

Evaluating the Merits

By Christopher A. Michener

**Who are these bonds intended to benefit and what should you do when a default is taken against a bond principal?**

# Mortgage Broker Bonds

A growing number of disgruntled homeowners and others impacted by foreclosures and “underwater” home loans resulting from high unemployment, the collapse of home values, and the fallout from the subprime mortgage-loan

market likely means that those perceived as responsible will face more claims and litigation. There is plenty of blame to go around, from lenders that failed to do due diligence to predatory or downright fraudulent activities of mortgage brokers, and from borrowers with unrealistic expectations of their abilities to repay mortgages to the nearly universal faith in the inexorable rise of home values.

Residential mortgage brokers, the middlemen bringing lenders and homebuyers together, present a particularly inviting target. A mortgage broker, often a small, undercapitalized enterprise, in many cases will not or cannot defend an action, and a surety bond issued on behalf of the broker may seem the path of least resistance to right a real or imagined wrong. In one typical scenario, a claimant sues a mortgage broker, the broker fails to defend, and the plaintiff presents the surety with a default judgment for a payment. The trend of increased bond penalties along with greater awareness of bonding requirements likely will serve to increase claims against mortgage brokers and their sureties.

Governmental regulation has closely followed the relatively recent rise of the mortgage-brokering industry, principally licensing regulation on the state level. Typical state statutes and implementing regulations mandate that individual brokers or originators meet certain education requirements and submit to criminal background checks, and brokerage entities must prove solvency—that they can meet potential obligations arising from conducting, or “misconducting,” business. These statutes also prohibit unlicensed origination of residential loans and designate a state agency to oversee the industry, conferring to it powers to enforce the licensing laws.

Additionally, the state-licensing laws often contain broad and vague provisions requiring mortgage brokers to act transparently, to safeguard held funds, and generally to conduct their regulated businesses legitimately and “in accordance with law.” These provisions, while seemingly intended to protect borrowers from abuses common in the industry, may be read much more broadly, as designed to protect *anyone*



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dealing with a broker from *any* statutory or common law violation at least arguably “in connection with” a broker’s licensed activity, specifically, originating loans.

In lieu of, or more typically, in addition to meeting minimum financial net-worth standards, mortgage brokers must either furnish the appropriate state agency with a surety bond, or less often, pay in to a state recovery or state guaranty fund. The state legislature or a state agency creates a standard surety bond form. Such forms always name the agency itself as the obligee, but they also generally specify that the bonds are for the benefit of “any person” damaged by a broker’s failure to comply with the state’s mortgage-brokering laws, importing into the condition of the bonds the broad and nebulous language requiring brokers to act “in accordance with law.” Initially, mandated bond penalties usually ranged from \$10,000 to \$25,000, but in recent years many states have increased these amounts or adopted a sliding scale based on volume of business. In some cases, a state may require a high-volume mortgage broker to post a bond in the hundreds of thousands of dollars, taking into account the penal sums, meaning the maximum sureties will pay under bonds. For instance, New Jersey caps the penal sum at \$300,000, Missouri caps the sum at \$250,000, and Arizona caps the sum at \$200,000.

Because mortgage-broker surety bonds by their terms usually apply to “any person” and establish the condition that a broker faithfully perform all acts “in connection with” or “related to” the mortgage-brokering business, they appear to provide much broader than intended recourse in terms of who can properly make claims against these bonds and which actions the bonds cover. As a result, they open the door to claimants other than borrowers and to claims beyond what someone would expect the intended scope of these bonds to cover. Because of scant legislative history about the state statutes and scant case law, due to the relatively recent vintage of these statutes, sureties and their attorneys have had little guidance on these issues. The relatively low penal sums once imposed by statutes and regulations for these bonds have likely precluded sureties in the past from litigating these matters through appeals and obtaining reported case law, which in

turn, presumably has contributed to the dearth of interpretive guidance.

On July 30, 2008, the president signed the federal Housing and Economic Recovery Act of 2008 (HERA) into law in the wake of and designed to alleviate the residential mortgage crisis. A key component of HERA is the Secure and Fair Enforcement for Mortgage Licensing Act of 2008 (SAFE), which attempts to unify the various states’ regulation of mortgage brokers by establishing minimum licensing requirements and by requiring originators and mortgage-brokering entities to register with a national database, the Nationwide Mortgage Licensing System and Registry. While SAFE has effected some change and some measure of standardization among state statutes, it has done little to shed light on the intended beneficiaries and scope of the bonds.

