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# NET BRANCHING



Starting a net branch? Before you take the leap — or even if you already have — it is imperative to do it on the right side of the law. Read on as net branching experts divulge the how-tos of proper financing procedures, license rental fees, employee indemnification, compensation, supervision and more. Think you've got it all figured out? Think again.



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Thinking about starting a net branch? Before you take the leap — or even if you already have — it is imperative to do it on the right side of the law.

**Bill Warren**, chief compliance officer, and **Daniel Jacobs**, chief executive officer, both of 1st Metropolitan Mortgage, shared insights into their own net branch operation and taught attendees at a recent NAMB legal conference how to do a net branch right.

**What is a net branch?**

“Net branching is a very, very hard term to define,” Warren said. “The U.S. Department of Housing and Urban Development (HUD) defines the term ‘net branch’ in Mortgagee Letter 00-15, which is now incorporated into its handbook, 4060.1 REV-2.”

According to HUD, “A branch manager’s compensation may be based upon the net profit of the branch. For example, the FHA-approved mortgagee may collect the revenue from the branch, pay the branch expenses, and then pay the branch manager the remaining revenues, if any, as a commission. Such an arrangement is, essentially, an alternative compensation program for the branch manager and is an acceptable arrangement if all other branch requirements are met.”

So what are the “other branch requirements?”

**Finances: General expenses**

*Leases, rent checks*

“The expenses of the branch must be those of the licensee,” Warren said. When taking leases, for instance, Warren said he requires the leases of the branches to be in the entity’s name.

“If someone were to come to us or join the organization that already had a lease arrangement, then we’d need to execute a sublease with the landlord’s consent,” Warren said. “The landlord is recognizing your entity as subleasing. And to take it one step further, all payments made on the first of the month are to the landlord — not the branch manager.”

In 1st Metropolitan Mortgage’s past 40 state examinations in the past two years, “one of the things we’ve asked for is,

‘show us the leases and show us the rent checks,’” Warren said. “Well if you don’t have them, it’s pretty indicative that you may have a prohibited net branch arrangement.”

*Operational expenses*

When it comes to operating expenses like the telephone bill, the utility bill or copier lease, the states as well as HUD require proof that the entity pays for these items. It is unacceptable for the checks to come from the branch manager or an employee of the branch.

“In our case, all our checks are cut directly from the corporate office and sent directly to the vendor,” Warren said.

And as for licensing, the entity pays for it.

“No employee of ours — whether it’s a branch manager, processor, loan officer, receptionist — is allowed to send us a check for anything,” Warren said. “Why? Because it could very much look like it could be a franchise. They can’t pay expenses. Only we can pay expenses.”

As for states that require registration fees or individual loan officers, the entity should pay all costs — not the locations or loan officer himself.

“If you do it any other way, you are running the risk of not being able to prove that the entity is paying the expenses of the branches,” Warren said.

*Employee indemnification*

A lot of times, the branches need copiers, desks, office supplies and equipment to start up, and can blur the line between who pays for or who owns what.

“When a branch needs new equipment, does the branch manager pay for it or does the licensee pay for it,” Jacobs said. “Well, the right answer is the licensee has to pay for it. When you start asking the branch manager to pay for office equipment, it starts to cross the line of employee indemnification and if you are operating correctly.”

Also, the entity is responsible for branch losses and a branch manager is prohibited from indemnifying the entity for losses.

*Bank accounts, payroll*

Warren also said no branches should have access to corporate or branch accounts or checkbooks.

“If you are in a branch that has an entity’s checkbook or if they have their own account in which they are a co-signer or can write checks on that, how do you know what they are paying for and not paying for?” he said. “You can’t make a branch have a separate operating account for which expenses are paid or reimbursed.”

Another concern Warren addressed was branch managers having access to payroll.

