

Defending Wholesale Lenders: Pitfalls and Potential Safety Nets

by

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Wholesale lending can be a prosperous business. However, in order for that business to function, the wholesale lender must use independent mortgage brokers to solicit the customers that seek to utilize the wholesale lender's money lending services. This creates the potential for pitfalls as the brokers are not employees of the wholesale lender that are subject to its day-to-day scrutiny. As a consequence, although all brokers are subject to state and/or federal licensing requirements and will agree in writing to follow the wholesale lender's guidelines and instructions, it cannot be disputed that some brokers will not always follow the rules. Thus, when the inevitable, but hopefully few, lawsuits are filed against the wholesale lender (and almost always the broker, too) as a result of the broker's indiscretions, an understanding of the legal interplay between the broker and the wholesale lender is critical to mounting a successful defense in favor of the wholesale lender.

The legally recognized separation between the wholesale lender and the independent broker can sometimes provide the wholesale lender with a safety net from the litany of claims that a borrower can interpose in a lawsuit. California law provides that a broker is customarily the agent of the borrower and not the lender. This means that the acts and/or omissions of the broker should not be imputed to the lender. For example, if the broker misrepresents the loan terms that a prospective borrower is purportedly going to obtain from the wholesale lender, but the wholesale lender never deviates from the loan terms it has represented that the borrower should (and in fact did) receive, the misrepresentations of the broker should not be attributed to the wholesale lender - only the broker. This is true even if the broker represents to the prospective borrower that it is an agent of the wholesale lender.

A wholesale lender would have to intentionally or negligently create a belief in the mind of the borrower that the broker is the agent of the wholesale lender, and not just the borrower, for the wholesale lender to be potentially liable for more than theoretical breach of contract damages. Therefore, if the wholesale lender keeps its distance from the broker, i.e., does not let the broker use stationary with the wholesale lender's name on it or let the broker post signs at the broker's office with the wholesale lender's name on it, the borrower will not be able to mount a

successful attack against the wholesale lender on the grounds that the broker is the agent of the wholesale lender and thus equally liable with the broker for its indiscretions. The requisite distance between the wholesale lender and its independent broker creates a shield that can be wielded by the lender's lawyers in a suit brought by an unhappy borrower to the benefit of the wholesale lender.

Since a broker is the agent of the borrower, under California law, this creates a fiduciary relationship between the broker and its customer. A fiduciary relationship is the highest duty of care recognized under the law. The fiduciary duties incumbent in such a relationship impose upon the broker the duty to disclose all known facts to the borrower and also requires the broker to exercise the highest possible care with respect to its customers' needs. This means that a broker is susceptible to negligence and breach of fiduciary duty claims, among others, if the borrower later decides that the loan terms negotiated by the broker are unsatisfactory or untrue.

In contrast, a financial institution generally owes no duty of care to a borrower when its involvement does not exceed its conventional role as a money lender. This means that if the wholesale lender merely loans money to a borrower for the purchase or refinance of a residential or commercial property, as opposed to the wholesale lender retaining control of the disbursement of funds for an ongoing construction effort, the only viable claim that can be asserted against the wholesale lender is for breach of contract. This should preclude the borrower from being able to assert a claim for punitive damages against the wholesale lender.

Although the lending industry, especially those involving subprime loans, is going through a turbulent time right now, the need for money lending will not go away. People and businesses will always need loans to purchase cars, real property and the like. The key for the wholesale lender is to structure its business to maximize the potential for profits while minimizing the expenses it might incur if the broker it utilizes to solicit customers does not follow the rules. Utilizing the separation between wholesale lenders and its independent brokers can deflect the pitfalls inherent in the wholesale lending industry and provide a safety net for the wholesale lender.



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