The two issues addressed in this article are (1) who has standing to sue a surety asserting a claim on a mortgage-broker bond, and (2) how does a surety address a claim and, specifically, a default judgment against its principal when the claim, the judgment, or both are not explicitly based on a violation of the mortgage-brokering statutes under which a broker issued the bond.

### Standing

The express language of many mortgage-broker bonds that allow a claim by “any person” conflicts with the presumed purpose of the statutes under which brokers issue the bonds: that is, consumer protection. However, such broad language appears to provide plaintiffs other than borrowers with grounds for maintaining actions against sureties issuing bonds, particularly given the dearth of expressed legislative intent.

Despite the existence of such opportunity, reported case law reveals few examples thus far of other classes of potential claimants seizing that opportunity. The earliest relevant cases addressing the issue mostly involve claims against sureties involving similar license bonds issued on behalf of other real estate professionals and against recovery funds that serve the same purposes.

### Employee and Insider Claims

The earliest example that the author has identified of an employee attempting to sue

a broker’s surety is *Sigler v. The Massachusetts Bonding & Insurance Co.*, 50 N.E.2d 390 (Ohio Ct. App. 1941). In *Sigler*, a real estate salesman obtained a judgment for unpaid sales commissions from his employer, an Ohio-licensed real estate brokerage, which was bonded as required under Ohio licensing statutes. The conditions of the mandatory bond were nearly identical

## The bond requirement

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to many mortgage-broker bonds in that it specified that “[a]ny person claiming to have been damaged... by reason of the violation of the terms of this act, may maintain an action at law against” such broker and its surety. The court then reviewed the licensing statutes and identified one that specified that the licensing board had the power to revoke a license of a broker for “[f]ailure within a reasonable time... to remit any moneys coming into his possession which belong to others.” Reading the plain language of these two provisions together, the court held that the claim fell within the bond. The court attempted to glean the legislative intent of enacting the licensing statutes, but rather than view them as aiming to protect consumers, it held that the legislature intended the statutes to ensure that the regulated business was conducted with honesty and integrity toward all. In 1956, the Oklahoma Supreme Court came to a similar conclusion by relying principally on *Sigler*. See *Nat’l Sur. Corp. v. Kneeland*, 294 P.2d 310 (Okla. 1956)

The tide turned, however, with a District of Columbia Court of Appeals opin-



ion addressing, again, a real estate broker's bond with a similar claim as in *Sigler*. In *Gilewicz v. Home Indemnity Co.*, 150 A.2d 627 (D.C. 1959), a real estate saleswoman also obtained a judgment against her employer, a real estate broker, for unpaid commissions, then sued the surety based on the broker's statutory bonds in both Maryland and the District of Columbia.

**The trend** at this point appears to limit claims to consumers or borrowers, but the results vary by state.

The lower court granted the surety a judgment on the pleadings on both claims, which was affirmed. The D.C. bonding statute provided that "any person aggrieved" was entitled to a claim while the Maryland statute specified that the bond was for the use and benefit of the public. The court reasoned that "when the legislature enacts a statute regulating a business for the purpose of protecting the public against existing or potential evils in that business, those engaged in the business are not generally regarded as a part of that public." *Id.* (quoting *Eberman v. Mass. Bonding & Ins. Co.*, 41 A.2d 844, 845-46 (D.C. 1945))

In *Fleishmann v. Sovereign Financial Consultants, Inc.*, 635 So. 2d 414 (La. Ct. App. 1994), the first reported case in which someone other than a borrower sued a surety based on a mortgage broker's bond, a Louisiana Court of Appeals held that an appraiser who had not been paid for services rendered to a mortgage broker lacked standing to maintain a claim against the bond. The statute at issue specified that "[a]ny person damaged by the loan broker's breach of contract or of any obligation arising therefrom, or by any violation of law... may bring an action against the bond...." *Id.* at 415. The court found "specious" the plaintiff's argument that as "any person" he was a proper claimant under the statute. *Id.* It stated that, although the bond requirement statute appeared when read in isolation to cover every contract executed by the broker,

the chapter containing the requirement was designed to protect only immediate parties to a loan-brokerage contract. Therefore, the bond requirement was not intended to provide security to anyone who executed a separate contract with the broker, including a person who provided services in connection with the loan transaction.

