68427-2

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No. 68427-2

IN THE COURT OF APPEALS
OF THE STATE OF WASHINGTON
DIVISION I

FINANCIAL CAPITAL, INC.,

Appellants,

v.

REMAX MUTUAL REALTY, INC., a Washington corporation,
ARNOLD CARLO DELIZO and JANE DOE DELIZO,
husband and wife, and ESCROW SOURCE, INC.

Respondents.

**OPENING BRIEF OF APPELLANT**

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## MISCELLANEOUS

## I. INTRODUCTION

Residential lending "occupancy fraud" is a too common illegal means of borrowing residential real estate purchase money for business purposes, with favorable down payment requirements, favorable interest rates, and favorable terms of payment. Occupancy fraud arises when residential real estate purchasers falsely state to lenders they are intending to live in the financed home as their primary residence, but in fact intend to buy the home for a business enterprise such as using the home as a rental property, operate a business out of the home (but not live in it), or to buy, fix up and sell as an investment. Occupancy fraud is a species of bank fraud.[1]

The Occupancy fraud at issue before this Court was a scheme among the buyers and their broker, and the sellers' broker, to purchase an adult family care home and business. The proceeds of an owner occupied home loan procured from Appellant Financial Capital, Inc. ("FCI") would pay for the real property and business assets. Receiving a residential loan under false pretenses would provide the buyers with

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[1] *See*, Lefcoe, George, *Should We Ban or Welcome "Spec" Home Buyers*, 36 J. Legis. 1 (2010) at Page 3 of copy in Appendix.

more favorable residential mortgage interest rates and low or no down payment requirements, then common in residential real estate lending in 2006.

The focus for this Court's inquiry is, given statutory, contractual and fiduciary obligations owed to FCI, whether there are material questions of fact in dispute regarding Appellee Escrow Source, Inc.'s ("Escrow Source") failure to disclose to FCI its payment of $109,482 of residential loan proceeds out of escrow to a third party for a "business sale," as required by FCI's escrow instructions.

At the very least FCI's escrow instructions and Washington law required this payment to have been recorded on the HUD-1 form provided by Escrow Source to FCI, just prior to the closing and disbursing the loan proceeds. Had FCI known that $109,482 was to be paid to a third party for the "business sale", it could not have legally loaned the money, and would have stopped the transaction, and not suffered $620,000 in losses.

## II. ASSIGNMENT OF ERROR

Whether the trial court erred by granting summary judgment and denying the resulting Motion for Reconsideration in favor of Escrow

Source on its lack of duty arguments, when the facts establish, at least inferentially, Escrow Source violated its statutory, contractual and fiduciary duties to FCI, leading to its substantial financial loss.

## III. STATEMENT OF THE CASE

### A. Factual Background.

The parties to this supposedly owner occupied residential loan transaction were the buyers Virgil and Divina Andres, their realtor Armando Moya and his Principal Fireside Homes Inc. The disclosed seller of the real property was Corazon Soriano. Ms. Grace Vallasin was the undisclosed recipient of $109,482 of loan proceeds. CP 515. Ms. Soriano's realtor was Arnold Carlo DeLizo and his principal was Remax Mutual Realty, Inc. The appraiser was Bruce Wolverton. Escrow Source was the Escrow agent requested by Mr. Moya. FCI was a mortgage bank with a Bellevue, Washington office.[2]

In the fall of 2006, Armando Moya requested that FCI lend the purchase monies for a residential mortgage transaction, in which Virgil Andres and Divina Andres (collectively the "Andres") were to purchase residential real property in Edmonds, Washington in which to live as

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[2] FCI has not done business since 2008 and is in liquidation. CP 251 – 255.

their primary residence. In reality the property contained an adult family care business. Armando Moya, and the Andres sought funding for this business purchase via conventional residential financing.

Arnold Delizo of Remax Mutual Reality was the real estate agent for the seller of the real property, Corazon Soriano. Unbeknownst to FCI her daughter Mary Grace Villasin, was the owner and operator of the adult family care business on the property. CP 97. Originally, Mr. Delizo prepared listings for both the business and the home separately. *Id.* CP 98; 100.[3] Ms. Soriano and Ms. Villasin had a number of offers for the property and business, but ended up selling to the Andres and Mr. Moya.

The buyers and sellers, and their realtors knew that purchasers would be using some of the loan proceeds to purchase the business. CP 760. The Andres applied for purchase money for an owner-occupied residential property, as they would pay a lower interest rate and not have to pay a down payment. They represented to the FCI that the property was to be owner occupied. CP 116.[4]

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[3] Deposition pp. 11:12 – 11:15; 18:9 – 18:12.
[4] Deposition pp. 50:13 – 50:15.

The residential purchase and sale and business purchase and sale documents were prepared by the realtors and executed by the buyers and sellers. CP 162 – 183. That set of documents was received from Mr. Delizo and Remax, pursuant to subpoena. Importantly the business purchase and sale documents were never disclosed to FCI. CP 111 – 112; 130 – 160.[5] Only the property (but not the Business) purchase and sale documents were presented to the lender, to support the loan.[6] CP 185 – 200. *Id.* The "Addendum to Purchase and Sale Agreement" at CP 171, was not included in the purchase and sale documents forwarded to FCI. Compare CP 185 – 200 with CP 162 -183.

While the documents presented to FCI made no mention of the business transaction, the seller's escrow instructions, prepared by Mr. Delizo a few days before Escrow Source closed the transaction, directed Escrow Source to disburse loan proceeds of $109,482 to Ms. Villasin, the owner of the adult care business, for "the business sale." CP 205. Mr. Delizo and Ms. Pratt concluded now Escrow Source would split the closing costs equally between Ms. Soriano and

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[5] Deposition pp. 41:21 – 42:11.

[6] At this point there is no evidence that the realtors delivered business purchase and sale documents to Escrow Source either.

Ms. Villasin. CP 224 - 225. Escrow Source received these instructions, and Escrow Source's closer, Julee Pratt, emailed the selling agent with questions regarding the split of closing fees between the two women. CP 219; 224 – 225. Escrow Source knew, or at a minimum had information which put it on notice, that the loan funds would pay for Ms. Villasin's sale of a business.

However, Julee Pratt, the Escrow Source closing agent, never informed FCI of this third party payment and escrow costs split with Ms. Villasin, nor did she provide FCI with a copy of the seller's escrow instructions referencing the business transaction. She admitted in deposition that if she becomes aware of a transaction that relates to the proceeds of a home loan, but is outside the transaction that she is closing, she is required to take a closer look and make sure that it conforms to the contract. CP 214. She understood that she is obligated, as a fiduciary, to notify the lender if she is made aware of a contemporaneous transaction in which the loan funds are going to a third party. CP 215. She also understood that at the very least she should inquire as to the circumstances, and potentially stop the transaction depending on the outcome of her inquiry. CP 220.

Ms. Pratt testified that she has no specific recollection of this particular transaction. However, on her review of her file before her deposition, she noted that there were documents discussing the title reference to the adult family home business on the premises, and based on this she agreed that at the time she was working on this transaction, she would have known that this information was there. CP 218; 222.

FCI and its warehouse lender issued escrow instructions which prohibited contemporaneous transactions related to the property. CP 495 - 497. Furthermore, FCI's escrow instructions informed Escrow Source that the title report referenced a home care business had been on the premises, and that FCI would not fund the transaction unless that use was removed from the title. CP 719.[7] FCI also specifically instructed Escrow Source that it must provide documentation that this use was removed from the title. CP 222. FCI could not and would not have lent the money if the purpose of the loan was to buy a business rather than for use solely as a primary residence. CP 227-228.[8]

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[7] Paragraph 2 thereof.
[8] Page 116 of deposition.

Ms. Lucinda Vergason, one of the owners of Escrow Source, testified that the escrow officer is obligated to follow the escrow instructions exactly. CP 231 & 232.[9] She agreed that Escrow Source could not close a transaction involving a business, CP 233[10]. and acknowledged that whether or not disclosure to the lender is required depends on what the closer knew. CP 234.[11] Here, the escrow instructions from FCI required the Escrow Source to disclose all disbursements on the HUD-1 and not to close if there was another, concurrent transaction that was part of the closing[12]. CP 205.

The specific closing instructions from FCI required that the final HUD-1 Settlement Statement be completed at settlement "... and must accurately reflect all receipts and disbursements indicated in these closing instructions and any amended closing instruction subsequent hereto." Additional closing instructions required by FCI's warehouse lender set forth the following clear language "...the Settlement Statement shows the party to whom each line item to be disbursed. The

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[9] Pages 19 and 24 thereof.
[10] Page 26 thereof.
[11] Page 34 thereof.
[12] This conforms with WAC § 208-680D - 040(8)(C).

fees and charges are fully and accurately shown on the Settlement Statement." CP 41-44. Thus on the face of it the failure to have included a reference to the $109,000 disbursement to Ms. Villasin violated these closing instructions from FCI.

To summarize, these facts are established:

1. The seller's escrow instructions specified that a portion of the loan proceeds be paid out "for the business sale" to Mary Grace Villasin;

2. The seller's escrow instructions specified that Mary Grace Villasin would pay half of the closing costs;

3. An adult home care business was (at least previously) housed on the premises;

4. FCI would not close the transaction if it involved the adult home care business;

5. That Escrow Source was to deliver $109,482 to Ms. Vallasin for the "business sale";

6. Just prior to closing Escrow Source provided a draft of the HUD-1 Closing Statement to FCI. It did not include a disbursement of $109,482 to Ms. Vallasin;

7. Escrow Source was not to close if there was a contemporaneous transaction relating to the property; and

8. Escrow Source failed to record the $109,482 disbursement on the HUD-1.

In reliance on the parties' representations made in the residential loan applications and closing documents and unaware of the business component of the transaction, FCI forwarded $620,000 to Escrow Source to fund the Andres' purchase of the Property. The Andres then defaulted on their first payment, leading to FCI's obligation to pay back the monies to the wholesale lender and a resulting loss to FCI from Escrow Source's negligence in excess of $620,000 plus interest and attorney fees and costs. See, CP 251 – 255.

**Procedural Background.**

FCI initiated a suit in the Snohomish County Superior Court on March 21, 2008. Initially, plaintiffs sued Realtor Fireside Homes and its agent Armando Moya and the Appraiser Bruce Wolverton for negligence, fraud and Consumer Protection Act violations. The initial claims asserted a conspiracy to induce FCI to lend more than the property was worth so that the buyers and the realtor could purchase the property for business use. CP 1206 – 1213.

Thereafter, discovery produced from the Remax Mutual Realty and its broker, showed that Escrow Source Inc. paid $109,482 to the seller's daughter, Mary Grace Villasin, the apparent owner of the adult family care business in the real property.

In due course, FCI foreclosed on the real property, settled its claims against the appraiser, Armando Moya and Fireside Homes. More recently, FCI resolved its claims against Mutual Realty and its broker, leaving for this Court only the claims against Escrow Source.

Escrow Source, was joined in this action on April 15, 2010, by way of FCI's Second Amended Complaint for damages. CP 1191 – 1196. After discovery and in due course, defendant Escrow Source filed its motion for summary judgment on January 3, 2012. The Superior Court received briefing from both parties and heard oral argument on January 31, 2012. On January 31, 2012, that court granted Escrow Source's motion for summary judgment on the apparent grounds that Escrow Source did not have a duty to disclose the third party disbursement. CP 57 – 59. FCI filed its Motion for Reconsideration on the Superior court's grant of summary judgment, including evidence that Escrow Source's draft HUD-1, approved by FCI, did not include the third-party disbursement. That Court denied FCI's Motion for Reconsideration on duty and reliance issues.

FCI timely filed its notice of this appeal.

## IV. ISSUES ON APPEAL

Did the Superior Court err in concluding that there were no material issues of fact in dispute and therefore grant Escrow Source summary judgment, when Escrow Source had knowledge of a concurrent transaction and failed to disclose to FCI and/or report on the HUD-1 the third party payment of $109,482 of loan proceeds to the third party business seller, which had been directed by seller's realtor and disbursed by Escrow Source, without informing FCI.

Did the Superior Court err in denying FCI's Motion for Reconsideration?

## V. ARGUMENT

### A. Summary Judgment should not stand because disputed material issues of fact exist.

This Court reviews appealed summary judgments just as the Superior Court does. *Wilson v. Steinbach*, 98 Wn.2d 434, 656 P.2d 1030 (1982). Summary judgment is appropriate ***only*** if the pleadings, depositions, and affidavits show that there is no genuine issue as to any material fact and that the moving party is entitled to judgment as a matter of law. CR 56(c). The Court must consider facts submitted and all reasonable inferences from those facts in the light most favorable to the nonmoving party. *Marks v. Wash. Ins. Guar. Ass'n*, 123 Wn. App. 274, 277, 94 P.3d 352 (2004). Summary judgment is appropriate only if, from all the evidence, reasonable persons could reach but one conclusion. *Wilson v. Steinbach*, *supra*. The existence of a legal duty is generally a question of law. *Degel v. Majestic Mobile Manor, Inc.*, 129 Wash.2d 43, 48, 914 P.2d 728 (1996). But where duty depends on proof of certain facts that may be disputed, summary judgment is inappropriate. *Sjogren v. Props. of the Pac. N.W., LLC,* 118 Wn. App. 144, 148, 75 P.3d 592 (2003).

The following facts must be taken as true in this summary judgment analysis, and specifically implicate Escrow Source's duty to FCI.

1. The premises had been used as an adult day care facility and Escrow Source was aware of this.
2. The title referenced an adult day care facility on the premises and Escrow Source was aware of this.
3. FCI specifically instructed Escrow Source to ensure that the adult day care use was removed from the title.

4. Escrow Source knew that FCI would not fund the loan if an adult care facility business was operated on the premises and that the adult day care use "definitely" had to be removed from title for the transaction to close.

5. FCI issued closing instructions requiring Escrow Source to, among other things:

   a. Not close the transaction or fund the loan if it has knowledge of a concurrent or subsequent transaction material to property; and

   b. Accurately reflect all receipts and disbursements indicated in the closing instructions on the final HUD-1 settlement statement.

6. FCI's warehouse lender issued closing instructions requiring Escrow Source to, among other things:

   a. Not close or fund the loan without prior written consent if it is in conjunction with, or simultaneous with, any other sale, transfer or financing of the property; and

   b. Not close or fund the loan without prior written consent if any transfers of the property or any interests therein have occurred, or will occur, other than the transfer of the property to the borrower from the seller.

   c. List all disbursements on the HUD-1, Escrow Source prepared.

7. The seller issued an escrow instruction asking that the proceeds from the sale be split between the seller and a third party, with the money to the third party "to be appropriated for the "business sale."

8. Escrow Source knew that the reason for the funds going to the third party was for sale of "the business."

9. Escrow Source knew that the third party business seller was receiving the funds was paying half of the closing costs for the transaction itself;

10. Escrow Source communicated with the seller's agent several times via email regarding the division of the proceeds between Corazon Soriano and Mary Grace Villasin, referring to them as "Cora" "Mary Grace", respectively.

11. Escrow Source made no mention to FCI of the daughter's involvement, nor did it list the funds being disbursed to the daughter on the draft HUD-1 which Escrow Source emailed to FCI one business day before the transaction closed.

12. WAC § 208-680D – 040(8)(C) requires each disbursement to specifically referenced in the HUD-1 Closing Statement. RCW 18.44.301(4) and (6) prohibit false or misleading entities or information in escrow records.

## B. An Escrow Agent owes a lender statutory, contractual and fiduciary duties.

Escrow Agents duties arise from Washington statutes and regulations, and the common laws of contract and fiduciary duty. In conducting a closing an escrow agent must provide a detailed closing statement, which include among other things an itemization of all adjustments, monies or things of value received or paid in compliance with the requirements of the Real Estate Settlement Procedures Act

Section 12 USC § 2601, and Regulation S, 24 CFR § 3500, and all applicable rules and regulations. Such itemization must include the name of the person or company to whom each individual amount is paid or from whom each individual amount is received. WAC § 208-680D-040(8)(C).

RCW § 18.44.301(4) and (6) prohibit an escrow agent from making false entries or omitting to make material entries in transaction books or records. These statutes and regulations provide the minimum standards of care inherent within the fiduciary obligations an escrow agent owes to the lender.

Contract duties arise from escrow instructions provided by transacting parties. Fiduciary duties arise as a matter of holding and disbursing the trust funds which are delivered by lenders. *See National Bank of Washington v. Equity Investors*, 81 Wn.2d 886, 910 506 P.2d 20 (1973). See, also, WAC § 208- 680A-040 which defines escrow deposits in "trust" to be a fiduciary relationship whereby a thing of value is delivered to an escrow agent with the intention that such thing of value be administered by the escrow agent for the benefit of the principal parties to the transaction.

A party accepting the position of escrow holder has established a special relationship in which a high degree of trust warrants that the fiduciary's conduct be measured by higher standards than ordinary contractual dealings between parties. *Nat'l Bank of Washington, supra.*, *Home Loan Corp. v. Texas American Title Co.*, 191 S.W.3d 728 (Tex. 2006). Escrow agents are prohibited from, directly or indirectly, misleading lenders or engaging in any deceptive practice, RCW § 18.44.301.

**C. Escrow Source is liable to FCI for damages resulting from its breach of its duties to FCI.**

There is no dispute Escrow Source owed statutory and common law duties to FCI. Escrow Source does not dispute that FCI lost all of the money it loaned, due to the buyers' payment default on the FCI loan soon thereafter. If Escrow Source had informed FCI of the facts regarding the "business sale" FCI would not have closed the loan, and this loss would not have occurred. Thus, if there is a question of material fact as to whether one or more of the duties were breached, this case must be remanded for trial.

## D. No dispute that Escrow Source failed to disclose the disbursement of $109,482 for the business sale to a third party.

An escrow agent's fiduciary duties include a duty to exercise reasonable care in its employment and conduct the affairs with which it is entrusted with scrupulous honesty, skill and diligence. *Natl. Bank of Washington,* 81 Wn.2d at 910. Although Washington courts have not determined the limits of an escrow agent's duty to disclose information to the lender, several other jurisdictions prescribe that an escrow agent owes a duty to disclose all material matters coming to the agent's notice or knowledge concerning the subject of the agency, for the parties to the transaction to know for their protection or guidance. *Aronoff v. Lenkin Co.,* 618 A.2d 669, 687 (D.C.1992); *Kitchen Krafters, Inc. v. Eastside Bank of Mont.,* 789 P.2d 567, 573 (Montana 1990), *overruled on other grounds by Busta v. Columbus Hosp. Corp.,* 916 P.2d 122, 134–40 (Montana 1996). At least two jurisdictions hold that an escrow agent has a duty to disclose facts that a reasonable escrow agent would perceive as evidence of fraud. *See Mark Props., Inc. v. Nat'l Title Co.,* 34 P.3d 587, 590–91 (Nev. 2001); *Burkons v. Ticor Title Ins. Co.,* 813 P.2d 710, 718 (Arizona 1991). An escrow agent is not permitted to "close its eyes in the face of known facts and console itself with the thought that no one has yet confessed the fraud." *Burkons,* 813 P.2d at 718, (Arizona 1991). Although not required to investigate, the agent has a duty to disclose when he is aware of facts and circumstances that a reasonable escrow agent would perceive as evidence of fraud. *Id.*; *Berry v. McLeod*, 604 P.2d 610 (Arizona 1979); *Mark Props., Inc. v. National Title Co.*, 34 P.3d 587 (Nevada 2001).

In *Burkons*, the court held that the escrow agent had the duty to disclose the actual facts of the transaction when it learned that the combined liens on the property were greater than the purchase price and the buyer intended to use the purchase loan not for development as represented, but to finance the down payment. *Burkons*, 813 P.2d at 718-19. The court determined that there was an issue of fact as to whether the escrow agent had evidence of fraud and breached its fiduciary duties by failing to disclose it to the parties. *Id.* The Court held that whether the facts and circumstances known to the escrow agent could support a finding that the agent should have revealed what it knew was a factual and therefore triable issue. *Burkons*, 813 P.2d at 718.

> ...[T]he trial judge erred in granting summary judgment on the count alleging that [the escrow agent] breached its fiduciary duty by failing to notify Burkons that the property was over-encumbered. It is impossible to say as a matter of law that a reasonable escrow agent would not perceive the over-encumbrance situation as substantial evidence of fraud...

*Burkons*, 813 P.2d at 719.

In *Home Loan Corp. v. Texas American Title Co.*, *supra.* 191 S.W.3d 728, 733 (Texas 2006), upon facts materially similar to this case, the Court held that an issue of fact existed as to whether the escrow agent had the duty to disclose, to the lender, the seller's instructions to disburse funds to the mortgage broker personally, or whether it had the duty to include that disbursement on the HUD-1. The mortgage lender sued the title company that closed a residential mortgage loan, alleging breach of fiduciary duty. After Home Loan sold the loan in the secondary market, no payments were made on it, and Home Loan was obligated to repurchase it. Home Loan then filed suit against the escrow agent alleging that it had breached fiduciary duties it owed Home Loan by failing to: (1) inform Home Loan that the seller had requested over half of the seller's proceeds to be paid to the mortgage loan broker; (2) inform Home Loan that (after the preceding request was denied) the seller had requested that those proceeds be paid to the principal of the mortgage loan broker and that it would comply with this request; and (3) accurately disclose on the HUD–1 settlement statement how the proceeds would be or had been disbursed. The parties filed cross-motions for summary judgment, disputing whether any such duties were owed or had been breached. *Home Loan Corp.,* 191 S.W.3d at 730.

The appellate court reversed summary judgment in favor of the escrow holder, concluding that genuine issue of material fact existed as to whether disclosure of the vendor's request for payment to third party was material to the funder's rights, precluding summary judgment for the escrow holder. *Home Loan Corp.,* 191 S.W.3d at 734.

The Court held:

> [An escrow agent] owes the party remitting those funds a duty of loyalty, a duty to make full disclosure, and a duty to exercise a high degree of care to conserve the money and pay it only to those persons who are entitled to receive it. [internal citations omitted.] Ordinarily, a fiduciary duty of full disclosure requires disclosure of all material facts known to the fiduciary that might affect the rights of the person to whom the duty is owed.
>
> *Home Loan Corp.,* 191 S.W.3d at 731.

In *Home Loan Corp.,* the escrow holder made arguments similar to those made by Escrow Source here: that its duties were limited to (1) carrying out the terms of the real estate contract and escrow agreement; and (2) disclosing only "actual knowledge of a scheme to defraud" Home Loan. The Texas Appellate Court disagreed, declining to adopt the escrow holder's proposed limitation on the escrow agent's duty of disclosure to requiring disclosure only when the escrow agent has actual knowledge of fraud. *Home Loan Corp.,* 191 S.W.3d at 734. The Court explained that there is no rationale for such a limitation, particularly given the escrow holder's fiduciary relationship with the lender and the fact that the fiduciary's conduct must be measured by higher standards than ordinary contractual dealings between parties. *Home Loan Corp.,* 191 S.W.3d at 733-734.

Similarly, this Court should not limit the Escrow Source's duties as the Superior Court has done here. Washington should (and likely would) follow Texas, Arizona and Nevada courts in holding that the escrow holder's fiduciary duty to the lender includes the duty to disclose material information relating to non-compliance, even if the escrow holder does not have actual and definite knowledge of fraud.

Here, Escrow Source knew that FCI would not fund a concurrent business transaction. It had been specifically asked to remove the business use of the premises from the chain of title. Sellers directed Escrow Source to deliver $109,482 of the loan proceeds to a third party to fund "the business sale", and that the third party was paying half of the closing costs of the real estate purchase and sale transaction, unbeknownst to FCI.

Ms. Pratt, Escrow Source's closer, stated in her deposition that she did not believe that she was on notice of the possibility of a contemporaneous transaction. CP 410-412. But this is, of course, the very factual issue to be determined. Seller's escrow instructions required Escrow Source to divert loan proceeds to a third party for another purpose. That should have put Escrow Source on notice of a possible concurrent transaction. That notice should have led to Escrow Source informing FCI and/or stopping the closing. On the information Escrow Source had, which plainly demonstrated that Ms. Villasin was receiving substantial home loan proceeds for a business sale, Escrow Source should have properly itemized the payment to Ms. Villasin as required by Washington law and/or informed FCI of these facts and/or stopped the closing. When viewed most favorably to FCI, at a *very* minimum, a material issue of fact exists as to whether disclosure was required.

### E. Escrow Source breached its contract with FCI.

In addition to breaching its statutory and fiduciary duty to FCI, Escrow Source also breached the parties' contract. The escrow agent must strictly comply with the escrow instructions. *Natl. Bank of Washington, supra,* at 910. Breach of the instructions or exceeding the authority conferred by the instructions will result in liability. *Id.* Escrow Source's contractual obligations were defined by the escrow instructions.

Here, the instructions required Escrow Source not to disburse funds if there was a concurrent transaction. The specific language was in one set of lenders escrow instructions. The closing could not occur "... in conjunction with or simultaneously with any other sale, transfer, or financing of the property...." That Ms. Pratt did not believe payment to Ms. Villasin of $109,482 for the "business sale" fell under this prohibition was an exercise of her poor judgment, when in fact the business sale was for the business assets of the adult family care home, separate from its owner occupied residential use.

The facts of which Escrow Source was aware gave it sufficient information for it to know that there was a concurrent related transaction, or ask about it. Indeed Julee Pratt, the closer, knew that there was to be a split of closing costs between the seller of the real property and the seller of a business. At a minimum, there is an issue of fact as to whether these facts should have put Escrow Source on notice of the possibility of a concurrent transaction, making its closing of the transaction a breach of contract.

An even more clear-cut contract provision was FCI's requirement that all disbursements were to be noted on the HUD-1. CP 493; 495; 500-502. That was also required by WAC 208-680D-040(8)(c). As stated above, Ms. Pratt failed to note the Villasin disbursement of loan proceeds on the HUD-1 closing form – in violation of FCI's specific escrow instruction and the law. Had Ms. Pratt noted the disbursements in the draft HUD-1 that FCI approved as instructed, FCI would have had notice of the concurrent transaction and could have stopped the closing.

As discussed above, FCI has presented facts sufficient to support a finding in its favor. Escrow Source possessed information which was undeniably material to FCI's decision to lend, and the trier of fact must determine whether, as a factual matter and given its regulatory and fiduciary duties to do so, whether Escrow Source should have disclosed what it knew to FCI.

FCI has also presented evidence sufficient to support its breach of contract claims by showing that Escrow Source had concurrent transaction, but closed the sale anyway, and that it failed to disclose the disbursement for the adult home care business on the HUD-1, both of which were in violation of its escrow instructions from FCI. Because of these factual disputes must be resolved in FCI's favor on summary judgment. The Superior Court's order should be reversed.

### F. Summary Judgment on FCI's CPA claim should be remanded.

Under the Consumer Protection Act, "unfair or deceptive acts or practices in the conduct of any trade or commerce" are unlawful. RCW 19.86.020. To prevail in a private claim under the Act, a plaintiff must establish five elements: (1) unfair or deceptive act or practice, (2) occurring in the trade or commerce, (3) public interest impact, (4) injury to plaintiff in his or her business or property, and (5) causation. *Hangman Ridge Training Stables, Inc. v Safeco Title Ins. Co.,* 105 Wn.2d 778, 780, 719 P.2d 531 (1986). Whether particular actions give rise to a violation of the Act is a question of law. *Svendsen v. Stock,* 143 Wn.2d 546, 553, 23 P.3d 455 (2001).

The Washington legislature held that violations of recordation and disbursement laws and regulations subjects and escrow agent to liability under the CPA. RCW § 18.44.400(5). The Washington Supreme Court has noted that the overall purpose of Escrow Agent Registration Act is to regulate escrow agents <u>for benefit of the public.</u> *Estate of Jordan by Jordan v. Hartford Acc. and Indem. Co.* 120 Wash.2d 490, 844 P.2d 403 (1993) (emphasis added.)

To show that a party has engaged in an unfair or deceptive act or practice, a plaintiff "need not show that the act in question was *intended* to deceive, but that the alleged act had the *capacity* to deceive a substantial portion of the public." *Hangman Ridge,* 105 Wn.2d at 785. Here, Escrow Source, undeniably in a position of trust, failed to disclose material facts within its knowledge to its principal. This is deceptive, and this type of withholding of information has the capacity to deceive.

A CPA claim exists on the facts alleged herein, especially when they are viewed in the light most favorable to FCI, as they must be in this setting. Here, the Court should allow Financial Capital to develop its Consumer Protection Act case in light of these facts, to allow a finding that Escrow Source's conduct impacted a public interest, and its actions violated the CPA. At the very least, this Court should find there are genuine issues of material fact present such that reversal of Escrow Source's summary judgment is appropriate.

