No. 32611 – *Rita K. Herrod and Jennifer A. Herrod v. First Republic Mortgage Corporation, Inc., dba First Security Mortgage Corporation, a corporation; Washtenaw Mortgage Company, a corporation; Chase Manhattan Mortgage Corporation, a corporation; Earl Young; Craddocks Last Stand, Inc., a corporation; Darleen Westfall; West Virginia Real Estate Appraiser Licensing and Certification Board; and Federal National Mortgage Association*

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OF WEST VIRGINIA

Starcher, J., concurring:

In the instant case, the majority has properly reversed the circuit court's grant of summary judgment to the defendant lender, and I concur in that judgment. Given the significance of the issues involved in the instant case to many West Virginia homeowners, I write separately to further address those issues.

The instant case involves a practice that is defined by the federal government as "predatory lending." *See* HUD-Treasury National Predatory Lending Task Force, Joint Report: "Curbing Predatory Home Mortgage Lending" (2000). According to this report, predatory lending involves providing a borrower a loan with limited or no benefit, often characterized by high fees, that erodes the borrower's equity through (1) deception or fraud, (2) manipulating the borrower through aggressive sale tactics, or (3) taking unfair advantage of a borrower's lack of understanding of loan terms.

As Justice Maynard explained in *Toppings v. Meritch Mtg. Servs., Inc.*, 212 W. Va. 73, 74, 569 S.E.2d 149, 150 (2002) (Maynard, J. concurring):

> Subprime lenders loan to those borrowers with past credit

> problems or low income at a higher cost than conventional mortgage loans. . . . The transformation from subprime lending to predatory lending occurs when lenders employ unethical and/or illegal tactics to secure the loans or offer subprime loans to those who qualify for prime loans.

The instant predatory lending case involves a broker, an appraiser, a lender, and at least two assignees. Washtenaw Mortgage Corp. ("Washtenaw") was the original lender in the transaction. The note and the deed of trust both bear Washtenaw's name. Washtenaw, which provided the money for the transaction, set the guidelines for the loan, set the requirements for funding the loan, and otherwise directed the activities of the broker. Washtenaw controlled the loan origination in order to protect its investment of upwards of $100,000.00. The evidence of this control is abundant in the record.

The loan officer for the broker, First Security Mortgage Corporation ("First Security"), testified that Washtenaw gave First Security rate sheets and underwriting criteria to make loans on its behalf. Plaintiff's expert also noted that Washtenaw had provided First Security software to facilitate the origination of loans. First Security was making representations to the Herrods about the loan that they would get with Washtenaw.

Conversely, Washtenaw had no employees in West Virginia. Therefore it relied solely on the broker to communicate the terms of the loan to borrowers here. The record demonstrates that this relationship between First Security, Washtenaw, and the funder of the loan, Federal National Mortgage Association ("Fannie Mae"), was not sporadic. Ninety percent of Fannie Mae loans brokered by First Security were originated through Washtenaw.

After Washtenaw originated the loan pursuant to an agreement with Fannie Mae, it assigned the note and deed of trust to Fannie Mae. The record demonstrates that Washtenaw made the loan with the intention of assigning it to Fannie Mae. The loan officer for First Security testified that he recognized the loan was a "Fannie Mae loan" even before it had ever been assigned to Fannie Mae. This scenario, wherein loans are originated by brokers at the direction of another lender and then sold shortly afterward, is a common scenario – known as "securitization" in the home loan market.

Securitization ostensibly provides a source of capital so that more home loans are available to borrowers. However, the series of corporate and banking transactions that make up securitization cannot be permitted to avoid liability by those who are actually providing the funding – and often controlling the transaction. *See* Kurt Eggert, *Held up in Due Course: Predatory Lending, Securitization, and the Holder in Due Course Doctrine*, 35 Creighton L. Rev. 503 (2002).

