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MEMORANDUM

TO: CLIENTS AND FRIENDS OF THE FIRM

FROM: Al Alsup

DATE: September 30, 2002

SUBJECT: Culpepper III Overruled: HUD's Statement of Policy 2001–1 Shown Deference and Applied Retroactively by 11th Circuit to Validate HUD's Interpretation Regarding the Legality of Yield-Spread Premiums

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INTRODUCTION

The same three-judge panel for the federal 11th Circuit Court of Appeals that last year upheld class certification in the landmark *yield-spread premium* case *Culpepper v. Irwin Mortgage Corporation*, 253 F.3d 1324 (11th Cir. 2001), commonly known as Culpepper III, has now overruled Culpepper III based on subsequent rulemaking by the Department of Housing and Urban Development (HUD) that refuted the Court's findings.

The new ruling in *Heimmermann v. First Union Mortgage Corporation* [2002 WL 31067330 (11th Ala.))] handed down on September 18, 2002 concluded that HUD's Statement of Policy 2001–1 published a few months after the Culpepper III decision must be shown deference by the Court and may be applied retroactively to effectively overrule the holdings in Culpepper III. The Court in Culpepper III had concluded that class certification was appropriate where plaintiffs could prevail in the suit without the necessity of producing loan-by-loan evidence of services performed for each loan in the class solely by proving that amounts paid to mortgage brokers by the mortgage lender under standardized terms and conditions based on an interest rate quote sheet were compensation for referring loans rather than *bona fide* fees for services. Statement of Policy 2001–1 refuted the holdings of the Court in Culpepper III and reiterated HUD's long-standing interpretation that yield-spread premiums are permissible under the federal Real Estate Settlement Procedures Act (RESPA) if paid as reasonable compensation for services actually performed.

This memorandum briefly outlines the holdings of the 11th Circuit in *Heimmermann* and comments on the significance of HUD's Statement of Policy 2001-1 as applied by the court in *Heimmermann* to overrule Culpepper III and finally resolve the issue of the legality of the common practice of home mortgage lender's compensating their brokers through payments of so-called yield-spread premiums. These back-end fees, also referred to sometimes as "yield differentials" or "servicing release premiums," are typically paid by wholesale lenders outside of closing and are derived from a premium, or “above par,” interest rate charged the borrower. Mortgage lenders currently are defending more than 100 class-action lawsuits across the country claiming that such payments are unlawful kick-backs or referral fees prohibited by Section 8 of RESPA.

BACKGROUND: HUD’S STATEMENT OF POLICY 2001 – 1 REFUTING THE CULPEPPER III DECISION

Culpepper III was viewed by the mortgage lending industry as an alarming setback in its defense of the common industry practice of paying yield-spread premium compensation to mortgage brokers because HUD’s earlier Statement of Policy 1999-1 (64 F.R. 10079) interpreting Section 8 of RESPA was thought to have favorably resolved the issue of the legality of yield-spread premiums. Under a two-part test espoused by HUD in its Statement of Policy 1999-1 (the “HUD Two-Part Test”) to determine the legality of any yield-spread premium paid a mortgage broker, it first must be determined whether services were actually performed or goods or facilities actually furnished in exchange for the yield-spread compensation paid and, if so, next determined whether the amount of the compensation paid is reasonably related to the value of the services performed or goods or facilities furnished. But in applying that legal standard, the Culpepper III court found the policy statement ambiguous as to a threshold question for granting or denying class certification, which is whether it is necessary to produce loan-by-loan evidence at the trial to prove liability.

When a complaint is certified as a class action under federal procedural rules, the plaintiffs are permitted to represent a whole class of persons similarly situated, which in Culpepper III included all persons who during a four-year period preceding certification obtained an FHA mortgage loan from Irwin Mortgage in which the mortgage broker was paid both a 1% loan origination fee and a yield spread premium. Class certification is significant because it provides these numerous borrowers the means for prosecuting virtually identical complaints that otherwise would not be economically feasible if brought individually.