**G. Denial of Motion for Reconsideration should be reversed.**

As set forth in FCI's Motion for Reconsideration and evidence attached thereto. CP 45 - 56, the Superior Court raised the question of whether Escrow Source would have delivered FCI draft HUD-1 prior to closing for FCI's approval. The evidence on reconsideration included evidence that the draft HUD-1 to FCI was presented shortly before the closing of the transaction, and that it, like the final HUD-1 did not include reference to the $109,482 payment to Ms. Villasin. Thus the Superior Court erred given that Escrow Source had provided false information to FCI prior to the closing and FCI relied upon that to approve the closing of the transaction and lend the money.

**H. Attorney fees**

FCI seeks an award of its fees and expenses in this appeal to the extent this Court rules in FCI's favor on its Consumer Protection Act claim.

## VI. CONCLUSION

To deny FCI its day in court to try this case, leaves escrow agents with no fiduciary duty at all. It allows escrow agents the "out" of never asking questions, with blinders on. It was not Escrow Source's duty to investigate for a fraud, but it was its duty to provide information as to the use of loan proceeds, and to stop the transaction to allow FCI to determine whether a contemporaneous transaction affecting the property was occurring.

Washington statutes, regulations, the escrow instructions and the fiduciary duties owed by Escrow Source, lead to only one conclusion: escrow source should have informed FCI of the planned payment of $109,483 of loan proceeds to a third party business transaction party. The buyers and sellers and their brokers deserve a good portion of the blame as well, but that does not mitigate Escrow Source's breach of its separate statutory and fiduciary duties.

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Respectfully submitted this 17th day of May, 2012.


RYAN, SWANSON & CLEVELAND, PLLC

By ______________________________
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## DECLARATION OF SERVICE

I declare that on the 21st day of May, 2012, I caused to be served the foregoing document on counsel for Respondents, as noted, at the following addresses:

| | | |
|---|---|---|
| Ms. Pamela Salgado<br>Littler Mendelson, P.C.<br>600 University Street, Suite 3200<br>One Union Square<br>Seattle, WA 98101 | ☐<br>☒<br>☐<br>☐ | U.S. Mail<br>Hand Delivery<br>E-mail<br>Facsimile |
| Ms. Donna M. Young<br>Lee Smart, P.S., Inc.<br>1800 One Convention Place<br>701 Pike Street<br>Seattle, WA 98101 | ☐<br>☒<br>☐<br>☐ | U.S. Mail<br>Hand Delivery<br>E-mail<br>Facsimile |

Valerie Dominique

Dated: 21 May, 2012

Place: Seattle, WA

**APPENDIX**

1. RCW 18.44.301
   RCW 18.44.301(4)
   RCW 18.44.301(6)
   RCW 18.44.400(5)

2. RCW 19.86.020

3. 12 USC § 2601

4. 24 CFR § 3500

5. WAC 208- 680A-040
   WAC 208-680D - 040(8)(C)

6. Lefcoe, George, Should We Ban or Welcome "Spec" Home Buyers, 36 J. Legis. 1 (2010)

# APPENDIX 1

# RCW 18.44.301
# Prohibited practices.

It is a violation of this chapter for any escrow agent, controlling person, officer, designated escrow officer, independent contractor, employee of an escrow business, or other person subject to this chapter to:

(1) Directly or indirectly employ any scheme, device, or artifice to defraud or mislead borrowers or lenders or to defraud any person;

(2) Directly or indirectly engage in any unfair or deceptive practice toward any person;

(3) Directly or indirectly obtain property by fraud or misrepresentation;

(4) Knowingly make, publish, or disseminate any false, deceptive, or misleading information in the conduct of the business of escrow, or relative to the business of escrow or relative to any person engaged therein;

(5) Knowingly receive or take possession for personal use of any property of any escrow business, other than in payment authorized by this chapter, and with intent to defraud, omit to make, or cause or direct to be made, a full and true entry thereof in the books and accounts of the business;

(6) Make or concur in making any false entry, or omit or concur in omitting to make any material entry, in its books or accounts;

(7) Knowingly make or publish, or concur in making or publishing any written report, exhibit, or statement of its affairs or pecuniary condition containing any material statement which is false, or omit or concur in omitting any statement required by law to be contained therein;

(8) Willfully fail to make any proper entry in the books of the escrow business as required by law;

(9) Fail to disclose in a timely manner to the other officers, directors, controlling persons, designated escrow officer, or other licensed escrow officers the receipt of service of a notice of an application for an injunction or other legal process affecting the property or business of an escrow agent, including in the case of a licensed escrow agent an order to cease and desist or other order of the director;

(10) Fail to make any report or statement lawfully required by the director or other public official;

(11) Fail to comply with any requirement of any applicable federal or state act including the truth-in-lending act, 15 U.S.C. Sec. 1601 et seq. and Regulation Z, 12 C.F.R. Sec. 226; the real estate settlement procedures act, 12 U.S.C. Sec. 2601 et seq. and Regulation X, 24 C.F.R. Sec. 3500; the equal credit opportunity act, 15 U.S.C. Sec. 1691 et seq. and Regulation B, Sec. 202.9, 202.11, and 202.12; Title V, Subtitle A of the financial modernization act of 1999 (known as the Gramm-Leach-Bliley act), 12 U.S.C. Secs. 6801-6809; the federal trade commission's privacy rules, 16 C.F.R. Secs. 313-314, mandated by the Gramm-Leach-Bliley act; as these acts existed on January 1, 2007, or such subsequent date as may be provided by the department by rule, or any other applicable escrow activities covered by the acts; or

(12) Collecting [Collect] a fee for tracking unclaimed funds unless it is a bona fide out-of-pocket expense or converting [convert] unclaimed funds for personal use.

[2010 c 34 § 8; 1999 c 30 § 9.]

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RCWs > Title 18 > Chapter 18.44 > Section 18.44.400

18.44.311 << 18.44.400 >> 18.44.410

# RCW 18.44.400
# Records and accounts — Segregation and disbursements of funds — Violation of section, penalties.

(1) Every licensed escrow agent shall keep adequate records, as determined by rule by the director, of all transactions handled by or through the agent including itemization of all receipts and disbursements of each transaction. These records shall be maintained in this state, unless otherwise approved by the director, for a period of six years from completion of the transaction. These records shall be open to inspection by the director or the director's authorized representatives.

(2) Every licensed escrow agent shall keep separate escrow fund accounts as determined by rule by the director in recognized Washington state depositaries authorized to receive funds, in which shall be kept separate and apart and segregated from the agent's own funds, all funds or moneys of clients which are being held by the agent pending the closing of a transaction and such funds shall be deposited not later than the first banking day following receipt thereof.

(3) An escrow agent, unless exempted by RCW 18.44.021(2), shall not make disbursements on any escrow account without first receiving deposits directly relating to the account in amounts at least equal to the disbursements. An escrow agent shall not make disbursements until the next business day after the business day on which the funds are deposited unless the deposit is made in cash, by interbank electronic transfer, or in a form that permits conversion of the deposit to cash on the same day the deposit is made. The deposits shall be in one of the following forms:

(a) Cash;

(b) Interbank electronic transfers such that the funds are unconditionally received by the escrow agent or the agent's depository;

(c) Checks, negotiable orders of withdrawal, money orders, cashier's checks, and certified checks that are payable in Washington state and drawn on financial institutions located in Washington state;

(d) Checks, negotiable orders of withdrawal, money orders, and any other item that has been finally paid as described in RCW 62A.4-213 before any disbursement; or

(e) Any depository check, including any cashier's check, certified check, or teller's check, which is governed by the provisions of the federal expedited funds availability act, 12 U.S.C. Sec. 4001 et seq.

(4) For purposes of this section, the word "item" means any instrument for the payment of money even though it is not negotiable, but does not include money.

(5) Violation of this section shall subject an escrow agent to penalties as prescribed in Title 9A RCW and remedies as provided in chapter 19.86 RCW and shall constitute grounds for suspension or revocation of the license of any licensed escrow agent or licensed escrow officer. In addition, an escrow agent who is required to be licensed under this chapter and who violates this section or an individual who is required to be licensed as an escrow officer

under this chapter and who violates this section, may be subject to penalties as prescribed in RCW 18.44.430.

[1999 c 30 § 8; 1990 c 203 § 1; 1988 c 178 § 1; 1977 ex.s. c 156 § 6; 1965 c 153 § 7. Formerly RCW 18.44.070.]

## Notes:

**Severability -- 1988 c 178:** "If any provision of this act or its application to any person or circumstance is held invalid, the remainder of the act or the application of the provision to other persons or circumstances is not affected." [1988 c 178 § 4.]

# APPENDIX 2

RCWs > Title 19 > Chapter 19.86 > Section 19.86.020

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19.86.010 << 19.86.020 >> 19.86.023

## RCW 19.86.020
## Unfair competition, practices, declared unlawful.

Unfair methods of competition and unfair or deceptive acts or practices in the conduct of any trade or commerce are hereby declared unlawful.

[1961 c 216 § 2.]

### Notes:

Hearing instrument dispensing, advertising, etc. -- Application: RCW 18.35.180.

# APPENDIX 3

-CITE-

***12 USC*** Sec. ***2601*** 01/03/2012 (112-90)

-EXPCITE-

TITLE 12 - BANKS AND BANKING

CHAPTER 27 - REAL ESTATE SETTLEMENT PROCEDURES

-HEAD-

Sec. 2601. Congressional findings and purpose

-STATUTE-

(a) The Congress finds that significant reforms in the real estate settlement process are needed to insure that consumers throughout the Nation are provided with greater and more timely information on the nature and costs of the settlement process and are protected from unnecessarily high settlement charges caused by certain abusive practices that have developed in some areas of the country. The Congress also finds that it has been over two years since the Secretary of Housing and Urban Development and the Administrator of Veterans' Affairs submitted their joint report to the Congress on "Mortgage Settlement Costs" and that the time has come for the recommendations for Federal legislative action made in that report to be implemented.

(b) It is the purpose of this chapter to effect certain changes in the settlement process for residential real estate that will result -

(1) in more effective advance disclosure to home buyers and sellers of settlement costs;

(2) in the elimination of kickbacks or referral fees that tend to increase unnecessarily the costs of certain settlement services;

(3) in a reduction in the amounts home buyers are required to place in escrow accounts established to insure the payment of real estate taxes and insurance; and

(4) in significant reform and modernization of local recordkeeping of land title information.

-SOURCE-

(Pub. L. 93-533, Sec. 2, Dec. 22, 1974, 88 Stat. 1724.)

-REFTEXT-

REFERENCES IN TEXT

This chapter, referred to in subsec. (b), was in the original "this Act", meaning Pub. L. 93-533, Dec. 22, 1974, 88 Stat. 1724, as amended, known as the Real Estate Settlement Procedures Act of 1974, which is classified principally to this chapter (Sec. 2601 et seq.). For complete classification of this Act to the Code, see Short Title note below and Tables.

-CHANGE-

CHANGE OF NAME

Reference to Administrator of Veterans' Affairs deemed to refer to Secretary of Veterans Affairs pursuant to section 10 of Pub. L. 100-527, set out as a Department of Veterans Affairs Act note under section 301 of Title 38, Veterans' Benefits.

-MISC1-

EFFECTIVE DATE

Section 20, formerly 19, of Pub. L. 93-533, as renumbered by Pub. L. 94-205, Sec. 10, Jan. 2, 1976, 89 Stat. 1159, provided that: "The provisions of this Act, and the amendments made thereby [see Short Title note below], shall become effective one hundred and eighty days after the date of the enactment of this Act [Dec. 22, 1974]."

SHORT TITLE OF 1976 AMENDMENT

Section 1 of Pub. L. 94-205, Jan. 2, 1976, 89 Stat. 1157, provided: "That this Act [enacting section 2617 of this title, amending sections 2602, 2603, 2604, 2607, 2609 and 2616 of this title and section 1631 of Title 15, Commerce and Trade, repealing sections 2605 and 2606 of this title, enacting provisions set out as a note under section 2602 of this title and amending provisions set out as a note under this section] may be cited as the 'Real Estate Settlement Procedures Act Amendments of 1975'."

SHORT TITLE

Section 1 of Pub. L. 93-533 provided that: "This Act [enacting this chapter and sections 1730f and 1831b of this title and provisions set out as notes under this section and section 1730f of this title] may be cited as the 'Real Estate Settlement Procedures Act of 1974'."

SIMPLIFICATION AND UNIFICATION OF DISCLOSURES REQUIRED UNDER RESPA AND TILA FOR MORTGAGE TRANSACTIONS

Pub. L. 104-208, div. A, title II, Sec. 2101, Sept. 30, 1996, 110 Stat. 3009-398, provided that:

"(a) In General. - With respect to credit transactions which are subject to the Real Estate Settlement Procedures Act of 1974 [12 U.S.C. 2601 et seq.] and the Truth in Lending Act [15 U.S.C. 1601 et seq.], the Board of Governors of the Federal Reserve System (hereafter in this section referred to as the 'Board') and the Secretary of Housing and Urban Development (hereafter in this section referred to as the 'Secretary') shall take such action as may be necessary before the end of the 6-month period beginning on the date of enactment of this Act [Sept. 30, 1996] -

"(1) to simplify and improve the disclosures applicable to such transactions under such Acts, including the timing of the disclosures; and

"(2) to provide a single format for such disclosures which will satisfy the requirements of each such Act with respect to such transactions.

"(b) Regulations. - To the extent that it is necessary to prescribe any regulation in order to effect any changes required to be made under subsection (a), the proposed regulation shall be published in the Federal Register before the end of the 6-month period referred to in subsection (a).

"(c) Recommendations for Legislation. - If the Board and the Secretary find that legislative action may be necessary or appropriate in order to simplify and unify the disclosure requirements under the Real Estate Settlement Procedures Act of 1974 [12 U.S.C. 2601 et seq.] and the Truth in Lending Act [15 U.S.C. 1601 et seq.], the Board and the Secretary shall submit a report containing recommendations to the Congress concerning such action."

# APPENDIX 4

APPENDIX MS-1 TO PART 3500—SERVICING DISCLOSURE STATEMENT

APPENDIX MS-2 TO PART 3500—NOTICE OF ASSIGNMENT, SALE, OR TRANSFER OF SERVICING RIGHTS

AUTHORITY: 12 U.S.C. 2601 *et seq.*; 42 U.S.C. 3535(d).

SOURCE: 57 FR 49607, Nov. 2, 1992, unless otherwise noted. Sections 3500.1 through 3500.19 and 3500.21 revised at 61 FR 13233, Mar. 26, 1996.

### § 3500.1 Designation.

This part may be referred to as Regulation X.

### § 3500.2 Definitions.

(a) *Statutory terms.* All terms defined in RESPA (12 U.S.C. 2602) are used in accordance with their statutory meaning unless otherwise defined in paragraph (b) of this section or elsewhere in this part.

(b) *Other terms.* As used in this part:

*Application* means the submission of a borrower's financial information in anticipation of a credit decision, whether written or computer-generated, relating to a federally related mortgage loan. If the submission does not state or identify a specific property, the submission is an application for a prequalification and not an application for a federally related mortgage loan under this part. The subsequent addition of an identified property to the submission converts the submission to an application for a federally related mortgage loan.

*Business day* means a day on which the offices of the business entity are open to the public for carrying on substantially all of the entity's business functions.

*Dealer* means, in the case of property improvement loans, a seller, contractor, or supplier of goods or services. In the case of manufactured home loans, "dealer" means one who engages in the business of manufactured home retail sales.

*Dealer loan or dealer consumer credit contract* means, generally, any arrangement in which a dealer assists the borrower in obtaining a federally related mortgage loan from the funding lender and then assigns the dealer's legal interests to the funding lender and receives the net proceeds of the loan. The funding lender is the lender for the purposes of the disclosure requirements of this part. If a dealer is a "creditor" as defined under the definition of "federally related mortgage loan" in this part, the dealer is the lender for purposes of this part.

*Effective date of transfer* is defined in section 6(i)(1) of RESPA (12 U.S.C. 2605(i)(1)). In the case of a home equity conversion mortgage or reverse mortgage as referenced in this section, the effective date of transfer is the transfer date agreed upon by the transferee servicer and the transferor servicer.

*Federally related mortgage loan* or *mortgage loan* means as follows:

(1) Any loan (other than temporary financing, such as a construction loan):

(i) That is secured by a first or subordinate lien on residential real property, including a refinancing of any secured loan on residential real property upon which there is either:

(A) Located or, following settlement, will be constructed using proceeds of the loan, a structure or structures designed principally for occupancy of from one to four families (including individual units of condominiums and cooperatives and including any related interests, such as a share in the cooperative or right to occupancy of the unit); or

(B) Located or, following settlement, will be placed using proceeds of the loan, a manufactured home; and

(ii) For which one of the following paragraphs applies. The loan:

(A) Is made in whole or in part by any lender that is either regulated by or whose deposits or accounts are insured by any agency of the Federal Government;

(B) Is made in whole or in part, or is insured, guaranteed, supplemented, or assisted in any way:

(*1*) By the Secretary or any other officer or agency of the Federal Government; or

(*2*) Under or in connection with a housing or urban development program administered by the Secretary or a housing or related program administered by any other officer or agency of the Federal Government;

(C) Is intended to be sold by the originating lender to the Federal National Mortgage Association, the Government

National Mortgage Association, the Federal Home Loan Mortgage Corporation (or its successors), or a financial institution from which the loan is to be purchased by the Federal Home Loan Mortgage Corporation (or its successors);

(D) Is made in whole or in part by a "creditor", as defined in section 103(f) of the Consumer Credit Protection Act (15 U.S.C. 1602(f)), that makes or invests in residential real estate loans aggregating more than $1,000,000 per year. For purposes of this definition, the term "creditor" does not include any agency or instrumentality of any State, and the term "residential real estate loan" means any loan secured by residential real property, including single-family and multifamily residential property;

(E) Is originated either by a dealer or, if the obligation is to be assigned to any maker of mortgage loans specified in paragraphs (1)(ii) (A) through (D) of this definition, by a mortgage broker; or

(F) Is the subject of a home equity conversion mortgage, also frequently called a "reverse mortgage," issued by any maker of mortgage loans specified in paragraphs (1)(ii) (A) through (D) of this definition.

(2) Any installment sales contract, land contract, or contract for deed on otherwise qualifying residential property is a federally related mortgage loan if the contract is funded in whole or in part by proceeds of a loan made by any maker of mortgage loans specified in paragraphs (1)(ii) (A) through (D) of this definition.

(3) If the residential real property securing a mortgage loan is not located in a State, the loan is not a federally related mortgage loan.

*Good faith estimate* means an estimate, prepared in accordance with section 5 of RESPA (12 U.S.C. 2604), of charges that a borrower is likely to incur in connection with a settlement.

*HUD-1 or HUD-1A settlement statement* (also *HUD-1 or HUD-1A*) means the statement that is prescribed by the Secretary in this part for setting forth settlement charges in connection with either the purchase or the refinancing (or other subordinate lien transaction) of 1- to 4-family residential property.

*Lender* means, generally, the secured creditor or creditors named in the debt obligation and document creating the lien. For loans originated by a mortgage broker that closes a federally related mortgage loan in its own name in a table funding transaction, the lender is the person to whom the obligation is initially assigned at or after settlement. A lender, in connection with dealer loans, is the lender to whom the loan is assigned, unless the dealer meets the definition of creditor as defined under "federally related mortgage loan" in this section. See also § 3500.5(b)(7), secondary market transactions.

*Managerial employee* means an employee of a settlement service provider who does not routinely deal directly with consumers, and who either hires, directs, assigns, promotes, or rewards other employees or independent contractors, or is in a position to formulate, determine, or influence the policies of the employer. Neither the term "managerial employee" nor the term "employee" includes independent contractors, but a managerial employee may hold a real estate brokerage or agency license.

*Manufactured home* is defined in § 3280.2 of this title.

*Mortgage broker* means a person (not an employee or exclusive agent of a lender) who brings a borrower and lender together to obtain a federally related mortgage loan, and who renders services as described in the definition of "settlement services" in this section. A loan correspondent approved under § 202.8 of this title for Federal Housing Administration programs is a mortgage broker for purposes of this part.

*Mortgaged property* means the real property that is security for the federally related mortgage loan.

*Person* is defined in section 3(5) of RESPA (12 U.S.C. 2602(5)).

*Public Guidance Documents* means documents that HUD has published in the FEDERAL REGISTER, and that it may amend from time-to-time by publication in the FEDERAL REGISTER. These documents are also available from HUD at the address indicated in 24 CFR 3500.3.

*Refinancing* means a transaction in which an existing obligation that was subject to a secured lien on residential real property is satisfied and replaced by a new obligation undertaken by the same borrower and with the same or a new lender. The following shall not be treated as a refinancing, even when the existing obligation is satisfied and replaced by a new obligation with the same lender (this definition of "refinancing" as to transactions with the same lender is similar to Regulation Z, 12 CFR 226.20(a)):

(1) A renewal of a single payment obligation with no change in the original terms;

(2) A reduction in the annual percentage rate as computed under the Truth in Lending Act with a corresponding change in the payment schedule;

(3) An agreement involving a court proceeding;

(4) A workout agreement, in which a change in the payment schedule or change in collateral requirements is agreed to as a result of the consumer's default or delinquency, unless the rate is increased or the new amount financed exceeds the unpaid balance plus earned finance charges and premiums for continuation of allowable insurance; and

(5) The renewal of optional insurance purchased by the consumer that is added to an existing transaction, if disclosures relating to the initial purchase were provided.

*Regulation Z* means the regulations issued by the Board of Governors of the Federal Reserve System (12 CFR part 226) to implement the Federal Truth in Lending Act (15 U.S.C. 1601 *et seq.*), and includes the Commentary on Regulation Z.

*Required use* means a situation in which a person must use a particular provider of a settlement service in order to have access to some distinct service or property, and the person will pay for the settlement service of the particular provider or will pay a charge attributable, in whole or in part, to the settlement service. However, the offering of a package (or combination of settlement services) or the offering of discounts or rebates to consumers for the purchase of multiple settlement services does not constitute a required use. Any package or discount must be optional to the purchaser. The discount must be a true discount below the prices that are otherwise generally available, and must not be made up by higher costs elsewhere in the settlement process.

*RESPA* means the Real Estate Settlement Procedures Act of 1974, 12 U.S.C. 2601 *et seq.*

*Servicer* means the person responsible for the servicing of a mortgage loan (including the person who makes or holds a mortgage loan if such person also services the mortgage loan). The term does not include:

(1) The Federal Deposit Insurance Corporation (FDIC) or the Resolution Trust Corporation (RTC), in connection with assets acquired, assigned, sold, or transferred pursuant to section 13(c) of the Federal Deposit Insurance Act or as receiver or conservator of an insured depository institution; and

(2) The Federal National Mortgage Corporation (FNMA); the Federal Home Loan Mortgage Corporation (Freddie Mac); the RTC; the FDIC; HUD, including the Government National Mortgage Association (GNMA) and the Federal Housing Administration (FHA) (including cases in which a mortgage insured under the National Housing Act (12 U.S.C. 1701 *et seq.*) is assigned to HUD); the National Credit Union Administration (NCUA); the Farmers Home Administration or its successor agency under Public Law 103–354 (FmHA); and the Department of Veterans Affairs (VA), in any case in which the assignment, sale, or transfer of the servicing of the mortgage loan is preceded by termination of the contract for servicing the loan for cause, commencement of proceedings for bankruptcy of the servicer, or commencement of proceedings by the FDIC or RTC for conservatorship or receivership of the servicer (or an entity by which the servicer is owned or controlled).

*Servicing* means receiving any scheduled periodic payments from a borrower pursuant to the terms of any mortgage loan, including amounts for escrow accounts under section 10 of RESPA (12 U.S.C. 2609), and making the payments to the owner of the loan or other third parties of principal and interest and such other payments with respect to the amounts received from the borrower as may be required pursuant to the terms of the mortgage servicing loan documents or servicing contract. In the case of a home equity conversion mortgage or reverse mortgage as referenced in this section, servicing includes making payments to the borrower.

*Settlement* means the process of executing legally binding documents regarding a lien on property that is subject to a federally related mortgage loan. This process may also be called "closing" or "escrow" in different jurisdictions.

*Settlement service* means any service provided in connection with a prospective or actual settlement, including, but not limited to, any one or more of the following:

(1) Origination of a federally related mortgage loan (including, but not limited to, the taking of loan applications, loan processing, and the underwriting and funding of such loans);

(2) Rendering of services by a mortgage broker (including counseling, taking of applications, obtaining verifications and appraisals, and other loan processing and origination services, and communicating with the borrower and lender);

(3) Provision of any services related to the origination, processing or funding of a federally related mortgage loan;

(4) Provision of title services, including title searches, title examinations, abstract preparation, insurability determinations, and the issuance of title commitments and title insurance policies;

(5) Rendering of services by an attorney;

(6) Preparation of documents, including notarization, delivery, and recordation;

(7) Rendering of credit reports and appraisals;

(8) Rendering of inspections, including inspections required by applicable law or any inspections required by the sales contract or mortgage documents prior to transfer of title;

(9) Conducting of settlement by a settlement agent and any related services;

(10) Provision of services involving mortgage insurance;

(11) Provision of services involving hazard, flood, or other casualty insurance or homeowner's warranties;

(12) Provision of services involving mortgage life, disability, or similar insurance designed to pay a mortgage loan upon disability or death of a borrower, but only if such insurance is required by the lender as a condition of the loan;

(13) Provision of services involving real property taxes or any other assessments or charges on the real property;

(14) Rendering of services by a real estate agent or real estate broker; and

(15) Provision of any other services for which a settlement service provider requires a borrower or seller to pay.

*Special information booklet* means the booklet prepared by the Secretary pursuant to section 5 of RESPA (12 U.S.C. 2604) to help persons understand the nature and costs of settlement services. The Secretary publishes the form of the special information booklet in the FEDERAL REGISTER. The Secretary may issue or approve additional booklets or alternative booklets by publication of a Notice in the FEDERAL REGISTER.

*State* means any State of the United States, the District of Columbia, the Commonwealth of Puerto Rico, and any territory or possession of the United States.

*Table funding* means a settlement at which a loan is funded by a contemporaneous advance of loan funds and an assignment of the loan to the person advancing the funds. A table-funded transaction is not a secondary market transaction (see §3500.5(b)(7)).

*Title company* means any institution, or its duly authorized agent, that is qualified to issue title insurance.

[61 FR 13233, Mar. 26, 1996, as amended at 61 FR 29252, June 7, 1996; 61 FR 58475, Nov. 15, 1996; 62 FR 20088, Apr. 24, 1997]

EFFECTIVE DATE NOTE: At 61 FR 29252, June 7, 1996, §3500.2(b) was amended by adding a definition of "managerial employee", effective Oct. 7, 1996. At 61 FR 51782, Oct. 4, 1996, the effective date was delayed until further notice.

**§ 3500.3 Questions or suggestions from public and copies of public guidance documents.**

Any questions or suggestions from the public regarding RESPA, or requests for copies of HUD Public Guidance Documents, should be directed to the Director, Office of Consumer and Regulatory Affairs, Department of Housing and Urban Development, 451 Seventh Street SW., Washington, DC 20410–8000, rather than to HUD field offices. Legal questions may be directed to the Assistant General Counsel, GSE/RESPA Division, at this address.

**§ 3500.4 Reliance upon rule, regulation or interpretation by HUD.**

(a) *Rule, regulation or interpretation.* (1) For purposes of sections 19 (a) and (b) of RESPA (12 U.S.C. 2617 (a) and (b)) only the following constitute a rule, regulation or interpretation of the Secretary:

(i) All provisions, including appendices, of this part. Any other document referred to in this part is not incorporated in this part unless it is specifically set out in this part;

(ii) Any other document that is published in the FEDERAL REGISTER by the Secretary and states that it is an "interpretation," "interpretive rule," "commentary," or a "statement of policy" for purposes of section 19(a) of RESPA. Such documents will be prepared by HUD staff and counsel. Such documents may be revoked or amended by a subsequent document published in the FEDERAL REGISTER by the Secretary.

(2) A "rule, regulation, or interpretation thereof by the Secretary" for purposes of section 19(b) of RESPA (12 U.S.C. 2617(b)) shall not include the special information booklet prescribed by the Secretary or any other statement or issuance, whether oral or written, by an officer or representative of the Department of Housing and Urban Development (HUD), letter or memorandum by the Secretary, General Counsel, any Assistant Secretary or other officer or employee of HUD, preamble to a regulation or other issuance of HUD, Public Guidance Document, report to Congress, pleading, affidavit or other document in litigation, pamphlet, handbook, guide, telegraphic communication, explanation, instructions to forms, speech or other material of any nature which is not specifically included in paragraph (a)(1) of this section.

(b) *Unofficial interpretations; staff discretion.* In response to requests for interpretation of matters not adequately covered by this part or by an official interpretation issued under paragraph (a)(1)(ii) of this section, unofficial staff interpretations may be provided at the discretion of HUD staff or counsel. Written requests for such interpretations should be directed to the address indicated in § 3500.3. Such interpretations provide no protection under section 19(b) of RESPA (12 U.S.C. 2617(b)). Ordinarily, staff or counsel will not issue unofficial interpretations on matters adequately covered by this part or by official interpretations or commentaries issued under paragraph (a)(1)(ii) of this section.