The partial dissent argues that the Herrods should not be able to pursue their unconscionability claim against Washtenaw because the Herrods presented no evidence that Washtenaw employees unconscionably induced the Herrods into the contract. However, the *West Virginia Consumer Credit and Protection Act* provides that a loan or any portion thereof may be voided if a court concludes that the loan was induced by unconscionable conduct *or* the loan contains unconscionable terms:

> With respect to a transaction which is or gives rise to a consumer credit sale, consumer lease or consumer loan, if the court as a matter of law finds:

> (a) The agreement or transaction to have been unconscionable at the time it was made, or to have been induced by unconscionable conduct, the court may refuse to enforce the agreement, or
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> (b) Any term or part of the agreement or transaction to have been unconscionable at the time it was made, the court may refuse to enforce the agreement, or may enforce the remainder of the agreement without the unconscionable term or part, or may so limit the application of any unconscionable term or part as to avoid any unconscionable result.

W. Va. Code, 46A-2-121(1).

In order to obtain equitable relief under this statute, it is not necessary that the Herrods establish that in addition to unconscionable terms or inducement, *Washtenaw itself* must have engaged in affirmative acts to unconscionably induce the loan. Though the affirmative acts of a participant are relevant to the measure of additional damages recoverable from a particular party, *W. Va. Code*, 46A-5-101(1), the identity of the party or parties who entered into an unconscionable agreement is not a determining fact for entitlement to equitable relief.

Additionally, it is apparent from the record, that with respect to the Herrods' unconscionability claim, Washtenaw is not without blame. Among other things, the Herrods claim the fees in the loan were unconscionable. Washtenaw was a signatory to the contract and clearly was aware that the fees (1) were on their face excessive; (2) rendered the loan a high cost loan under federal law; and (3) violated its agreement not to originate loans for assignment to Fannie Mae that contained more than 5% in fees.

As the majority correctly concludes, there was substantial evidence already in the record, and the Herrrods were entitled to an opportunity to present that evidence in support of their unconscionability claim. Indeed, in contrast to virtually all other types of claims, the statute mandates an opportunity to fully present evidence. *See W. Va. Code*, 46A-2-121(2).

The circuit court found that summary judgment was appropriate in favor of Washtenaw on the illegal mortgage solicitation claim under the Credit Services Organization Act, on the basis that the broker did not collect a fee prior to the extension of credit. The majority concludes, correctly, that there is nothing in section 46A-6C-1 *et seq.* that requires lenders to comply with the CSO provisions of the Act.

However, the trial court went further, and suggested that not even First Security was required to comply with the CSO provisions. This Court's holding simply states that lenders are not bound by the CSO provisions of the *West Virginia Consumer Credit and Protection Act*. *Accord*, *Brown v. MortgageStar, Inc.*, 194 F. Supp. 2d 473, 476 (S.D.W. Va. 2002) (lenders are exempt).

This Court's holding should not be misinterpreted to suggest that brokers, who have heretofore been bound by the CSO provisions, are not covered by the Act. *See Arnold v. United Companies Lending Corp.*, 204 W.Va. 229, 238, 511 S.E.2d 854, 863 (1998). There is nothing in the language of the statute that exempts brokers. Section 31-17-8(k) simply states that brokers cannot accept a fee until they have complied with the CSO provisions. It does not say that *only* when fees are paid prior to closing are brokers subject to the Act.

Furthermore, it is axiomatic that to be bound for payment of broker fees for services rendered, borrowers must have signed and received a written contract that provides the nature of the services to be provided and the cost of the services. *See generally W.Va. Code*, 46-2-201. In the instant case, the broker obtained over $10,000.00 in fees. Borrowers certainly have a right to a written contract when deciding whether to purchase such services; and if they do, to receive a copy of the written agreement for services costing them over $10,000.00.

In discussing the question of fraud and misrepresentation, the dissenting and the circuit court focused on an asserted lack of direct evidence of any direct misrepresentations by Washtenaw. This case, however, concerns whether Washtenaw can use brokers who do engage in fraud, suppressions, and misrepresentations to induce borrowers into predatory loans – and then enforce the predatory loans against the borrowers.

