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| Issue Date<br>December 12, 2006 | |
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TO: Brian D. Montgomery, Assistant Secretary for Housing, Federal Housing Commissioner, H

Joan S. Hobbs

FROM: Joan S. Hobbs, Regional Inspector General for Audit, Region IX, 9DGA

SUBJECT: First Magnus Financial Corporation Did Not Comply with HUD Guidelines When Operating and Managing Net Branches

# HIGHLIGHTS

## What We Audited and Why

We audited First Magnus Financial Corporation's (First Magnus) branch office operations, primarily the branch doing business as Great Southwest Mortgage, located at 17015 North Scottsdale Road, Suite 325, Scottsdale, Arizona. The objective of the audit was to determine whether First Magnus operated its net branches in accordance with U.S. Department of Housing and Urban Development (HUD) requirements.

## What We Found

First Magnus did not follow HUD requirements when operating and managing its Great Southwest Mortgage "net branches." It violated HUD requirements by allowing officers to enact noncompete clauses, requiring net branch managers to indemnify branch-related losses, allowing nonexclusive employment, and failing to execute office lease agreements and equipment lease agreements in First Magnus' name. These arrangements resulted in the branch offices operating without the close supervisory control and oversight HUD requires lenders to maintain over their branch offices.

## What We Recommend

We recommend that the assistant secretary for housing take appropriate administrative action regarding First Magnus. This action should include imposing civil money penalties for operating its net branches outside HUD requirements.

For each recommendation without a management decision, please respond and provide status reports in accordance with HUD Handbook 2000.06, REV-3. Please furnish us copies of any correspondence or directives issued because of the audit.

## Auditee's Response

We provided the draft report to First Magnus on November 9, 2006, and held an exit conference on December 6, 2006. First Magnus generally disagreed with our report. The complete text of the auditee's response, along with our evaluation of that response, can be found in appendix A of this report.

# TABLE OF CONTENTS

# BACKGROUND AND OBJECTIVE

## Background

First Magnus Financial Corporation (First Magnus) is a direct endorsement lender that was incorporated and approved by the U.S. Department of Housing and Urban Development (HUD) as a nonsupervised lender in 1996. Its corporate office is located in Tucson, Arizona. As of October 24, 2006, First Magnus had 343 active branch offices and sponsored 2,175 Federal Housing Administration-approved loan correspondents. As a direct endorsement lender, First Magnus underwrites and funds loans that it and its branches originate and loans received by its loan correspondents and other brokers.

We reviewed the First Magnus branch office doing business as Great Southwest Mortgage, located at 17015 North Scottsdale Road, Suite 325, Scottsdale, Arizona. The Great Southwest Mortgage branch office had been approved to originate and process Federal Housing Administration loans since May 22, 2000. Based on data from HUD's database system, the Scottsdale, Arizona, branch office originated 1,220 Federal Housing Administration-insured loans totaling more than $157 million between January 1, 2003, and September 30, 2006. The chart below shows the current status of those loans.

| Description | Number | Percentage | Amount |
|---|---|---|---|
| Loans originated | 1,220 | 100.0 | $157,411,177 |
| Defaults reported | 54 | 4.4 | $7,067,482 |
| Loans to claim | 11 | 0.9 | $1,422,913 |

## Objective

Our objective was to determine whether First Magnus operated its net branches in accordance with HUD requirements.

# RESULTS OF AUDIT

## Finding 1: First Magnus Did Not Follow HUD Requirements When Operating and Managing Its Great Southwest Mortgage "Net Branches"

First Magnus did not comply with HUD rules, regulations, procedures, and instructions in operating and managing its Great Southwest Mortgage net branches. It violated HUD requirements by allowing officers to enact noncompete clauses, requiring net branch managers to indemnify branch-related losses, allowing nonexclusive employment, and failing to execute office lease agreements and equipment lease agreements in First Magnus' name. Such arrangements create prohibited net branches in violation of requirements set out in HUD Handbook 4060.1, REV-1, Mortgagee Approval Handbook, and Mortgagee Letter 2000-15[1]. As a result of this noncompliance, HUD's insurance funds and the public are exposed to an increased risk because First Magnus did not provide close supervisory control of all of its branch offices and employees as required by HUD.

