant portion of the district court's ruling then focused upon whether American Mortgage exercised apparent authority to bind Countrywide to a contract with the Hawthornes.

In Pennsylvania, apparent authority is defined as the "power to bind a principal that the principal has not actually granted but that he leads persons with whom his agent deals to believe that he has granted, for instance where 'the principal knowingly permits the agent to exercise such power or if the principal holds the agent out as possessing such power.'"

Since none of the courts in Pennsylvania has handed down a decision-discussing agency in the context of a mortgage brokerage relationship, the Hawthornes, in opposition to the motion for summary judgment, directed the district court to "the well-litigated question of when, if ever, an insurance broker is the agent of the insurer whose policy it sells."

The district court ultimately found that the "analogy of mortgage broker cases to insurance broker cases, while conceptually instructive, d[id] not help the Hawthornes in this case."

In Pennsylvania "[t]he general rule for insurance cases is that the broker is the agent of the insured who purchases insurance, not the agent of the insurer who issues it." Pennsylvania courts reason that "[w] here a person desiring to have his property insured applies not to any particular company or its known agent, but to an insurance broker, permitting him to choose which company shall become the insurer, a long line of decisions has declared the broker to be the agent of the insured; not of the insurer."

The Hawthornes similarly argued that American Mortgage was free to shop Mr. Hawthorne's mortgage loan application, just as an insurance broker is free to shop an insured's application to different insurance companies. As such, the district court found that, "if mortgage brokers are like insurance brokers, as the Hawthornes suggest, they are the agents of the mortgagors and not the mortgagees."

The district court also emphasized that the Hawthornes knew of American Mortgage's independent status when Hawthorne applied for the mortgage loan. During the mortgage-loan-application process, American Mortgage disclosed in writing to Hawthorne that it had "entered into separate independent contractor agreements with various lenders."

The district court also found the Hawthornes' reliance on the Pennsylvania Superior Court's holding in *Triage Inc. v. Prime Ins. Synd. Inc.* as unavailing. In *Triage Inc.*, the plaintiff sought a refund of unearned premiums from both an insurance company and the insurance broker to whom it had remitted the premium payments. Although the insurance company refunded the amounts it actually received, it refused to return amounts retained by the insurance broker claiming that no agency relationship existed between the insurance company and the insurance broker.

Recognizing that apparent authority ordinarily exists only where a principal somehow creates an appearance of authority, the Superior Court in *Triage* held that "[t]he requisite indicia of agency need not, however, be especially overt, as the broker's mere placement of the policy and collection of premium may suffice." The Superior Court stated that this principle applied "even in the face of contractual language that, as here, attempted to deny any agency relationship."

Unlike the insurance broker in *Triage*, the district court found that the Hawthornes failed to show that American Mortgage collected premiums on Countrywide's behalf. According to the district court, "[i]n

the absence of a collection of premiums, there is 'no affirmative act' in this case which is consistent with an agency relationship." The district court emphasized that, "even if American Mortgage collected payments on Countrywide's behalf, the scope of the authority thereby created would be limited to the function of collecting payments and would not include the authority to enter into agreements on Countrywide's behalf."

The district court also believed that the *Restatement (Second) of Agency* made clear that "Countrywide's authorizing American Mortgage to solicit business on its behalf does not, by itself, provide American Mortgage the authority to bind Countrywide to a contract." Under the *Restatement*, "[a]uthority to contract is not inferred from authority to solicit business for the principal nor from authority to perform acts of service for the principal. By way of illustration: 'P employs A, a real estate broker, to find a purchaser for Blackacre, at a stated price. A has no authority to contract for its sale.'"

The *Restatement* also directly addresses the brokerage context: "[o]ne who receives goods from another for resale to a third person is not thereby the other's agent in the transaction: whether he is an agent for this purpose or is himself a buyer depends upon whether the parties agree that his duty is to act primarily for the benefit of the one delivering the goods to him or is to act primarily for his own benefit." The district court clearly believed that American Mortgage was acting primarily for its own benefit.

LESSONS LEARNED

The district court's ruling in *Hawthorne* is certainly a sigh of relief for mortgage lenders across the commonwealth. If the district court had ruled differently, Pennsylvania mortgage lenders would be responsible for the misconduct of essentially independent mortgage brokers. On the other hand, purchasers of real estate looking for a mortgage loan must remain extremely diligent in ensuring that financing is secured in time for closing.

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