There appears to be some confusion in the dissent and the circuit court's opinions between the concepts of fraudulent misrepresentation as a defense to contract, and the concept of fraud as a tort. The Restatement (Second) of Contracts notes the difference between fraud as a contractual defense and fraud as a tort:

> A misrepresentation is an assertion that is not in accord with the facts. Concealment, and in some cases non-disclosure of a fact are equivalent to such an assertion. A misrepresentation may have three distinct effects under the rules stated in this Chapter. First, in rare cases, it may prevent the formation of any contract at all. Second, it may make a contract voidable. Third, it may be the grounds for a decree reforming the contract. In the

> case of non-disclosure by a fiduciary, making a contract with his beneficiary, these rules are supplemented by the rule stated in § 173.
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> *A misrepresentation may also be the basis for an affirmative claim for liability for misrepresentation under the law of torts*. Such liability for misrepresentation is dealt with in the Restatement, Second, Torts. See Restatement, Torts chs. 22, 23. The rules stated there conform generally to those stated here. However, because tort law imposes liability in damages for misrepresentation, while contract law does not, the requirements imposed by contract law are in some instances less stringent. Notable, under tort law a misrepresentation does not give rise to liability for fraudulent misrepresentation unless it is both fraudulent and material, while under contract law a misrepresentation may make a contract voidable if it is either fraudulent or material.

Restatement (Second) Contracts ch. 7, Introductory Note (1981) (citations omitted) (emphasis added).

The question of whether a party was fraudulently induced into a contract may go to the formation of the contract. A party that is misled as to the essential terms of a contract does not technically agree to the contract, as no assent to its terms has been formulated due to the misrepresentation. In this situation, it is irrelevant whether the misrepresentation was made by the other party to the contract or a third person. *See* Restatement (Second) Contracts § 163 (1981) ("It is immaterial under the rule stated in this Section whether the misrepresentation is made by a party to the transaction or by a third person.").

If a misrepresentation does not prevent a party from assenting to the contract, the misrepresentation, whether it be fraudulent or material, may render the contract merely voidable. *See* Restatement (Second) Contracts 164 (1981). A misrepresentation by a third party may render the contract voidable. *See id.* 164(2).

Article 3 of the Uniform Commercial Code governs the claims and defenses a party may make arising out of negotiable instruments. The UCC provides that the right to enforce an obligation arising out of a negotiable instrument is subject to "[a] claim in recoupment of the obligor against the original payee of the instrument if the claim *arose from the transaction that gave rise to the instrument*; but the claim of the obligor may be asserted against a transferee of the instrument only to reduce the amount owing on the instrument at the time the action is brought." *W.Va. Code*, 46-3-305 (emphasis added). Under this provision, it is clear that any claim an obligor may have arising out of the transaction may be asserted defensively against the original payee in the transaction in an action for recoupment.

To the extent that borrowers are defrauded, as a matter of contract law, they have defenses against the holder of the obligation in an action for recoupment.[1] There is no basis for Washtenaw to wipe out the Herrods' contractual defense of fraud, regardless of whether the fraud was directly induced by a third person.

A securitization model – a system wherein parties that provide the money for loans and drive the entire origination process from afar and behind the scenes – does nothing

[1]Since a lender in this state may foreclose on property without a judicial proceeding, *see W.Va. Code* 38-8-1 *et seq.*, a borrower who wants to avoid foreclosure and seek other relief must initiate a new civil action.

to abolish the basic right of a borrower to assert a defense to the enforcement of a fraudulent loan, regardless of whether it was induced by another party involved in the origination of the loan transaction, be it a broker, appraiser, closing agent, or another.

Thus, the Herrods may assert these equitable claims in recoupment. Moreover to the extent the Herrods can prove that Washtenaw was engaged in a joint venture, agency, or conspiracy with the broker and/or appraiser, they may pursue their actual and punitive damages under tort theories. *See Muzelak v. King Chevrolet*, 179 W.Va. 340, 345, 368 S.E.2d 710, 715 (1988); Restatement (Second) Contracts, ch. 7, Introductory Note (1981).

In this case, the Herrods presented substantial evidence that they were fraudulently induced into the loan. The evidence, taken in a light most favorable to the Herrods, tended to show the broker and the appraiser had an arrangement – arguably a conspiracy – to provide inflated appraisals to justify predatory loans. The evidence of this scheme was sufficient enough for the circuit court to deny summary judgment to the appraiser.[2] While the Herrods have produced no evidence to hold Washtenaw directly liable for fraud as a tort, they nonetheless have the ability to maintain an action for recoupment for fraudulent misrepresentation in contract, and for damages in joint venture, conspiracy, or agency, as explained by the Opinion of the Court.