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First Magnus operates its net branches under written net branch agreements. A review of the net branch agreements (dated September 1999 and October 2004), relating to the operations of the principal First Magnus net branch doing business as Great Soutwest Mortgage (located at 17015 North Scottsdale Road, Suite 325, Scottsdale, Arizona), identified the following provisions that do net meet HUD requirements for bona fide branch office operations (Note: First Magnus' net branch agreements for its other Great Southwest Mortgage branches contain provisions similar to those discussed below, and, accordingly, these other branch office agreements also violate HUD requirements).

**First Magnus Allowed Officers to Enact Noncompete Clauses**

Both the September 1999 and October 2004 net branch agreements included noncompete clauses that allowed officers of Great Southwest Mortgage branch operations to dictate the growth of First Magnus in Maricopa County, Arizona. Although the September 1999 agreement resulted in the dissolution of Great Southwest Mortgage Corporation and the establishment of a Great Southwest Mortgage division within First Magnus, the officers of the Great Southwest Mortgage division had almost complete control over how First Magnus conducted its operations in Maricopa County. Both agreements allowed First Magnus to develop additional retail lending-related business ventures and relationships in Maricopa County but only with the consent of the Great Southwest Mortgage officers. If the officers consented and participated in the organization, management, and operation of such entities, First Magnus and the officers would

[1] HUD Handbook 4060.1, REV-1, CHG-1 and Mortgagee Letter 2000-15 were cancelled and replaced by HUD Handbook 4060.1, REV-2 dated August 14, 2006. However, this revision resulted in no material changes with regard to branch requirements that affected this finding.

divide any profits generated by these new entities. The agreements allowed the Great Southwest Mortgage officers to exclusively control First Magnus' ability to expand its business within Maricopa County, Arizona, which includes the Phoenix metropolitan area. In accordance with these agreements, First Magnus could not expand its business in Maricopa County without consent from the Great Southwest Mortgage officers. These arrangements, in which the employees, not the employer, dictate business expansion, raise concerns as to whether First Magnus has appropriate oversight and control over its net branches. In addition, this practice gives the appearance that Great Southwest Mortgage net branches operate as independent entities using First Magnus' Federal Housing Administration-approved lender identification number solely as a means to originate and process Federal Housing Administration loans. This type of arrangement violates HUD requirements (see footnote 1), which does not allow a separate/independent entity to originate loans using a HUD-approved lender's identification number.

**First Magnus Required the Indemnification of Branch-Related Losses**

The October 2004 agreement contained provisions holding the Great Southwest Mortgage officers responsible for many of the legal penalties and loan losses resulting from net branch operations. For example, the agreement states "…FMFC [First Magnus] and Employees [Great Southwest Mortgage officers] agree that all loan losses, claims, lawsuits and settlements shall be allocated between FMFC and Employees by mutual agreement on a case by case basis. In such event that FMFC and Employees are unable to agree to the allocation of such loan losses, claims, lawsuits and settlements, then such items shall be allocated equally between the parties." This provision shifts responsibility to the net branch managers/Great Southwest Mortgage officers and is not consistent with the supervision, control, and responsibility that a lender would have over a traditional branch office. HUD requirements (see footnote 1) consider "employment" agreement provisions in which branches are required to indemnify approved lenders for losses as violations of HUD branch requirements.

**First Magnus Allowed Nonexclusive Employment**

The September 1999 and October 2004 net branch agreements allowed Great Southwest Mortgage officers to operate other business ventures in addition to their employment with First Magnus in violation of HUD requirements (see footnote 1).

The September 1999 agreement, section H, Covenant Not to Compete, did not allow the Great Southwest Mortgage officers to "directly or indirectly" provide services to "any business, including, but not limited to mortgage broker or mortgage banking business which is competing, directly or indirectly..." with First Magnus. However, an additional condition was added to the agreement to allow the officers "to conduct mortgage related seminars (for-profit) through-out the United States. Employer [First Magnus] agrees that 'the seminars' would not be in violation of the not to compete agreement." This condition contradicted the prior agreement and allowed Great Southwest Mortgage officers to conduct outside for-profit businesses that could compete with First Magnus. Also, the condition allowed the officers to operate outside businesses while employed as full-time employees of First Magnus. The October 2004 net branch agreement did not include a noncompete clause or conditions similar to the September 1999 net branch agreement.

The Great Southwest Mortgage officers took advantage of these agreements to operate limited liability companies that provided various services, including but not limited to recruiting loan officers for mortgage companies, office equipment and office space leasing, and mortgage industry training. First Magnus used these services and paid the Great Southwest Mortgage officers (through the officers' limited liability companies) more than $5.4 million for the services during the period January 1, 2003, to December 31, 2005. In addition to the payments to the Great Southwest Mortgage employees for their outside business interests, First Magnus also paid the Great Southwest Mortgage officers more than $12.6 million in employee compensation during the same period.

