Regulating Mortgage Lending In Wisconsin

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Wisconsin regulates mortgage lending through Subchapter III of Chapter 224 of the Wisconsin Statutes. These statutes are an underutilized but potentially powerful tool in the hands of mortgagors, and needs to be understood by anyone who represents a party to any real estate transaction. The significant criminal and civil penalties available, combined with the plethora of responsibilities and potential violations, create a minefield of potential violations and evidentiary issues.

Given the growth of the subprime market in recent years, and the well-documented difficulties suffered by subprime lenders, any foreclosure action should be analyzed from both plaintiff and defendants' sides to determine whether the mortgage banker or broker laws provide cause for alarm or damages. A familiarity with those rules and how to litigate them will be a must over the next few years for debtor and creditor attorneys alike.

Regulated Entities and Individuals:

Not every person or business involved in mortgage lending is governed by Chapter 224; those statutes apply only to loan originators, mortgage bankers, and mortgage brokers.

A "**Loan originator**" generally is someone who finds a loan or negotiates a land contract, loan or commitment for a loan. Sec. 224.71(1r). (Full texts of the statutes follow this outline.) "Loan originators" work for mortgage bankers or mortgage brokers and are limited to working only for one such banker or broker. All applications for mortgages must be signed by a loan originator.

A "**Mortgage banker**" generally means a person who originates, sells, or services mortgage loans. Sec. 224.71(3)(a), while a "**Mortgage broker"** is a person who in exchange for something of value, finds a loan or negotiates a land contract, loan or commitment for a loan or engages in table funding.[1]

The definitions of mortgage bankers and brokers have limiting factors that should be examined in light of the context of each case.

[1] "Table funding" is defined by the mortgage broker statutes as a transaction in which the closing is done in one person's name with funds from a 3rd party to whom the loan is later assigned.

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There are also lengthy lists of exceptions to the definition. The following are declared *not* to be mortgage bankers or brokers:

- banks
- trust companies
- savings banks
- savings and loan associations
- insurance companies
- credit unions or other Chapter 138-licensed entities (see sec. 138.09)
- land mortgage or farm loan associations,
- Certain low-income oriented community-based organizations and housing authorities,
- The Department of Veterans Affairs
- Lawyers who negotiate loans incidental to the general practice of law
- Landlords who make loans secured by leasehold improvements.

Lenders who use only their own funds and have not made more than 4 loans in the previous 12 months are not mortgage bankers but are not excluded from being mortgage brokers. Sec. 224.71(3)(b) and (c), Stats.

The definitions of “loan originator,” “mortgage banker” and “mortgage broker” each refer to those entities as a “person.” “Person” is not defined in subchapter III. The exclusions of the definitions speak in both terms of corporations (excluding, for example, certain banks and other business entities) and individuals (excluding employees of business entities.) An argument therefore could be made that for covered individuals, “mortgage brokers” would include both the business entity and any individual employees, especially considering that registrations may be issued to a “person,” including a partnership, corporation, or Limited Liability Company. Sec. 224.72(2), Stats.

Unlike many other consumer-protection laws, there is no limitation on the type of mortgage loans which can subject a person to regulation. Covered individuals are those whose practices involve a “loan,” and a “loan” is any loan secured by a lien or mortgage or equivalent security interest on real property. Companies which deal primarily in loans to businesses or for business purposes could be subject to regulation under Chapter 224 as a result of that broad definition.

Duties under Chapter 224

Subchapter III imposes a number of affirmative duties on regulated persons.

Applications and Registrations.

All loan originators, mortgage bankers, and mortgage brokers must be registered. Registration is open to individuals or business entities, and has a lengthy list of requirements.

Applications submitted by **loan originators** must state who will employ the originator, and must include a criminal background check. To renew their registrations, originators must complete 16 hours of approved continuing education in the 2 years preceding renewal.