One of the factors that the Culpepper III court had to consider in upholding class certification was whether there are questions of law or fact common to all class members or, instead, if evidence specific to each plaintiff’s loan transaction would predominate at trial, making class treatment improper. A *common* question for this purpose is one that, when answered as to one class member, will affect all or a significant number of the other putative class members. Class certification must be denied if the trial court would be burdened with examining the particular facts of each loan transaction to determine the extent of services performed and the reasonableness of compensation paid. The appellate court concluded that this so-called *commonality* factor was satisfied in Culpepper III because under the Culpeppers’ core theory of liability it would be unnecessary to make a loan-by-loan factual determination of the nature or extent of services performed by the mortgage brokers if they could show that the yield-spread premiums under the facts were referral fees and not paid as part of the “services-for-money exchange” required by the first part of the HUD Two-Part Test. The court agreed with the Culpeppers’ interpretation that the first part of the HUD Two-Part Test for legality of yield-spread premiums under RESPA, Section 8, requires a determination not only that the mortgage brokers performed some services, but also that the yield-spread premiums were compensation for those services — rather than for the referral of the loans. If the Culpeppers could prove that the yield-spread premiums were paid as referral fees, liability under RESPA, Section 8, would be established and it would be unnecessary to reach the second part of the HUD Two-Part Test requiring loan-by-loan evidence to determine if the mortgage brokers’ total compensation were reasonable in each instance.

The appellate court observed in that regard that the record of the proceedings of the district court failed to establish that the yield-spread premiums paid by Irwin Mortgage in these many loans were payments to mortgage brokers for services actually performed, rather than unlawful referral fees. The formula for determining the amounts of the yield-spread premiums in question did not take into account the amount or quality of work the mortgage brokers actually performed in originating the loans or how much the borrowers may have additionally paid in fees for the mortgage brokers' services. Furthermore, nothing in the mortgage brokers' written agreements with Irwin Mortgage indicated that the amount paid to the mortgage brokers was in any way dependent on the services performed or that Irwin Mortgage ever inquired into how much work the brokers actually performed in connection with any loan. Rather, the evidence tended to show that Irwin Mortgage paid yield-spread premiums according to standardized terms common to all the loans based solely on the calculated spread between the contract interest rate and the quoted par rate on a published rate sheet, without regard to services performed. Class certification was appropriate under these circumstances, the court concluded, because the Culpeppers could prevail in the suit without presenting loan-by-loan evidence of services performed by the mortgage brokers solely by proving that amounts paid to mortgage brokers by Irwin Mortgage under standardized terms and conditions based on a rate sheet were compensation for referring loans rather than bona fide fees for services.

HUD subsequently issued its Statement of Policy 2001-1 on October 18, 2001 in refutation of Culpepper III for the stated purposes of (i) eliminating any ambiguity found by the Culpepper III court in applying the HUD Two-Part Test for determining the legality under RESPA, Section 8, of back-funded lender payments to mortgage brokers characterized as yield-spread premiums and (ii) reiterating its long-standing interpretation of RESPA, Section 8(b)'s prohibitions. Statement of Policy 2001-1 reaffirms HUD's position that yield-spread premiums are not *per se* legal or illegal and clarifies the HUD Two-Part Test for determining legality of such payments under RESPA, Section 8, originally espoused in its Statement of Policy 1999-1.

In determining whether such a payment by a lender to a mortgage broker is permissible under RESPA, Section 8, HUD reaffirmed in its Statement of Policy 2001-1 that the HUD Two-Part Test must be applied, under which:

> Part One – Determine whether services were actually performed or goods or facilities were actually furnished in exchange for the compensation paid; and, if so
>
> Part Two – Determine whether the amount of the compensation is reasonably related to the value of services actually performed or the goods or facilities actually furnished.