HUD requirements (see footnote 1) require all employees of an approved lender except receptionists, whether full time or part time, to be employed exclusively by the lender at all times and conduct only the business affairs of the lender during normal business hours. In addition, HUD requirements (see footnote 1) require a lender's senior corporate officers to spend their full time on the lender's operations.

First Magnus executed agreements that allowed Great Southwest Mortgage officers to conduct outside businesses while employed by the lender. The lender's actions violated HUD requirements and give the appearance of a lack of control and supervision by First Magnus over the Great Southwest Mortgage division's branch offices.

## First Magnus Failed to Execute Office Lease Agreements in Its Name

First Magnus entered into office sublease agreements with companies, typically owned by its branch office managers, to rent office space for use by its Great Southwest Mortgage branch offices. In the sublease agreements, First Magnus was listed as the renter of the office, with the actual rental agreement with the property owner being retained by the branch office managers' company. For example, First Magnus/Great Southwest Mortgage operated a branch office in Suite 325 of a building located at 17015 North Scottsdale Road in Scottsdale, Arizona. The Great Southwest Mortgage officers leased office space in this building, which included suite 325, from the building owners through their leasing company, Lender Support Services, LLC. Lender Support Services in turn subleased suite 325 to First Magnus for use as a branch office. According to the sublease agreement, First Magnus paid Lender Support Services a monthly rental of $64,000 for rental of office space and office equipment. The lease agreement between First Magnus and Lender Support Services was on a month-to-month basis, whereas Lender Support Services' actual lease with the property owner was for 10 years.

HUD requirements (see footnote 1) require all agreements, including office space leases, to be in the name of the lender. First Magnus' practice of not executing primary lease agreements in its name resulted in the responsibility and control of the office space being born by Lender Support Services (and other companies of branch office managers), not First Magnus.

## First Magnus Failed to Execute Equipment Lease Agreements in Its Name

First Magnus also entered into agreements with leasing companies, typically owned by its branch office managers, to rent office equipment such as furniture and computers for use at its Great Southwest Mortgage branch offices. These agreements listed First Magnus as the renter of the office equipment with ownership of the equipment retained by companies owned by its branch office managers.

For example, on December 28, 2004, Lender Support Services executed an equipment lease agreement with First Magnus dba Great Southwest to lease office furniture and equipment for use at 17015 North Scottsdale Road, Suite 325, in Scottsdale, Arizona. Lender Support Services is a leasing company owned and operated by Great Southwest Mortgage officers. According to the agreement, the Great Southwest Mortgage branches were to rent office and computer equipment from Lender Support Services for a monthly fee of $20,123. The lease agreement term was on a month-to-month basis. The agreement listed Lender Support Services as the owner of the office and computer equipment and First Magnus dba Great Southwest Mortgage as the renter.

HUD requirements (see footnote 1) require all agreements, including office space leases, to be in the name of the lender. First Magnus' practice of not executing agreements in its name effectively resulted in the financial liability and control relating to its office and computer equipment being retained by a third party, Lender Support Services, not First Magnus, in violation of HUD requirements.

## Conclusion

First Magnus disregarded HUD requirements by allowing the use of noncompete clauses, requiring indemnification of branch-related losses, allowing nonexclusive employment, and failing to execute office lease agreements and equipment lease agreements in its name. These deficiencies exposed HUD's insurance funds and the public to an increased risk through the origination of Federal Housing Administration-insured mortgages by branches and employees, the management of whose operations and activities were inconsistent with the close supervisory control mandated by HUD for all lender branch office origination activities.

Further, allowing Great Southwest Mortgage branches to operate under executed branch and net branch agreement terms prohibited by HUD limited First Magnus' expected responsibility over and oversight of branch offices and personnel who originate and process Federal Housing Administration-insured loans. Essentially, as set out in its Web site advertisements, First Magnus offered franchise (mortgage broker) arrangements with its affiliates and not valid branch office operations as required by HUD rules and regulations.

## Recommendations

We recommend that the assistant secretary for housing-federal housing commissioner

1A. Impose civil money penalties against First Magnus for Federal Housing Administration-insured loans originated by its net branches that were being operated in violation of HUD requirements during the period of January 1, 2003, to August 31, 2006. The closure of this recommendation is subject to the consideration for administrative action and assessment of civil money penalties by the Mortgagee Review Board.