Mortgage banker applications for bankers who maintain an office in Wisconsin must show either show proof of federal approval of their activities or proof that they have at least $25,000 to satisfy claims (which can be done by filing a bond or showing the person's net worth is $25,000 or more). If a mortgage banker does not have a *bona fide* office in Wisconsin, it must file a bond and provide evidence of a net worth exceeding $25,000.

Mortgage broker applicants with in-state offices must show net worth or a bond of $10,000. Mortgage broker applicants without *bona fide* Wisconsin offices must file a bond in the amount of $120,000 and show a minimum net worth of $250,000.

Supervision and Recordkeeping.

Loan originators are limited to working for only one mortgage bankers or mortgage broker at a time. The banker or broker they work for is responsible for supervising their activities. Sec. 224.73, Stats.

The laws impose significant recordkeeping requirements. Mortgage bankers and brokers must keep records showing all fees that were charged to applicants or mortgagors and the disposition of those fees. Bankers and brokers must also retain all documents shown to or signed by a loan applicant, including:

- The completed loan application
- The loan commitment
- The TILA disclosures
- The loan closing statement
- A copy of the note.
- The appraisal report
- The credit report
- (If the application was rejected) a copy of the rejection letter
- All other correspondence related to the loan if the banker services the loan.

- Records showing the fees charged to applicants or mortgagors, and the application or disposition of those fees.
- Records showing, for each mortgage loan application:
    - The date of application.
    - Name of applicant
    - Address of property involved,
    - Disposition of application, with reasons, and
    - The type of loan.
- Deposit receipts, canceled checks, trust account records, and "other relevant documents or correspondence received or prepared" by the banker or broker.

See Secs. 224.75(1)(a)-(c).

The record must be kept a minimum of 25 months from the closing date, or the application date if the application is denied, or the date the loan is paid in full if the mortgage banker services the loan 224.75(2).

In addition, mortgage bankers and brokers must submit annual reports and audits of their operations. They must maintain a trust account for funds they receive other than their own nonrefundable fees. Sec. 224.76.

Mortgage brokers face an additional requirement: all contracts they enter into with consumers must be in writing on an approved form (the form is available for download from the DFI website.) Before signing the form, the broker must provide the consumer with a disclosure statement and get the consumer to initial or sign that statement. (A copy of the form is provided at the end of this section.)

Violations and penalties:

Violations of Subchapter III can be punishable as a crime, can be regulated by administrative action, and can be the subject of civil suits.

As an initial matter, it is a violation of subchapter III if the originator, banker, or broker failed violated any provision of subchapter III, or violates any provision of Chapter 138 (relating to banking and licensing), or violated any federal or state statute, rule, or regulation "which statute, rule or regulation relates to practice as a mortgage banker, loan originator or mortgage broker." Sec. 224.77(1)(k), Stats. This is a significant statute because it subjects regulated individuals to steep penalties if they violate even the most technical of statutes; and because it provides remedies for violations of federal and state laws that might not otherwise themselves impose a penalty. For example, the Real Estate Settlement Procedures Act [RESPA] imposes duties such as providing informational booklets, but there is no penalty set forth for failing to comply. See 12 USC secs. 2604(c) and (d). RESPA applies to residential loans, and if a court were to determine that RESPA is a “statute” which relates to practice as a mortgage broker, Chapter 224 would provide a penalty for that failure.

In addition to the imposing list of requirements on covered individuals, Subchapter III of Chapter 224 also contains numerous other potential violations.