“If they have access to payroll, how do you know what they are paying people or who they are paying,” he said. “Are they paying someone who is a nonemployee? Do you have

**Things to consider before taking the plunge**

<p><b>Finances: General expenses</b> Leases, rent checks operational expenses employee indemnification bank accounts, payroll</p> <p><b>Finances: Income</b> License ‘rental fees’</p> <p><b>Finances: Compensation</b></p>	<p><b>Supervision</b> Policies and procedures Quality control Keeping track of individual license insurance Transfer of license</p> <p><b>Employee/employer rights</b></p>
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someone co-brokering with another entity because your branch has a license in that state? Or maybe you have a lender agreement with a lender who has a specific product and that other person, who is outside your state, doesn't have access to that lender."

In most lender agreements, third-party originations are prohibited and that's why it is imperative for the entity to be in charge of payroll, he said.

### Finances: Income

According to Warren, all income must be payable to and deposited directly in an account of the entity.

"If it's deposited into any other account, it becomes a supervision issue," he said. "All branch income must be accounted for and reflected in the licensee's financial records. Most states, when they come to examine, are not looking at the branch financial records. Why? Because the branch has no financial records. They are corporate records. They want to see that the income came in, it was booked into your operating account, properly accounted for, paid out on a proper payroll system and that everything balances."

### License 'rental fees'

In addition, Warren said that he sees the way new branch companies work through "rental fee" e-mails.

"We have branch managers all over the United States that say, 'Is this an acceptable arrangement?'" he said. "I got this from XYZ mortgage broker that says if I'm not licensed in New Jersey and New York and Texas, no problem. (They want me to) send them my loans and they'll take them."

Jacobs said that there's a misconception out there that some folks can do business as a net branch without knowing what a net branch is.

"They say, 'I've got a company. I want to do loans out of state. I'm not licensed. I'll just be a net branch for you. But I'm still going to do it in my company's name,'" he said. "That is a prohibited activity. The branch has to truly be an extension of the licensee."

### Finances: Compensation

"A branch manager may earn the 'net profit' of the branch," Warren said at a recent NAMB legal conference how to do a net branch right. "That's HUD's definition. Earning 'net profit' in a net branch in an alternative compensation method

that is acceptable as long as long as all other requirements are met."

Some states and HUD require that all employees be paid on a W-2 basis, Warren said.

"There are some states that don't have that requirement," he said. "There are some states that actually believe that people will be paid as independent contractors. Florida comes to mind right away. California is another one."

A few years ago during a HUD examination, Warren recalled the examiner saying that their workers had to be exclusive employees.

Warren then asked her, "but what's to keep someone from writing W-2 income from two different employers?" he said. She said if there is any question, HUD will "call up your tax returns to see if (the worker) was not exclusive or was exclusively your employee. So, for a lot of reasons, we've become W-2. We have some people who ask us, 'Hey, can I be a 1099?' and the answer is no."

Jacobs did say, however, if you're not an FHA-approved lender and you are looking to do business in certain states, having 1099 originators may not be a problem. But if you are FHA-approved, in many states, it's a problem.

"We go to great lengths to determine if someone is an employee in some other settlement service, particularly if they are going to be in the FHA branch," Warren said. "We want to make sure there is not some sort of conflict of interest that may take them out of that exclusivity."

Also in this segment of net branching, license "rental fees" are prohibited.

### Supervision

#### Policies and procedures

"Licensees bear all responsibility for everything employees do or fail to do," Warren said. "So if you've got loose arrangements with employees or a lack of supervision, then you're asking for more trouble than you can possibly handle."

Warren urges entities to have policies and procedures in place that are firmly established and are consistent to branches and employees across the board.

He mentioned that one of the things his company is measured on is his policies and procedures manual.

"It addresses almost everything you can encounter about what our procedure is, what our policy is — from employee

### WHEN STARTING A NET BRANCH...

#### DO NOT

- have branch level lines of credit, warehouse lines, or investor agreements separate from your entity;

- pay companies owned by your employees;

- allow unlicensed home-based branches; or

- rent licenses for monthly flat fees.