1B. Require First Magnus to either discontinue operations of all net branches that are being operated in a manner that violates HUD requirements or bring these branches into compliance with such requirements.

# SCOPE AND METHODOLOGY

We performed audit work from May through September 2006. The audit period covered January 2003 through August 2006.

To accomplish our objective, we

- Reviewed the operations and agreements related to First Magnus' net branch (dba Great Southwest Mortgage) located at 17015 North Scottsdale Road, Suite 325, Scottsdale, Arizona, for the period of January 2003 through August 2006;

- Reviewed net branch agreements of three other net branches operating in the Phoenix metropolitan area also doing business under the control of First Magnus/Great Southwest Mortgage;

- Interviewed First Magnus and Great Southwest Mortgage personnel;

- Interviewed government agency personnel and real estate development company personnel;

- Reviewed First Magnus' financial records, employee personnel files, and employee benefits documents; and

- Reviewed public records and databases.

During the review, we identified information indicating Real Estate Settlement Procedures Act violations by First Magnus involving the payment of marketing fees to real estate companies and real estate developers in exchange for referrals of federally related mortgage loan business. We plan to conduct followup work, and the results will be addressed in a later audit report.

We performed our review in accordance with generally accepted government auditing standards.

# INTERNAL CONTROLS

Internal control is an integral component of an organization's management that provides reasonable assurance that the following objectives are being achieved:

- Effectiveness and efficiency of operations,
- Reliability of financial reporting,
- Compliance with applicable laws and regulations, and
- Safeguarding of assets.

Internal controls relate to management's plans, methods, and procedures used to meet its mission, goals, and objectives. Internal controls include the processes and procedures for planning, organizing, directing, and controlling program operations. They include the systems for measuring, reporting, and monitoring program performance.

## Relevant Internal Controls

We determined the following internal controls were relevant to our audit objectives:

- Reliability of documents used to operate and manage net branches.

- Policies and procedures in place to ensure operation and management of net branches in compliance with HUD rules and regulations.

- Safeguarding Federal Housing Administration-insured loans from high-risk exposure through controls over net branch operations.

We assessed the relevant controls identified above.

A significant weakness exists if management controls do not provide reasonable assurance that the process for planning, organizing, directing, and controlling program operations will meet the organization's objectives.

## Significant Weaknesses

Based on our review, we believe the following item is a significant weakness:

- First Magnus disregarded applicable HUD rules and regulations in the operation and management of its net branches.

# APPENDIX

## Appendix A

## AUDITEE COMMENTS AND OIG'S EVALUATION

**Ref to OIG Evaluation** | **Auditee Comments**

FIRST MAGNUS
FINANCIAL CORPORATION

November 29, 2006

***VIA E-MAIL: JHOBBS@HUDOIG.GOV***
***AND FEDERAL EXPRESS***

U.S. Department of Housing and Urban Development
Office of Inspector General, Region IX, 9DGA
c/o Ms. Joan S. Hobbs, Regional Inspector General for Audit
611 West Sixth Street, Suite 1160
Los Angeles, California 90017

Re: Draft Audit Report
Net Branch Operations of First Magnus Financial Corporation
d/b/a Great Southwest Mortgage ("GSW")
Scottsdale, Arizona

Dear Ms. Hobbs:

First Magnus Financial Corporation ("FMFC") is in receipt of the discussion draft report issued by your office on November 9, 2006. As a result of the findings set forth therein, the discussion draft report recommended that the Assistant Secretary for Housing-Federal Housing Commissioner:

1. Impose civil money penalties against FMFC for FHA-insured loans originated by its net branches that were being operated in violation of HUD requirements during the period of January 1, 2003 through August 31, 2006.

2. Require FMFC to either discontinue operations of all net branches that are being operated in a manner that violates HUD requirements or bring these branches into compliance with such requirements.

FMFC believes that it operates and manages its net branches in accordance with all HUD rules, regulations, procedures and instructions. It strongly disagrees with the finding and recommendations set forth in the discussion draft report. A detailed analysis of the report's conclusions is set forth below.