But HUD in its Statement of Policy 2001-1 refuted the court's interpretation and application of the HUD Two-Part Test in Culpepper III in several important respects, stating that:

- The test is a two-part test, and if compensable services are performed, *both parts of the test must be applied* before a determination can be made regarding the legality under RESPA of a lender's payment to a mortgage broker;
- In order to discern whether a yield-spread premium was paid in any case for goods, facilities, or services under the first part of the test, *it is necessary to examine each transaction individually* (including examining all goods and facilities provided or services performed by the broker in the transaction, whether paid for by the borrower, the lender, or both); and
- A yield-spread premium cannot be presumed to be a referral fee under the test solely because it is based upon a rate sheet or because the lender does not have specific knowledge of what services the broker has performed. HUD observed that a yield-spread premium by definition is derived from the interest rate of the loan, and the rate sheet is merely a mechanism for displaying the interest rate and yield-spread premium. The legality of a yield-spread premium cannot be determined by reference to a rate sheet, therefore, but only by a determination whether the yield-spread premium is a reasonable payment for goods, facilities or services under the HUD Two-

Part Test. Moreover, HUD believes that it would be a rare occurrence under common industry practices in which loan files are reviewed for compliance with underwriting standards that any lender would not know whether a mortgage broker had performed the necessary services to meet its standards.

THE HEIMMERMANN DECISION OVERRULING CULPEPPER III

Heimmermann was one of several cases before the 11th Circuit Court of Appeals challenging the legality of the payment of yield-spread premiums under Section 8 of RESPA and was argued the same day as Culpepper III. Class certification had been granted by the trial court and the 11th Circuit reviewed the case on appeal by First Union Mortgage Corporation for abuse of discretion by the trial court in certifying the case for class action. For a district court to apply the wrong legal standard is an abuse of discretion.

In deciding *Heimmermann*, the appeals court first had to determine several threshold issues regarding the applicability of HUD Statement of Policy 2001–1 as the appropriate legal standard:

- *Whether the 2001 Rule May be Applied Retroactively.* Statement of Policy 2001–1 was published after the loan transactions that gave rise to the Culpepper III and *Heimmermann* litigation and after the district court's ruling in each case on the issue of class certification. However, the appeals court found that both Statement of Policy 2001 – 1 and Statement of Policy 1999 – 1, which it sought to clarify, are both clarifications of existing law and not new rules or regulations. The court turned to cases holding that an administrative rule clarifying an unsettled or confusing area of the law does not change the law, but instead restates what the agency regards is, and always has been, the law. In that sense, relying on such an administrative rule is no more applying it retroactively than when a court construes the meaning of a statute and applies it to a case at hand. In determining that Statement of Policy 2001–1 is merely a clarification of existing law, the court relied heavily on HUD's own assertion in the rule itself that it was merely clarifying the 1999 statement of policy, which the court acknowledged it had found to be "ambiguous" and subject to different interpretations. While not dispositive of the issue, an agency's determination that a new ruling is a clarification of existing law, rather than an entirely new rule, is given deference "unless the prior interpretation … is "patently inconsistent with the later one."
- *Whether Judicial Deference Must be Given the 2001 Rule*. Appellate courts typically defer to federal agency's interpretations of statutes when the agency has been delegated interpretive authority by Congress unless the agency's interpretation is found by the reviewing court to be . . . "at odds with the plain meaning of the statute." This principle of deference is established by a 1984 decision of the United States Supreme Court styled *Chevron, U.S.A., Inc. v. Natural Resources Defense Council, Inc*., and is generally referred to as "Chevron deference." Not all agency pronouncements are due Chevron deference, however. Customs Service ruling letters, Department of Labor letters, informal letters from HUD's general counsel to Congress, and agencies' pleadings in law suits are examples given by the court of the kinds of agency pronouncements that are not entitled to Chevron deference.