(c) All informal counsel's opinions and staff interpretations issued before November 2, 1992, were withdrawn as of that date. Courts and administrative agencies, however, may use previous opinions to determine the validity of conduct under the previous Regulation X.

**§ 3500.5 Coverage of RESPA.**

(a) *Applicability.* RESPA and this part apply to all federally related mortgage loans, except for the exemptions provided in paragraph (b) of this section.

(b) *Exemptions.* (1) A loan on property of 25 acres or more.

(2) *Business purpose loans.* An extension of credit primarily for a business, commercial, or agricultural purpose, as defined by Regulation Z, 12 CFR 226.3(a)(1). Persons may rely on Regulation Z in determining whether the exemption applies.

(3) *Temporary financing.* Temporary financing, such as a construction loan. The exemption for temporary financing does not apply to a loan made to finance construction of 1- to 4-family residential property if the loan is used as, or may be converted to, permanent financing by the same lender or is used to finance transfer of title to the first user. If a lender issues a commitment for permanent financing, with or without conditions, the loan is covered by

this part. Any construction loan for new or rehabilitated 1- to 4-family residential property, other than a loan to a *bona fide* builder (a person who regularly constructs 1- to 4-family residential structures for sale or lease), is subject to this part if its term is for two years or more. A "bridge loan" or "swing loan" in which a lender takes a security interest in otherwise covered 1- to 4-family residential property is not covered by RESPA and this part.

(4) *Vacant land.* Any loan secured by vacant or unimproved property, unless within two years from the date of the settlement of the loan, a structure or a manufactured home will be constructed or placed on the real property using the loan proceeds. If a loan for a structure or manufactured home to be placed on vacant or unimproved property will be secured by a lien on that property, the transaction is covered by this part.

(5) *Assumption without lender approval.* Any assumption in which the lender does not have the right expressly to approve a subsequent person as the borrower on an existing federally related mortgage loan. Any assumption in which the lender's permission is both required and obtained is covered by RESPA and this part, whether or not the lender charges a fee for the assumption.

(6) *Loan conversions.* Any conversion of a federally related mortgage loan to different terms that are consistent with provisions of the original mortgage instrument, as long as a new note is not required, even if the lender charges an additional fee for the conversion.

(7) *Secondary market transactions.* A *bona fide* transfer of a loan obligation in the secondary market is not covered by RESPA and this part, except as set forth in section 6 of RESPA (12 U.S.C. 2605) and § 3500.21. In determining what constitutes a *bona fide* transfer, HUD will consider the real source of funding and the real interest of the funding lender. Mortgage broker transactions that are table-funded are not secondary market transactions. Neither the creation of a dealer loan or dealer consumer credit contract, nor the first assignment of such loan or contract to a lender, is a secondary market transaction (see § 3500.2.)

[61 FR 13233, Mar. 26, 1996, as amended at 61 FR 58475, Nov. 15, 1996]

### § 3500.6 Special information booklet at time of loan application.

(a) *Lender to provide special information booklet.* Subject to the exceptions set forth in this paragraph, the lender shall provide a copy of the special information booklet to a person from whom the lender receives, or for whom the lender prepares, a written application for a federally related mortgage loan. When two or more persons apply together for a loan, the lender is in compliance if the lender provides a copy of the booklet to one of the persons applying.

(1) The lender shall provide the special information booklet by delivering it or placing it in the mail to the applicant not later than three business days (as that term is defined in § 3500.2) after the application is received or prepared. However, if the lender denies the borrower's application for credit before the end of the three-business-day period, then the lender need not provide the booklet to the borrower. If a borrower uses a mortgage broker, the mortgage broker shall distribute the special information booklet and the lender need not do so. The intent of this provision is that the applicant receive the special information booklet at the earliest possible date.

(2) In the case of a federally related mortgage loan involving an open-ended credit plan, as defined in § 226.2(a)(20) of Regulation Z (12 CFR), a lender or mortgage broker that provides the borrower with a copy of the brochure entitled "When Your Home is On the Line: What You Should Know About Home Equity Lines of Credit", or any successor brochure issued by the Board of Governors of the Federal Reserve System, is deemed to be in compliance with this section.

(3) In the categories of transactions set forth at the end of this paragraph, the lender or mortgage broker does not have to provide the booklet to the borrower. Under the authority of section 19(a) of RESPA (12 U.S.C. 2617(a)), the Secretary may issue a revised or separate special information booklet that

deals with these transactions, or the Secretary may chose to endorse the forms or booklets of other Federal agencies. In such an event, the requirements for delivery by lenders and the availability of the booklet or alternate materials for these transactions will be set forth in a Notice in the FEDERAL REGISTER. This paragraph shall apply to the following transactions:

(i) Refinancing transactions;

(ii) Closed-end loans, as defined in 12 CFR 226.2(a)(10) of Regulation Z, when the lender takes a subordinate lien;

(iii) Reverse mortgages; and

(iv) Any other federally related mortgage loan whose purpose is not the purchase of a 1- to 4-family residential property.

(b) *Revision.* The Secretary may from time to time revise the special information booklet by publishing a notice in the FEDERAL REGISTER.

(c) *Reproduction.* The special information booklet may be reproduced in any form, provided that no change is made other than as provided under paragraph (d) of this section. The special information booklet may not be made a part of a larger document for purposes of distribution under RESPA and this section. Any color, size and quality of paper, type of print, and method of reproduction may be used so long as the booklet is clearly legible.

(d) *Permissible changes.* (1) No changes to, deletions from, or additions to the special information booklet currently prescribed by the Secretary shall be made other than those specified in this paragraph (d) or any others approved in writing by the Secretary. A request to the Secretary for approval of any changes shall be submitted in writing to the address indicated in § 3500.3, stating the reasons why the applicant believes such changes, deletions or additions are necessary.

(2) The cover of the booklet may be in any form and may contain any drawings, pictures or artwork, provided that the words "settlement costs" are used in the title. Names, addresses and telephone numbers of the lender or others and similar information may appear on the cover, but no discussion of the matters covered in the booklet shall appear on the cover.

(3) The special information booklet may be translated into languages other than English.

### § 3500.7 Good faith estimate.

(a) *Lender to provide.* Except as provided in this paragraph (a) or paragraph (f) of this section, the lender shall provide all applicants for a federally related mortgage loan with a good faith estimate of the amount of or range of charges for the specific settlement services the borrower is likely to incur in connection with the settlement. The lender shall provide the good faith estimate required under this section (a suggested format is set forth in appendix C of this part) either by delivering the good faith estimate or by placing it in the mail to the loan applicant, not later than three business days after the application is received or prepared.

(1) If the lender denies the application for a federally related mortgage loan before the end of the three-business-day period, the lender need not provide the denied borrower with a good faith estimate.

(2) For "no cost" or "no point" loans, the charges to be shown on the good faith estimate include any payments to be made to affiliated or independent settlement service providers. These payments should be shown as P.O.C. (Paid Outside of Closing) on the Good Faith Estimate and the HUD–1 or HUD–1A.

(3) In the case of dealer loans, the lender is responsible for provision of the good faith estimate, either directly or by the dealer.

(4) If a mortgage broker is the exclusive agent of the lender, either the lender or the mortgage broker shall provide the good faith estimate within three business days after the mortgage broker receives or prepares the application.

(b) *Mortgage broker to provide.* In the event an application is received by a mortgage broker who is not an exclusive agent of the lender, the mortgage broker must provide a good faith estimate within three days of receiving a loan application based on his or her knowledge of the range of costs (a suggested format is set forth in appendix C of this part). As long as the mortgage broker has provided the good faith estimate, the funding lender is not required to provide an additional good faith estimate, but the funding lender is responsible for ascertaining that the good faith estimate has been delivered. If the application for mortgage credit is denied before the end of the three-business-day period, the mortgage broker need not provide the denied borrower with a good faith estimate.

(c) *Content of good faith estimate.* A good faith estimate consists of an estimate, as a dollar amount or range, of each charge which:

(1) Will be listed in section L of the HUD–1 or HUD–1A in accordance with the instructions set forth in appendix A to this part; and

(2) That the borrower will normally pay or incur at or before settlement based upon common practice in the locality of the mortgaged property. Each such estimate must be made in good faith and bear a reasonable relationship to the charge a borrower is likely to be required to pay at settlement, and must be based upon experience in the locality of the mortgaged property. As to each charge with respect to which the lender requires a particular settlement service provider to be used, the lender shall make its estimate based upon the lender's knowledge of the amounts charged by such provider.

(d) *Form of good faith estimate.* A suggested good faith estimate form is set forth in appendix C to this part and is in compliance with the requirements of the Act except for any additional requirements of paragraph (e) of this section. The good faith estimate may be provided together with disclosures required by the Truth in Lending Act, 15 U.S.C. 1601 *et seq.*, so long as all required material for the good faith estimate is grouped together. The lender may include additional relevant information, such as the name/signature of the applicant and loan officer, date, and information identifying the loan application and property, as long as the form remains clear and concise and the additional information is not more prominent than the required material.

(e) *Particular providers required by lender.* (1) If the lender requires the use (see § 3500.2, "required use") of a particular provider of a settlement service, other than the lender's own employees, and also requires the borrower to pay any portion of the cost of such service, then the good faith estimate must:

(i) Clearly state that use of the particular provider is required and that the estimate is based on the charges of the designated provider;

(ii) Give the name, address, and telephone number of each provider; and

(iii) Describe the nature of any relationship between each such provider and the lender. Plain English references to the relationship should be utilized, e.g., "X is a depositor of the lender," "X is a borrower from the lender," "X has performed 60% of the lender's settlements in the past year." (The lender is not required to keep detailed records of the percentages of use. Similar language, such as "X was used [regularly] [frequently] in our settlements the past year" is also sufficient for the purposes of this paragraph.) In the event that more than one relationship exists, each should be disclosed.

(2) For purposes of paragraph (e)(1) of this section, a "relationship" exists if:

(i) The provider is an associate of the lender, as that term is defined in 12 U.S.C. 2602(8);

(ii) Within the last 12 months, the provider has maintained an account with the lender or had an outstanding loan or credit arrangement with the lender; or

(iii) The lender has repeatedly used or required borrowers to use the services of the provider within the last 12 months.

(3) Except for a provider that is the lender's chosen attorney, credit reporting agency, or appraiser, if the lender is in an affiliated business relationship (see § 3500.15) with a provider, the lender may not require the use of that provider.

(4) If the lender maintains a controlled list of required providers (five or more for each discrete service) or relies on a list maintained by others, and at the time of application the lender has not yet decided which provider will be selected from that list, then the lender may satisfy the requirements of this section if the lender:

(i) Provides the borrower with a written statement that the lender will require a particular provider from a lender-controlled or -approved list; and

(ii) Provides the borrower in the Good Faith Estimate the range of costs for the required provider(s), and provides the name of the specific provider and the actual cost on the HUD–1 or HUD–1A.

(f) *Open-end lines of credit (home-equity plans) under Truth in Lending Act.* In the case of a federally related mortgage loan involving an open-end line of credit (home-equity plan) covered under the Truth in Lending Act and Regulation Z, a lender or mortgage broker that provides the borrower with the disclosures required by 12 CFR 226.5b of Regulation Z at the time the borrower applies for such loan shall be deemed to satisfy the requirements of this section.

(Approved by the Office of Management and Budget under control number 2502–0265)

[61 FR 13233, Mar. 26, 1996, as amended at 61 FR 58476, Nov. 15, 1996]

### § 3500.8 Use of HUD–1 or HUD–1A settlement statements.

(a) *Use by settlement agent.* The settlement agent shall use the HUD–1 settlement statement in every settlement involving a federally related mortgage loan in which there is a borrower and a seller. For transactions in which there is a borrower and no seller, such as refinancing loans or subordinate lien loans, the HUD–1 may be utilized by using the borrower's side of the HUD–1 statement. Alternatively, the form HUD–1A may be used for these transactions. Either the HUD–1 or the HUD–1A, as appropriate, shall be used for every RESPA-covered transaction, unless its use is specifically exempted, but the HUD–1 or HUD–1A may be modified as permitted under this part. The use of the HUD–1 or HUD–1A is exempted for open-end lines of credit (home-equity plans) covered by the Truth in Lending Act and Regulation Z.

(b) *Charges to be stated.* The settlement agent shall complete the HUD–1 or HUD–1A in accordance with the instructions set forth in appendix A to this part.

(c) *Aggregate accounting at settlement.* (1) After itemizing individual deposits in the 1000 series using single-item accounting, the servicer shall make an adjustment based on aggregate accounting. This adjustment equals the difference in the deposit required under aggregate accounting and the sum of the deposits required under single-item accounting. The computation steps for both accounting methods are set out in § 3500.17(d). The adjustment will always be a negative number or zero (–0–). The settlement agent shall enter the aggregate adjustment amount on a final line in the 1000 series of the HUD–1 or HUD–1A statement.

(2) During the phase-in period, as defined in § 3500.17(b), an alternative procedure is available. The settlement agent may initially calculate the 1000 series deposits for the HUD–1 and HUD–1A settlement statement using single-item analysis with only a one-month cushion (unless the mortgage loan documents indicate a smaller amount). In the escrow account analysis conducted within 45 days of settlement, however, the servicer shall adjust the escrow account to reflect the aggregate accounting balance. Appendix E to this part sets out examples of aggregate analysis. Appendix A to this part contains instructions for completing the HUD–1 or HUD–1A settlement statements using an aggregate analysis adjustment and the alternative process during the phase-in period.

(Approved by the Office of Management and Budget under control numbers 2502–0265 and 2502–0491)

[61 FR 13233, Mar. 26, 1996, as amended at 61 FR 58476, Nov. 15, 1996]

### § 3500.9 Reproduction of settlement statements.

(a) *Permissible changes—HUD–1.* The following changes and insertions are permitted when the HUD–1 settlement statement is reproduced:

(1) The person reproducing the HUD–1 may insert its business name and logotype in section A and may rearrange, but not delete, the other information that appears in section A.

(2) The name, address, and other information regarding the lender and settlement agent may be printed in sections F and H, respectively.

(3) Reproduction of the HUD–1 must conform to the terminology, sequence, and numbering of line items as presented in lines 100–1400. However, blank lines or items listed in lines 100–1400 that are not used locally or in connection with mortgages by the lender may be deleted, except for the following: Lines 100, 120, 200, 220, 300, 301, 302, 303, 400, 420, 500, 520, 600, 601, 602, 603, 700, 800, 900, 1000, 1100, 1200, 1300, and 1400. The form may be shortened correspondingly. The number of a deleted item shall not be used for a substitute or new item, but the number of a blank space on the HUD–1 may be used for a substitute or new item.

(4) Charges not listed on the HUD–1, but that are customary locally or pursuant to the lender's practice, may be inserted in blank spaces. Where existing blank spaces on the HUD–1 are insufficient, additional lines and spaces may be added and numbered in sequence with spaces on the HUD–1.

(5) The following variations in layout and format are within the discretion of persons reproducing the HUD–1 and do not require prior HUD approval: size of pages; tint or color of pages; size and style of type or print; vertical spacing between lines or provision for additional horizontal space on lines (for example, to provide sufficient space for recording time periods used in prorations); printing of the HUD–1 contents on separate pages, on the front and back of a single page, or on one continuous page; use of multicopy tear-out sets; printing on rolls for computer purposes; reorganization of sections B through I, when necessary to accommodate computer printing; and manner of placement of the HUD number, but not the OMB approval number, neither of which may be deleted. The designation of the expiration date of the OMB number may be deleted. Any changes in the HUD number or OMB approval number may be announced by notice in the FEDERAL REGISTER, rather than by amendment of this part.

(6) The borrower's information and the seller's information may be provided on separate pages.

(7) Signature lines may be added.

(8) The HUD–1 may be translated into languages other than English.

(9) An additional page may be attached to the HUD–1 for the purpose of including customary recitals and information used locally in real estate settlements; for example, breakdown of payoff figures, a breakdown of the borrower's total monthly mortgage payments, check disbursements, a statement indicating receipt of funds, applicable special stipulations between buyer and seller, and the date funds are transferred. If space permits, such information may be added at the end of the HUD–1.

(10) As required by HUD/FHA in FHA-insured loans.

(11) As allowed by § 3500.17, relating to an initial escrow account statement.

(b) *Permissible changes—HUD–1A.* The changes and insertions on the HUD–1 permitted under paragraph (a) of this section are also permitted when the HUD–1A settlement statement is reproduced, except the changes described in paragraphs (a)(3) and (6) of this section.

(c) *Written approval.* Any other deviation in the HUD–1 or HUD–1A forms is permissible only upon receipt of written approval of the Secretary. A request to the Secretary for approval shall be submitted in writing to the address indicated in § 3500.3 and shall state the reasons why the applicant believes such deviation is needed. The prescribed form(s) must be used until approval is received.

(Approved by the Office of Management and Budget under control numbers 2502–0265 and 2502–0491)

## § 3500.10 One-day advance inspection of HUD–1 or HUD–1A settlement statement; delivery; recordkeeping.

(a) *Inspection one day prior to settlement upon request by the borrower.* The settlement agent shall permit the borrower to inspect the HUD–1 or HUD–1A settlement statement, completed to set forth those items that are known to the settlement agent at the time of inspection, during the business day immediately preceding settlement. Items related only to the seller's transaction may be omitted from the HUD–1.

(b) *Delivery.* The settlement agent shall provide a completed HUD–1 or HUD–1A to the borrower, the seller (if there is one), the lender (if the lender is not the settlement agent), and/or their agents. When the borrower's and seller's copies of the HUD–1 or HUD–1A differ as permitted by the instructions in appendix A to this part, both copies shall be provided to the lender (if the lender is not the settlement agent). The settlement agent shall deliver the completed HUD–1 or HUD–1A at or before the settlement, except as provided in paragraphs (c) and (d) of this section.

(c) *Waiver*. The borrower may waive the right to delivery of the completed HUD–1 or HUD–1A no later than at settlement by executing a written waiver at or before settlement. In such case, the completed HUD–1 or HUD–1A shall be mailed or delivered to the borrower, seller, and lender (if the lender is not the settlement agent) as soon as practicable after settlement.

(d) *Exempt transactions*. When the borrower or the borrower's agent does not attend the settlement, or when the settlement agent does not conduct a meeting of the parties for that purpose, the transaction shall be exempt from the requirements of paragraphs (a) and (b) of this section, except that the HUD–1 or HUD–1A shall be mailed or delivered as soon as practicable after settlement.

(e) *Recordkeeping*. The lender shall retain each completed HUD–1 or HUD–1A and related documents for five years after settlement, unless the lender disposes of its interest in the mortgage and does not service the mortgage. In that case, the lender shall provide its copy of the HUD–1 or HUD–1A to the owner or servicer of the mortgage as a part of the transfer of the loan file. Such owner or servicer shall retain the HUD–1 or HUD–1A for the remainder of the five-year period. The Secretary shall have the right to inspect or require copies of records covered by this paragraph (e).

(Approved by the Office of Management and Budget under control number 2502–0265)

### § 3500.11 Mailing.

The provisions of this part requiring or permitting mailing of documents shall be deemed to be satisfied by placing the document in the mail (whether or not received by the addressee) addressed to the addresses stated in the loan application or in other information submitted to or obtained by the lender at the time of loan application or submitted or obtained by the lender or settlement agent, except that a revised address shall be used where the lender or settlement agent has been expressly informed in writing of a change in address.

### § 3500.12 No fee.

No fee shall be imposed or charge made upon any other person, as a part of settlement costs or otherwise, by a lender in connection with a federally related mortgage loan made by it (or a loan for the purchase of a manufactured home), or by a servicer (as that term is defined under 12 U.S.C. 2605(i)(2)) for or on account of the preparation and distribution of the HUD–1 or HUD–1A settlement statement, escrow account statements required pursuant to section 10 of RESPA (12 U.S.C. 2609), or statements required by the Truth in Lending Act, 15 U.S.C. 1601 *et seq*.

### § 3500.13 Relation to State laws.

(a) State laws that are inconsistent with RESPA or this part are preempted to the extent of the inconsistency. However, RESPA and these regulations do not annul, alter, affect, or exempt any person subject to their provisions from complying with the laws of any State with respect to settlement practices, except to the extent of the inconsistency.

(b) Upon request by any person, the Secretary is authorized to determine if inconsistencies with State law exist; in doing so, the Secretary shall consult with appropriate Federal agencies.

(1) The Secretary may not determine that a State law or regulation is inconsistent with any provision of RESPA or this part, if the Secretary determines that such law or regulation gives greater protection to the consumer.

(2) In determining whether provisions of State law or regulations concerning affiliated business arrangements are inconsistent with RESPA or this part, the Secretary may not construe those provisions that impose more stringent limitations on affiliated business arrangements as inconsistent with

RESPA so long as they give more protection to consumers and/or competition.

(c) Any person may request the Secretary to determine whether an inconsistency exists by submitting to the address indicated in § 3500.3, a copy of the State law in question, any other law or judicial or administrative opinion that implements, interprets or applies the relevant provision, and an explanation of the possible inconsistency. A determination by the Secretary that an inconsistency with State law exists will be made by publication of a notice in the FEDERAL REGISTER. "Law" as used in this section includes regulations and any enactment which has the force and effect of law and is issued by a State or any political subdivision of a State.

(d) A specific preemption of conflicting State laws regarding notices and disclosures of mortgage servicing transfers is set forth in § 3500.21(h).

[61 FR 13233, Mar. 26, 1996, as amended at 61 FR 58476, Nov. 15, 1996]

### § 3500.14 Prohibition against kickbacks and unearned fees.

(a) *Section 8 violation.* Any violation of this section is a violation of section 8 of RESPA (12 U.S.C. 2607) and is subject to enforcement as such under § 3500.19.

(b) *No referral fees.* No person shall give and no person shall accept any fee, kickback or other thing of value pursuant to any agreement or understanding, oral or otherwise, that business incident to or part of a settlement service involving a federally related mortgage loan shall be referred to any person. Any referral of a settlement service is not a compensable service, except as set forth in § 3500.14(g)(1). A company may not pay any other company or the employees of any other company for the referral of settlement service business.

(c) *No split of charges except for actual services performed.* No person shall give and no person shall accept any portion, split, or percentage of any charge made or received for the rendering of a settlement service in connection with a transaction involving a federally related mortgage loan other than for services actually performed. A charge by a person for which no or nominal services are performed or for which duplicative fees are charged is an unearned fee and violates this section. The source of the payment does not determine whether or not a service is compensable. Nor may the prohibitions of this part be avoided by creating an arrangement wherein the purchaser of services splits the fee.

(d) *Thing of value.* This term is broadly defined in section 3(2) of RESPA (12 U.S.C. 2602(2)). It includes, without limitation, monies, things, discounts, salaries, commissions, fees, duplicate payments of a charge, stock, dividends, distributions of partnership profits, franchise royalties, credits representing monies that may be paid at a future date, the opportunity to participate in a money-making program, retained or increased earnings, increased equity in a parent or subsidiary entity, special bank deposits or accounts, special or unusual banking terms, services of all types at special or free rates, sales or rentals at special prices or rates, lease or rental payments based in whole or in part on the amount of business referred, trips and payment of another person's expenses, or reduction in credit against an existing obligation. The term "payment" is used throughout §§ 3500.14 and 3500.15 as synonymous with the giving or receiving any "thing of value" and does not require transfer of money.

(e) *Agreement or understanding.* An agreement or understanding for the referral of business incident to or part of a settlement service need not be written or verbalized but may be established by a practice, pattern or course of conduct. When a thing of value is received repeatedly and is connected in any way with the volume or value of the business referred, the receipt of the thing of value is evidence that it is made pursuant to an agreement or understanding for the referral of business.

(f) *Referral.* (1) A referral includes any oral or written action directed to a person which has the effect of affirmatively influencing the selection by any person of a provider of a settlement service or business incident to or part of a settlement service when such person will pay for such settlement service or business incident thereto or pay a charge attributable in whole or in part to such settlement service or business.

(2) A referral also occurs whenever a person paying for a settlement service or business incident thereto is required to use (see § 3500.2, "required use") a particular provider of a settlement service or business incident thereto.

(g) *Fees, salaries, compensation, or other payments.* (1) Section 8 of RESPA permits:

(i) A payment to an attorney at law for services actually rendered;

(ii) A payment by a title company to its duly appointed agent for services actually performed in the issuance of a policy of title insurance;

(iii) A payment by a lender to its duly appointed agent or contractor for services actually performed in the origination, processing, or funding of a loan;

(iv) A payment to any person of a *bona fide* salary or compensation or other payment for goods or facilities actually furnished or for services actually performed;

(v) A payment pursuant to cooperative brokerage and referral arrangements or agreements between real estate agents and real estate brokers. (The statutory exemption restated in this paragraph refers only to fee divisions within real estate brokerage arrangements when all parties are acting in a real estate brokerage capacity, and has no applicability to any fee arrangements between real estate brokers and mortgage brokers or between mortgage brokers.);

(vi) Normal promotional and educational activities that are not conditioned on the referral of business and that do not involve the defraying of expenses that otherwise would be incurred by persons in a position to refer settlement services or business incident thereto; or

(vii) An employer's payment to its own employees for any referral activities.

(2) The Department may investigate high prices to see if they are the result of a referral fee or a split of a fee. If the payment of a thing of value bears no reasonable relationship to the market value of the goods or services provided, then the excess is not for services or goods actually performed or provided. These facts may be used as evidence of a violation of section 8 and may serve as a basis for a RESPA investigation. High prices standing alone are not proof of a RESPA violation. The value of a referral (i.e., the value of any additional business obtained thereby) is not to be taken into account in determining whether the payment exceeds the reasonable value of such goods, facilities or services. The fact that the transfer of the thing of value does not result in an increase in any charge made by the person giving the thing of value is irrelevant in determining whether the act is prohibited.

(3) *Multiple services.* When a person in a position to refer settlement service business, such as an attorney, mortgage lender, real estate broker or agent, or developer or builder, receives a payment for providing additional settlement services as part of a real estate transaction, such payment must be for services that are actual, necessary and distinct from the primary services provided by such person. For example, for an attorney of the buyer or seller to receive compensation as a title agent, the attorney must perform core title agent services (for which liability arises) separate from attorney services, including the evaluation of the title search to determine the insurability of the title, the clearance of underwriting objections, the actual issuance of the policy or policies on behalf of the title insurance company, and, where customary, issuance of the title commitment, and the conducting of the title search and closing.

(h) *Recordkeeping.* Any documents provided pursuant to this section shall be retained for five (5) years from the date of execution.

(i) *Appendix B of this part.* Illustrations in appendix B of this part demonstrate some of the requirements of this section.

[61 FR 13233, Mar. 26, 1996, as amended at 61 FR 29252, June 7, 1996; 61 FR 58476, Nov. 15, 1996]

EFFECTIVE DATE NOTE: At 61 FR 29252, June 7, 1996, § 3500.14 was amended by revising the last sentence of paragraph (b), the heading of paragraph (g), and paragraph (g)(1), effective Oct. 7, 1996. At 61 FR 51782, Oct. 4, 1996, the effective date was delayed until further notice. For the convenience of the user, the new text is set forth as follows:

**§ 3500.14 Prohibition against kickbacks and unearned fees.**

* * * * *

(b) * * * A business entity (whether or not in an affiliate relationship) may not pay any other business entity or the employees of any other business entity for the referral of settlement service business.

* * * * *

(g) *Exemptions for fees, salaries, compensation, or other payments.* (1) The following are permissible:

(i) A payment to an attorney at law for services actually rendered;

(ii) A payment by a title company to its duly appointed agent for services actually performed in the issuance of a policy of title insurance;

(iii) A payment by a lender to its duly appointed agent or contractor for services actually performed in the origination, processing, or funding of a loan;

(iv) A payment to any person of a *bona fide* salary or compensation or other payment for goods or facilities actually furnished or for services actually performed;

(v) A payment pursuant to cooperative brokerage and referral arrangements or agreements between real estate agents and real estate brokers. (The statutory exemption restated in this paragraph refers only to fee divisions within real estate brokerage arrangements when all parties are acting in a real estate brokerage capacity, and has no applicability to any fee arrangements between real estate brokers and mortgage brokers or between mortgage brokers.)

(vi) Normal promotional and educational activities that are not conditioned on the referral of business and do not involve the defraying of expenses that otherwise would be incurred by persons in a position to refer settlement services or business incident thereto;

(vii) A payment by an employer to its own *bona fide* employee for generating business for that employer;

(viii) In a controlled business arrangement, a payment by an employer of a bonus to a managerial employee based on criteria relating to performance (such as profitability, capture rate, or other thresholds) of a business entity in the controlled business arrangement. However, the amount of such bonus may not be calculated as a multiple of the number or value of referrals of settlement service business to a business entity in a controlled business arrangement; and

(ix)(A) A payment by an employer to its *bona fide* employee for the referral of settlement service business to a settlement service provider that has an affiliate relationship with the employer or in which the employer has a direct or beneficial ownership interest of more than 1 percent, if the following conditions are met:

(*1*) The employee does not perform settlement services in any transaction; and

(*2*) Before the referral, the employee provides to the person being referred a written disclosure in the format of the Controlled Business Arrangement Disclosure Statement, set forth in appendix D to this part.