Issue 1: Employee noncompete clauses

**Comment 1**

FMFC disputes the conclusion that it violated HUD requirements by allowing employees to enact noncompete clauses in their net branch employment agreements. Contractually granting an exclusive sales territory (which is the practical effect of a noncompete clause) to one or more branch managers is not expressly prohibited by HUD Handbook 4060.1 REV-1 (issued September 30, 1993) or HUD Mortgagee Letter 00-15. HUD's guidance with respect to acceptable net branch arrangements sets forth the legal parameters for which approved mortgagees must comply; however, its guidance does not dictate any particular business model or structure which must be utilized in order to ensure

603 North Wilmot Road • Tucson, AZ 85711 • Office: 520.618.9275 • Fax: 520.202.0275
E-Mail: joel.herk@firstmagnus.com
Admitted in Arizona

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such compliance. As in many other industries, the granting of exclusive sales territories to employees is commonplace in the mortgage banking industry. Rational business justifications exist for such practice. Namely, granting exclusive sales territories to its employees allows companies to most efficiently allocate their resources, oftentimes resulting in better service to the consumer.

**Comment 2**

While such arrangements allow the branch managers to control the expansion of business in a particular sales territory, they do not equate to a lack of oversight and control by FMFC. As employees of FMFC, FMFC has ultimate control over its branch managers because they can terminate them upon written notice for any reason. In addition, not unlike other large organizations, FMFC has developed a multi-tiered supervisory structure, and established audit and reporting policies and procedures to ensure adequate oversight, compliance and control over its operations. These controls have proven very effective in FMFC's operations. Attached as Exhibit 1 is an organizational chart which reflects GSW's corporate structure. FMFC's executive management directly supervises the branch managers who oversee GSW's branch operations. These branch managers report directly to FMFC's executive management.

**Comment 3**

Contrary to the discussion draft report's assertion, FMFC's exclusive sales territory arrangement with the GSW branch managers does not morph GSW into an independent entity created solely as a means to originate and process FHA loans. Simply put, the mere existence of an exclusive sales territory arrangement does not support the OIG's conclusion that GSW is being operated as an independent entity, separate and distinct from FMFC. Indeed, the only support the OIG provides for its conclusion is that this practice "gives the appearance" that GSW net branches operate as independent entities solely as a means to originate and process FHA loans. Furthermore, the employees' net branch employment agreement makes it clear that they are employees of FMFC with an alternative compensation program based upon the "net" profits of the branches that they manage. Pursuant to HUD Mortgagee Letter 00-15, FMFC collects the revenue from the GSW branches managed by the branch managers, pays the expenses of each branch, and then pays the branch managers the remaining revenues, if any, as a commission.

Issue 2: Indemnification of branch-related losses

**Comment 4**

FMFC disputes the conclusion that that it violated HUD requirements by requiring net branch managers to indemnify FMFC for branch-related losses. While the discussion draft report bases its conclusion upon the language set forth in Section 6.2 of the employees' 2004 net branch employment agreement, such conclusion fails to take into account the effect of the indemnity language set forth in Section 13. Section 6.2 and Section 13 should not be interpreted in a vacuum, instead they are meant to be interpreted together in a consistent fashion. While Section 6 focuses on the allocation of certain expenses between FMFC and the branch managers, Section 13 specifically limits the net branch managers' indemnification obligations to "the fullest extent permissible by law and to the extent of all the Net Profits of the Branches." In other words, FMFC pays for all of the operating expenses of the branch, including all loan losses, claims, lawsuits and settlements, but may allocate all or a portion of such expenses to the branch when calculating net profits. If the

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monthly expenses exceed the monthly profits, then the branch manager is not paid a commission for such month. However, at no time does FMFC hold the branch manager personally liable for any such expenses.[1] Such arrangement is consistent with HUD Mortgagee Letter 00-15. Such letter makes HUD's position regarding net branches clear: "[i]f the expenses are paid by the HUD/FHA approved mortgagee, the arrangement is acceptable."

Issue 3: Nonexclusive employment

**Comment 5**

FMFC disputes the conclusion that that it violated HUD requirements by allowing GSW branch managers to operate other business ventures in addition to their employment with FMFC. In accordance with HUD Handbook 4060.1 REV-1, paragraph 2-14, all GSW branch managers are employed exclusively by GSW and conduct only the business affairs of GSW during normal business hours. Even though the branch managers' 1999 employment agreement expressly allows "the Branch Managers to conduct mortgage related seminars (for profit) throughout the United States," such activities were never undertaken by the branch managers individually. However, the branch managers passively own membership interests in certain limited liability companies which perform a variety of services, including but not limited to, recruiting loan officers for mortgage companies, leasing office equipment and office space, and training in the mortgage industry. Such branch managers are not employees of such limited liability companies, nor do they perform any day-to-day management duties related to such entities. Instead, they receive Schedule K-1 distribution compensation only based upon the profitability of such limited liability companies.