Statutory violations of Chapter 224 include any situation in which the loan originator, mortgage broker, or mortgage banker:

(a) Made a substantial misrepresentation in the course of practice injurious to one or more of the parties to a transaction.
(b) Made a false promise that influences, persuades or induces a client to act to his or her injury or damage.
(c) Pursued a continued and flagrant course of misrepresentation, or made false promises, whether directly or through agents or advertising.
(d) Acted for more than one party in a transaction without the knowledge and consent of all parties on whose behalf the mortgage banker, loan originator or mortgage broker is acting
(e) Accepted a commission, money or other thing of value for performing an act as a loan originator unless the payment is from a mortgage banker or mortgage broker who is registered under *s. 224.72 (3)* as employing the loan originator.
(f) Failed, within a reasonable time, to account for or remit any moneys coming into the mortgage banker’s, loan originator’s or mortgage broker’s possession which belong to another person
(g) Acted in a discriminatory manner in their practice.
(h) Failed to notify the division that the mortgage banker’s or mortgage broker’s net worth fell below the minimum amount required.

That list is not exhaustive; see the full statutes for the entire list. There are three provisions that deserve to be singled out, though, because they expand the list of potential violations well beyond those enumerated in the statutes and make clear that the statutory listed items are only examples and not the limit of potential violations.

These “catch-all” violations make it illegal, under subchapter III, for originators, bankers, and brokers to:

- demonstrate a lack of competency to act as a mortgage banker, loan originator or mortgage broker in a way which safeguards the interests of the public, or

- engage in conduct which violates a standard of professional behavior which, through professional experience, has become established for mortgage bankers, loan originators or mortgage brokers, or
- engage in conduct, whether of the same or a different character than specified elsewhere in section 224.77, which constitutes improper, fraudulent or dishonest dealing.

Those specific provisions expand the universe of violations to any activity which can be shown to potentially harm the public, or go contrary to the usual professional practices of originators, bankers, or brokers.

The DFI has further provided examples of what constitutes "incompetency," and makes clear in its regulation of that issue that the listed items are examples only. Examples of incompetency which can lead to civil penalties include failing to act "promptly" on applications or to tell people their loans have been approved or disapproved, failing to ensure that all promises and agreements are in writing, failing to notify the regulators of the conviction of *any* crime, and failing to maintain the net worth or bonding requirements.

The DFI took over 70 administrative actions against mortgage brokers, mortgage bankers and loan originators in 2007 alone. The majority of those were revocations of licenses for failure to maintain required bonds or net worth.

There are, comparatively, relatively few civil suits, and even fewer appellate suits, which is surprising given the number of mortgage brokers regulated by the DFI and the damages and fees available. A civil suit is available to any person who is "aggrieved by an act" committed by a covered individual. "Aggrieved" is not defined in subchapter III. The term differs from that used to describe who may sue under other statutes imposing liability. (For example, persons must be "injured" by illegal debt collection activities to sue, sec. 427.105, Stats., while a person must suffer "damage or loss" to claim treble damages under section 895.446, Stats.) That difference suggests that the violation need not cause "damages" to be actionable. In other contexts, a person is "aggrieved" if their legal rights are affected, even if they have not yet been harmed. See, e.g., *Fedders v. American Family Mut. Ins. Co.,* 230 Wis.2d 577, 601 N.W.2d 861 (Ct. App. 1999).

That possibility is supported also by the penalties available. Subchapter III offers the opportunity to collect the greater of statutory damages, or the actual damages caused.

Statutory damages are not less than $100 and not more than $2,000; so an action is possible even though no damages were caused the 'aggrieved' person. Winning claimants are awarded their reasonable costs and attorney's fees. Sec. 224.80(2)(b), Stats.

One intriguing note is that statutory damages are for “each violation,” suggesting that where there are multiple violations, an “aggrieved” person could collect multiple statutory penalties.

Violations of these statutes do not necessarily result in voiding transactions. *See Felland v. Sauey*, 2001 WI App 257, 248 Wis.2d 963, 637 N.W.2d 403 (Failure to have contract in writing did not void agreement with loan originator.)