(B) For purposes of this paragraph (g)(1)(ix), the marketing of a settlement service or product of an affiliated entity, including the collection and conveyance of information or the taking of an application or order for an affiliated entity, does not constitute the performance of a settlement service. Under this paragraph (g)(1)(ix), marketing of a settlement service or product may include incidental communications with the consumer after the application or order, such as providing the consumer with information about the status of an application or order; marketing shall not include serving as the ongoing point of contact for coordinating the delivery and provision of settlement services.

* * * * *

**§ 3500.15 Affiliated business arrangements.**

(a) *General.* An affiliated business arrangement is defined in section 3(7) of RESPA (12 U.S.C. 2602(7)).

(b) *Violation and exemption.* An affiliated business arrangement is not a violation of section 8 of RESPA (12 U.S.C. 2607) and of § 3500.14 if the conditions set forth in this section are satisfied. Paragraph (b)(1) of this section shall not apply to the extent it is inconsistent with section 8(c)(4)(A) of RESPA (12 U.S.C. 2607(c)(4)(A)).

(1) The person making each referral has provided to each person whose business is referred a written disclosure, in the format of the Affiliated Business Arrangement Disclosure Statement set forth in appendix D of this part, of the nature of the relationship (explaining the ownership and financial interest) between the provider of settlement services (or business incident thereto) and the person making the referral and of an estimated charge or range of charges generally made by such provider (which describes the

charge using the same terminology, as far as practical, as section L of the HUD–1 settlement statement). The disclosures must be provided on a separate piece of paper no later than the time of each referral or, if the lender requires use of a particular provider, the time of loan application, except that:

(i) Where a lender makes the referral to a borrower, the condition contained in paragraph (b)(1) of this section may be satisfied at the time that the good faith estimate or a statement under §3500.7(d) is provided; and

(ii) Whenever an attorney or law firm requires a client to use a particular title insurance agent, the attorney or law firm shall provide the disclosures no later than the time the attorney or law firm is engaged by the client. Failure to comply with the disclosure requirements of this section may be overcome if the person making a referral can prove by a preponderance of the evidence that procedures reasonably adopted to result in compliance with these conditions have been maintained and that any failure to comply with these conditions was unintentional and the result of a *bona fide* error. An error of legal judgment with respect to a person's obligations under RESPA is not a *bona fide* error. Administrative and judicial interpretations of section 130(c) of the Truth in Lending Act shall not be binding interpretations of the preceding sentence or section 8(d)(3) of RESPA (12 U.S.C. 2607(d)(3)).

(2) No person making a referral has required (as defined in §3500.2, "required use") any person to use any particular provider of settlement services or business incident thereto, except if such person is a lender, for requiring a buyer, borrower or seller to pay for the services of an attorney, credit reporting agency, or real estate appraiser chosen by the lender to represent the lender's interest in a real estate transaction, or except if such person is an attorney or law firm for arranging for issuance of a title insurance policy for a client, directly as agent or through a separate corporate title insurance agency that may be operated as an adjunct to the law practice of the attorney or law firm, as part of representation of that client in a real estate transaction.

(3) The only thing of value that is received from the arrangement other than payments listed in §3500.14(g) is a return on an ownership interest or franchise relationship.

(i) In an affiliated business arrangement:

(A) *Bona fide* dividends, and capital or equity distributions, related to ownership interest or franchise relationship, between entities in an affiliate relationship, are permissible; and

(B) *Bona fide* business loans, advances, and capital or equity contributions between entities in an affiliate relationship (in any direction), are not prohibited—so long as they are for ordinary business purposes and are not fees for the referral of settlement service business or unearned fees.

(ii) A return on an ownership interest does not include:

(A) Any payment which has as a basis of calculation no apparent business motive other than distinguishing among recipients of payments on the basis of the amount of their actual, estimated or anticipated referrals;

(B) Any payment which varies according to the relative amount of referrals by the different recipients of similar payments; or

(C) A payment based on an ownership, partnership or joint venture share which has been adjusted on the basis of previous relative referrals by recipients of similar payments.

(iii) Neither the mere labelling of a thing of value, nor the fact that it may be calculated pursuant to a corporate or partnership organizational document or a franchise agreement, will determine whether it is a *bona fide* return on an ownership interest or franchise relationship. Whether a thing of value is such a return will be determined by analyzing facts and circumstances on a case by case basis.

(iv) A return on franchise relationship may be a payment to or from a franchisee but it does not include any payment which is not based on the franchise agreement, nor any payment which varies according to the number or amount of referrals by the franchisor or franchisee or which is based on a franchise agreement which has been adjusted on the basis of a previous number or amount of referrals by the franchiser or franchisees. A franchise agreement may not be constructed to insulate against kickbacks or referral fees.

(c) *Definitions.* As used in this section:

(1) *Associate* is defined in section 3(8) of RESPA (12 U.S.C. 2602(8)).

(2) *Affiliate relationship* means the relationship among business entities where one entity has effective control over the other by virtue of a partnership or other agreement or is under common control with the other by a third entity or where an entity is a corporation related to another corporation as parent to subsidiary by an identity of stock ownership.

(3) *Beneficial ownership* means the effective ownership of an interest in a provider of settlement services or the right to use and control the ownership interest involved even though legal ownership or title may be held in another person's name.

(4) *Control,* as used in the definitions of "associate" and "affiliate relationship," means that a person:

(i) Is a general partner, officer, director, or employer of another person;

(ii) Directly or indirectly or acting in concert with others, or through one or more subsidiaries, owns, holds with power to vote, or holds proxies representing, more than 20 percent of the voting interests of another person;

(iii) Affirmatively influences in any manner the election of a majority of the directors of another person; or

(iv) Has contributed more than 20 percent of the capital of the other person.

(5) *Direct ownership* means the holding of legal title to an interest in a provider of settlement service except where title is being held for the beneficial owner.

(6) *Franchise* is defined in 16 CFR 436.2(a).

(7) *Franchisor* is defined in 16 CFR 436.2(c).

(8) *Franchisee* is defined in 16 CFR 436.2(d).

(9) *Person who is in a position to refer settlement service business* means any real estate broker or agent, lender, mortgage broker, builder or developer, attorney, title company, title agent, or other person deriving a significant portion of his or her gross income from providing settlement services.

(d) *Recordkeeping.* Any documents provided pursuant to this section shall be retained for 5 years after the date of execution.

(e) *Appendix B of this part.* Illustrations in appendix B of this part demonstrate some of the requirements of this section.

[61 FR 13233, Mar. 26, 1996, as amended at 61 FR 29252, June 7, 1996; 61 FR 58476, Nov. 15, 1996]

EFFECTIVE DATE NOTE: At 61 FR 29252, June 7, 1996, §3500.15 was amended by revising the introductory text of paragraph (b)(1), effective Oct. 7, 1996. At 61 FR 51782, Oct. 4, 1996, the effective date was delayed until further notice. For the convenience of the user, the new text is set forth as follows:

**§3500.15 Controlled business arrangements.**

* * * * *

(b) * * *

(1) Prior to the referral, the person making a referral has provided to each person whose business is referred a written disclosure, in the format of the Controlled Business Arrangement Disclosure Statement set forth in appendix D of this part. This disclosure shall specify the nature of the relationship (explaining the ownership and financial interest) between the person performing settlement services (or business incident thereto) and the person making the referral, and shall describe the estimated charge or range of charges (using the same terminology, as far as practical, as section L of the HUD-1 or HUD-1A settlement statement) generally made by the provider of settlement services. The disclosure must be provided on a separate piece of paper no later than the time of each referral or, if the lender requires the use of a particular provider, the time of loan application, except that:

* * * * *

## §3500.16 Title companies.

No seller of property that will be purchased with the assistance of a federally related mortgage loan shall violate section 9 of RESPA (12 U.S.C. 2608). Section 3500.2 defines "required use" of a provider of a settlement service. Section 3500.19(c) explains the liability of a seller for a violation of this section.

**§ 3500.17 Escrow accounts.**

(a) *General.* This section sets out the requirements for an escrow account that a lender establishes in connection with a federally related mortgage loan. It sets limits for escrow accounts using calculations based on monthly payments and disbursements within a calendar year. If an escrow account involves biweekly or any other payment period, the requirements in this section shall be modified accordingly. A HUD Public Guidance Document entitled "Biweekly Payments—Example" provides examples of biweekly accounting and a HUD Public Guidance Document entitled "Annual Escrow Account Disclosure Statement—Example" provides examples of a 3-year accounting cycle that may be used in accordance with paragraph (c)(9) of this section. A HUD Public Guidance Document entitled "Consumer Disclosure for Voluntary Escrow Account Payments" provides a model disclosure format that originators and servicers are encouraged, but not required, to provide to consumers when the originator or servicer anticipates a substantial increase in disbursements from the escrow account after the first year of the loan. The disclosures in that model format may be combined with or included in the Initial Escrow Account Statement required in § 3500.17(g).

(b) *Definitions.* As used in this section:

*Acceptable accounting method* means an accounting method that a servicer uses to conduct an escrow account analysis for an escrow account subject to the provisions of § 3500.17(c).

*Aggregate (or) composite analysis,* hereafter called *aggregate analysis,* means an accounting method a servicer uses in conducting an escrow account analysis by computing the sufficiency of escrow account funds by analyzing the account as a whole. Appendix E to this part sets forth examples of aggregate escrow account analyses.

*Annual escrow account statement* means a statement containing all of the information set forth in § 3500.17(i). As noted in § 3500.17(i), a servicer shall submit an annual escrow account statement to the borrower within 30 calendar days of the end of the escrow account computation year, after conducting an escrow account analysis.

*Conversion date* means the date three years after the publication date of the rule adding this section (i.e., October 27, 1997) by which date all servicers shall use aggregate analysis.

*Cushion or reserve* (hereafter cushion) means funds that a servicer may require a borrower to pay into an escrow account to cover unanticipated disbursements or disbursements made before the borrower's payments are available in the account, as limited by § 3500.17(c).

*Deficiency* is the amount of a negative balance in an escrow account. As noted in § 3500.17(f), if a servicer advances funds for a borrower, then the servicer must perform an escrow account analysis before seeking repayment of the deficiency.

*Delivery* means the placing of a document in the United States mail, first-class postage paid, addressed to the last known address of the recipient. Hand delivery also constitutes delivery.

*Disbursement date* means the date on which the servicer actually pays an escrow item from the escrow account.

*Escrow account* means any account that a servicer establishes or controls on behalf of a borrower to pay taxes, insurance premiums (including flood insurance), or other charges with respect to a federally related mortgage loan, including charges that the borrower and servicer have voluntarily agreed that the servicer should collect and pay. The definition encompasses any account established for this purpose, including a "trust account", "reserve account", "impound account", or other term in different localities. An "escrow account" includes any arrangement where the servicer adds a portion of the borrower's payments to principal and subsequently deducts from principal the disbursements for escrow account items. For purposes of this section, the term "escrow account" excludes any account that is under the borrower's total control.

*Escrow account analysis* means the accounting that a servicer conducts in the form of a trial running balance for an escrow account to:

(1) Determine the appropriate target balances;

(2) Compute the borrower's monthly payments for the next escrow account computation year and any deposits needed to establish or maintain the account; and

(3) Determine whether shortages, surpluses or deficiencies exist.

*Escrow account computation year* is a 12-month period that a servicer establishes for the escrow account beginning with the borrower's initial payment date. The term includes each 12-month period thereafter, unless a servicer chooses to issue a short year statement under the conditions stated in §3500.17(i)(4).

*Escrow account item* or *separate item* means any separate expenditure category, such as "taxes" or "insurance", for which funds are collected in the escrow account for disbursement. An escrow account item with installment payments, such as local property taxes, remains one escrow account item regardless of multiple disbursement dates to the tax authority.

*Initial escrow account statement* means the first disclosure statement that the servicer delivers to the borrower concerning the borrower's escrow account. The initial escrow account statement shall meet the requirements of §3500.17(g) and be in substantially the format set forth in §3500.17(h).

*Installment payment* means one of two or more payments payable on an escrow account item during an escrow account computation year. An example of an installment payment is where a jurisdiction bills quarterly for taxes.

*Payment due date* means the date each month when the borrower's monthly payment to an escrow account is due to the servicer. The initial payment date is the borrower's first payment due date to an escrow account.

*Penalty* means a late charge imposed by the payee for paying after the disbursement is due. It does not include any additional charge or fee imposed by the payee associated with choosing installment payments as opposed to annual payments or for choosing one installment plan over another.

*Phase-in period* means the period beginning on May 24, 1995, and ending on the conversion date, i.e., October 27, 1997, by which date all servicers shall use the aggregate accounting method in conducting escrow account analyses.

*Post-rule account* means an escrow account established in connection with a federally related mortgage loan whose settlement date is on or after May 24, 1995.

*Pre-accrual* is a practice some servicers use to require borrowers to deposit funds, needed for disbursement and maintenance of a cushion, in the escrow account some period before the disbursement date. Pre-accrual is subject to the limitations of §3500.17(c).

*Pre-rule account* is an escrow account established in connection with a federally related mortgage loan whose settlement date is before May 24, 1995.

*Shortage* means an amount by which a current escrow account balance falls short of the target balance at the time of escrow analysis.

*Single-item analysis* means an accounting method servicers use in conducting an escrow account analysis by computing the sufficiency of escrow account funds by considering each escrow item separately. Appendix E to this part sets forth examples of single-item analysis.

*Submission* (of an escrow account statement) means the delivery of the statement.

*Surplus* means an amount by which the current escrow account balance exceeds the target balance for the account.

*System of recordkeeping* means the servicer's method of keeping information that reflects the facts relating to that servicer's handling of the borrower's escrow account, including, but not limited to, the payment of amounts from the escrow account and the submission of initial and annual escrow account statements to borrowers.

*Target balance* means the estimated month end balance in an escrow account that is just sufficient to cover the remaining disbursements from the escrow account in the escrow account computation year, taking into account the remaining scheduled periodic payments, and a cushion, if any.

*Trial running balance* means the accounting process that derives the target balances over the course of an escrow account computation year. Section 3500.17(d) provides a description of the steps involved in performing a trial running balance.

(c) *Limits on payments to escrow accounts; acceptable accounting methods to determine limits.* (1) A lender or servicer (hereafter servicer) shall not require a borrower to deposit into any escrow account, created in connection with a federally related mortgage loan, more than the following amounts:

(i) *Charges at settlement or upon creation of an escrow account.* At the time a servicer creates an escrow account for a borrower, the servicer may charge the borrower an amount sufficient to pay the charges respecting the mortgaged property, such as taxes and insurance, which are attributable to the period from the date such payment(s) were last paid until the initial payment date. The "amount sufficient to pay" is computed so that the lowest month end target balance projected for the escrow account computation year is zero (–0–) (see Step 2 in appendix E to this part). In addition, the servicer may charge the borrower a cushion that shall be no greater than one-sixth (1/6) of the estimated total annual payments from the escrow account.

(ii) *Charges during the life of the escrow account.* Throughout the life of an escrow account, the servicer may charge the borrower a monthly sum equal to one-twelfth (1/12) of the total annual escrow payments which the servicer reasonably anticipates paying from the account. In addition, the servicer may add an amount to maintain a cushion no greater than one-sixth (1/6) of the estimated total annual payments from the account. However, if a servicer determines through an escrow account analysis that there is a shortage or deficiency, the servicer may require the borrower to pay additional deposits to make up the shortage or eliminate the deficiency, subject to the limitations set forth in § 3500.17(f).

(2) *Escrow analysis at creation of escrow account.* Before establishing an escrow account, the servicer must conduct an escrow account analysis to determine the amount the borrower must deposit into the escrow account (subject to the limitations of paragraph (c)(1)(i) of this section), and the amount of the borrower's periodic payments into the escrow account (subject to the limitations of paragraph (c)(1)(ii) of this section). In conducting the escrow account analysis, the servicer must estimate the disbursement amounts according to paragraph (c)(7) of this section. Pursuant to paragraph (k) of this section, the servicer must use a date on or before the deadline to avoid a penalty as the disbursement date for the escrow item and comply with any other requirements of paragraph (k) of this section. Upon completing the initial escrow account analysis, the servicer must prepare and deliver an initial escrow account statement to the borrower, as set forth in paragraph (g) of this section. The servicer must use the escrow account analysis to determine whether a surplus, shortage, or deficiency exists and must make any adjustments to the account pursuant to paragraph (f) of this section.

(3) *Subsequent escrow account analyses.* For each escrow account, the servicer must conduct an escrow account analysis at the completion of the escrow account computation year to determine the borrower's monthly escrow account payments for the next computation year, subject to the limitations of paragraph (c)(1)(ii) of this section. In conducting the escrow account analysis, the servicer must estimate the disbursement amounts according to paragraph (c)(7) of this section. Pursuant to paragraph (k) of this section, the servicer must use a date on or before the deadline to avoid a penalty as the disbursement date for the escrow item and comply with any other requirements of paragraph (k) of this section. The servicer must use the escrow account analysis to determine whether a surplus, shortage, or deficiency exists, and must make any adjustments to the account pursuant to paragraph (f) of this section. Upon completing an escrow account analysis, the servicer must prepare and submit an annual escrow account statement to the borrower, as set forth in paragraph (i) of this section.

(4) Acceptable accounting methods to determine escrow limits. The following are acceptable accounting methods that servicers may use in conducting an escrow account analysis.

(i) *Pre-rule accounts.* For pre-rule accounts, servicers may use either single-item analysis or aggregate-analysis during the phase-in period. In conducting the escrow account analysis, servicers shall use "month-end" accounting. Under month-end accounting, the timing of the disbursements and payments within the month is irrelevant. As of the conversion date, all pre-rule accounts shall comply with the requirements for post-rule accounts in paragraph (c)(4)(ii) of this section. During the phase-in period, the transfer of servicing of a pre-rule account to another servicer does not convert the account to a post-rule account. After May 24, 1995, refinancing transactions (as defined in § 3500.2) shall comply with the requirements for post-rule accounts.

(ii) *Post-rule accounts.* For post-rule accounts, servicers shall use aggregate accounting to conduct an escrow account analysis. In conducting the escrow account analysis, servicers shall use "month-end" accounting. Under month-end accounting, the timing of the disbursements and payments within the month is irrelevant.

(5) *Cushion.* For post-rule accounts, the cushion shall be no greater than one-sixth (1/6) of the estimated total annual disbursements from the escrow account using aggregate analysis accounting. For pre-rule accounts, the cushion may not exceed the total of one-sixth of the estimated annual disbursements for each escrow account item using single-item analysis accounting. In determining the cushion using single-item analysis, a servicer shall not divide an escrow account item into sub-accounts, even if the payee requires installment payments.

(6) *Restrictions on pre-accrual.* For pre-rule accounts, a servicer shall not require any pre-accrual that results in the escrow account balance exceeding the limits of paragraph (c)(1) of this section. In addition, if the mortgage documents in a pre-rule account are silent about the amount of pre-accrual, the servicer shall not require in excess of one month of pre-accrual, subject to the additional limitations provided in paragraph (c)(8) of this section. For post-rule accounts, a servicer shall not practice pre-accrual.

(7) *Servicer estimates of disbursement amounts.* To conduct an escrow account analysis, the servicer shall estimate the amount of escrow account items to be disbursed. If the servicer knows the charge for an escrow item in the next computation year, then the servicer shall use that amount in estimating disbursement amounts. If the charge is unknown to the servicer, the servicer may base the estimate on the preceding year's charge, or the preceding year's charge as modified by an amount not exceeding the most recent year's change in the national Consumer Price Index for all urban consumers (CPI, all items). In cases of unassessed new construction, the servicer may base an estimate on the assessment of comparable residential property in the market area.

(8) *Provisions in mortgage documents.* The servicer shall examine the mortgage loan documents to determine the applicable cushion and limitations on pre-accrual for each escrow account. If the mortgage loan documents provide for lower cushion limits or less pre-accrual than this section, then the terms of the loan documents apply. Where the terms of any mortgage loan document allow greater payments to an escrow account than allowed by this section, then this section controls the applicable limits. Where the mortgage loan documents do not specifically establish an escrow account, whether a servicer may establish an escrow account for the loan is a matter for determination by State law. If the mortgage loan document is silent on the escrow account limits (for cushion or pre-accrual) and a servicer establishes an escrow account under State law, then the limitations of this section apply unless State law provides for a lower amount. If the loan documents provide for escrow accounts up to the RESPA limits, then the servicer may require the maximum amounts consistent with this section, unless an applicable State law sets a lesser amount.

(9) *Assessments for periods longer than one year.* Some escrow account items

may be billed for periods longer than one year. For example, servicers may need to collect flood insurance or water purification escrow funds for payment every three years. In such cases, the servicer shall estimate the borrower's payments for a full cycle of disbursements. For a flood insurance premium payable every 3 years, the servicer shall collect the payments reflecting 36 equal monthly amounts. For two out of the three years, however, the account balance may not reach its low monthly balance because the low point will be on a three-year cycle, as compared to an annual one. The annual escrow account statement shall explain this situation (see example in the HUD Public Guidance Document entitled "Annual Escrow Account Disclosure Statement—Example", available in accordance with § 3500.3).

(d) *Methods of escrow account analysis.* Paragraph (c) of this section prescribes acceptable accounting methods. The following sets forth the steps servicers shall use to determine whether their use of an acceptable accounting method conforms with the limitations in § 3500.17(c)(1). The steps set forth in this section derive maximum limits. Servicers may use accounting procedures that result in lower target balances. In particular, servicers may use a cushion less than the permissible cushion or no cushion at all. This section does not require the use of a cushion.

(1) *Aggregate analysis.* (i) When a servicer uses aggregate analysis in conducting the escrow account analysis, the target balances may not exceed the balances computed according to the following arithmetic operations:

(A) The servicer first projects a trial balance for the account as a whole over the next computation year (a trial running balance). In doing so the servicer assumes that it will make estimated disbursements on or before the earlier of the deadline to take advantage of discounts, if available, or the deadline to avoid a penalty. The servicer does not use pre-accrual on these disbursement dates. The servicer also assumes that the borrower will make monthly payments equal to one-twelfth of the estimated total annual escrow account disbursements.

(B) The servicer then examines the monthly trial balances and adds to the first monthly balance an amount just sufficient to bring the lowest monthly trial balance to zero, and adjusts all other monthly balances accordingly.

(C) The servicer then adds to the monthly balances the permissible cushion. The cushion is two months of the borrower's escrow payments to the servicer or a lesser amount specified by State law or the mortgage document (net of any increases or decreases because of prior year shortages or surpluses, respectively).

(ii) *Lowest monthly balance.* Under aggregate analysis, the lowest monthly target balance for the account shall be less than or equal to one-sixth of the estimated total annual escrow account disbursements or a lesser amount specified by State law or the mortgage document. The target balances that the servicer derives using these steps yield the maximum limit for the escrow account. Appendix E to this part illustrates these steps.

(2) *Single-item or other non-aggregate analysis method.* (i) When a servicer uses single-item analysis or any hybrid accounting method in conducting an escrow account analysis during the phase-in period, the target balances may not exceed the balances computed according to the following arithmetic operations:

(A) The servicer first projects a trial balance for each item over the next computation year (a trial running balance). In doing so the servicer assumes that it will make estimated disbursements on or before the earlier of the deadline to take advantage of discounts, if available, or the deadline to avoid a penalty. The servicer does not use pre-accrual on these disbursement dates. The servicer also assumes that the borrower will make periodic payments equal to one-twelfth of the estimated total annual escrow account disbursements.

(B) The servicer then examines the monthly trial balance for each escrow account item and adds to the first monthly balance for each separate item an amount just sufficient to bring the lowest monthly trial balance for that item to zero, and then adjusts all other monthly balances accordingly.

(C) The servicer then adds the permissible cushion, if any, to the monthly balance for the separate escrow account item. The permissible cushion is two months of escrow payments for the escrow account item (net of any increases or decreases because of prior year shortages or surpluses, respectively) or a lesser amount specified by State law or the mortgage document.

(D) The servicer then examines the balances for each item to make certain that the lowest monthly balance for that item is less than or equal to one-sixth of the estimated total annual escrow account disbursements for that item or a lesser amount specified by State law or the mortgage document.

(ii) In performing an escrow account analysis using single-item analysis, servicers may account for each escrow account item separately, but servicers shall not further divide accounts into sub-accounts, even if the payee of a disbursement requires installment payments. The target balances that the servicer derives using these steps yield the maximum limit for the escrow account. Appendix F to this part illustrates these steps.

(e) *Transfer of servicing*. (1) If the new servicer changes either the monthly payment amount or the accounting method used by the transferor (old) servicer, then the new servicer shall provide the borrower with an initial escrow account statement within 60 days of the date of servicing transfer.

(i) Where a new servicer provides an initial escrow account statement upon the transfer of servicing, the new servicer shall use the effective date of the transfer of servicing to establish the new escrow account computation year.

(ii) Where the new servicer retains the monthly payments and accounting method used by the transferor servicer, then the new servicer may continue to use the escrow account computation year established by the transferor servicer or may choose to establish a different computation year using a short-year statement. At the completion of the escrow account computation year or any short year, the new servicer shall perform an escrow analysis and provide the borrower with an annual escrow account statement.

(2) The new servicer shall treat shortages, surpluses and deficiencies in the transferred escrow account according to the procedures set forth in §3500.17(f).

(3) A pre-rule account remains a pre-rule account upon the transfer of servicing to a new servicer so long as the transfer occurs before the conversion date.

(f) *Shortages, surpluses, and deficiencies requirements*—(1) *Escrow account analysis*. For each escrow account, the servicer shall conduct an escrow account analysis to determine whether a surplus, shortage or deficiency exists.

(i) As noted in §3500.17(c)(2) and (3), the servicer shall conduct an escrow account analysis upon establishing an escrow account and at completion of the escrow account computation year.

(ii) The servicer may conduct an escrow account analysis at other times during the escrow computation year. If a servicer advances funds in paying a disbursement, which is not the result of a borrower's payment default under the underlying mortgage document, then the servicer shall conduct an escrow account analysis to determine the extent of the deficiency before seeking repayment of the funds from the borrower under this paragraph (f).

(2) *Surpluses*. (i) If an escrow account analysis discloses a surplus, the servicer shall, within 30 days from the date of the analysis, refund the surplus to the borrower if the surplus is greater than or equal to 50 dollars ($50). If the surplus is less than 50 dollars ($50), the servicer may refund such amount to the borrower, or credit such amount against the next year's escrow payments.

(ii) These provisions regarding surpluses apply if the borrower is current at the time of the escrow account analysis. A borrower is current if the servicer receives the borrower's payments within 30 days of the payment due date. If the servicer does not receive the borrower's payment within 30 days of the payment due date, then the servicer may retain the surplus in the escrow account pursuant to the terms of the mortgage loan documents.

(iii) After an initial or annual escrow analysis has been performed, the servicer and the borrower may enter into a voluntary agreement for the forthcoming escrow accounting year for the borrower to deposit funds into the escrow account for that year greater than the limits established under paragraph (c) of this section. Such an agreement shall cover only one escrow accounting year, but a new voluntary agreement may be entered into after the next escrow analysis is performed. The voluntary agreement may not alter how surpluses are to be treated when the next escrow analysis is performed at the end of the escrow accounting year covered by the voluntary agreement.

(3) *Shortages.* (i) If an escrow account analysis discloses a shortage of less than one month's escrow account payment, then the servicer has three possible courses of action:

(A) The servicer may allow a shortage to exist and do nothing to change it;

(B) The servicer may require the borrower to repay the shortage amount within 30 days; or

(C) The servicer may require the borrower to repay the shortage amount in equal monthly payments over at least a 12-month period.

(ii) If an escrow account analysis discloses a shortage that is greater than or equal to one month's escrow account payment, then the servicer has two possible courses of action:

(A) The servicer may allow a shortage to exist and do nothing to change it; or

(B) The servicer may require the borrower to repay the shortage in equal monthly payments over at least a 12-month period.

(4) *Deficiency.* If the escrow account analysis confirms a deficiency, then the servicer may require the borrower to pay additional monthly deposits to the account to eliminate the deficiency.

(i) If the deficiency is less than one month's escrow account payment, then the servicer:

(A) May allow the deficiency to exist and do nothing to change it;

(B) May require the borrower to repay the deficiency within 30 days; or

(C) May require the borrower to repay the deficiency in 2 or more equal monthly payments.

(ii) If the deficiency is greater than or equal to 1 month's escrow payment, the servicer may allow the deficiency to exist and do nothing to change it or may require the borrower to repay the deficiency in two or more equal monthly payments.