Contrary to the discussion draft report's assertion, FMFC is also in compliance with HUD Handbook 4060.1 REV-1, paragraph 2-11A, which requires approved mortgagees to have one or more senior corporate officer spending full time managing the approved mortgagee's loan origination and servicing operations. As discussed above, FMFC's executive management directly supervises the branch managers who oversee GSW's branch operations. These branch managers report directly to FMFC's executive management. FMFC's executive management spends its full time managing FMFC's (including GSW's) mortgage loan origination and servicing operations.

Issue 4: Execution of office lease agreements and equipment lease agreements

**Comment 6**

FMFC disputes the conclusion that that it violated HUD requirements by failing to execute office lease agreements and equipment lease agreements in its own name. FMFC acknowledges that at many of its GSW branch locations, the branch manager or an entity owned by the branch manager has signed branch equipment and furnishing leases. GSW's practice is to frequently sublease the equipment and furnishings from the branch manager or entity pursuant to a written, binding agreement between GSW and the original lessee. In some of these instances, the branch manager previously operated as a mortgage banker or mortgage broker under a different license from the same location prior to becoming an

[1] The discussion draft report presented no evidence that FMFC has ever held any branch manager personally liable for branch-related expenses.

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employee of GSW. Accordingly, the branch location was already fully equipped and furnished pursuant to an existing lease agreement. GSW could not directly enter the lease with the landlord without forcing a termination of the existing lease, which might violate the lease terms and subject the existing lessee to penalties. GSW follows a similar procedure with respect to office leases. In both of these instances, in accordance with HUD Mortgagee Letter 00-15, FMFC assumes full liability and responsibility for the branch lease expenses. FMFC has paid for, and continues to pay for, the leased furnishings and equipment for each of its branches, as well as for the office space for each of its leased branch locations.

GSW's execution of subleases in no way lessens FMFC's obligation for its branch expenses. The subleases legally obligate FMFC to pay for the specified branch expenses, and FMFC's policies require it to pay all branch office and equipment expenses.

Conclusion

FMFC believes that it operates and manages its net branches in accordance with all HUD rules, regulations, procedures and instructions. HUD's guidance with respect to acceptable net branch arrangements sets forth the legal parameters for which approved mortgagees must comply; however, its guidance does not dictate any particular business model or structure which must be utilized in order to ensure such compliance. FMFC believes that the OIG has incorrectly interpreted HUD's guidance in such a way as to dictate the particular business model or structure that FMFC must utilize in order to ensure its compliance. Such interpretation is beyond the scope of HUD's guidance. Furthermore, many of the conclusions set forth in the discussion draft report are not supported with any concrete evidence, instead the OIG relies "concerns" and "appearances" to substantiate its conclusions.

Regards,

Joel J. Herk
Deputy General Counsel

JJH/nw
Enclosure: GSW Organizational Chart

cc: G.S. Jaggi
Karl Young
Gary Malis
Dominick Marchetti
Douglas G. Lemke
Carl Fornaris