#### DO

- maintain physical access to branch locations;

- use only the name of the corporate entity at the branch;

- license all branch locations and, where required, individuals; and

- avoid sham business arrangements.

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problems to disclosures to redisclosures — the whole gamete,” Warren said.

Jacobs mentioned that the procedures and policies manual doesn’t just need to be written, it needs to be a “living, breathing document” -- not just something that collects dust waiting for the regulator to come around.

### *Quality control*

In addition, liability for the actions of all branch employees with respect to their conduct of the mortgage business lie solely with the licensee.

“You ask, ‘how on earth do I do that,’” Warren said. “You do it by 100 percent quality control on every loan. That’s the report card. It doesn’t make any difference if you are a branching company or just a mortgage broker, you have the same responsibility with the broker agreement and the contract with the borrower. If you do not live up to that contract, maybe charge more than that contract, in the examination the examiner is not only going to make you refund that, they’re probably going to step up their examination ... and that’s just the beginning of your problem.”

Warren said an entity must have an active and affective quality control program with an on-site business that goes on the road to inspect the branches.

Find out “what kind of branch you really have,” he said. “Is there really a branch out there? We had a Virginia examiner go examine one of our branches and she said that it was the smallest branch she had ever seen. I said, ‘what do you mean?’ She explained that the branch was just a post office box and yet we licensed it.”

### *Keeping track of individual license insurance*

Jacobs said one of the hardest things to supervise is the location of individual license insurance.

“It’s one thing to catch that after the loan has closed,” he said, “and the only thing is to refund the money and hope the consumer doesn’t complain to the state regulatory agency.”

To alleviate the problem, 1st Metropolitan Mortgage worked with Ellie Mae and Encompass to develop a bridge to their licensing database which not only hooks up on the branch level but also on the individual level and if somebody is trying to originate a loan in the state of Ohio, in other words, the state code is 08, and if it appears anywhere on the 1003, or on the property disclosure, it goes in and checks against our database and before they can go any further, if they don’t hold an individual license and that branch does not have a branch license in there, they get a message on the screen that says ‘contact your systems administrator.’ It will not allow them to go any further.”

However, Warren did say that originators can get around the system by filling out a hand-written application and they have yet to stop that practice.

“We do require they send in a copy of their license when they close a loan,” he said, “everytime.”

Overall, licensees must have monitoring and control in place.

“If you don’t have monitoring and you don’t have control, you can have production without compliance,” he said. “You just can’t have it for very long.”

### *Transfer of license*

“You may not assign or transfer a license to branch managers or other owners,” Warren said. “There is a way for someone to do that if they are spinning out and starting their own company and get their own license. But you can’t assign that license unless you do a change of control. And if you are doing a change of control, there is a question of if that person is really an employee of yours or not.”

### **Employer/employee rights**

The employer rights of control don’t always apply with 1099 contractors and may be inconsistent with certain state and federal regulations, Warren noted.

“If they are W-2ed, they are your employees,” he said. “If they are independent contractors by the IRS’ definition, they can’t be controlled, directed or monitored by you. Some states allow that and actually anticipate that will be the case. Most states want to make sure your employees are managed because they don’t regulate individuals. They regulate entities.’ If one of your employees create a problem for you they’re not going after the employee. They are going after you.”

Why? Because the branch manager equity in the branch is inconsistent with regulation.

“Can a branch manager sell a branch?” Warren said. “No! It’s not his to sell.”

In addition, the licensee employs everyone. The branch managers do not have “employees.”

“A branch manager can recommend a hiring but the only person who can hire anyone is the corporation,” he said.

### **Concluding wisdom**

“Net branch doesn’t mean ‘illegal,’” Warren said, “although, to regulators, it throws up a red flag.”

That’s why it is so important to have good policies and procedures in place, he stressed, to know the good players in the industry from the bad.

“It’s like the alarm system in my home,” he said. “It doesn’t keep the crooks out. It just lets me know that they’ve arrived.”