(iii) These provisions regarding deficiencies apply if the borrower is current at the time of the escrow account analysis. A borrower is current if the servicer receives the borrower's payments within 30 days of the payment due date. If the servicer does not receive the borrower's payment within 30 days of the payment due date, then the servicer may recover the deficiency pursuant to the terms of the mortgage loan documents.

(5) *Notice of shortage or deficiency in escrow account.* The servicer shall notify the borrower at least once during the escrow account computation year if there is a shortage or deficiency in the escrow account. The notice may be part of the annual escrow account statement or it may be a separate document.

(g) *Initial escrow account statement.* (1) Submission at settlement, or within 45 calendar days of settlement. As noted in § 3500.17(c)(2), the servicer shall conduct an escrow account analysis before establishing an escrow account to determine the amount the borrower shall deposit into the escrow account, subject to the limitations of § 3500.17(c)(1)(i). After conducting the escrow account analysis for each escrow account, the servicer shall submit an initial escrow account statement to the borrower at settlement or within 45 calendar days of settlement for escrow accounts that are established as a condition of the loan.

(i) The initial escrow account statement shall include the amount of the borrower's monthly mortgage payment and the portion of the monthly payment going into the escrow account and shall itemize the estimated taxes, insurance premiums, and other charges that the servicer reasonably anticipates to be paid from the escrow account during the escrow account computation year and the anticipated disbursement dates of those charges. The initial escrow account statement shall indicate the amount that the servicer selects as a cushion. The statement shall include a trial running balance for the account.

(ii) Pursuant to § 3500.17(h)(2), the servicer may incorporate the initial escrow account statement into the HUD–1 or HUD–1A settlement statement. If the servicer does not incorporate the initial escrow account statement into the HUD–1 or HUD–1A settlement statement, then the servicer shall submit the initial escrow account statement to the borrower as a separate document.

(2) *Time of submission of initial escrow account statement for an escrow account established after settlement.* For escrow accounts established after settlement (and which are not a condition of the loan), a servicer shall submit an initial escrow account statement to a borrower within 45 calendar days of the date of establishment of the escrow account.

(h) *Format for initial escrow account statement.* (1) The format and a completed example for an initial escrow account statement are set out in HUD Public Guidance Documents entitled "Initial Escrow Account Disclosure Statement—Format" and "Initial Escrow Account Disclosure Statement—Example", available in accordance with § 3500.3.

(2) *Incorporation of initial escrow account statement into HUD–1 or HUD–1A settlement statement.* Pursuant to § 3500.9(a)(11), a servicer may add the initial escrow account statement to the HUD–1 or HUD–1A settlement statement. The servicer may include the initial escrow account statement in the basic text or may attach the initial escrow account statement as an additional page to the HUD–1 or HUD–1A settlement statement.

(3) *Identification of payees.* The initial escrow account statement need not identify a specific payee by name if it provides sufficient information to identify the use of the funds. For example, appropriate entries include: county taxes, hazard insurance, condominium dues, etc. If a particular payee, such as a taxing body, receives more than one payment during the escrow account computation year, the statement shall indicate each payment and disbursement date. If there are several taxing authorities or insurers, the statement shall identify each taxing body or insurer (e.g., "City Taxes", "School Taxes", "Hazard Insurance", or "Flood Insurance," etc.).

(i) *Annual escrow account statements.* For each escrow account, a servicer shall submit an annual escrow account statement to the borrower within 30 days of the completion of the escrow account computation year. The servicer shall also submit to the borrower the previous year's projection or initial escrow account statement. The servicer shall conduct an escrow account analysis before submitting an annual escrow account statement to the borrower.

(1) *Contents of annual escrow account statement.* The annual escrow account statement shall provide an account history, reflecting the activity in the escrow account during the escrow account computation year, and a projection of the activity in the account for the next year. In preparing the statement, the servicer may assume scheduled payments and disbursements will be made for the final 2 months of the escrow account computation year. The annual escrow account statement must include, at a minimum, the following (the items in paragraphs (i)(1)(i) through (i)(1)(iv) must be clearly itemized):

(i) The amount of the borrower's current monthly mortgage payment and the portion of the monthly payment going into the escrow account;

(ii) The amount of the past year's monthly mortgage payment and the portion of the monthly payment that went into the escrow account;

(iii) The total amount paid into the escrow account during the past computation year;

(iv) The total amount paid out of the escrow account during the same period for taxes, insurance premiums, and other charges (as separately identified);

(v) The balance in the escrow account at the end of the period;

(vi) An explanation of how any surplus is being handled by the servicer;

(vii) An explanation of how any shortage or deficiency is to be paid by the borrower; and

(viii) If applicable, the reason(s) why the estimated low monthly balance was not reached, as indicated by noting differences between the most recent account history and last year's projection. HUD Public Guidance Documents entitled "Annual Escrow Account Disclosure Statement—Format" and "Annual Escrow Account Disclosure Statement—Example" set forth an acceptable format and methodology for conveying this information.

(2) *No annual statements in the case of default, foreclosure, or bankruptcy.* This paragraph (i)(2) contains an exemption from the provisions of §3500.17(i)(1). If at the time the servicer conducts the escrow account analysis the borrower is more than 30 days overdue, then the servicer is exempt from the requirements of submitting an annual escrow account statement to the borrower under §3500.17(i). This exemption also applies in situations where the servicer has brought an action for foreclosure under the underlying mortgage loan, or where the borrower is in bankruptcy proceedings. If the servicer does not issue an annual statement pursuant to this exemption and the loan subsequently is reinstated or otherwise becomes current, the servicer shall provide a history of the account since the last annual statement (which may be longer than 1 year) within 90 days of the date the account became current.

(3) *Delivery with other material.* The servicer may deliver the annual escrow account statement to the borrower with other statements or materials, including the Substitute 1098, which is provided for federal income tax purposes.

(4) *Short year statements.* A servicer may issue a short year annual escrow account statement ("short year statement") to change one escrow account computation year to another. By using a short year statement a servicer may adjust its production schedule or alter the escrow account computation year for the escrow account.

(i) *Effect of short year statement.* The short year statement shall end the "escrow account computation year" for the escrow account and establish the beginning date of the new escrow account computation year. The servicer shall deliver the short year statement to the borrower within 60 days from the end of the short year.

(ii) *Short year statement upon servicing transfer.* Upon the transfer of servicing, the transferor (old) servicer shall submit a short year statement to the borrower within 60 days of the effective date of transfer.

(iii) *Short year statement upon loan payoff.* If a borrower pays off a mortgage loan during the escrow account computation year, the servicer shall submit a short year statement to the borrower within 60 days after receiving the pay-off funds.

(j) *Formats for annual escrow account statement.* The formats and completed examples for annual escrow account statements using single-item analysis (pre-rule accounts) and aggregate analysis are set out in HUD Public Guidance Documents entitled "Annual Escrow Account Disclosure Statement—Format" and "Annual Escrow Account Disclosure Statement—Example".

(k) *Timely payments.* (1) If the terms of any federally related mortgage loan require the borrower to make payments to an escrow account, the servicer must pay the disbursements in a timely manner, that is, on or before the deadline to avoid a penalty, as long as the borrower's payment is not more than 30 days overdue.

(2) The servicer must advance funds to make disbursements in a timely manner as long as the borrower's payment is not more than 30 days overdue. Upon advancing funds to pay a disbursement, the servicer may seek repayment from the borrower for the deficiency pursuant to paragraph (f) of this section.

(3) For the payment of property taxes from the escrow account, if a taxing jurisdiction offers a servicer a choice between annual and installment disbursements, the servicer must also comply with this paragraph (k)(3). If the taxing jurisdiction neither offers a discount for disbursements on a lump sum annual basis nor imposes any additional charge or fee for installment disbursements, the servicer must make disbursements on an installment basis. If, however, the taxing jurisdiction offers a discount for disbursements on a lump

sum annual basis or imposes any additional charge or fee for installment disbursements, the servicer may at the servicer's discretion (but is not required by RESPA to), make lump sum annual disbursements in order to take advantage of the discount for the borrower or avoid the additional charge or fee for installments, as long as such method of disbursement complies with paragraphs (k)(1) and (k)(2) of this section. HUD encourages, but does not require, the servicer to follow the preference of the borrower, if such preference is known to the servicer.

(4) Notwithstanding paragraph (k)(3) of this section, a servicer and borrower may mutually agree, on an individual case basis, to a different disbursement basis (installment or annual) or disbursement date for property taxes from that required under paragraph (k)(3) of this section, so long as the agreement meets the requirements of paragraphs (k)(1) and (k)(2) of this section. The borrower must voluntarily agree; neither loan approval nor any term of the loan may be conditioned on the borrower's agreeing to a different disbursement basis or disbursement date.

(l) *System of recordkeeping.* (1) Each servicer shall keep records, which may involve electronic storage, microfiche storage, or any method of computerized storage, so long as the information is easily retrievable, reflecting the servicer's handling of each borrower's escrow account. The servicer's records shall include, but not be limited to, the payment of amounts into and from the escrow account and the submission of initial and annual escrow account statements to the borrower.

(2) The servicer responsible for servicing the borrower's escrow account shall maintain the records for that account for a period of at least five years after the servicer last serviced the escrow account.

(3) A servicer shall provide the Secretary with information contained in the servicer's records for a specific escrow account, or for a number or class of escrow accounts, within 30 days of the Secretary's written request for the information. The servicer shall convert any information contained in electronic storage, microfiche or computerized storage to paper copies for review by the Secretary.

(i) To aid in investigations, the Secretary may also issue an administrative subpoena for the production of documents, and for the testimony of such witnesses as the Secretary deems advisable.

(ii) If the subpoenaed party refuses to obey the Secretary's administrative subpoena, the Secretary is authorized to seek a court order requiring compliance with the subpoena from any United States district court. Failure to obey such an order of the court may be punished as contempt of court.

(4) Borrowers may seek information contained in the servicer's records by complying with the provisions set forth in 12 U.S.C. 2605(e) and § 3500.21(f).

(5) After receiving a request (by letter or subpoena) from the Department for information relating to whether a servicer submitted an escrow account statement to the borrower, the servicer shall respond within 30 days. If the servicer is unable to provide the Department with such information, the Secretary shall deem that lack of information to be evidence of the servicer's failure to submit the statement to the borrower.

(m) *Penalties.* (1) A servicer's failure to submit to a borrower an initial or annual escrow account statement meeting the requirements of this part shall constitute a violation of section 10(d) of RESPA (12 U.S.C. 2609(d)) and this section. For each such violation, the Secretary shall assess a civil penalty of 55 dollars ($55), except that the total of the assessed penalties shall not exceed $110,000 for any one servicer for violations that occur during any consecutive 12-month period.

(2) Violations described in paragraph (m)(1) of this section do not require any proof of intent. However, if a lender or servicer is shown to have intentionally disregarded the requirements that it submit the escrow account statement to the borrower, then the Secretary shall assess a civil penalty of $110 for each violation, with no limit on the total amount of the penalty.

(n) *Civil penalties procedures.* The following procedures shall apply whenever the Department seeks to impose a civil money penalty for violation of section 10(c) of RESPA (12 U.S.C. 2609(c)):

(1) *Purpose and scope.* This paragraph (n) explains the procedures by which the Secretary may impose penalties under 12 U.S.C. 2609(d). These procedures include administrative hearings, judicial review, and collection of penalties. This paragraph (n) governs penalties imposed under 12 U.S.C. 2609(d) and, when noted, adopts those portions of 24 CFR part 30 that apply to all other civil penalty proceedings initiated by the Secretary.

(2) *Authority.* The Secretary has the authority to impose civil penalties under section 10(d) of RESPA (12 U.S.C. 2609(d)).

(3) *Notice of intent to impose civil money penalties.* Whenever the Secretary intends to impose a civil money penalty for violations of section 10(c) of RESPA (12 U.S.C. 2609(c)), the responsible program official, or his or her designee, shall serve a written Notice of Intent to Impose Civil Money Penalties (Notice of Intent) upon any servicer on which the Secretary intends to impose the penalty. A copy of the Notice of Intent must be filed with the Chief Docket Clerk, Office of Administrative Law Judges, at the address provided in the Notice of Intent. The Notice of Intent will provide:

(i) A short, plain statement of the facts upon which the Secretary has determined that a civil money penalty should be imposed, including a brief description of the specific violations under 12 U.S.C. 2609(c) with which the servicer is charged and whether such violations are believed to be intentional or unintentional in nature, or a combination thereof;

(ii) The amount of the civil money penalty that the Secretary intends to impose and whether the limitations in 12 U.S.C. 2609(d)(1), apply;

(iii) The right of the servicer to a hearing on the record to appeal the Secretary's preliminary determination to impose a civil penalty;

(iv) The procedures to appeal the penalty;

(v) The consequences of failure to appeal the penalty; and

(vi) The name, address, and telephone number of the representative of the Department, and the address of the Chief Docket Clerk, Office of Administrative Law Judges, should the servicer decide to appeal the penalty.

(4) *Appeal procedures.* (i) *Answer.* To appeal the imposition of a penalty, a servicer shall, within 30 days after receiving service of the Notice of Intent, file a written Answer with the Chief Docket Clerk, Office of Administrative Law Judges, Department of Housing and Urban Development, at the address provided in the Notice of Intent. The Answer shall include a statement that the servicer admits, denies, or does not have (and is unable to obtain) sufficient information to admit or deny each allegation made in the Notice of Intent. A statement of lack of information shall have the effect of a denial. Any allegation that is not denied shall be deemed admitted. Failure to submit an Answer within the required period of time will result in a decision by the Administrative Law Judge based upon the Department's submission of evidence in the Notice of Intent.

(ii) *Submission of evidence.* A servicer that receives the Notice of Intent has a right to present evidence. Evidence must be submitted within 45 calendar days from the date of service of the Notice of Intent, or by such other time as may be established by the Administrative Law Judge (ALJ). The servicer's failure to submit evidence within the required period of time will result in a decision by the Administrative Law Judge based upon the Department's submission of evidence in the Notice of Intent. The servicer may present evidence of the following:

(A) The servicer did submit the required escrow account statement(s) to the borrower(s); or

(B) Even if the servicer did not submit the required statement(s), that the failure was not the result of an intentional disregard of the requirements of RESPA (for purposes of determining the penalty).

(iii) *Review of the record.* The Administrative Law Judge will review the evidence submitted by the servicer, if any, and that submitted by the Department. The Administrative Law Judge shall make a determination based upon a review of the written record, except that the Administrative Law Judge may order an oral hearing if he or she finds that the determination turns on the credibility or veracity of a witness, or that the matter cannot be resolved by review of the documentary evidence. If the Administrative Law Judge decides that an oral hearing is appropriate, then the procedural rules set forth at 24 CFR part 30 shall apply, to the extent that they are not inconsistent with this section.

(iv) *Burden of proof.* The burden of proof or the burden of going forward with the evidence shall be upon the proponent of an action. The Department's submission of evidence that the servicer's system of records lacks information that the servicer submitted the escrow account statement(s) to the borrower(s) shall satisfy the Department's burden. Upon the Department's presentation of evidence of this lack of information in the servicer's system of records, the burden of proof shifts from the Secretary to the servicer to provide evidence that it submitted the statement(s) to the borrower.

(v) *Standard of proof.* The standard of proof shall be the preponderance of the evidence.

(5) *Determination of the Administrative Law Judge.* (i) Following the hearing or the review of the written record, the Administrative Law Judge shall issue a decision that shall contain findings of fact, conclusions of law, and the amount of any penalties imposed. The decision shall include a determination of whether the servicer has failed to submit any required statements and, if so, whether the servicer's failure was the result of an intentional disregard for the law's requirements.

(ii) The Administrative Law Judge shall issue the decision to all parties within 30 days of the submission of the evidence or the post-hearing briefs, whichever is the last to occur.

(iii) The decision of the Administrative Law Judge shall constitute the final decision of the Department and shall be final and binding on the parties.

(6) *Judicial review.* (i) A person against whom the Department has imposed a civil money penalty under this part may obtain a review of the Department's final decision by filing a written petition for a review of the record with the appropriate United States district court.

(ii) The petition must be filed within 30 days after the decision is filed with the Chief Docket Clerk, Office of Administrative Law Judges.

(7) *Collection of penalties.* (i) If any person fails to comply with the Department's final decision imposing a civil money penalty, the Secretary, if the time for judicial review of the decision has expired, may request the Attorney General to bring an action in an appropriate United States district court to obtain a judgment against the person that has failed to comply with the Department's final decision.

(ii) In any such collection action, the validity and appropriateness of the Department's final decision imposing the civil penalty shall not be subject to review in the district court.

(iii) The Secretary may obtain such other relief as may be available, including attorney fees and other expenses in connection with the collection action.

(iv) Interest on and other charges for any unpaid penalty may be assessed in accordance with 31 U.S.C. 3717.

(8) *Offset.* In addition to any other rights as a creditor, the Secretary may seek to collect a civil money penalty through administrative offset.

(9) At any time before the decision of the Administrative Law Judge, the Secretary and the servicer may enter into an administrative settlement. The settlement may include provisions for interest, attorney's fees, and costs related to the proceeding. Such settlement will terminate the appearance before the Administrative Law Judge.

(o) *Discretionary payments.* Any borrower's discretionary payment (such as credit life or disability insurance) made as part of a monthly mortgage payment is to be noted on the initial and annual statements. If a discretionary payment is established or terminated during the escrow account computation year, this change should be noted on the next annual statement. A discretionary payment is not part of the escrow account unless the payment is required by the lender, in accordance with the definition of "settlement service" in § 3500.2, or the servicer chooses to place the discretionary payment in the escrow account. If a servicer has not established an escrow account for a federally related mortgage loan and only receives payments for discretionary items, this section is not applicable.

(Approved by the Office of Management and Budget under control number 2502–0501)

[61 FR 13233, Mar. 26, 1996, as amended at 61 FR 46510, Sept. 3, 1996; 61 FR 50219, Sept. 24, 1996; 61 FR 58476, Nov. 15, 1996; 63 FR 3236, Jan. 21, 1998]

EFFECTIVE DATE NOTE: At 68 FR 12789, Mar. 17, 2003, §3500.17 was amended by revising paragraph (m)(1), effective Apr. 16, 2003. For the convenience of the user, the revised text follows:

**§ 3500.17 Escrow accounts.**

* * * * *

(m) *Penalties.* (1) A servicer's failure to submit to a borrower an initial or annual escrow account statement meeting the requirements of this part shall constitute a violation of section 10(d) of RESPA (12 U.S.C. 2609(d)) and this section. For each such violation, the Secretary shall assess a civil penalty of 65 dollars ($65), except that the total of the assessed penalties shall not exceed $120,000 for any one servicer for violations that occur during any consecutive 12-month period.

* * * * *

## § 3500.18 Validity of contracts and liens.

Section 17 of RESPA (12 U.S.C. 2615) governs the validity of contracts and liens under RESPA.

## § 3500.19 Enforcement.

(a) *Enforcement policy.* It is the policy of the Secretary regarding RESPA enforcement matters to cooperate with Federal, State or local agencies having supervisory powers over lenders or other persons with responsibilities under RESPA. Federal agencies with supervisory powers over lenders may use their powers to require compliance with RESPA. In addition, failure to comply with RESPA may be grounds for administrative action by the Secretary under part 24 of this title concerning debarment, suspension, ineligibility of contractors and grantees, or under part 25 of this title concerning the HUD Mortgagee Review Board. Nothing in this paragraph is a limitation on any other form of enforcement which may be legally available.

(b) *Violations of section 8 of RESPA (12 U.S.C. 2607), § 3500.14, or § 3500.15.* Any person who violates §§3500.14 or 3500.15 shall be deemed to violate section 8 of RESPA and shall be sanctioned accordingly.

(c) *Violations of section 9 of RESPA (12 U.S.C. 2608) or § 3500.16.* Any person who violates section 3500.16 of this part shall be deemed to violate section 9 of RESPA and shall be sanctioned accordingly.

(d) *Investigations.* The procedures for investigations and investigational proceedings are set forth in 24 CFR part 3800.

## § 3500.20 [Reserved]

## § 3500.21 Mortgage servicing transfers.

(a) *Definitions.* As used in this section:

*Master servicer* means the owner of the right to perform servicing, which may actually perform the servicing itself or may do so through a subservicer.

*Mortgage servicing loan* means a federally related mortgage loan, as that term is defined in §3500.2, subject to the exemptions in §3500.5, when the mortgage loan is secured by a first lien. The definition does not include subordinate lien loans or open-end lines of credit (home equity plans) covered by the Truth in Lending Act and Regulation Z, including open-end lines of credit secured by a first lien.

*Qualified written request* means a written correspondence from the borrower to the servicer prepared in accordance with paragraph (e)(2) of this section.

*Subservicer* means a servicer who does not own the right to perform servicing, but who does so on behalf of the master servicer.

*Transferee servicer* means a servicer who obtains or who will obtain the right to perform servicing functions pursuant to an agreement or understanding.

*Transferor servicer* means a servicer, including a table funding mortgage broker or dealer on a first lien dealer loan, who transfers or will transfer the right to perform servicing functions pursuant to an agreement or understanding.

(b) *Servicing Disclosure Statement and Applicant Acknowledgement; requirements.* (1) At the time an application for a mortgage servicing loan is submitted, or within 3 business days after submission of the application, the lender, mortgage broker who anticipates using table funding, or dealer who anticipates a first lien dealer loan shall provide to each person who applies for such a loan a Servicing Disclosure Statement. This requirement shall not apply when the application for credit is turned down within three business days after receipt of the application. A format for the Servicing Disclosure Statement appears as appendix MS–1 to this part. Except as provided in paragraph (b)(2) of this section, the specific language of the Servicing Disclosure Statement is not required to be used, but the Servicing Disclosure Statement must include the information set out in paragraph (b)(3) of this section, including the statement of the borrower's rights in connection with complaint resolution. The information set forth in Instructions to Preparer on the Servicing Disclosure Statement need not be included on the form given to applicants, and material in square brackets is optional or alternative language.

(2) The Applicant's Acknowledgement portion of the Servicing Disclosure Statement in the format stated is mandatory. Additional lines may be added to accommodate more than two applicants.

(3) The Servicing Disclosure Statement must contain the following information, except as provided in paragraph (b)(3)(ii) of this section:

(i) Whether the servicing of the loan may be assigned, sold or transferred to any other person at any time while the loan is outstanding. If the lender, table funding mortgage broker, or dealer in a first lien dealer loan does not engage in the servicing of any mortgage servicing loans, the disclosure may consist of a statement to the effect that there is a current intention to assign, sell, or transfer servicing of the loan.

(ii) The percentages (rounded to the nearest quartile (25%)) of mortgage servicing loans originated by the lender in each calendar year for which servicing has been assigned, sold, or transferred for such calendar year. Compliance with this paragraph (b)(3)(ii) is not required if the lender, table funding mortgage broker, or dealer on a first lien dealer loan chooses option B in the model format in paragraph (b)(4) of this section, including in square brackets the language "[and have not serviced mortgage loans in the last three years.]". The percentages shall be provided as follows:

(A) This information shall be set out for the most recent three calendar years completed, with percentages as of the end of each year. This information shall be updated in the disclosure no later than March 31 of the next calendar year. Each percentage should be obtained by using as the numerator the number of mortgage servicing loans originated during the calendar year for which servicing is transferred within the calendar year and, as the denominator, the total number of mortgage servicing loans originated in the calendar year. If the volume of transfers is less than 12.5 percent, the word "nominal" or the actual percentage amount of servicing transfers may be used.

(B) This statistical information does not have to include the assignment, sale, or transfer of mortgage loan servicing by the lender to an affiliate or subsidiary of the lender. However, lenders may voluntarily include transfers to an affiliate or subsidiary. The lender should indicate whether the percentages provided include assignments, sales, or transfers to affiliates or subsidiaries.

(C) In the alternative, if applicable, the following statement may be substituted for the statistical information required to be provided in accordance with paragraph (b)(3)(ii) of this section: "We have previously assigned, sold, or transferred the servicing of federally related mortgage loans."

(iii) The best available estimate of the percentage (0 to 25 percent, 26 to 50 percent, 51 to 75 percent, or 76 to 100 percent) of all loans to be made during the 12-month period beginning on the date of origination for which the servicing may be assigned, sold, or transferred. Each percentage should be obtained by using as the numerator the estimated number of mortgage servicing loans that will be originated for which servicing may be transferred within the 12-month period and, as the denominator, the estimated total number of mortgage servicing loans that will be originated in the 12-month period.

(A) If the lender, mortgage broker, or dealer anticipates that no loan servicing will be sold during the calendar year, the word "none" may be substituted for "0 to 25 percent." If it is anticipated that all loan servicing will be sold during the calendar year, the word "all" may be substituted for "76 to 100 percent."

(B) This statistical information does not have to include the estimated assignment, sale, or transfer of mortgage loan servicing to an affiliate or subsidiary of that person. However, this information may be provided voluntarily. The Servicing Disclosure Statements should indicate whether the percentages provided include assignments, sales or transfers to affiliates or subsidiaries.

(iv) The information set out in paragraphs (d) and (e) of this section.

(v) A written acknowledgement that the applicant (and any co-applicant) has/have read and understood the disclosure, and understand that the disclosure is a required part of the mortgage application. This acknowledgement shall be evidenced by the signature of the applicant and any co-applicant.

(4) The following is a model format, which includes several options, for complying with the requirements of paragraph (b)(3) of this section. The model format may be annotated with additional information that clarifies or enhances the model language. The lender or table funding mortgage broker (or dealer) should use the language that best describes the particular circumstances.

(i) *Model format:* The following is the best estimate of what will happen to the servicing of your mortgage loan:

(A) *Option A.* We may assign, sell, or transfer the servicing of your loan while the loan is outstanding. [We are able to service your loan[.][,] and we [will] [will not] [haven't decided whether to] service your loan.]; or

(B) *Option B.* We do not service mortgage loans[.][,] [and have not serviced mortgage loans in the past three years.] We presently intend to assign, sell, or transfer the servicing of your mortgage loan. You will be informed about your servicer.

(C) As appropriate, the following paragraph may be used:

We assign, sell, or transfer the servicing of some of our loans while the loans are outstanding, depending on the type of loan and other factors. For the program for which you have applied, we expect to [assign, sell, or transfer all of the mortgage servicing][retain all of the mortgage servicing] [assign, sell, or transfer ____% of the mortgage servicing].

(ii) [Reserved]

(c) *Servicing Disclosure Statement and Applicant Acknowledgement; delivery.* The lender, table funding mortgage broker, or dealer that anticipates a first lien dealer loan shall deliver Servicing Disclosure Statements to each applicant for mortgage servicing loans. Each applicant or co-applicant must sign an Acknowledgement of receipt of the Servicing Disclosure Statement before settlement.

(1) In the case of a face-to-face interview with one or more applicants, the Servicing Disclosure Statement shall be delivered at the time of application. An applicant present at the interview may sign the Acknowledgment on his or her own behalf at that time. An applicant present at the interview also may accept delivery of the Servicing Disclosure Statement on behalf of the other applicants.

(2) If there is no face-to-face interview, the Servicing Disclosure Statement shall be delivered by placing it in the mail, with prepaid first-class postage, within 3 business days from receipt of the application. If co-applicants indicate the same address on their application, one copy delivered to that address is sufficient. If different addresses are shown by co-applicants on the application, a copy must be delivered to each of the co-applicants.

(3) The signed Applicant Acknowledgment(s) shall be retained for a period of 5 years after the date of settlement as part of the loan file for every settled loan. There is no requirement for retention of Applicant Acknowledgment(s) if the loan is not settled.

(d) *Notices of Transfer; loan servicing*—(1) *Requirement for notice.* (i) Except as provided in this paragraph (d)(1)(i) or paragraph (d)(1)(ii) of this section, each transferor servicer and transferee servicer of any mortgage servicing loan shall deliver to the borrower a written Notice of Transfer, containing the information described in paragraph (d)(3) of this section, of any assignment, sale, or transfer of the servicing of the loan. The following transfers are not considered an assignment, sale, or transfer of mortgage loan servicing for purposes of this requirement if there is no change in the payee, address to which payment must be delivered, account number, or amount of payment due:

(A) Transfers between affiliates;

(B) Transfers resulting from mergers or acquisitions of servicers or subservicers; and

(C) Transfers between master servicers, where the subservicer remains the same.

(ii) The Federal Housing Administration (FHA) is not required under paragraph (d) of this section to submit to the borrower a Notice of Transfer in cases where a mortgage insured under the National Housing Act is assigned to FHA.

(2) *Time of notice.* (i) Except as provided in paragraph (d)(2)(ii) of this section:

(A) The transferor servicer shall deliver the Notice of Transfer to the borrower not less than 15 days before the effective date of the transfer of the servicing of the mortgage servicing loan;

(B) The transferee servicer shall deliver the Notice of Transfer to the borrower not more than 15 days after the effective date of the transfer; and

(C) The transferor and transferee servicers may combine their notices into one notice, which shall be delivered to the borrower not less than 15 days before the effective date of the transfer of the servicing of the mortgage servicing loan.