Three years later, in *Great American Mortgage, Inc. v. Statewide Insurance Co.*, 938 P.2d 1124 (Ariz. Ct. App. 1997), an Arizona court addressed the issue as applied to a mortgage-banker bond. Employees asserted claims for unpaid wages against the mortgage banker and its statutory bond, citing this from the statute: "The bond is payable to any person injured by the wrongful act, default, fraud or misrepresentation of the licensee." *Id.* at 1126 (emphasis added). The surety contended and the court agreed that the claimants read the statute too broadly and that they did not belong to the class that the legislature had intended to protect. *Id.* In explaining its interpretation, the court in part addressed the unintended consequences that would result if the court interpreted the statutory bonding requirement as the claimants' proposed:

[I]f we were to interpret A.R.S. section 6-947(M) as Employees propose, all creditors of a mortgage banker would have recourse against the license bond. This would include, for example, a seller of office supplies or a provider of telephone service, and would distort the class of persons that the Legislature intended to protect by requiring a mortgage banker license bond, *i.e.*, those persons wrongfully injured by the licensee's mortgage banking activities. Employees asserting their rights of employment simply do not fall within this protected class.

Moreover, exposing the license bond to such diverse claims would frustrate, rather than serve, the Legislature's intent of protecting the public. For example, an employee likely would be the first to realize the mortgage banker's financial difficulties and, by quickly filing an action, could exhaust the license bond before injured borrowers could act. This result would be particularly inequitable if the unpaid employee was partly responsible for the mortgage banker's financial difficulties.

Sureties have prevailed in several cases from other jurisdictions under similar cir-

cumstances. See, *e.g.*, *Phoenix Assurance Co. of N.Y. v. R.D. Young*, 121 S.E.2d 70, 71 (Ga. Ct. App. 1961) ("Even if it could be said that the purpose of the law in requiring the bond is to protect the salesman of a broker, the purposes of the law is not to protect the salesman from a breach of a contractual obligation on the part of the broker. However, we are of the opinion that the law requiring such bond is intended to protect members of the public and not the employees of a broker"); *Middelsteadt v. Karpe*, 124 Cal. Rptr. 840 (Cal. Ct. App. 1975) (denying a sales agent's claim on state recovery fund for commissions due from licensed broker); *Burnett v. Foley*, 660 S.W.2d 884, 886 (Tex. Ct. App. 1983) (expressing similar concerns as in *Fleishmann*: "[I]f agents and brokers were allowed to recover from the Real Estate Recovery Fund every time another broker or salesman fraudulently or deceitfully deprived him or her of a commission, there would, in all probability, be a significant depletion of the fund available to reimburse the general public"). With that said, little of this law was decided in the mortgage-brokering context, leaving the opportunity open for claims by brokers' employees and others working with brokers.

### Lender Claims

While the threat that employees or others engaged by brokers could sue sureties appears to have abated for now, a new, more serious threat may emerge from an opinion issued by the Oregon Supreme Court in 2003: *American Bankers Insurance Co. v. State*, 92 P.3d 117 (Or. 2004). In *American Bankers*, the surety was notified of approximately 20 claims that far exceeded the \$50,000 penal sum of the mortgage-broker bond that it executed, and the surety interpleaded the funds. The trial court held that the only two proper claims were those of creditors who had provided credit information and appraisals in connection with loans. The intermediate appellate court held that not even those creditors of the broker were proper claimants. Two individuals who had jointly loaned funds in a transaction brokered by the principal and alleged that they had been fraudulently induced by the broker to part with their money appealed the rulings that they, as lenders, did not properly belong to the class of claimants against the bond.

The court reviewed the plain language of the Oregon mortgage-broker licensing statutes. Those statutes expressly stated that “any person” who suffered an ascertainable loss in a regulated mortgage transaction had a direct, private right of action against the broker if the broker violated any provision of the licensing act or engaged in what amounted to either negligent or fraudulent misrepresentation. While not passing on the merits of the lenders’ misrepresentation claim, the court held that such a claim clearly fell within the plain language of the statutes, and therefore within the terms of the bond. It seems that policy arguments similar to those addressed in *Fleishmann* were raised by the surety, but the court noted only that “nothing in the legislative history or the policy arguments that the parties advance is inconsistent with [its] analysis.” *Id.* at 120.

That decision contrasts, however, with *Midlantic Nat’l Bank v. Peerless Ins. Co.*, 601 A.2d 243 (N.J. Super. Ct. App. Div. 1992), which addressed a mortgage banker’s bond issued in accordance with the New Jersey Mortgage Bankers and Brokers Act. Despite sparse legislative history, after reviewing the mortgage-banker licensing statutes, the *Midlantic* court determined that their general purpose was to protect consumers. Consequently, it held that the lower court properly had granted a summary judgment against a commercial bank bond claimant that had provided funds to the bonded mortgage banker to finance allegedly fraudulent home loans in exchange for mortgages under a “warehousing” agreement.