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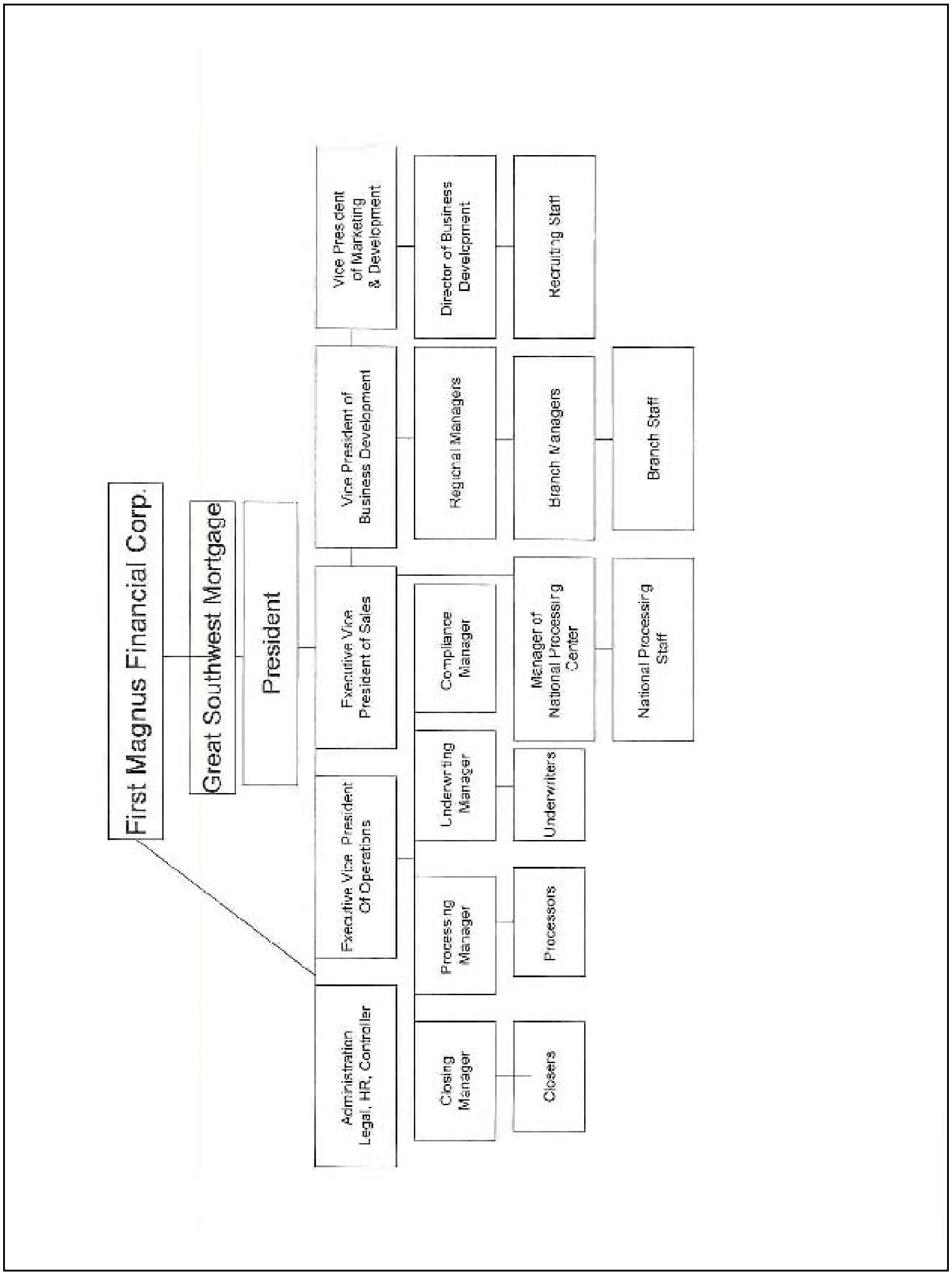
First Magnus Financial Corp.
Great Southwest Mortgage
President
Administration Legal, HR, Controller
Executive Vice President Of Operations
Executive Vice President of Sales
Vice President of Business Development
Vice President of Marketing & Development
Closing Manager
Processing Manager
Underwriting Manager
Compliance Manager
Regional Managers
Director of Business Development
Closers
Processors
Underwriters
Manager of National Processing Center
Branch Managers
Recruiting Staff
National Processing Staff
Branch Staff

## OIG Evaluation of Auditee Comments

**Comment 1** We agree that HUD's guidance does not dictate any particular business model or structure that mortgagee net branch arrangements/operations must adhere to. However, HUD's requirements do have the intent of ensuring that a mortgagee maintains full control and supervision over its "net branches" and that the branch office arrangements are not designed to maintain a distinct separation from the HUD/FHA approved mortgagee. The net branch agreements executed between First Magnus and its branch managers wherein the employees, not the employer, dictate how and where First Magnus can grow its business, specifically in Maricopa County, in our opinion, demonstrates a clear violation of these control standards.

First Magnus also stated other industries, including the mortgage banking industry, engage in similar practices. However, when a mortgage company's expansion is controlled by its "branch office employees," the mortgagee does not have full control over the operations of the branch as intended by HUD's requirements. If it was a true branch office, the company, not the employees, would have the ultimate decision-making role in determining whether to expand into or within a specific geographical area.