(ii) The Notice of Transfer shall be delivered to the borrower by the transferor servicer or the transferee servicer not more than 30 days after the effective date of the transfer of the servicing of the mortgage servicing loan in any case in which the transfer of servicing is preceded by:

(A) Termination of the contract for servicing the loan for cause;

(B) Commencement of proceedings for bankruptcy of the servicer; or

(C) Commencement of proceedings by the Federal Deposit Insurance Corporation (FDIC) or the Resolution Trust Corporation (RTC) for conservatorship or receivership of the servicer or an entity that owns or controls the servicer.

(iii) Notices of Transfer delivered at settlement by the transferor servicer and transferee servicer, whether as separate notices or as a combined notice, will satisfy the timing requirements of paragraph (d)(2) of this section.

(3) *Notices of Transfer; contents.* The Notices of Transfer required under paragraph (d) of this section shall include the following information:

(i) The effective date of the transfer of servicing;

(ii) The name, consumer inquiry addresses (including, at the option of the servicer, a separate address where qualified written requests must be sent), and a toll-free or collect-call telephone number for an employee or department of the transferee servicer;

(iii) A toll-free or collect-call telephone number for an employee or department of the transferor servicer that can be contacted by the borrower for answers to servicing transfer inquiries;

(iv) The date on which the transferor servicer will cease to accept payments relating to the loan and the date on which the transferee servicer will begin to accept such payments. These dates shall either be the same or consecutive days;

(v) Information concerning any effect the transfer may have on the terms or the continued availability of mortgage life or disability insurance, or any other type of optional insurance, and any action the borrower must take to maintain coverage;

(vi) A statement that the transfer of servicing does not affect any other term or condition of the mortgage documents, other than terms directly related to the servicing of the loan; and

(vii) A statement of the borrower's rights in connection with complaint resolution, including the information set forth in paragraph (e) of this section. Appendix MS–2 of this part illustrates a statement satisfactory to the Secretary.

(4) *Notices of Transfer; sample notice.* Sample language that may be used to comply with the requirements of paragraph (d) of this section is set out in appendix MS–2 of this part. Minor modifications to the sample language may be made to meet the particular circumstances of the servicer, but the substance of the sample language shall not be omitted or substantially altered.

(5) *Consumer protection during transfer of servicing.* During the 60-day period beginning on the effective date of transfer of the servicing of any mortgage servicing loan, if the transferor servicer (rather than the transferee servicer that should properly receive payment on the loan) receives payment on or before the applicable due date (including any grace period allowed under the loan documents), a late fee may not be imposed on the borrower with respect to that payment and the payment may not be treated as late for any other purposes.

(e) *Duty of loan servicer to respond to borrower inquiries*— (1) *Notice of receipt of inquiry.* Within 20 business days of a servicer of a mortgage servicing loan receiving a qualified written request from the borrower for information relating to the servicing of the loan, the servicer shall provide to the borrower a written response acknowledging receipt of the qualified written response. This requirement shall not apply if the action requested by the borrower is taken within that period and the borrower is notified of that action in accordance with the paragraph (f)(3) of this section. By notice either included in the Notice of Transfer or separately delivered by first-class mail, postage prepaid, a servicer may establish a separate and exclusive office and address for the receipt and handling of qualified written requests.

(2) *Qualified written request; defined.* (i) For purposes of paragraph (e) of this section, a qualified written request means a written correspondence (other than notice on a payment coupon or other payment medium supplied by the servicer) that includes, or otherwise enables the servicer to identify, the name and account of the borrower, and includes a statement of the reasons that the borrower believes the account is in error, if applicable, or that provides sufficient detail to the servicer regarding information relating to the servicing of the loan sought by the borrower.

(ii) A written request does not constitute a qualified written request if it is delivered to a servicer more than 1 year after either the date of transfer of servicing or the date that the mortgage servicing loan amount was paid in full, whichever date is applicable.

(3) *Action with respect to the inquiry.* Not later than 60 business days after receiving a qualified written request from the borrower, and, if applicable, before taking any action with respect to the inquiry, the servicer shall:

(i) Make appropriate corrections in the account of the borrower, including the crediting of any late charges or penalties, and transmit to the borrower a written notification of the correction. This written notification shall include the name and telephone number of a representative of the servicer who can provide assistance to the borrower; or

(ii) After conducting an investigation, provide the borrower with a written explanation or clarification that includes:

(A) To the extent applicable, a statement of the servicer's reasons for concluding the account is correct and the name and telephone number of an employee, office, or department of the servicer that can provide assistance to the borrower; or

(B) Information requested by the borrower, or an explanation of why the information requested is unavailable or cannot be obtained by the servicer, and the name and telephone number of an employee, office, or department of the servicer that can provide assistance to the borrower.

(4) *Protection of credit rating.* (i) During the 60-business day period beginning on the date of the servicer receiving from a borrower a qualified written request relating to a dispute on the borrower's payments, a servicer may not provide adverse information regarding any payment that is the subject of the qualified written request to any consumer reporting agency (as that term is defined in section 603 of the Fair Credit Reporting Act, 15 U.S.C. 1681a).

(ii) In accordance with section 17 of RESPA (12 U.S.C. 2615), the protection of credit rating provision of paragraph (e)(4)(i) of this section does not impede a lender or servicer from pursuing any of its remedies, including initiating foreclosure, allowed by the underlying mortgage loan instruments.

(f) *Damages and costs.* (1) Whoever fails to comply with any provision of this section shall be liable to the borrower for each failure in the following amounts:

(i) *Individuals.* In the case of any action by an individual, an amount equal to the sum of any actual damages sustained by the individual as the result of the failure and, when there is a pattern or practice of noncompliance with the requirements of this section, any additional damages in an amount not to exceed $1,000.

(ii) *Class actions.* In the case of a class action, an amount equal to the sum of any actual damages to each borrower in the class that result from the failure and, when there is a pattern or practice of noncompliance with the requirements of this section, any additional damages in an amount not greater than $1,000 for each class member. However, the total amount of any additional damages in a class action may not exceed the lesser of $500,000 or 1 percent of the net worth of the servicer.

(iii) *Costs.* In addition, in the case of any successful action under paragraph (f) of this section, the costs of the action and any reasonable attorneys' fees incurred in connection with the action.

(2) *Nonliability.* A transferor or transferee servicer shall not be liable for any failure to comply with the requirements of this section, if within 60 days after discovering an error (whether pursuant to a final written examination report or the servicer's own procedures) and before commencement of an action under this section and the receipt of written notice of the error from the borrower, the servicer notifies the person concerned of the error and makes whatever adjustments are necessary in the appropriate account to ensure that the person will not be required to pay an amount in excess of any amount that the person otherwise would have paid.

(g) *Timely payments by servicer.* If the terms of any mortgage servicing loan require the borrower to make payments to the servicer of the loan for deposit into an escrow account for the purpose of assuring payment of taxes, insurance premiums, and other charges with respect to the mortgaged property, the servicer shall make payments from the escrow account in a timely manner for the taxes, insurance premiums, and other charges as the payments become due, as governed by the requirements in §3500.17(k).

(h) *Preemption of State laws.* A lender who makes a mortgage servicing loan or a servicer shall be considered to have complied with the provisions of any State law or regulation requiring notice to a borrower at the time of application for a loan or transfer of servicing of a loan if the lender or servicer complies with the requirements of this section. Any State law requiring notice to the borrower at the time of application or at the time of transfer of servicing of the loan is preempted, and there shall be no additional borrower disclosure requirements. Provisions of State law, such as those requiring additional notices to insurance companies or taxing authorities, are not preempted by section 6 of RESPA or this section, and this additional information may be added to a notice prepared under this section, if the procedure is allowable under State law.

(Approved by the Office of Management and Budget under control number 2502–0458)

# APPENDIX 5

43.320.040, 19.146.223. 08-05-126, § 208-660-600, filed 2/20/08, effective 3/22/08. Statutory Authority: RCW 43.320.040, 19.146.223, 2006 c 19. 06-23-137, § 208-660-600, filed 11/21/06, effective 1/1/07.]

**WAC 208-660-700 Mortgage broker commission.** (1) **What is the role of the mortgage broker commission (commission)?** The commission acts in an advisory capacity to the director on mortgage broker issues. The commission advises the director on the characteristics and needs of the mortgage broker profession.

(2) **Who serves on the commission?**

(a) The director appoints the seven members of the commission for two-year terms. Commission members must have at least five years' experience in the business of residential mortgage lending. The experience must be within the past five years from the date of appointment. When appointing a commission member, the director will consider the recommendations from professional organizations that represent mortgage brokers and loan originators.

(b) Of the seven voting members of the commission, at least three members of the commission must be licensed mortgage brokers, at least two must be licensed loan originators who are not designated brokers, and at least one must be a mortgage broker who is exempt from licensure under RCW 19.146.020(1).

(c) The director or a designee serves as an ex officio, nonvoting member of the commission.

(3) **How do interested parties apply for a position on the commission?** In November of each year the department sends a notification to all mortgage brokers to advise them that the director is accepting applications for appointment to the commission. The director will accept applications in the form of a cover letter and resume until December 15th. The director will select the number of applicants needed to fill the vacancies by January 31st so the appointee(s) can attend the February meeting of the commission.

(4) **What are some of the actions the commission may take?** The commission may:

(a) Adopt and meet according to a regular schedule;

(b) Attend special meetings if called by the chairperson;

(c) Hear testimony, and advise the director on proposed changes to the act; and

(d) Advise the director on the licensing of mortgage brokers and loan originators.

[Statutory Authority: RCW 43.320.040, 19.146.223, 2006 c 19. 06-23-137, § 208-660-700, filed 11/21/06, effective 1/1/07.]

**WAC 208-660-800 Forms.** Reserved.

[Statutory Authority: RCW 43.320.040, 19.146.223, 2006 c 19. 06-23-137, § 208-660-800, filed 11/21/06, effective 1/1/07.]

## Chapter 208-680A WAC

## ESCROW—ORGANIZATION AND ADMINISTRATION

(Formerly chapter 308-128A WAC)



**DISPOSITION OF SECTIONS FORMERLY CODIFIED IN THIS CHAPTER**

| | |
|---|---|
| 208-680A-010 | Promulgation—Authority. [96-05-018, recodified as § 208-680A-010, filed 2/12/96, effective 4/1/96. Statutory Authority: RCW 18.44.320. 88-19-016 (Order PM 763), § 308-128A-010, filed 9/9/88; Order RE 122, § 308-128A-010, filed 9/21/77.] Repealed by 96-21-082, filed 10/16/96, effective 11/16/96. Statutory Authority: RCW 42.320.040 [43.320.040] and 18.44.320. |

**WAC 208-680A-020 Organization.** The department of financial institutions administers the Washington Escrow Agent Registration Act, chapter 18.44 RCW. The escrow commission, composed of the director or designee and five board members, appointed by the director, approve examination questions for license applicants, act in an advisory capacity to the director in the activities of escrow agents and escrow officers and perform such other duties and functions as prescribed by chapter 18.44 RCW.

[Statutory Authority: RCW 42.320.040 [43.320.040] and 18.44.320. 96-21-082, § 208-680A-020, filed 10/16/96, effective 11/16/96. 96-05-018, recodified as § 208-680A-020, filed 2/12/96, effective 4/1/96. Statutory Authority: RCW 18.44.320. 94-04-050, § 308-128A-020, filed 1/31/94, effective 3/3/94; 88-19-016 (Order PM 763), § 308-128A-020, filed 9/9/88; Order RE 122, § 308-128A-020, filed 9/21/77.]

**WAC 208-680A-030 Meeting notice.** Individuals desiring to be informed as to date, time, place and agenda of the escrow commission meetings must make a written request to the Department of financial institutions.

[Statutory Authority: RCW 42.320.040 [43.320.040] and 18.44.320. 96-21-082, § 208-680A-030, filed 10/16/96, effective 11/16/96. 96-05-018, recodified as § 208-680A-030, filed 2/12/96, effective 4/1/96. Statutory Authority: RCW 18.44.320. 94-04-050, § 308-128A-030, filed 1/31/94, effective 3/3/94; 88-19-016 (Order PM 763), § 308-128A-030, filed 9/9/88; Order RE 122, § 308-128A-030, filed 9/21/77.]

*** WAC 208-680A-040 Definitions.** The terms and definitions used in chapter 18.44 RCW have the same meanings given therein when used in these rules.

"Third party to the transaction" means those persons providing professional services necessary for the closing of the escrow. "Third party to the transaction" includes, but is not limited to: Real estate brokers, lenders, mortgage brokers, attorneys engaged to review the escrow, tax facilitators or underlying lien holders.

"Applicant" means any person applying for an escrow officer license or any person or group of persons applying for an escrow agent license. The term "applicant" includes the officers and controlling persons of the applicant, as well as any escrow officer seeking to become an escrow agent's designated escrow officer or designated branch escrow officer.

"Cash deposit" means funds deposited, in lieu of an errors and omissions policy, in an account in a recognized Washington state depository which account is maintained separate and apart from the escrow agent's own funds. The funds shall be deposited in such a manner to permit only the director to withdraw from the principal amount. The escrow agent may withdraw any interest accumulated to the account.

"Closing" means the transfer of title of real or personal property or execution of a real estate contract whichever event occurs first.

"Completed escrow" means a transaction in which the escrow agent has fully discharged its duties to the principal parties to the transaction. This includes obtaining all necessary documents, obtaining required signatures, completing reconveyance or title elimination, and disbursing funds to the principal parties to the transaction, the agents to the transaction, and to third parties to the transaction as agreed by the principal parties in the escrow instructions or on the settlement form (such as HUD1 or HUD1A).

"Conversion" means an unauthorized assumption and exercise of the right of ownership over moneys, property, or things of value belonging to another, to the alteration of the condition of, or the exclusion of the owner's rights to such moneys, property, or things of value. It includes any unauthorized act which deprives an owner of his/her property permanently or for an indefinite time, including but not limited to theft, embezzlement, forgery, swindling, and unauthorized control.

"Escrow instructions" are the instructions, signed by the principal parties to the transaction that identify the duties and responsibilities of the escrow agent in carrying out the escrow, that identify the thing or things of value held by the escrow agent and the specified condition or set of conditions under which the thing or things of value are to be transferred.

"Investigation" means an examination undertaken for the purpose of detection of violations of chapter 18.44 RCW, and these rules or securing information lawfully required under chapter 18.44 RCW, and these rules. The director or his or her designee may make private or public investigations.

"Officers" of the escrow agent shall include the president, secretary, treasurer, vice-president, and any other persons with control over management decisions of the escrow agent.

"Overdue instrument" means a negotiable instrument that is overdue as defined in RCW 62A.3-304.

"Permanent record" means any record required to be kept under RCW 18.44.400 for a period of six years from the completion of the escrow transaction.

"Principal parties" means the buyers and sellers in a purchase transaction, and the borrower in a refinance transaction.

"Reconveyance" means an instrument used to transfer title from an individual holding such title in trust to the equitable owner of real estate, when title is held as collateral security for a debt.

"Split escrow" means a transaction in which two or more escrow agents act to effect and close an escrow transaction.

"Transfer of title" occurs at the time the seller executes a deed or bill of sale and such is delivered to the purchaser or recorded.

"Trust" means a fiduciary relationship whereby a thing of value is delivered to an escrow agent with the intention that such thing of value be administered by the escrow agent for the benefit of the principal parties to the transaction.

"Trust account" or "trust bank account" means a bank account holding funds of any party to the transaction.

"Unclaimed funds" means any funds that are abandoned under the Uniform Unclaimed Property Act, chapter 63.29 RCW.

[Statutory Authority: RCW 18.44.410. 05-03-038, § 208-680A-040, filed 1/10/05, effective 2/10/05; 01-08-055, § 208-680A-040, filed 4/2/01, effective 5/3/01. Statutory Authority: RCW 42.320.040 [43.320.040] and 18.44.320. 96-21-082, § 208-680A-040, filed 10/16/96, effective 11/16/96. 96-05-018, recodified as § 208-680A-040, filed 2/12/96, effective 4/1/96. Statutory Authority: RCW 18.44.320. 94-04-050, § 308-128A-040, filed 1/31/94, effective 3/3/94; 88-19-016 (Order PM 763), § 308-128A-040, filed 9/9/88; 79-07-009 (Order RE 126), § 308-128A-040, filed 6/7/79; Order RE 122, § 308-128A-040, filed 9/21/77.]

## Chapter 208-680B WAC

## ESCROW—LICENSING AND EXAMINATION

(Formerly chapter 308-128B WAC)



**WAC 208-680B-010 Credit and character report.** Any person making application for an escrow officer license after passing an examination, or making application to be a designated escrow officer, shall, as an integral part of the application, supply the director with satisfactory proof of applicant's character and credit rating. Such proof shall be obtained and provided by a recognized credit-reporting agency in a form approved by the department.

Any person making application for an escrow agent license shall, as an integral part of the application, supply the director with satisfactory proof of character and credit rating for the natural person making the application, principal officers, designated escrow officer, controlling persons and partners. Such proof shall be obtained and provided by a recognized credit-reporting agency in a form approved by the department.

[Statutory Authority: RCW 18.44.410. 01-08-055, § 208-680B-010, filed 4/2/01, effective 5/3/01. 96-05-018, recodified as § 208-680B-010, filed 2/12/96, effective 4/1/96. Statutory Authority: RCW 18.44.320. 88-19-016 (Order PM 763), § 308-128B-010, filed 9/9/88; Order RE 122, § 308-128B-010, filed 9/21/77.]

**WAC 208-680B-015 License not transferable—Notice of change in principal officer or controlling person.** (1) An escrow agent license may not be transferred.

(2) An escrow officer's license may not be transferred.

(3) Whenever a licensed escrow agent contemplates a transfer involving all or substantially all of its assets, the licensee shall provide written notice to the director at least thirty days prior to the effective date of the transfer. This notice must include a copy of the signed agreement between the parties, which provides in part:

(a) A stipulation that the transferee is responsible for obtaining a license prior to completion of the transfer;

(b) A stipulation that the transferee shall obtain and submit to the director evidence of financial responsibility in the form of the required bond or bonds and errors and omission

[Statutory Authority: RCW 18.44.410. 01-08-055, § 208-680D-010, filed 4/2/01, effective 5/3/01. 96-05-018, recodified as § 208-680D-010, filed 2/12/96, effective 4/1/96. Statutory Authority: RCW 18.44.320. 94-04-050, § 308-128D-010, filed 1/31/94, effective 3/3/94; 88-19-016 (Order PM 763), § 308-128D-010, filed 9/9/88; Order RE 122, § 308-128D-010, filed 9/21/77.]

**WAC 208-680D-020 Required records.** Escrow agents shall be required to keep the following transaction records as a minimum; and all records except the reconciled bank statements, shall identify the transaction to which they pertain by escrow number or other clearly identifying information:

(1) Trust account records.

(a) Copies of all duplicate deposit slips validated by the bank or bearing the signature of the designated escrow officer and the date of actual deposit, wires, separate receipts, or other evidence of the deposit of funds into the trust account;

(b) Copies of all checks, wires, or other evidence of any disbursement from the trust account;

(c) Copies of all bank statements for the trust account, including all paid checks or copies of paid checks, electronic or otherwise, provided that such copies are made in such a manner that the endorsement on the paid check is visible and readable;

(d) Client's ledger containing an individual ledger sheet for each transaction: Provided however, That for computerized record systems, an individual ledger sheet need not be maintained in the transaction files until the closing of the transaction if the computer records demonstrate on a daily basis the status of the transaction funds;

(e) If a manual trust accounting system is employed to administer the trust account, copies of all written receipts and prenumbered checks.

(2) Other records.

(a) A transaction file shall be maintained to contain all agreements, contracts, documents, leases, escrow instructions, closing statements and correspondence for each transaction;

(b) Reconciled bank statements and cancelled checks for all bank accounts of the escrow agent, including but not limited to the pooled escrow trust accounts, individual escrow trust accounts, and general business operating accounts of the agent;

(c) All checks and receipts produced by any computerized accounting or record system must be sequentially numbered. The escrow agent shall retain the original of any voided or incomplete sequentially numbered check or receipt which was not issued.

[Statutory Authority: RCW 18.44.410. 01-08-055, § 208-680D-020, filed 4/2/01, effective 5/3/01. 96-05-018, recodified as § 208-680D-020, filed 2/12/96, effective 4/1/96. Statutory Authority: RCW 18.44.320. 88-23-049 (Order PM 790), § 308-128D-020, filed 11/14/88; 88-19-016 (Order PM 763), § 308-128D-020, filed 9/9/88; Order RE 122, § 308-128D-020, filed 9/21/77.]

**WAC 208-680D-030 Accuracy and accessibility of records.** (1) **Accuracy.** All records shall be accurate, posted and kept current to the date of the most recent transaction.

(2) **Location.** The escrow agent must maintain all records available for inspection by the department for a minimum of six years at an address where the escrow agent is licensed to maintain an escrow office. Records of transactions may be stored at a remote location within the state of Washington after the escrow has been completed for at least one year. Records stored at a remote location shall be available upon demand of the department during business hours and maintained in a manner to be readily retrievable.

(3) **Permanent storage.** After completion of the escrow transaction records may be stored on permanent storage media, such as optical disk or microfilm, provided the retrieval process does not permit modification of the documents. "Retrieval process" means the on-site ability to view and print the document in its original form including signatures or other writing placed upon the original document. The escrow agent must have in its records a statement signed by the supplier of the permanent storage system that the system does not permit the user to modify a document after it has been permanently stored.

(4) **Restrictions on storage.** Transactions and accounting records may not be stored at a remote location or on permanent storage media as described in subsection (2) or (3) of this section if there are funds relating to the transaction, such as reconveyance or holdbacks, remaining in the trust bank account.

[Statutory Authority: RCW 18.44.410. 01-08-055, § 208-680D-030, filed 4/2/01, effective 5/3/01. Statutory Authority: RCW 42.320.040 [43.320.-040] and 18.44.320. 96-21-082, § 208-680D-030, filed 10/16/96, effective 11/16/96. 96-05-018, recodified as § 208-680D-030, filed 2/12/96, effective 4/1/96. Statutory Authority: RCW 18.44.320. 94-04-050, § 308-128D-030, filed 1/31/94, effective 3/3/94; 88-19-016 (Order PM 763), § 308-128D-030, filed 9/9/88; Order RE 122, § 308-128D-030, filed 9/21/77.]

*** WAC 208-680D-040 Agreements and closings.** The escrow agent shall be responsible for the effecting and closing of escrow agreements between the principal parties. The agent shall as a minimum:

(1) Prepare or accept an instrument of escrow instructions among the principal parties and the escrow agent. The escrow instructions shall be signed by the principal parties. Escrow instructions shall contain any and all agreements between the principals and the escrow agent or incorporate other written agreements by reference. The escrow instructions shall not be modified except by written agreement signed by the principals and accepted by the escrow agent.

(2) Disclose in writing to the principal parties when fees for services provided may be realized by the escrow agent. The disclosure must specifically identify the fees using the same terminology as that provided on the closing statement (for example HUD1 or HUD1A), and reflect the dollar amount associated with each item identified as a fee payable to the escrow agent. For purposes of this section, fees payable to the escrow agent shall mean any item payable directly to the escrow agent whether realized by the escrow agent as profit, potential for profit, or the offset of justifiable costs.

(3) Ensure that all fees and/or justifiable costs are for bona fide services performed by the escrow agent or contractually ordered by the escrow agent to be performed by a third party to the transaction and bear a reasonable relationship in value to the services performed. No justifiable costs known at the time of closing for services performed by a third party to the transaction may exceed the actual cost of the third-party service. When the cost of a third-party service cannot be known with certainty at the time of closing, an escrow agent may:

(a) Provide an estimate of the justifiable cost of the third-party service on the preliminary closing statement, disclose the actual justifiable cost of the third-party service on the final disclosure statement, and refund any amounts collected in excess of the actual justifiable cost of the third-party service to the principal parties to the transaction; or

(b) Assume responsibility for performing the service and charge the principal parties to the transaction a one-time fee for performing the service. The one-time fee must be reasonably related to the value of the service provided. The escrow agent may contract with a third party to perform the service. The escrow agent must disclose to the principal parties to the transaction in the preliminary and final settlement statement that the fee is being paid to the escrow agent. The escrow agent may transfer such fees earned into the general account in compliance with WAC 208-680E-011 (12)(a).

(4) Comply with the instructions for completing the closing statement. All funds disbursed on the closing statement should be bona fide and supported with adequate documents.

(5) Maintain copies of the escrow instructions and closing statement (for example, HUD1 or HUD1A) in the transaction file.

(6) Require an addendum to the purchase agreement for any and all material changes in the terms of the transaction, including but not limited to, changes in the financing of the transaction.

(7) Provide the services and perform all acts pursuant to the escrow instructions.

(8) Provide a complete detailed closing statement (for example HUD1 or HUD1A) as it applies to each principal at the time the transaction is closed. The escrow agent shall retain a copy of all closing statements in the transaction file, even if funds are not handled by the agent. The closing statements (for example HUD1 or HUD1A) shall show:

(a) The date of closing.

(b) The total purchase price.

(c) An itemization of all adjustments, moneys or things of value received or paid in compliance with requirements of the Real Estate Settlement Procedures Act, 12 U.S.C. Section 2601, and Regulation X, 24 C.F.R. Section 3500 and all applicable rules and regulations. Such itemization must include the name of the person or company to whom each individual amount is paid, or from whom each individual amount is received.

(d) A detail of debits and credits identified to each principal party.

(e) Names of payees, makers and assignees of all notes paid, made or assumed.

(9) Pay the net proceeds of sale directly to the seller unless otherwise provided in writing by the seller or a court of competent jurisdiction.

(10) Obtain original signatures of the principals on either the preliminary or final closing statement and maintain a copy of the signed closing statement in the transaction file.

(11) Provide a copy of the final closing statement to each principal party and to each real estate broker involved with the transaction.

[Statutory Authority: RCW 18.44.410. 01-08-055, § 208-680D-040, filed 4/2/01, effective 5/3/01. 96-05-018, recodified as § 208-680D-040, filed 2/12/96, effective 4/1/96. Statutory Authority: RCW 18.44.320. 94-04-050, § 308-128D-040, filed 1/31/94, effective 3/3/94; 88-23-049 (Order PM 790), § 308-128D-040, filed 11/14/88; Order RE 122, § 308-128D-040, filed 9/21/77.]

**WAC 208-680D-050 Expeditious performance.** An escrow agent shall perform all acts required of the escrow agent as expeditiously as possible and within any time period identified in the escrow instructions. Intentional or negligent delay in such performance shall be considered in violation of RCW 18.44.430 (1)(i).

[Statutory Authority: RCW 18.44.410. 01-08-055, § 208-680D-050, filed 4/2/01, effective 5/3/01. 96-05-018, recodified as § 208-680D-050, filed 2/12/96, effective 4/1/96; Order RE 122, § 308-128D-050, filed 9/21/77.]

**WAC 208-680D-060 Disbursement of funds.** The escrow agent shall disburse funds as set forth in the escrow instructions. Disbursement of any money or other items in violation of the trust or before the happening of the conditions of the escrow agreement or escrow instructions is a violation of RCW 18.44.430 (1)(e). Funds and other items or documents must be paid and/or disbursed immediately upon closing of the transaction or as specifically agreed to in writing by all of the principal parties: Provided, That funds are disbursed in compliance with RCW 18.44.400(3).

Upon written notice from any principal party that the ownership of the funds is in dispute or is unclear based on the written agreement of the parties, the escrow agent must hold such funds until receiving written notice from all principal parties that the dispute has been resolved. In lieu of holding such funds the escrow agent may interplead the funds into a court of competent jurisdiction pursuant to chapter 4.08 RCW. Upon notification of a bona fide dispute between the principal parties, the director may, at his/her discretion, order the escrow agent to interplead the funds into a court of competent jurisdiction.

At no time may an escrow agent disburse or delay the disbursement of funds without the written consent of all principal parties.

[Statutory Authority: RCW 18.44.410. 01-08-055, § 208-680D-060, filed 4/2/01, effective 5/3/01. Statutory Authority: RCW 42.320.040 [43.320.-040] and 18.44.320. 96-21-082, § 208-680D-060, filed 10/16/96, effective 11/16/96. 96-05-018, recodified as § 208-680D-060, filed 2/12/96, effective 4/1/96. Statutory Authority: RCW 18.44.320. 88-23-049 (Order PM 790), § 308-128D-060, filed 11/14/88; Order RE 122, § 308-128D-060, filed 9/21/77.]

**WAC 208-680D-070 Suit or complaint notification.** Every escrow agent and escrow officer shall, within twenty days after service or knowledge thereof, notify the department of the following:

(1) Any criminal complaint, information, indictment, or conviction (including a plea of guilty or nolo contendere) in which the licensee is named as a defendant.

(2) Entry of a civil court order, verdict, or judgment, against the licensee in any court of competent jurisdiction in which the subject matter therein involves any escrow or business related activity by the licensee. Notification is required regardless of any pending appeal.