### Statutory Modifications

While the Oregon statutes typify the language of the mortgage-broker licensing and bonding statutes and the bond forms promulgated under them, a few jurisdictions have attempted to define who properly can maintain claims against a mortgage broker’s surety to recover from the bond by statute, and some more explicitly than others. The trend at this point appears to limit claims to consumers or borrowers, but the results vary by state.

For instance, the applicable Washington statute, Wash. Rev. Code §19.146.205(6) (a), while stating that the penal sum will be determined as the director deems sufficient to protect the “public interest,” also states

that borrowers receive first priority, followed by the state and any “other person” damaged, indicating that individuals other than consumers properly fall into this category, although they don’t receive priority treatment.

In 2009, Missouri revised the state bonding provision, which now explicitly states that the bond “is for the protection of borrowers.” Mo. Rev. Stat. §443.849.5. However, the form of bond, which arguably included a much broader sweep, only recently has been removed from the code of state regulations and has yet to be replaced.

The Ohio statute, Ohio Rev. Code §1322.05(A)(2) states, “The bond shall be for the exclusive benefit of any buyer injured by a violation by the licensee of any provision of sections 1322.01 to 1322.12 of the Revised Code or any rule adopted thereunder.” The term “buyer” replaced the term “person” in 2001, effective January 1, 2002.

In sum, an attorney would need to closely review the applicable statute, regulation, and bond to determine whether it explicitly states who may properly assert a claim against a surety based on a bond. In the jurisdictions that do not provide a definitive answer, however, jurisdictions generally have tended to limit the class of claimants to “borrowers” or customers of a broker. While the newly enacted SAFE does not expressly define appropriate claimants, SAFE’s more general language concerning its purpose might benefit sureties. In section 1502, enhancing consumer protections is listed as a primary goal of SAFE.

### Default Judgment and the Scope of Coverage

In one not uncommon scenario, either a borrower or some other “person” initially sues the broker who fails to defend and then suffers a default judgment. The legal bases of these underlying claims often sound in conversion, fraud, negligent misrepresentation, violation of the Truth in Lending Act (TILA), violation of the Real Estate Settlement Procedures Act (RESPA), or violation of the state’s equivalent of a consumer protection statute prohibiting “deceptive practices.” Notably, the underlying claim against the broker rarely invokes the state-licensing statute. It may well be that even if the broker’s liability is clear, the surety’s is not.

### Bond Conditions

Mortgage-broker bonds are almost never “judgment bonds.” They are instead “faithful performance bonds” and establish as a condition that the mortgage broker must act in accordance with state-licensing law. These bonds in some cases also require a broker to refrain from certain conduct, such as fraud, or to pay all obligations due.

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A fairly typical example is the terms of the Nevada bond form:

Now, therefore, if the principal, the principal’s agents and employees, strictly, honestly and faithfully comply with the provisions of chapter 645B, 645E and 645F of NRS and any regulation adopted pursuant thereto, and pay all damages suffered by any person because of a violation of any of the provisions of chapter 645B of NRS or any regulation adopted pursuant to thereto, or by reason of any fraud, dishonesty, misrepresentation or concealment of material facts growing out of any transaction governed by the provisions of chapter 645B, 645E and 645F of NRS or any regulation adopted pursuant thereto, then this obligation is void; otherwise, it remains in full force.

### Judgment Against a Broker

Although mortgage-broker bonds typically are “faithful performance” bonds, a claimant will often first sue only the broker, obtain a judgment by default or otherwise, then attempt to use that judgment to prove the claim or case against the surety. The claimant may take that approach because he or she believes that the broker is solvent,



he or she does not initially know about the bond, or he or she wants to attempt to “establish” liability and damages without the interference of a party that is more likely to defend the claim actively. Subject to some variance among jurisdictions, the rule has emerged that unless the bond at issue is a “judgment bond,” a surety that has no notice of or opportunity to defend an action

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against its principal is not bound by a judgment against its principal, although sometimes courts have held that a judgment is rebuttable, prima facie evidence of liability and damages. When a surety does receive notice and does have opportunity to defend a principal, the surety will often become conclusively bound even by a default judgment against its principal. *See generally, Drill S., Inc. v. International Fid. Ins. Co.*, 234 F.3d 1232 (11th Cir. 2000); *McAlpine v. Zangara Dodge*, 183 P.3d 975, 980–82 (N.M. Ct. App. 2008)