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[2]The broker, First Security, abandoned its defense during the litigation and apparently was facing a default judgment when summary judgment was entered for Washtenaw. The Appellants claim that several of the issues for which Washtenaw received summary judgment were actually claims exclusive to the broker. This Court apparently did not consider the legitimacy of any claims that were asserted only against the broker, who was not a party to this appeal.

The Herrods also allege the broker engaged in unfair and deceptive acts or practices in the origination of the loan in violation of *W.Va. Code*, 46A-6-101 *et seq.* These claims were made against the broker, not the lender. To be sure, the UDAP provisions do not apply to lending activities, but only apply to the sale of services – in this case, broker services. *See W.Va. Code*, 46A-6-102(d). I agree with the majority that the Herrods asserted no claims for unfair and deceptive acts or practices against Washtenaw. This Court has not passed on the Herrods' UDAP claims, to the extent they may be asserted against the broker in connection with the sale of broker services.

The Opinion of the Court also affirms the right of the Herrods to pursue liability against Washtenaw for any wrongdoing that they are able to prove against the broker.

Though direct claims for fraud, failure to provide a proper broker agreement, and UDAP were properly dismissed, actual and punitive damages may nevertheless be pursued against the lender. Participation in a joint venture with a broker or other party in a predatory lending context gives rise to liability for such claims under a claim of joint venture. *See Short v. Wells Fargo Bank Minnesota, N.A.*, ___ F. Supp. 2d ___, *available in* 2005 WL 3091873, at 14-15 (S.D.W.Va. Nov. 18, 2005); *see also generally Armor v. Lantz*, 207 W. Va. 672, 677-78, 535 S.E.2d 737, 742-43 (2000); *Simple v. Starr*, 205 W.Va. 717, 725, 520 S.E.2d 884, 892 (1999); *Price v. Halstead*, 177 W.Va. 592, 594, 355 S.E.2d 380, 384 (1987).

Similarly, if one party is directing or exercising control over loan origination in the circumstance of securitized lending, it is a factual question as to whether there is a principal/agency relationship sufficient to impose such liability on all the participants. *See Short v. Wells Fargo Bank Minnesota, N.A., supra*, 2005 WL 3091873, at 14-15; *England v. MG Investments, Inc.*, 93 F. Supp. 2d 718, 723 (S.D.W.Va. 2000); *Arnold*, 204 W.Va. at 240, 511 S.E.2d at 865.

The dissent contends that the Herrods presented no more than a scintilla of evidence in support of their claims for joint venture, agency, and conspiracy. While the Opinion of the Court states that the evidence presented by the Herrods was inferential, this by no means suggests that the evidence was not sufficient for a jury to find there was a relationship between Washtenaw and the broker. This Court has previously held "'[p]roof of an express contract of agency is not essential to the establishment of the relation. *It may be inferred from facts and circumstances,* including conduct.'" *Arnold*, 204 W.Va. at 239, 511 S.E.2d at 864 (quoting *General Elec. Credit Corp. v. Fields*, 148 W.Va. 176, 181, 133 S.E.2d 780, 783 (1963)) (emphasis added).

Indeed, it would defy common sense to suggest that there was no relationship between the broker and the lender in this case. Washtenaw had no employees in this State. Its only ability to communicate with the Herrods was through the broker. The loan broker testified and the Herrods' expert explained that Washtenaw provided First Security with rate sheets, underwriting criteria, and software to facilitate the broker's origination of loans for Washtenaw. Washtenaw directed the broker in all aspects of the loan. It would be surprising if Washtenaw did not control all details of the origination of the loan considering

Washtenaw's considerable investment.

And finally, there was evidently an agreement to share in the profits in the loan. In addition to significant up-front fees that presumably would not be paid if the loan were not closed, Washtenaw paid First Security a yield spread premium, which was tied directly to the rate the broker persuaded the Herrods to take. While all this evidence may be termed as "inferential," it certainly was more than a "scintilla." On the other hand, the only evidence presented in contradiction of the Herrods' evidence was that First Security had a broker relationship with other lenders. At the very least there exists a fact issue for the jury on the Herrods' joint venture, agency, and conspiracy claims.

Accordingly, I concur.