[96-05-018, recodified as § 208-680D-070, filed 2/12/96, effective 4/1/96. Statutory Authority: RCW 18.44.320. 94-04-050, § 308-128D-070, filed 1/31/94, effective 3/3/94; 88-19-016 (Order PM 763), § 308-128D-070, filed 9/9/88; Order RE 122, § 308-128D-070, filed 9/21/77.]

# APPENDIX 6

C

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Article

# *1 SHOULD WE **BAN** OR **WELCOME** "**SPEC**" **HOME BUYERS**?



This article begins by recounting the extent to which speculating **buyers** contributed more than proportionately to housing price volatility and the rate of mortgage foreclosure. **Home** "flippers" never expect to take up occupancy in the houses they buy; instead, they hope to profit from a quick resale. Speculating **home buyers** represented about a quarter of the market in many cities and accelerated falling house prices and rising foreclosure rates by defaulting as soon as the housing bubble started to shrink--far more quickly than would owner occupants. If **spec buyers** had been kept out of the market, housing prices would have been less volatile and foreclosure rates lower.

The second section turns to the way **spec buyers** deceived mortgage lenders by committing occupancy fraud, claiming falsely that they were buying as owner occupants so they could benefit from more favorable mortgage rates and terms. Though the FBI has pursued some egregious perpetrators of occupancy fraud, the best way of deterring borrowers from committing occupancy fraud is by lenders screening them out through improved underwriting. Telltale signs in loan applications and borrower background checks make occupancy fraud detectable, especially with the aid of specially designed software and a considerable determined effort.

The third section starts by describing the mischief **spec buyers** caused **home** builders and condo developers by signaling phantom housing demand and degrading "for sale" housing tracts and condo developments by leaving newly bought **homes** vacant or filling them with short term rentals. Next, I describe the means used by homebuilders to restrain **home** flippers. I also explain why these restraints tended to appear only in purchase and sale contracts and not in deeds, confining enforcement to contract actions against flip **buyers** but not upsetting sales to the flip **buyers' buyers**. The doctrine barring all but promissory restraints on alienation figures prominently here, along with practical marketing considerations.

The fourth section explores the rationale for a government imposed **ban** on **home** flipping. This would be a publicly imposed constraint on alienability. Here, I examine a particular proposal that a law professor advanced a few years ago for a local ordinance that would bar new **home** or condo resales by **spec buyers** for a period of years. After detailing the drafting issues that would need to be resolved in such an ordinance, I conclude that an inalienability ordinance would no longer be sustainable, because **spec buyers** are now **welcome** and widely perceived as much needed rescuers in resuscitating deflated housing markets by bidding up the prices of foreclosed properties.

By George Lefcoe*

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I. Spec Buyers Contributed to House Price Volatility

When house and condo prices were soaring in many regions of the United States from 2004 to 2006, [FN1] speculating ("spec") buyers climbed on board for the all-too-fleeting joyride. They hoped to profit from reselling swiftly without ever moving in, and they lied to lenders and developers, claiming their acquisitions were for their own use and occupancy. [FN2] Spec buyers (a.k.a. non-owner occupants) began to awaken from their dreams of quick riches and started defaulting on their mortgages in droves the moment house prices showed signs of flattening out; they would not be able to recoup their invested equity plus their share of the closing costs. [FN3] With spec buyers forming about a quarter of the market, University of Texas Economics Professor Stan Leibowitz explains: "[The number of spec buyers is] large enough that if only a minority of speculators defaulted when housing prices stopped increasing, it could have explained all or most of the entire increase in foreclosures started." [FN4]

To see how this played out in one market, consider Las Vegas where home and condo prices rose sharply in 2004-2005, peaked in 2006, [FN5] and then began a slow descent, dropping 40-50% by 2009. [FN6] Their profits peaked at about 20% in 2004, ***3** accounting for opportunity costs, but had fallen to zero by 2007. [FN7] For several years, Las Vegas's foreclosure rates have stood highest in the nation. [FN8] Spec buyers accounted for up to 60% of the Las Vegas foreclosures, [FN9] which is about three times the rate of foreclosures among owner occupants. [FN10]

Another reason foreclosure rates spiked among spec buyers is that they preferred subprime loans with low introductory, barely affordable "teaser" rates. Subprime borrowing increased dramatically among all types of borrowers in locales with escalating home prices. Even buyers with credit scores good enough to qualify them for prime mortgage loans took out subprime loans. [FN11] Spec buyers were not too worried about the high long-term cost of servicing this subprime debt once the "teaser" period ended. Optimistically, they expected to sell at a whopping profit long before then and to prepay their acquisition financing from sale proceeds. [FN12] As house prices cooled and then fell, buyers looking for a quick exit were not able to sell or refinance their subprime mortgages. Mix spec buyers with subprime loans and declining home prices, and you have a stomach churning recipe for a housing finance disaster.

As prices subside, spec buyers are more inclined to default than purchasers intent on occupancy, "because the vast majority of people who live in their homes plan to stay there for the long term and will not sell based on periodic economic corrections, thus keeping the market relatively stable." [FN13] Owner occupants search for the best available place to live and tend not to abandon their homes--and forfeit their sunk costs--at the first sign of prices leveling off. They tend to stay put at least until their current housing outlays exceed what they will need to spend to acquire their next domicile-- taking into account all the expenses of selling, buying, or renting and moving to their next place, as well as the hardship of disrupting the lives of everyone in the household and blemishing their own credit. [FN14] Most purchasers planning to remain in their homes for a number of ***4** years tend to shrug off home price declines as temporary. Of course, owner occupants sometimes default, too, and lose their homes to foreclosure. But their defaults are almost always precipitated by events other than fluctuating house prices-- job loss, divorce, illness, or the death or disability of the primary wage earner. [FN15] Of course, they do not need to stand passively by and lose their homes to foreclosure when house prices are buoyant. In good times, they just need to face reality, list the home with a competent broker, and prepare to relocate.

Perhaps if Las Vegas and other cities could have found a way to reduce the ranks of spec buyers in overheated markets, there would have been less overbuilding during the housing boom and fewer foreclosures now. This article recounts the main options potentially available to builders and lenders to detect and keep out spec buyers, including a law professor's proposal for a government imposed alienability limit: a minimum holding period before sale. This is a good time to understand what these options can accomplish, to appreciate their limitations, and to realize why we cannot expect much interest in them during a house price deflation.

II. Real Estate Lenders Suffer from and Are Good Cost Avoiders of Mortgage Occupancy Fraud

The most favorable home mortgage terms are reserved for owner occupants both to advance home ownership and to recognize the lower delinquency rates of owner occupants. [FN16] Owner occupants qualify for mortgages with interest rates 40% lower than what banks would charge an investor, much smaller down payments, two months reserve to cover property taxes and insurance (instead of six months), and significantly less documentation since lenders require investors to demonstrate a history of success in managing properties. [FN17]

Mortgage lenders insist that borrowers seeking to qualify for these advantageous terms affirm that they will move into the mortgaged property as their principal residence within sixty days of executing their loan agreements and will continue occupancy for at least one year, barring extenuating circumstances beyond the borrower's control or the lender's written consent. [FN18] Borrowers signing Fannie Mae (FNMA) or Freddie Mac (FHLMC) uniform deeds of trust or mortgages are in default if they provide "materially false, misleading, or inaccurate information" in their loan applications, specifically including misrepresentations concerning occupancy as the borrower's principal residence. [FN19]

***5** Many spec buyers commit occupancy fraud, [FN20] lying about their intentions to reside in the mortgaged property in order to qualify for low- or no-down payment loans with favorable interest rates. [FN21] This enables them to benefit from leverage, [FN22] magnifying their gains if home prices go up while leaving the mortgage lender with the losses if prices go down. [FN23]

Current federal law provides enforcement agencies with authority to prosecute mortgage fraud. [FN24] Penalties include the possible loss of the property, which would result in a forfeiture of the borrower's equity. [FN25] State criminal laws empower state law enforcement agencies to pursue perpetrators of mortgage fraud, and many state civil laws empower private individuals and institutions to pursue mortgage fraud as unfair or deceptive acts or practices. [FN26] Also, mortgage lenders are entitled to enforce owner occupancy provisions in their loan agreements, allowing them to foreclose against breaching borrowers. [FN27]

After-the-fact prosecutions do not prevent losses nearly as well as improved ***6** underwriting and mortgage lenders denying loans to spec buyers in the first place. On average, lenders will lose about one-third of their investment in a home or condo foreclosure. [FN28] There are fairly good indicators of occupancy fraud risk, but they require loan originators to scrutinize loan application carefully, increasing the costs of underwriting and delaying loan closings. [FN29] "The mortgage application is, and always will be, the starting or ending point for fraud. The catastrophic collapse of the subprime market demonstrates a need for all lenders and investors to seriously reevaluate their current approach to risk management." [FN30]

One tell-tale sign of fraud is when the borrower's current monthly housing costs are much lower--200% or more--than the borrower's projected monthly costs for the home being purchased. [FN31] Another is when a loan applicant who says she is a renter has filed a tax return claiming homeowner deductions for property taxes and mortgage interest payments. [FN32] A private firm called BasePoint Analytics markets software that is specially designed to ferret out these anomalies. But even the best available software does not eliminate the need for extensive, skillful underwriting, because six out of every seven transactions the BasePoint software identifies as suspicious prove to be legitimate. [FN33]

The increased underwriting effort may be cost justified. "The savings from detecting the fraudulent loan far outweigh the time to review," notes BasePoint Analytics. [FN34] But many lenders did not act as if they believed this in 2003-2006 when the rush was on to speed loan approvals in a climate of swiftly rising home prices that many lenders believed could never fall. [FN35] Lenders could have done more to detect ***7** occupancy fraud, according to Frank McKenna, chief fraud strategist for BasePoint Analytics, "but the industry was very focused on volume." [FN36]

Greater loan volume meant sizable loan origination fees and interest rate premiums for lenders making risky loans. Lenders competed with each other for investors' funds, and until the riskiness of poorly underwritten portfolios came to light through torrential rates of default and foreclosure losses, investors flocked to lenders offering the highest yields. Even as late as 2008, a lender whose short-term profits fell, as it reduced loan volume by taking more time to underwrite loans and rejecting the riskiest loan applicants, stood to lose investors to its more aggressive competitors. Many investors would have perceived the lender's claim that it was reducing future losses from excessive risk taking as an excuse for its failure to produce competitive yields in the midst of what turned out to be a housing bubble. [FN37]

Unfortunately, lenders usually uncover evidence of mortgage fraud only after the borrower has defaulted and the lender or its agent has carefully examined the original loan file. [FN38] Lenders reserve the right to call their loans, declaring the balance immediately due and payable, and to foreclose if the borrower did not already prepay the loan. [FN39] Ordinarily, people who fib do not cost their lenders a dime. They tend to make their payments on time, just like most everybody else. But when those who use deception to obtain financing get in over their heads and cannot--or will not-- make their payments, their lenders stand to lose big too. [FN40] As long as the borrower is making payments on time, a lender who happens to suspect mortgage fraud is put to a hard choice: keep collecting mortgage payments as if nothing is amiss or face a big financial hit by precipitating a foreclosure.

III. Tract **Home** Builders and Condo Developers Have Found Various Means of Deterring **Spec Buyers**; All of Them Are Imperfect, Though Not Completely Ineffectual

The Damage **Spec Buyers** Wrought

**Spec buyers** are good news and bad news for condo developers and tract **home** builders. A unit sold, even to someone who never plans to live in it, is better for the builder's bottom line than a unit unsold--though only a minority of **home** builders admit to **welcoming spec buyers**. [FN41] Yet, no builder or developer **welcomes** competition from **spec buyers** before successfully concluding its marketing and sales effort. [FN42] In ***8** addition to adding to the supply of unsold units, **spec buyers** can undercut the developer's prices. [FN43] And before the speculator sells, he or she will either rent the unit or leave it vacant. None of these moves support developers' efforts to create viable residential communities. **Spec buyers** are not going to be good neighbors; they do not lavish the same tender loving care for their properties as owner occupants, participate actively in **home** or condo association activities, or join local service organizations, churches, bowling leagues, or PTAs. Several builders recently told the Wall Street Journal that they had underestimated the percentage of their sales to investors. Builders figured that maybe 10% of their buyers were speculators, when speculators were probably actually picking up a quarter of their inventory. Speculators routinely signed documents promising they would reside in their homes when they had no such intention. [FN44]

Spec buyers also send false signals to builders and developers regarding housing demand. [FN45] Tract homebuilders and condo developers try to avoid building units too far ahead of demand by first taking non-binding reservations and then entering purchase and sale agreements with potential buyers before commencing construction. [FN46] One Miami condo developer explained how non-owner occupants defaulting on their purchase contracts misled him into building a 1,646 unit condo building that had been 90% presold with non refundable deposits of 20%. [FN47] Speculators fueled the market and then fled, abandoning their contracts as soon as prices began to level off. [FN48] Of the first 500 units built, the Miami condo developer only sold thirty, and many earlier buyers filed suit for a refund of their deposits. [FN49] Currently, FNMA won't purchase a mortgage from a bank unless 70% of the units have been presold to residents rather than investors. [FN50] This should make mortgage lenders more cautious about financing projects for developers who don't institute appropriate procedures for detecting spec buyers.

***9** How Home Builders and Condo Developers Tried to Screen Out Home Flippers.

Homebuilders are well aware of the risks posed by buyers who are non-owner occupants. According to a 2005 survey of its members by the National Association of Homebuilders, four-fifths of all homebuilders try to confine sales to owner occupants. [FN51] Home builders report a variety of means to screen out speculators:

1. 64% reported prohibiting buyers from assigning their purchase and sale agreements or designating a nominee to take title at closing;

2. More than half insert provisions in purchase and sale agreements prohibiting sales within the first year of ownership;

3. 36% of builders reserved rights of first refusal to buy back homes sold within the first year at the builder's selling price;

4. 36% refused to allow any units to be rented within the first year after purchase;

5. 18% would not sell more than one home to buyers with the same last names;

6. 18% used a variety of other measures, including steep fees for homes resold within the first year. [FN52]

7. Some builders have reserved the right to disclose suspected mortgage fraud to the buyer's lender.

Condo developers and home builders seldom place the types of restrictions mentioned above into recorded deeds. [FN53] Instead, these restrictions tend to appear only in purchase and sale contracts, unrecorded. There are two reasons for this. First, deed restrictions are best reserved for relatively permanent restraints, not transitory ones. Developers and builders have no reason to preclude non-owner occupants from buying individual units in the resale market after they have sold out all their units. During the initial sales push for a new development, spec buyers can impact prices enormously, because so many units are on the market at once. After the initial sell out, it is unlikely that individual unit buyers will place their units on the market all at once, thereby reducing the chances that spec buyers could skew prices throughout the project.

Second, developers and builders want to avoid impairing the marketability and value of their units. By placing either a contract or deed in the public land records that limits transfers by non-owner occupants, developers put subsequent purchasers and ***10** mortgagees on constructive notice, potentially clouding the titles of all grantees, owner occupants and non-owner occupants alike. [FN54] Before buying or financing a unit subject to a recorded restriction like this, observant purchasers and cautious lenders would demand title policies assuring them that they are not buying in contravention of the restriction. [FN55] In order to write such policies, prudent title insurers would seek written, recordable evidence of compliance, probably verified by the grantor or the grantor's successors. [FN56] This could impede sales not just to spec buyers but also to owner occupants who might have no problem confirming their intentions regarding residency in a purchase and sale agreement but who might balk at accepting a deed restriction that could complicate their attempts to sell sometime in the future and possibly also deter a mortgage lender from financing their present purchase or eventual sale.

Imagine, though, a developer or builder determined to stamp out spec buying by any lawful means, regardless of the potentially adverse impact on sales. The most effective way of doing this would be through a recorded deed restriction calling for title to revert to the grantor if a non owner occupant tried to sell within, say, six months or a year of acquiring title. The venerable doctrine barring restraints against alienation might bar enforcement of such a restriction.

Alternately, condo regimes often prohibit owners from renting their units. Such restrictions upon rentals are contemplated in state condominium laws, [FN57] may appear in the Declaration of Condominium, [FN58] in deeds from the developer to individual units, [FN59] or by laws enacted by the homeowners' association according to procedures outlined in the documents that established the condominium regime. [FN60] Doctrinally, restraints on ***11** alienation fall into one of three broad categories: disabling, forfeiture, and promissory. [FN61] A disabling restraint invalidates the grantee's attempt to transfer property contrary to the terms of the restraint. [FN62] The transferee takes nothing; title remains intact with the grantee, unburdened by the purported transfer. [FN63] Under a forfeiture restraint, the grantee's title terminates following a prohibited transfer, and title reverts to the grantor. [FN64] A forfeiture provision may take the form of a reservation by the conveyor of a power of reentry, exercisable when the grantee tries to sell in disregard of the restriction. [FN65] The third type, promissory restraints, consists of covenants, conditions or restrictions on the ownership or use of the transferred property, enforceable by a suit for injunction or damages against the breaching owner. [FN66] A grantee that violates a promissory restraint becomes liable to the grantor for damages or injunctive relief.

The burden of disabling and forfeiture restraints falls upon those to whom the grantee attempted to convey in violation of them. Generally, courts are extremely wary of disabling or forfeiture restraints; some courts treat them as invalid per se, [FN67] while other courts tend to grant enforcement subject to a judicial determination of reasonableness, case-by-case. [FN68] The venerable doctrine baring restraints against alienation would probably bar enforcement of a restriction calling for title to revert to the grantor if the grantee failed to occupy the unit within a specified time. [FN69]

Generally, no-lease restrictions avoid characterization as unlawful restraints on alienation by virtually always being made enforceable only as promissory restraints. [FN70] The penalties for breach are usually monetary and fall on the condo unit owner who violates the no-lease restriction. Courts generally uphold promissory restraints upon rentals as reasonable restraints on alienation unless the monetary penalties are horrifically disproportionate to the harms done. [FN71] Rarely are provisions prohibiting ***12** rentals cast as disabling restraints invalidating the tenant's lease or as forfeiture restraints, forcing the unit owner to surrender title to the condo association [FN72] or prohibiting sale to a grantee who admits no interest in ever occupying the unit. [FN73]

Sometimes, courts allow gift-givers to impose forfeiture and disabling restraints against ungrateful donees and their inattentive lenders when the grantor had marked down the purchase price to account for the diminished value of the restricted conveyance. [FN74] Similarly, courts uphold restrictions imposed by the promoters of subsidized housing to preclude occupants from capturing the benefit of the subsidies by selling or leasing at market prices and, thereby, frustrating the purpose of making subsidized housing available to low- or moderate-income occupants for a long enough time to amortize the social investment. [FN75]

By contrast, the doctrine barring forfeiture restraints against alienation would almost certainly preclude developers and builders who sold to spec buyers at market prices from deeding property in fee simple determinable but reserving the right to ***13** recapture title to properties sold by non-owner occupants contrary to the agreed "blackout"' period on sales. Instead, developers are entitled to reserve rights of first refusal. [FN76] They do not have to match the price that the spec buyer may contract to receive from a third party buyer; but developers seeking to exercise rights of first refusal to prevent spec buyers from realizing quick resale profits need to reimburse the spec buyer's purchase price to avoid perpetrating a forfeiture. [FN77]

IV. Should Governments Impose Alienability Constraints on Spec Buyers?

In one of the most often cited law review articles ever written, Guido Calabresi and Douglas Melamed pointed out that the government not only grants basic entitlements but also decides how individuals may enforce those entitlements. [FN78] There are three choices, which Calabresi and Melamed characterized as property, liability and inalienability entitlements. [FN79] The owners of an entitlement protected as a property right have the prerogative of selling or not and of naming a price of their own choosing. [FN80] A liability rule empowers others to interfere with or destroy an entitlement (like the right not to be run down by a careless driver) upon payment of compensation through a government-determined procedure. [FN81] An entitlement becomes inalienable when the state prohibits or limits its transferability between willing buyers and sellers. [FN82]

University of Chicago Law Professor Lee Anne Fennell, in a recent law review article, noted that law and economics scholars have confined most of their writing to property and liability rules and, for the most part, have overlooked the potential positive role that restricting alienability might play. [FN83] She had in mind situations where market driven transactions are usually thought appropriate but where for special reasons a norm of inalienability could usefully discourage potential resellers from acquiring an asset in the first place. [FN84] She explores "conditions under which alienability limits offer a more promising point of intervention than limits on acquisition, use, or exclusion." [FN85]

Could alienability rules be superior to limitations on use or sales in discouraging spec buyers from purchasing units in the first place? As Professor Fennell points out, property can be acquired in a quest for wealth accumulation or as an item for personal use and enjoyment. [FN86] Most home and condo owners acquire property for their personal use and only incidentally as investments. Spec buyers, by contrast, are only interested in profitable resales. Restricting their alienability options should discourage their acquisitions in the first place, relieving lenders and developers from having to spend so ***14** much energy trying to screen them out.

To date, no government has initiated a measure to render property inalienable in the hands of non-owner occupants pretending to become residents in the way that, for instance, sales of stolen goods [FN87] or endangered species [FN88] are prohibited even by bona fide purchasers. Instead, probably the most effective disincentives to spec buying are the provisions in the federal tax code that greatly favor home ownership [FN89] and deny spec buyers capital gains treatment if they sell too soon. [FN90]

To probe the implications of a government imposed alienability restriction on spec buyers, consider as an example University of Nevada Law Professor Ngai Pindell's proposal of locally enacting an "anti-speculation zoning ordinance." [FN91] Enacting such legislation on a local basis makes sense because of the uneven distribution of foreclosures and spec buying "within states and within cities in each state." [FN92] The proposed ordinance would preclude "first purchasers of residential property in newly constructed developments of a certain size" from selling the property for three years "in medium and large-scale communities of approximately twenty or more units" and "would apply to both attached and detached single-family housing." [FN93]

***15** Professor Pindell's proposal is preliminary and suggestive. Though he does not purport to spell out all the details, he recognizes the need for administrative exceptions for those purchasers truly intending to hold the property for three years, but unable to complete the period because of extenuating circumstances. The inclusions of such exceptions to the ordinance would likely necessitate an administrative system to evaluate the merit of waiver claims, monitor compliance, and conduct enforcement through civil or perhaps criminal penalties. [FN94]

However, Professor Pindell also thoughtfully acknowledges:

> [E]xceptions to an anti-speculation measure threaten to swallow the rule as local governments would face understandable pressure to approve individual or categorical exceptions to the application of the ordinance for hardship and similar unforeseen occurrences. The number of people entitled to exceptions could outnumber those not entitled to exceptions, and the administrative burden of identifying bona fide cases for exception could be overwhelming and threaten to outweigh the benefits of the legislation. [FN95]

Professor Pindell's outline of an anti-spec buyer ordinance leaves open "the appropriate resale limitation period [and] the appropriate punishment for violations." [FN96] To comply with due process standards, an ordinance would probably have to be recorded in the chain of title of each affected property in order to invalidate the titles of those who purchased from spec buyers within the three year blackout period. [FN97]

Would real estate closing attorneys, brokers or title insurers be responsible for warning the buyers they represented or insured of the existence and implications of the ordinance? Maybe so. Professor Pindall suggests:

> The local government could require that an affidavit of compliance be included with the sales contract or

other aspects of the purchase process. A person making a false statement on the affidavit or failing to comply with the instructions of the affidavit would be subject to civil or criminal proceedings. Local government might monitor buyer activity through property tax payments or deed recordings. [FN98]

Since lenders and developers are in a far better position to recognize spec buyers than most city administrators and have a greater incentive to do so, Professor Pindell advances the possibility that developers and builders could be the primary initiators of anti-spec sales provisions. [FN99] They could enlist local governments to assist with enforcement through development agreements or other means, [FN100] in the way that private deed restrictions are enforced by local governments in Texas. [FN101]

***16** On balance, alienability limits would not be a sensible response to deter spec buying. For starters, there is the cost to the government of enforcement and of possibly recording notices of the ordinance in the chains of title of all affected properties.

The assumption that a municipally-imposed minimum holding period would deter spec buyers is questionable. After all, this is a class of buyers willing to risk the possibility of FBI investigations and federal prosecutions for mortgage fraud and of having their mortgages foreclosed for violating pledges of owner occupancy. The sanctions for violating a minimum holding period ordinance pale by comparison, especially since it is highly improbable that enforcement would be well-funded and effective. [FN102]

While such an ordinance might not deter spec buyers, it might discourage buyers from acquiring personal residences anywhere in the enacting jurisdiction. The buyers' and mortgagees' title insurance costs would be greater, because proof would be required that they were not buying or financing into a violation. Additionally, purchasers forced to sell within the blackout period due to changing life circumstances--divorce, death, job relocation, financial stress-- would need to procure an administrative exception from the local government. They could not safely conclude a sale until the exception was granted. This process could result in a costly delay in a market where house prices were steadily declining, especially if the local government was slow to respond.

Affected owners might find themselves locked into a less-than-optimal situation for a period of years. At least with privately imposed constraints, developers and lenders could grant waivers to **spec buyers** should a time come when market conditions make **spec buyers** more **welcome**.

Consider the adverse consequences Professor Pindell's ordinance would have wrought in his **home** town of Las Vegas if enacted in 2006. Precluding **spec buyers** from selling for three years might have deterred some **buyers** from entering the then overheated market in the first place, but it would probably also have added to the stock of unsold, abandoned and foreclosed houses once the market plunged.

Inalienability rules are a bad idea if they are designed to hold back the shifting sands of market values. Richard Posner reminds us that "speculation is a valid method of aligning prices with underlying values." [FN103] In 2005 **spec buyers** were disdained for driving prices out of reach for **home** seekers. Though **spec buyers** were not held in high regard when their bidding was perceived as fueling a dangerously expanding housing bubble, speculators are now warmly **welcomed** for bidding prices off of historic lows. There is a good reason for this. A bursting housing bubble causes pain to many, starting with **home** owners, builders, developers and lenders. Conversely, **spec buyers** who snap up houses at severely depressed prices are seen as helping to avert a free fall deflation in ***17** house prices and the job layoffs and bank insolvencies that deflation can bring. [FN104]

In the present post-bubble era, speculative buyers are playing a vital function in stabilizing falling prices, especially where they are putting a floor on house prices by actively bidding on foreclosed homes. [FN105] Some housing markets have become virtually moribund where prices once soared and then collapsed to less than half their former levels. [FN106] These markets are being resurrected with the help of absentee investors purchasing nearly the same ratio of homes as when house prices were peaking. [FN107] Perhaps in tacit recognition of the important role of spec buyers in the current market, Fannie Mae and Freddie Mac now will purchase up to ten home mortgages owned by the same borrower, where previously they would have purchased no more than four. [FN108] Often, the foreclosed borrowers become tenants in the very houses they once owned, pay rents at levels well below their previous mortgage payments, and hope someday to buy back their homes. [FN109]

Though genuine homebuyers may not miss the challenge of trying to outbid home flippers in the housing market, builders and developers welcome any entrants into the ranks of home buyers who can help lift prices above production costs and make homebuilding become profitable once more. [FN110] A seasoned California real estate broker specializing in branded real estate, resort and luxury condo sales recently remarked, "[O]ne thing is for certain, we sure miss those speculators." [FN111] Had an ordinance been enacted in Las Vegas like the one Professor Pindell suggested, it would almost certainly have been repealed by now at the insistence of real estate brokers, home builders, mortgage lenders and home owners. An inalienability ordinance would no longer be sustainable because spec buyers are now welcome as much needed rescuers of deflated housing markets.

[FN1]. See Anthony Downs, Real Estate and the Financial Crisis: How Turmoil in the Capital Markets Is Restructuring Real Estate Finance 56-59 & exh.2-16 to 2-17 (2009) (describing the variation in median home prices and the rate of change in home prices in various metropolitan areas since 1997); Dennis Cauchon, USA Today, Why Home Values May Take Decades to Recover (2009), http:// i.usatoday.net/news/graphics/housing_prices/home_prices.pdf ("The housing bubble began in 1998, peaked in 2006 and burst in 2007."); see also Andrea Pescatori & Bethany Tinlin, Home Prices, Econ. Trends, Apr. 2007, at 7, 8, available at http://www.clevelandfed.org/research/trends/2007/0407/ET_ apr07.pdf ("Although growth rates in structure values have been fairly similar and stable across regions, land values on both coasts have accelerated significantly. This means that the driving force behind home price growth is the value of the land rather than the structure itself. Except for the Southwest, where land is relatively abundant, land's share of total home value has increased in all regions.").

[FN2]. See Ruth Simon & Michael Corkery, Speculators May Have Accelerated Housing Downturn, Wall St. J., Feb. 6, 2008, at B8 (reporting that results of a study in which Fitch Ratings found that, in two-thirds of the subprime loan cases studied where borrowers with good credit scores defaulted within the first twelve months, the borrowers had never moved into the properties they said they were going to occupy in their loan applications).