**Comment 2** First Magnus contends it has "ultimate control" over its branch managers due to its ability to terminate them upon written notice for any reason. However, the executed agreements between First Magnus and the branch managers allow the branch managers to explicitly control the business growth and future opportunities of the company into markets such as Maricopa County, Arizona. This arrangement, as specified in detail under Section A of the 1999 agreement and Section 5 of the 2004 agreement clearly showed First Magnus did not have "ultimate control" over its branch managers. Further, the ability to terminate its "branch manager" for any reason, does not equate to control as contemplated by HUD requirements. Under First Magnus' business relationships with the branch offices, it has no financial real responsibility for or investment in the "branch offices" operations (see comments 4, 5 and 6) and termination of its branches/branch managers and their respective branch offices would be no different than ceasing the purchase of loans originated by any other mortgage broker or loan correspondent.

**Comment 3** First Magnus contends the exclusive sales territory arrangement does not result in Great Southwest Mortgage being an independent entity, separate and distinct from First Magnus Financial Corporation. In addition, First Magnus states that under its net branch agreements the branch managers are First Magnus employees paid under an alternative compensation program, i.e. First Magnus pays all branch expenses and then pays its branch managers a commission which equates to the remaining revenue (net profit) generated by the respective branch office.

However, in OIG's opinion, the executed agreements that allow the branch managers to dictate the growth of First Magnus into the Maricopa County, Arizona market, and other provisions of the agreements relating to branch managers' liability and branch office expenses (see comments 4, 5 and 6), do not provide complete control and supervision over its net branches as required by HUD guidelines.

**Comment 4** First Magnus contends that it pays all loan losses, claims, lawsuits and settlements, but *may* allocate all or a portion of such expenses to the branch when calculating net profits, i.e. the branch office managers' compensation. Further, First Magnus stated that OIG provided no evidence that First Magnus ever held any branch manager personally liable for branch-related expenses. However, in OIG's opinion, in that the 2004 branch office agreement (Section 6) requires that in instances where "Net Profits are negative" the amount be carried forward and offset against future net profits, then the branch office managers are in effect being held responsible for loan losses, claims, etc. Under the terms of the branch office agreement such charges would reduce the net profit of the branch and the compensation/commission payable to the branch office manager. As discussed in the Finding, HUD has determined that branch office arrangements that require the "employee" indemnify the HUD/FHA approved lender if it incurs damage from any apparent, express, or implied agency representation by or through the "employee's" actions are deemed a violation of HUD branch office requirements. Sections 6 and 13 of First Magnus' 2004 branch office agreement and Section K of First Magnus' 1999 branch office agreement clearly violate this requirement.

**Comment 5** We disagree with First Magnus' contention that its branch managers were only involved with their outside business interests on a passive basis and did not perform any individual or day-to day management duties related to these businesses. Discussions with the branch managers showed they actively participated in the operation of their equipment and office leasing companies and training company. According to the branch managers, Section H, in the 1999 agreement allows them to provide real estate industry-related training without violating their agreement with First Magnus. Discussions with branch managers revealed that in 2004, they started and actively participated in a training company specializing in teaching real estate industry-related courses. On the training company's website, the branch officers are listed as a corporate partner and national trainer, which explicitly demonstrates they are actively involved in a real estate industry-related entity.

The state of Arizona Corporate Commission also showed that the branch managers are managers of an office leasing company and a real estate lending personnel recruitment company. OIG's review noted the branch officers actively participated in their office space and equipment leasing and recruitment companies, including signing agreements granting approval of various business transactions such as the transfer of property.

Based on the discussions and documentation obtained directly from the branch managers, it is clear they were actively involved in real estate-related companies outside of their employment with First Magnus. Their active involvement in real estate industry-related entities outside of First Magnus violates HUD branch requirements, specifically, HUD Handbook 4060.1 REV-1, paragraphs 2-11 and 2-14 that require all employees and senior corporate officers to be employed exclusively by the lender at all times and conduct only the business affairs of that lender during normal business hours.

**Comment 6** Even though First Magnus pays the applicable office and equipment leases on a monthly basis, the underlying agreements are not in the name of the lender, First Magnus. Rather, OIG's review found the underlying long term leases were executed in the name of branch managers' limited liability companies, who in turn executed month to month leases with First Magnus. Mortgagee Letter 00-15 requires "all" contractual relationships with vendors such as leases be in the name of the lender, not in the name of the branch employee. First Magnus' practice of having the actual long term leases be placed in the name of its branch office managers, not in its name, serves to limit First Magnus' responsibility and risk and violates the intent of HUD's branch office requirements.