In *Swayne v. Capitol Indemnity Corp.*, 2010 WL 2663209 (S.D. Ohio 2010), a mortgage-broker bond case, the court made clear that a surety need not have much notice or opportunity to defend for a judgment against its principal to bind to the surety. In *Swayne*, an 80-year-old plaintiff, a widow, contacted the defendant, a broker, to arrange a cash-out refinancing to pay for repairs to her home. The plaintiff sued the broker in state court under the Ohio licensing act and for fraud and unconscionability based on the allegedly predatory nature of the loan, which required a balloon payment on the back end of the loan term. The trial court awarded a summary judgment

to the plaintiff and rendered a decision on damages before the surety was even notified of the claim or the action. Shortly after, the surety received notice of the action, and two months later the trial court entered a final judgment against the broker. In a subsequent action on the bond, an Ohio federal court held that the two-month period between the surety receiving notice and the court entering the final judgment afforded the surety sufficient opportunity to intervene in the underlying action to prevent the court from entering the final judgment somehow. Because the surety did not do this, it was held conclusively bound by the determination in that action.

In practice, when a mortgage-broker principal is unwilling or unable to defend an underlying action, it can become difficult for the surety, even with notice, to defend the principal by raising the substantive merits of a lawsuit. With that said, a surety does have recourse. Certainly, a surety has its own defenses, such as notice and limitations periods, which in some cases statutes do not prohibit a surety from invoking, and may defeat a claim to the bond if invoked. *See, e.g., Ins. Co. of N. Am. v. Home Loan Corp.*, 862 N.E.2d 1230 (Ind. Ct. App. 2007) (holding that although the action against the broker was filed timely, the two-year bond limitation period barred that action against the surety when the surety was not joined to the lawsuit until more than three years after closing). In some jurisdictions, the applicable statutes and bond forms explicitly permit such defenses.

Sometimes a transaction will not fall within the broker’s regulated business. In *Accerbi v. Hartford Fire Ins. Co.*, 2005 WL 2406150 (S.D. Ga. 2005), the mortgage broker represented to lenders that a loan was to be secured by the borrower’s principal residence although the property had actually been a floral business for some 40 years. The broker ultimately failed to secure financing but closed a sham loan. The borrower obtained a \$90,000 judgment against the broker for fraud. The broker shut its doors, surrendering its license, and the borrower sued the surety to recover from the mortgage broker’s bond. In applying the “read-in read-out” rule of Georgia under which a statutory bond covers no more and no less than what statute requires, the court held that only residen-

tial transactions constituted regulated and bonded “licensed business.” Regardless of how the loan was characterized by the broker, it was not in fact a residential loan and therefore did not implicate the bond.

As previously mentioned, civil actions against mortgage brokers are rarely filed under a theory invoking the licensing statutes, violation of which is the most common bond condition. This means that if a plaintiff wants to use a judgment against a broker in a later action against the surety, the plaintiff will have to show that through issue preclusion the violation of law “proved” in the underlying action is the equivalent of violation of the licensing statutes, or in some cases, an additional condition of the bond imposed by statute or regulation. A plaintiff’s ability to do this will vary depending on the precise language of the licensing statute. The only other alternative for a plaintiff is to start over from zero and re-prove the underlying case against a broker and a surety.

When a plaintiff receives an underlying default judgment against a broker and the surety did not receive notice or opportunity to defend the broker, or when a plaintiff achieves it with a theory that is not expressly a condition of the bond, after actively defending the broker, re-proving the case against the surety may present its own obstacles. In either of those circumstances, a surety should have available to it the defenses of its principal, allowing the surety to challenge flimsy or incompetent evidence and inflated or speculative damages.

### Conclusion

With the present housing market and given the current stringent regulation of mortgage brokers and rising bond penalties, it is reasonable to expect that more plaintiffs will sue sureties, seeking to include themselves in the classes covered under mortgage-broker bonds. To evaluate the merits of such a claim, an attorney should consult the relevant bond, statutes, and regulations and consider suretyship defenses. A surety should also consider who is making the claim, the status and effect of proceedings against the broker bond principal, and whether the conduct of the broker that the plaintiff complains of falls within the regulated activities of brokers under the jurisdiction’s applicable licensing law. 