[FN3]. Closing costs typically range from 5% to 10% of the house price. Ginnie Mae, Your Path to Home Ownership: A Guide to Owning Your Own Home, http://www.ginniemae.gov/4_home/closing_cost.asp?section=YPTH (last visited Oct. 28, 2009).

[FN4]. Stan J. Liebowitz, Anatomy of a Trainwreck: Causes of the Mortgage Meltdown, in Housing America: Building out of a Crisis 287, 316 (Randall G. Holcombe & Benjamin W. Powell eds., 2009).

[FN5]. See Les Christie, Las Vegas Tops Foreclosure List, CNNMoney.com, Feb. 5, 2008,http://money.cnn.com/2008/02/05/real_estate/zip_code_ foreclosures/index.htm ("In 2004 alone, the median, single-family home price in the city grew by [47%], and that was followed by another [14%] rise the next year. By 2006, the median home cost $317,400, nearly [50%] higher than the national average."); see also Brian Wargo, Prediction: LV Home-Price Decline Will Hit 52 Percent, In Business Las Vegas, Jan. 30, 2009, at 15, available at http://www.lasvegassun.com/news/2009/jan/30/prediction-las-vegas-home-price-decline-will-hit-5/.

[FN6]. See Las Vegas October 2008 Home Sales Report, DQNews.com, Nov. 29, 2008, http://www.dqnews.com/Articles/2008/News/Las-Vegas/RRCLNV081129.aspx ("The overall median sale price has fallen on a year-over-year basis for [eighteen] consecutive months and is now [37.2%] below the region's peak $312,000 median in November 2006. October's median was the lowest since it was $192,000 in January 2004. Another gauge analysts watch suggests greater price weakness: The median price paid per square foot for resale detached houses fell to $104 in October--the lowest since May 2003. Last month's figure was down [34.8%] from a year ago and down [45.1%] from the $190 peak reached in June 2006.").

[FN7]. Id. at 259-260 & fig.7.

[FN8]. See Press Release, RealtyTrac, Foreclosure Activity Remains at Record Levels in April (May 13, 2009), http:// www.realtytrac.com/contentmanagement/pressrelease.aspx? channelid=9&accnt=0&itemid=6379.

[FN9]. Simon & Corkery, supra note 2.

[FN10]. BasePoint Analytics LLC, Occupancy Fraud and the Impact to the Mortgage Industry 7 (2008) (on file with author) (reporting that an analysis conducted by the Mortgage Bankers Association in 2007 "indicated that investment properties represented up to [three] times the level of risk of default than owner occupied properties").

[FN11]. Markham Lee, Subprime Mortgages Crossing Income and Credit Strata, Seeking Alpha, Oct. 12, 2007, http://seekingalpha.com/article/49701-subprime-mortgages-crossing-income-and-credit-strata ("The truth is that many affluent buyers used subprime loans to purchase more home then they could afford with a prime loan, make speculative real estate 'investments' and/or to withdraw more equity from their home than they could with a prime [home equity line of credit].").

[FN12]. See Steven Malanga, Foreclosure Myths: Can the Media Handle the Truth?, RealClearMarkets, Oct. 29, 2008, http:// www.realclearmarkets.com/articles/2008/10/foreclosure_myths_can_media_ha.html (explaining that adjustable-rate mortgages tend to draw buyers who expect to sell or refinance before the mortgage rates reset).

[FN13]. Randy Steinberg, Curbing Flipping, Multifamily Trends, Sept.-Oct. 2005, at 20, 23.

[FN14]. Cf. Christopher L. Foote, Kristopher S. Gerardi & Paul Willen, Negative Equity and Foreclosure: Theory and Evidence, 64 J. Urb. Econ. 234, 240-41 (2008) (studying the foreclosure history of 100,000 Massachusetts homeowners with negative equity in the 1990s). The study found that (1) only about 6.4% of these homeowners lost their homes through foreclosure; (2) the borrowers' cash flow situations greatly influenced their risk of default; and (3) the net present value of defaulting on a mortgage can be negative even for a borrower with negative equity. See id. at 240-42.

[FN15]. See Charles A. Capone, Jr., Cong. Budget Office, Research into Mortgage Default and Affordable Housing: A Primer 13 (2002), available at http://www.lisc.org/files/906_file_asset_upload_file755_793.pdf.

[FN16]. See BasePoint Analytics LLC, supra note 10, at 2 ("Because lenders typically charge a higher interest rate for non-owner occupied properties, which historically have higher delinquency rates, the lenders often times will receive insufficient return on their capital, and are over-exposed on risk losses relative to what they would have expected for an owner occupied property.").

[FN17]. Id. at 3.

[FN18]. See Fannie Mae/ Freddie Mac, Form 3005: California Deed of Trust, P 6, http://www.freddiemac.com/uniform/unifsecurity.html (follow "Form 3005: California Deed of Trust" hyperlink).

[FN19]. Id. at P 8 ("Material misrepresentations include, but are not limited to, representations concerning Borrower's occupancy of the Property as Borrower's principal residence.").

[FN20]. See George Lefcoe, Real Estate Transactions, Finance, and Development 171-73 (6th ed. 2009).

[FN21]. See The Prieston Group Finds Occupancy Fraud Dominates Claims, Nat'l Mortgage News, Sept. 19, 2005, at 28 (reporting that over half of the mortgage fraud claims filed with The Prieston Group in the first half of 2005 involved occupancy fraud; The Prieston Group is a firm that provides due diligence services on behalf of lenders and insures them against loss due to fraud); Lew Sichelman, Lenders Looking at 'White Lie' Fraud, Origination News, Jan. 2006, at 6, 6 (reporting that in 75% of the insurance claims involving occupancy fraud, the fraud was committed by borrowers who did not want to pay investor interest rates).

[FN22]. Financial leverage is the "use of debt to increase the expected return on equity." Bloomberg.com, Financial Glossary, http:// www.bloomberg.com/invest/glossary/bfglosf.htm (last visited Oct. 28, 2009).

[FN23]. See Joshua Rosner, Housing in the New Millennium: A Home Without Equity Is Just a Rental with Debt 29 (2001), http://ssrn.com/abstract=1162456 ("The virtuous circle of increasing homeownership through greater leverage has the potential to become a vicious cycle of lower home prices due to an accelerating rate of foreclosures caused by lower savings.").

[FN24]. See, e.g., 18 U.S.C. § 1341 (2006) (mail fraud); 18 U.S.C. § 1343 (2006) (wire fraud); 18 U.S.C. § 2314 (2006) (transfers in interstate or foreign commerce of fraudulently obtained funds or goods); 18 U.S.C. § 1344 (2006) (defrauding federally chartered or federally insured institutions); 18 U.S.C. § 1014 (2006) (making false statements or reports, including overvaluations, to influence federal agencies or federally chartered or federally insured institutions); United States v. Hitchens, 62 F. App'x 417, 418-19 (3d Cir. 2002) (holding that the prosecutor did not need to show that real estate agent personally used the mails or wires to convey fraudulent documents as long as she knew that the mails or wires would be used in the ordinary course of business).

[FN25]. See, e.g., United States v. 874 Gartel Drive, 79 F.3d 918, 923-24 (9th Cir. 1996) (affirming order of forfeiture where the owners falsely reported their income in order to obtain a loan from a federally insured financial institution and the owners knew, or were willfully blind to, the false statements in the loan application); United States v. 403 Skyline Drive, 797 F. Supp. 796, 798 (C.D. Cal. 1992) (granting summary judgment in forfeiture action where owner had misrepresented his employment status on his loan application, even though loan was not in default).

[FN26]. Mortgage Bankers Ass'n, Mortgage Fraud: Strengthening Federal and State Mortgage Fraud Prevention Efforts 17 (2007), http:// www.mortgagebankers.org/files/Conferences/2008/2008Fraud/Fraud08MBAFraudPreventionHandoutNewReg.p.

[FN27]. Investors Sav. & Loan Ass'n v. Ganz, 416 A.2d 918, 921-22 (N.J. Super. Ct. Ch. Div. 1980) ("[The court does] not find that the owner occupancy requirement is unconscionable or inequitable. Given plaintiff's purpose to promote home ownership, its policy of not making loans except for that reason, and the language of [the statute], it cannot be said that its requirement of owner occupancy as a condition for the granting of a mortgage loan is unjust. Defendants were fully aware of this condition when they freely and voluntarily entered into the mortgage transaction. Furthermore, plaintiff's fear that the lack of owner occupancy might jeopardize its security is not unreasonable. Since defendants have defaulted, plaintiff has the right to accelerate the due date of the unpaid balance of the debt and to require payment thereof. Such payment having not been made as demanded, summary judgment of foreclosure is appropriate.").

[FN28]. See Mortgage Bankers Ass'n, Lenders' Cost of Foreclosure 2 (2008), http:// www.mortgagebankers.org/files/Advocacy/2008/LendersCostofForeclosure.pdf ("While losses can vary widely, several independent studies find them to be generally quite significant: over $50,000 per foreclosed home or as much as [30-60%] of the outstanding loan balance.").

[FN29]. RMBS Trends: Tighter U.S. Subprime Mortgage Underwriting Showing up Slowly in Rated Securitizations, Standard & Poor's (May 8, 2007), (on file with author). In fact, the brisk and breezy underwriting practices of 2000-2007 enabled home loans to close in thirty days while current stringent bank underwriting has brought us back the ninety day closings reminiscent of the 1990s and earlier.

[FN30]. Kevin Coop, It's Time to Go Back to the Future, Mortgage Banking, Nov. 1, 2007, at 118. According to the chief executive officer of Interthinx, a company that supplies risk mitigation and regulatory compliance tools to the financial services industry:

A new wave of insidious mortgage fraud awaits us. As lending requirements change, fraudsters change their methods to evade new loan guidelines. With many lenders now requiring a [20%] down payment and W-2s to prove income, Interthinx investigators are seeing an increase in silent-second mortgages and "self-employed" borrowers. [Interthinx is] also seeing an increase in family members and straw buyers "rescuing" borrowers facing foreclosure, builder bail-outs and severe fallout from fraudulent condo conversions.

Id.

[FN31]. BasePoint Analytics LLC, supra note 10, at 7 ("Borrowers experiencing payment shock over 200% are more likely to be purchasing an investment property.").

[FN32]. Id.

[FN33]. Id. at 8.

[FN34]. Id.

[FN35]. See Mortgage Asset Research Inst., Eighth Periodic Mortgage Fraud Case Report to Mortgage Bankers Association 11 (2006), available at http:// www.marisolutions.com/resources-news/reports.asp (follow "Eighth Case Report to MBA (April 2006)" hyperlink) (identifying "the ever-present drive to speed up the mortgage approval process" and "escalating home prices in many markets" as "[t]wo exacerbating factors [that] have combined over the past few years to pressure the industry into non-traditional practices that will contribute to future fraud reports").

[FN36]. Simon & Corkery, supra note 2.

[FN37]. Richard A. Posner, A Failure of Capitalism: The Crisis of '08 and the Descent into Depression 90-91 (2009).

[FN38]. See Sichelman, supra note 21.

[FN39]. See id.

[FN40]. See id.

[FN41]. See Downs, supra note 1, at 22 & exh.1-14 ("Although many homebuilders tried to avoid selling to such speculators, the shares of home and condominium sales to speculators reached amazing levels in a few hot markets.").

[FN42]. See James Jacobson, The Fight Against Speculation, AllBusiness.com, Dec. 21, 2008, http://www.allbusiness.com/economy-economic-indicators/economic-indicators-new/11728820-1.html (explaining that developers used no-sales clauses to prevent sales competition from speculators within their own development).

[FN43]. Id. (explaining that a developer's selling price during the first phase of a development is usually 15-20% less than the selling price during the last few phases, which allows speculators to buy during the first phase of a development and then resell the property for less than the developer's selling price during the last phase).

[FN44]. Steven Malanga, Predatory Lending, or Mortgage Fraud?, RealClearMarkets, Apr. 9, 2008, http://www.realclearmarkets.com/articles/2008/04/predatory_lending_or_mortgage.html.

[FN45]. See Downs, supra note 1, at 21 ("Accelerating increases in home prices and commercial property prices in most parts of the nation from 2002 to 2005 stimulated further expansion of homebuilding, home purchases by former renters, home purchases by speculators interested only in flipping the units they bought, and greater investing in commercial real properties by institutional and other investors around the world.").

[FN46]. See Douglas J. Short, Comment, Use Versus Abuse: A Comprehensive Analysis of Nonbinding Reservation Agreements and Real Estate Developers' Ability to Freely Rescind, 30 Campbell L. Rev. 201, 203-07 (2007).

[FN47]. Terry Pristin, Miami's Monument to Excess: Condo Colossus Becomes Symbol of a Building Boom Gone Bust, N.Y. Times, Mar. 11, 2009, at B7.

[FN48]. Id.

[FN49]. Id. Spec buyers are suing Florida condo developers for deposit refunds, claiming that the developers knew, or could easily have learned, that these buyers wouldn't qualify for financing and encouraged them to buy anyway, promising they could "flip" their units profitably. The plaintiff's lawyer, Robert H. Cooper, explains: "They were, across the board, signing contracts with purchasers they knew did not have the ability to consummate the transaction." Patrick Danner, Condo-buyer Lawsuits Mount, Miami Herald, Nov. 3, 2007, at 1C.

[FN50]. Pristin, supra note 47. See also Fannie Mae, Announcement 08-34: Process Eligibility Review Service and Changes to Condominium and Cooperative Project Policies (Dec. 16, 2008), https://www.efanniemae.com/sf/guides/ssg/annltrs/pdf/2008/0834.pdf.

[FN51]. David F. Seiders, The Seiders' Report, National Outlook, July 2005, at 11 (on file with author).

[FN52]. Id.

[FN53]. Because developers seldom impose owner occupancy requirements in new housing tracts or condos, local governments require developers of affordable housing to impose such restrictions. In this way they hope to benefit future buyers of limited means, and prevent the first generation of buyers from pocketing the subsidy by selling their units to the highest bidders. See, e.g., Alfaro v. Community Housing Imp. System & Planning Ass'n, Inc., 171 Cal. App. 4th 1356, 89 Cal. Rptr. 3d 659 (Cal. App. 6th Dist. 2009), as modified on denial of reh'g, 2009 Cal. App. LEXIS 377 (Cal. App. 6th Dist. Mar. 18, 2009) and review denied, 2009 Cal. LEXIS 4875 (Cal. May 13, 2009).

[FN54]. See William H. Pivar & Robert J. Bruss, California Real Estate Law 225-27 (3d ed. Update 1997) ("The recording statutes provide that, after being acknowledged, any instrument or judgment affecting title to, possession of or rights in real property may be recorded.... Recording a document gives the whole world constructive notice of the fact recorded.").

[FN55]. Cf. Terri Cullen, Lenders Should Pay for Title Insurance, Wall St. J. Online, Feb. 11, 2005, http://www.realestatejournal.com/buysell/taxesandinsurance/20050211-cullen.html (explaining that lenders require home buyers to purchase title insurance before closing).

[FN56]. See Kenneth M. Morgan & Tracy A. Siebold, Discouragement of Affordable Housing Development and Financing, 195 N.J.L.J. 856, 857 (2009) (describing the necessity for title companies of discovering affordable housing restrictions in title searches and requiring documentation from borrowers to ensure that the borrower complies with the restrictions). Title insurers will want to assure compliance with recorded deed restrictions because the insured lender or buyer would take title subject to those restrictions and would seek indemnity from the title insurer. See id.

[FN57]. See Joe Adams, Condo Act Requires Insurance, FORT MYERS NEWS-PRESS, May 25, 2006, at G1, available at http://www.becker-poliakoff.com/pubs/articles/adams/adams_2006_05_25.pdf ("Section 718.110(13) of the Florida Condominium Act was amended effective October 1, 2004 to provide that any amendment restricting unit owners' rights relating to the rental of units applies only to unit owners who consent to the amendment, and unit owners who purchased their units after the effective date of that amendment.").

[FN58]. Cf. Mullin v. Silvercreek Condo., Owner's Ass'n, Inc., 195 S.W.3d 484, 488 (Mo. Ct. App. 2006) (interpreting restrictions in the Declaration of Condominium, which provided that "[n]othing in this [section] is intended to restrict the right of any condominium unit owner to rent or lease his ... condominium unit from time to time").

[FN59]. See, e.g., Villas West II Homeowners Ass'n v. McGlothin, 885 N.E.2d 1274, 1277-1280 (Ind. 2008) (involving homeowners' association's enforcement of a no-lease covenant in the deed of a home purchased in a planned unit development).

[FN60]. See, e.g., Kroop v. Caravelle Condo., Inc., 323 So. 2d 307, 309 (Fla. Dist. Ct. App. 1975) (affirming lower court's determination that an amendment to the Declaration of Condominium prohibiting leasing of any unit more than once during the period of ownership was reasonable and could be applied to an owner who purchased the unit before the amendment was adopted, because the owner had purchased the unit subject to all terms of the Declaration, including the term that the Declaration could be amended in the future).

[FN61]. 61 Am. Jur. 2d Perpetuities and Restraints on Alienation § 90 (2008).

[FN62]. Merrill I. Schnebly, Restraints upon the Alienation of Legal Interests: I, 44 Yale L. J. 961, 963-64 (1935).

[FN63]. Id. at 963.

[FN64]. See id.

[FN65]. Id. at 963.

[FN66]. 61 Am. Jur. 2d, supra note 61, at § 90 (promissory restraints). See Dieckmeyer v. Redevelopment Agency of Huntington Beach, 24 Cal. Rptr. 3d 895, 897 (Cal. Ct. App. 2005) (holding that the equity share of the condominium, which was part of an affordable housing program, was not due upon the purchaser's prepayment of the loan since the covenants, conditions, and restrictions recorded on the deed had not been violated).

[FN67]. William B. Stoebuck & Dale A. Whitman, The Law of Property 30 (3d ed. 2000) ("Provisions purporting, without any limitation as to duration or scope, to prohibit the transfer of a present fee simple absolution--so-called 'disabling restraints'--or to defeat or terminate what would otherwise be a present fee simple absolute upon transfer--so-called 'forfeiture restraints'-- are universally held void in the United States.").

[FN68]. See, e.g., William B. Stoebuck & John W. Weaver, Restraints on Alienation, in 17 Wash. Prac., Real Estate 2d § 1.26 (2009); Richard Seigler, Cooperatives and Condominiums, N.Y.L.J., Nov. 11, 2007, at 1, 3, available at http://www.stroock.com/SiteFiles/Pub243.pdf ("Generally, New York courts will uphold restrictions on the alienation of property if such restrictions are deemed reasonable. The reasonable test consists of three main factors: price, duration, and purpose." (citing Metro. Transp. Auth. v. Brunken Realty Corp., 492 N.E.2d 379, 385 (N.Y. 1986)).

[FN69]. See, e.g., Bankers Trust Co. of Cal. v. Bregant, 661 N.W.2d 498, 502-03 (Wis. Ct. App. 2003).

[FN70]. See Kelley v. Broadmoor Coop. Apartments, 676 A.2d 453, 458-461 (D.C. 1996) (upholding a condo association's levy of a surcharge on the monthly association dues of any owner renting her unit, up to a maximum of 25%, where there was no evidence that the surcharge was unreasonable, subjective, or discriminatory).

[FN71]. See, e.g., Laguna Royale Owners Ass'n v. Darger, 174 Cal. Rptr. 136, 144-45 (Cal. Ct. App. 1981) (setting forth the criteria for testing the reasonableness of restrictions). In Laguna Royale, the court held:

The criteria for testing the reasonableness of [a restriction on the right of alienation set] by an owners' association are (1) whether the reason for [the restriction] is rationally related to the protection, preservation or proper operation of the property and the purposes of the Association as set forth in its governing instruments and (2) whether the power was exercised in a fair and nondiscriminatory manner. Another consideration might be the nature and severity of the consequences of application of the restriction (e.g., transfer declared void, estate forfeited, action for damages).

Id. (citations omitted).

[FN72]. See Jordan I. Shifrin, No-Leasing Restrictions on Condominium Owners: The Legal Landscape, 94 Ill. B.J. 80, 80-81 (2006) (reporting that condominium associations are adopting provisions eliminating rentals; legal challenges to these restrictions are seldomly successful); William B. Stoebuck & John W. Weaver, Occupancy Controls, in 18 Wash. Prac., Real Estate 2d § 12.9 (2009) (reporting on precedents which suggest that "no [forfeiture] restraint should be imposed upon the owners of Washington condominium units"); see also Flagler Fed. Sav. & Loan Ass'n v. Crestview Towers Condo. Ass'n, 595 So. 2d 198, 200 (Fla. Dist. Ct. App. 1992).

In Flagler Federal Savings & Loan, the original recorded Declaration of Condominium prohibited owners from leasing their units without approval of the owners' association, but the no-leasing restriction did not apply to institutional mortgagees who acquired title to the units. The plaintiff became a mortgagee of two units while the original Declaration was in effect. In 1984, the owners' association amended the Declaration to prohibit leasing entirely. A few years later, the plaintiff acquired title to one of the units through foreclosure and the other unit by quitclaim deed in lieu of foreclosure. When the plaintiff attempted to lease the units, the owners' association objected, prompting the plaintiff to file a declaratory judgment action. The court held that the plaintiff was bound by the no-leasing rule included in the amended Declaration, just like non-institutional mortgagee owners who acquired title prior to the amendment.

[FN73]. See Bregant, 661 N.W.2d at 502-03 (denying the right of the homeowners' association to enjoin a mortgage foreclosure sale to a buyer with no intention of occupying the unit purchased, because it would unduly impair the marketability of the condominium).

[FN74]. See, e.g., Alby v. Banc One Financial, 128 P.3d 81, 84 (Wash. 2006) (upholding a restraint on alienation where it was reasonable and justified by the legitimate interests of the parties).

In Alby, an aunt and uncle deeded a family farm that was worth $100,000 to their niece and her husband for $15,000. They conveyed a fee simple determinable, reserving a right of reverter if the grantees sold to a non-family member or mortgaged the property while the aunt and uncle were still alive. Five years later, the grantees mortgaged the property for over $100,000 and soon defaulted. The lender foreclosed. The aunt brought suit to quiet title in herself--the uncle having passed away--and prevailed. The foreclosing lender was left with only a personal cause of action against the niece and her husband for repayment of the debt.

[FN75]. See Oceanside v. McKenna, 264 Cal. Rptr. 275, 279 (Cal. Ct. App. 1989) (upholding restrictions requiring owner occupancy and precluding owners from renting their units in a subsidized housing project where the restrictions were "clearly and directly ... related to the stated purposes of maintaining a stabilized community of low and moderate income residents and discouraging speculation by real estate investors"); see also Laura M. Padilla, Reflections on Inclusionary Housing and a Renewed Look at Its Vitality, 23 Hofstra L. Rev. 539, 621 (1995) (arguing that a court would likely uphold resale restrictions on a proposed mixed-income housing program).

[FN76]. See Jacobson, supra note 42 ("The addition of the 'first right of refusal' to new home sale contracts essentially allowed for a purchaser to re-sell their home by first offering it back to the developer ....").

[FN77]. Cf. id. (finding that the right of first refusal allowed the purchaser to sell the home back to the developer, "in most cases, at the price that was originally paid for by the purchaser").

[FN78]. See Guido Calabresi & A. Douglas Melamed, Property Rules, Liability Rules, and Inalienability: One View of the Cathedral, 85 Harv. L. Rev. 1089, 1092 (1972).

[FN79]. See id.

[FN80]. See id.

[FN81]. See id.

[FN82]. See id.

[FN83]. Fennell, supra note 53, at 1404-05.

[FN84]. Id. at 1406.

[FN85]. Id. at 1408.

[FN86]. Id. at 1442.

[FN87]. 63C Am. Jur. 2d, supra note 61, at § 34 ("Even though [an innocent purchaser of stolen goods] may be treated as having title and the right to possession as against everyone but the rightful owner, a sale by the thief or by any person claiming under the thief does not vest any title in the purchaser as against the owner, although the sale was made in the ordinary course of trade and the purchaser acted in good faith.... The owner may, through an appropriate action or proceeding, recover the stolen goods, or their value, either from the thief ... or from any other person who has not acquired such title and into whose possession they have come, whether innocently or otherwise.") (citations omitted).

[FN88]. Steven D. Andrews, Does the Endangered Species Act Contain an Innocent Owner Defense to Civil Forfeiture?, 1997 U. Chi. Legal F. 375 (evaluating the success of innocent owner defenses under the Lacey Act and the Endangered Species Act).

[FN89]. See Gerald J. Robinson, Federal Income Taxation of Real Estate 1-1 to 1-2 (6th ed. 2007) (summarizing the tax benefits of homeownership).

Part of our heritage is rooted in Coke's declaration, "A man's home is his castle." Pride of home ownership runs deep in the American character. Indeed, from colonial times to the present, virtue has somehow been associated with property ownership. The tax favoritism that Congress has bestowed upon homeowners is a reflection of these attitudes and of the immense political power of homeowners.

Homeowners are accorded numerous tax privileges not allowed to the landless tenant. For example, the homeowner is permitted to deduct direct payments of real estate taxes [26 U.S.C. § 503 (2006)] and mortgage interest [26 U.S.C. § 163(h) (2006)]. Yet residential rent is a wholly nondeductible "personal" expense, even though part of it is indirectly attributable to the landlord's taxes and mortgage interest. Similarly, the virtue of home ownership is rewarded when the owner sells a home at a gain. Tax on the gain may be escaped entirely if it does not exceed $250,000 or $500,000 for married taxpayers filing a joint return [26 U.S.C. § 121 (2006)]. No other personal asset is so favored. Indeed, the favoritism is so marked that it was in substantial measure responsible for sparking a nationwide movement to cooperative and condominium apartment ownership, which enjoy similar tax blessings.

Id.

[FN90]. 26 U.S.C. § 121(a) (2006) (excluding the "gain from the sale or exchange of property if, during the [five] year period ending on the date of the sale or exchange, such property has been owned and used by the taxpayer as the taxpayer's principal residence for periods aggregating [two] years or more" from gross income).

[FN91]. Ngai Pindell, Fear and Loathing: Combating Speculation in Local Communities, 39 U. Mich. J.L. Reform 543 (2006).

[FN92]. Downs, supra note 1, at 69. See also id. at 22 exh.1-14, 68-69 & exh.3-4 to 3-5 (comparing rate of foreclosure by city, state, and county within California, respectively).

[FN93]. Pindell, supra note 91, at 546.

[FN94]. Id. at 547.

[FN95]. Id. at 595.

[FN96]. Id. at 547.

[FN97]. See Story Bed & Breakfast, LLP v. Brown County Area Plan Comm'n, 789 N.E.2d 13, 21 (Ind. Ct. App. 2003) (holding that "a covenant, standing alone without having been recorded, may not be asserted against a subsequent [bona fide purchaser] who is without knowledge of the covenant's existence").

[FN98]. Pindell, supra note 91, at 588.

[FN99]. Id. at 588-89.

[FN100]. Id. at 589.

[FN101]. See e.g., Tex. Loc. Gov't Code Ann. § 212.153 (2009) (allowing municipalities to sue to enjoin or abate violations of restrictions affecting subdivisions within the municipality); 15 Houston Code §§ 10-551 to 10-555 (2009), available at http://www.municode.com/resources/gateway.asp? pid=10123&sid=43 (expand "Chapter 10" list; then expand "Article XV Deed Restriction Compliance" list) (authorizing city attorney to bring a suit for injunction in order to enforce restrictions that affect subdivisions within Houston).

[FN102]. William Fulton, Guide to California Planning 139-40 (2d ed. 1999). ("Even when code violations are caught and cited, local governments have difficulty motivating property owners to comply with the law. The property owners may pay a fine and promise to clean up their act, but in all likelihood they won't change the way they do business--for two reasons. One is that code enforcement officers are usually overworked, and property owners know it will take a long time before the officers get around to doing follow-up. The second reason is that the threat of further punishment usually doesn't exist.").

[FN103]. Posner, supra note 37, at 89.

[FN104]. Id. at 199-201.

[FN105]. Jacobson, supra note 42.

[FN106]. See David Streitfeld, Amid Rubble of Housing Bust, One City Begins a New Frenzy, N.Y. Times, May 24, 2009, at A1.

[FN107]. See id.

[FN108]. Fannie Mae, Announcement 09-02: Updates to Multiple Mortgages to the Same Borrower Policy, Reserve Requirements, and Form 3170 (Feb. 6, 2009), https://www.efanniemae.com/sf/guides/ssg/annltrs/pdf/2009/0902.pdf.

[FN109]. Streitfeld, supra note 106 (noting that the previous property owners remained as rent-paying tenants for about a quarter of the houses that Brewer Caldwell, a property management firm in Phoenix, purchased for its clients in 2009).

[FN110]. William C. Wheaton & Gleb Nechayev, What Will It Take To Restore the Housing Market? 22 (Mass. Inst. Tech. Dep't of Econ., Working Paper No. 09-06, 2009), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1356243.

[FN111]. Jacobson, supra note 42.

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