  The appeals court in *Heimmermann* observed that although RESPA, Section 8, broadly prohibits unlawful kick-backs and referral fees, it does not specifically address how to determine whether a yield-spread premium or similar compensation is a lawful fee. The court therefore found that HUD's 1999 and 2001 rules did not conflict with the plain meaning of RESPA, but instead were promulgated to interpret its meaning. The court noted in that regard that it did not purport to rely upon a "plain meaning" reading of RESPA, Section 8, when deciding Culpepper III, but instead relied on both an interpretation of RESPA's language and HUD's earlier Statement of Policy 1999–1, which it had found to be ambiguous. Furthermore, the court noted that it is immaterial that the agency's interpretation is not the only permissible interpretation that could be adopted or that the court may not have reached the same decision in a judicial proceeding. Such considerations, the court said, "do not require – or even allow – the court to reject HUD's interpretation" in its Statement of Policy 2001–1. Considering that interpretive authority was expressly delegated by Congress to HUD in RESPA and HUD's 2001 interpretive rule was promulgated pursuant to that delegated authority, the court concluded that HUD's Statement of Policy 2001–1 carries the full force of law and must be given Chevron deference.

- *Whether an Agency's Statutory Interpretation can Overrule a Court's Prior Decision.* When entitled to Chevron deference, appellate courts also must defer to an agency's statutory interpretation that is at odds with circuit precedent, so long as the agency's interpretation is based on a permissible construction of the statute. Citing authority from a 1990 United States Supreme Court decision, the court observed that, once determining a statute's meaning as it had in Culpepper III, a court must adhere to that determination under the doctrine of *stare decisis* binding a court to legal precedents, but must judge an agency's later interpretation of the statute against that prior judicial determination. If the agency's interpretation is a permissible construction of the statute and is entitled to Chevron deference, it may overrule a prior judicial determination. Accordingly, the court concluded that HUD Statement of Policy 2001–1 can, in effect, overrule the 11th Circuit's holding in Culpepper III.

Having resolved these threshold issues in favor of applying HUD's 2001 rule as the appropriate legal standard, the 11th Circuit concluded that the 2001 rule compels a different result than its decision in Culpepper III. The court points out that HUD's 2001 rule explicitly rejects the foundation upon which that decision and *Heimmermann* were based. Specifically, the 2001 rule rejected the determinations that a yield-spread premium can be presumed to be a referral fee based solely upon the fact that its amount is based upon a rate sheet or that the lender paying the yield-spread premium does not have specific knowledge of what services the mortgage broker performed. Moreover, the 2001 rule rejected the court's determination in Culpepper III that it is unnecessary to examine the second part of the HUD Two-Part Test if the lender and mortgage broker are unable to tie the yield-spread premium payment to specific services performed. Contrary to the conclusion in Culpepper III the court observed, the 2001 rule provides that if the first part of the test is satisfied, the court *must* proceed to the second part of the test to determine whether the total compensation paid to the mortgage broker is reasonably related to the value of the goods or services actually provided — which in turn would require that each loan transaction be examined individually for that purpose.

The 11th Circuit accordingly concluded that the district court in *Heimmermann* erred in granting class certification based on its determinations that common questions of fact would predominate because plaintiffs could prevail merely by showing that for each class member's loan the amount of the yield-spread premium was based solely upon the amount by which the loan rate exceeded the quoted par rate of interest and that the amount was not tied to additional specific services performed by the mortgage broker receiving the payment. HUD Statement of Policy 2001–1 makes it clear that these facts alone are not sufficient to establish a violation of Section 8 of RESPA, but instead that it would be necessary to determine whether compensable services had been performed by the mortgage broker and, if so, whether the total amount of broker compensation was reasonable in light of the circumstances of each loan. Because it applied the wrong legal standard in *Heimmermann,* therefore, the 11th Circuit found that the district court abused its discretion in granting class certification and that class certification must be vacated and the case remanded to the district court for further proceedings.

Conclusion: Legality of YSPs Settled for Now — But Not for Long

The 11th Circuit's declaration in *Heimmermann* that HUD Statement of Policy 2001–1 has the force of law and is the appropriate legal standard to apply in cases challenging the legality of yield-spread premiums under Section 8 of RESPA should effectively settle the issue of legality for now. Because the case brings the 11th Circuit in line with other circuit courts' holdings that have given judicial deference to HUD Statement of Policy 2001–1, furthermore, review on certiorari to the United States Supreme Court is now thought by legal observers to be highly unlikely. Mortgage lenders should now be taking stock of their policies and procedures to be assured that they are operating within the protections that this official interpretive rule provides them against the risks of regulatory enforcement actions or civil liability based on complaints that the payment of yield-spread premiums violates Section 8 of RESPA.