Also, the fact that an originator, broker, or banker may not have registered as such with Wisconsin does not necessarily prevent that broker or banker from foreclosing. In *McDonnell v. Von Feldt*, 1999 WL 970973 (Unpublished, 231 Wis.2d 239), the Court of Appeals determined that a mortgagee could bring an action to foreclose a mortgage because chapter 224 prohibits unregistered litigants from “collecting a commission, money or other things of value,” but does not prohibit “a foreclosure action to recover on the secured debt.” It appears that in *McDonnell* the parties did not dispute that the mortgagor was a “mortgage banker.” The Court of Appeals did not explain why the “secured debt” is not a “thing[] of value.” The entire discussion of the application of the mortgage banker statutes is limited to one paragraph.

<u>Practice Tips</u>

In analyzing any claim involving a real estate mortgage, attention should be paid to whether the person or business involved *could be* deemed a loan originator, mortgage broker, or mortgage banker, even if they do not call themselves that or have a registration. Merely because a business or person is not registered does not mean that they would not qualify as a “mortgage broker,” “mortgage banker,” or “loan originator.” In some administrative actions, the DFI penalized businesses or individuals for actions which fell within the scope of the regulation. Finding a defendant acting as an unregistered or unlicensed broker or banker could entitle your client to up to $2,000 in statutory penalties, which could be used to offset damages or as an affirmative claim. In addition, an unlicensed broker or banker may also have violated other provisions, providing the possibility for greater damages.

If the mortgage documents are unusual, or complicated, or otherwise raise concerns, investigation should be done into whether the mortgage broker or banker gave adequate disclosures to the mortgagors and whether the mortgagors fully understood the risks and limitations of the loans they were entering into. Since it is a violation of the law for registrants to engage in “conduct which constitutes improper… dealing,” a claim could be made that advising people to enter into risky loans they do not understand is “improper,” especially if you can establish also that the usual standard of professional behavior for mortgage brokers would not allow such advice.

If the loan was not one that the mortgagors should have entered into or with which they could not have complied, then "actual damages" could potentially include all of the moneys paid under the loan.

Discovery in these cases should be far-reaching; it should request proof of compliance with all document retention requirements, as well as proof of compliance with administrative requirements such as continuing education, trust account maintenance, and audits. Because of the net worth requirements and required disclosure of any criminal convictions, discovery can include seeking the audit materials and tax documents for the defendants or registrants, and can also ask them to reveal any criminal convictions. Discovery could also invade potentially embarrassing or private matters; the DFI restricts the ability of registrants to perform services when impaired by "mental or emotional disorder, drugs, or alcohol," so discovery of medical records during the relevant time period may be allowed to determine if a mental, emotional, or physical condition might have impaired the competence of the registrant.

Beyond discovery, a lawyer should look to the DFI for materials that can help prove violations or establish standards. The DFI maintains a comprehensive (if hard-to-navigate) website that provides not only the required forms, but articles relating to mortgage topics and administrative orders issued.

Recent articles include a "Statement on Subprime Mortgage Lending" in which the DFI adopts standards to protect borrowers from the adverse consequences of risky loans and sets up standards for determining which loans are risky, and the "Guidance on Nontraditional Mortgage Product Risks," adopted to "address risks associated with the growing use of mortgage products that allow borrowers to defer payment of principal and sometimes interest." Such documents set up standards to follow when analyzing whether a loan should be made. Use of these documents can help establish standards of behavior and conduct and also determine what might be an improper or incompetent activity; such documents can also be used to determine if the banker or broker involved actually is competent to engage in his or her profession. If the banker or broker is unfamiliar with the standards prescribed by the DFI, that could be used to show a lack of competence. These articles can be found at: http://www.wdfi.org/fi/mortbank/**.**

Administrative orders issued are valuable both to help determine if in the past a given registrant has been sanctioned, and to determine what type of conduct has been found by the DFI to violate the statutes and regulations. The administrative orders can be found at http://www.wdfi.org/newsroom/admin_orders/mb_default.htm**.**

And you can search to see if a particular person or business has been or is licensed at http://www.wdfi.org/fi/mortbank/view.htm.