If HUD has its way, however, the victory for the mortgage banking industry will be short lived. HUD in bold new rulemaking has now proposed to fundamentally change the way that fees to mortgage brokers and other settlement service providers are paid and disclosed under RESPA and, in the process, eliminate the practice of compensating mortgage brokers through the payment of yield-spread premiums. HUD's proposal is set forth in its controversial new Proposed Rule published July 29, 2002 in the Federal Register (67 F.R. 49133), which is open to public comment until October 28, 2002.

HUD's Proposed Rule would require home loan originators, including both mortgage lenders and mortgage brokers, to provide early written disclosures of settlement costs and other loan-related information to loan applicants that both (i) accurately disclose their own maximum origination fees and charges and, within tolerances, the maximum closing costs of other settlement service providers and (ii) effectively guarantee those costs for a period of at least 30 days while the applicants are allowed to shop for better loan terms among the loan originators' competitors. By also redefining what constitutes an "application," HUD would require loan originators in some cases to deliver the new disclosures and cost guarantees even before a written loan application is prepared or received by the loan originator.

Under what HUD characterizes as a "dual approach" to RESPA compliance, loan originators could choose between providing these written disclosures in the form of a significantly revamped Good Faith Estimate (GFE) or as part of a Guaranteed Mortgage Package Agreement (GMPA). GFEs would not be required of those loan originators who offer borrowers GMPAs that guarantee a stipulated interest rate and a lump-sum price covering all required closing costs for a period of at least 30 days and that, if accepted by the borrower within that period, become binding agreements. Loan originators and other settlement service providers participating in any GMPA that satisfies HUD's requirements would be given "safe harbor" protections that exempt or confer immunity on those parties from violations of RESPA, Section 8.

Under either of these approaches, mortgage lenders would no longer be permitted to compensate mortgage brokers for their services through the payment outside of closing of so-called "yield-spread premiums" derived from premium interest rates charged the borrower. Mortgage brokers instead would be required to disclose, guarantee, and directly charge their total compensation to the borrower for any loan transaction, and any amounts routinely paid by the lender to the mortgage broker as a yield-spread premium under current practices would be credited to the borrower on the HUD-1 settlement statement at closing to offset, in whole or in part, the mortgage broker's direct charges to the borrower. Mortgage brokers could neither increase their compensation without the borrower's knowledge by packing the yield-spread premium or by splitting or retaining any portion of discount points charged the borrower by the mortgage lender. Although the economic effect should be equivalent to a lender's direct payment of a yield-spread premium to the mortgage broker in like amount, the Proposed Rule would make the amount of the mortgage broker's total compensation apparent to the borrower from the outset and eliminate any incentive for the mortgage broker to quote or arrange an excessive interest rate — because any interest rate spread producing lender credits greater than needed to cover payment of the mortgage broker's guaranteed maximum compensation would benefit the borrower solely.

While HUD believes its proposed changes in disclosure requirements would resolve virtually all disputes challenging the legality under RESPA, Section 8, of lender-paid yield-spread premiums to mortgage brokers in table-funded and intermediary transactions, the pronouncements by the 11th Circuit in *Heimmermann* seem to have already lifted that veil of legal uncertainty. Moreover, most legal observers believe that HUD by effectively imposing price guarantees under its Proposed Rule would be exceeding its delegated authority to interpret and implement the provisions of RESPA, and that fundamental RESPA reform by Congress would be required to forestall a legal challenge by the industry over HUD's authority to promulgate the Proposed Rule. But HUD has now thrown down the gauntlet to the mortgage lending industry to endorse fundamental change in the way that mortgage broker compensation is paid and disclosed so as to assure that consumers when seeking home mortgage financing are given reliable cost information upfront that enables them to make informed decisions when engaging mortgage brokers. And some fundamental change necessary to provide consumers that transparency, if not immediate, ultimately seems inevitable.