ABA SECTION OF REAL PROPERTY, PROBATE AND TRUST LAW
RPPT eREPORT
NEWS, PRACTICE UPDATES AND MEMBER BENEFITS

Real Property Article

This Issue's Table of Contents

Changes in the ACORD 28 Insurance Form and Lender Reaction

By Rod Clement

When lenders make loans secured by real estate, they usually require the borrower to provide proof that the borrower has property insurance in an amount sufficient to pay off the loan in case the improvements are destroyed by casualty. The traditional proof of the existence of property insurance has been certificates of insurance on forms promulgated by the Association for Cooperative Development, or ACORD . In 2006 ACORD made changes to the standard proof of property insurance form that have arguably reduced the usefulness of these certificates to lenders and have left lenders searching for alternatives to the current ACORD form.

Background

Certificates of insurance are important to lenders whose loans are secured by real estate because, while lenders typically require the borrower to provide property insurance identifying the lender as an additional insured, the policy itself usually is not available at closing. So a certificate of insurance is usually the only proof of insurance that is available to the lender.

In order to appreciate the 2006 changes to the ACORD, it helps to review the changes made to the history of the relevant ACORD forms. Prior to 2003, if an insured asked his or her agent for a certificate of insurance, the agent usually would provide an ACORD 24 Certificate of Property. The Form 24 provided, among other things, that "This certificate is issued as a matter of information only and confers no rights upon the certificate holder. This certificate does not amend, extend or alter the coverage afforded by the policies below." The Form 24 also provided that if the policy was cancelled, the issuing agent would endeavor to mail notice to the certificate holder, but that the failure to give the notice would not impose liability on the company. Savvy lenders would insist on the ACORD Form 27, which provided that it was “evidence that the insurance as identified below has been issued, is in force, and conveys all the rights and privileges afforded under the policy.” The Form 27 also provided that the issuer would give notice to the lender prior to cancellation of the policy. The Form 27 left blank spaces for the description of the coverages that existed, leaving the person completing the certificate considerable discretion about how to describe the types and amounts of coverage. The differences between the ACORD Form 27 and a predecessor of the ACORD Form 24, and the problems with the Form 24 in the context of a commercial real estate loan, were the subject of an article by Alfred S. Joseph III & Arthur E. Pape, “Certificates of Insurance: The Illusion of Protection”, Vol. 9, No. 1, *Probate & Property* 55 (Jan./Feb. 1995).

In 2003, at the request of the Mortgage Bankers Association and others, ACORD issued a new ACORD 28 Evidence of Commercial Property Insurance. The 2003 Form 28 among other things, contained the same language from the old Form 27 that the form “conveys all the rights and privileges afforded under the policy” and that the issuer would give the lender written notice prior to cancellation of the policy. The 2003 Form 28 also contained check boxes for the existence of coverages and specific places for limits and deductibles to be listed, making it easier for lenders to know what the policy provided. ACORD and the Mortgage Bankers Association issued a joint press announcement regarding the new form. A “frequently asked questions” article about the 2003 form by the Mortgage Bankers Association explains the changes in greater detail. The old ACORD Form 27 was revised for use for residential and personal property transactions. The “matter of information only” and “endeavor to mail” language was added to revised Form 27.

Then in July 2006, ACORD issued a revised form of the ACORD 28. The 2006 form provides, “This evidence of commercial property insurance is issued as a matter of information only and confers no rights upon the additional interest named below.” The form also provides that “Should any of the above described policies be cancelled before the expiration date thereof, the issuing insurer will endeavor to mail __ days written notice to the additional interest named below, but failure to mail such notice shall impose no obligation or liability of any kind on the insurer, its agents or representatives.” In other words, for practical purposes the form was changed back to the Form 24. One reason for the change was a concern by the insurance industry that the 2006 Form 28 arguably expanded the insurer’s obligations beyond the terms of the policy. This concern is compounded by the fact that the certificates are usually issued by insurance brokers or agents rather than by the insurance companies themselves.

Lenders have criticized the changes, primarily because of the absence of notice of cancellation of the policy. The Mortgage Bankers Association has issued a statement criticizing the changes. Freddie Mac and other lenders have refused to accept the 2006 Form 28 because the language of the form conflicts with the standard mortgagee loss payment endorsement requiring notice to the lender in case of policy cancellation.

The changes to the form are particularly troublesome for lenders making non-recourse loans, since the property is the only source of repayment of their loans. The 2006 changes in Form 28 also are particularly problematic for the commercial mortgage-backed securities industry. According to the statement of the Mortgage Bankers Association, rating agencies are excluding loans that rely on the 2006 Form 28 from pools of loans that are being securitized.

Attempted solutions

ACORD, recognizing the conflict between the lending and insurance industries regarding the changes to the form, has formed a working group of representatives of the lending and insurance industries to study possible changes to the 2006 Form 28. This group has been meeting weekly since February 2007.

Meanwhile, how are real estate lenders who currently making loans getting comfortable about the existence of property insurance? First, and by far the most common, lenders are requiring the use of the 2003 ACORD form. One potential issue with this practice is whether these forms are approved forms under state regulatory laws. Another potential issue is, if this form is issued by an insurance broker or agent rather than an insurance agent, whether the broker has the authority to issue the 2003 form on behalf of the insurer. Second, lenders are pushing to get the original policies at closing. Certificates are substitutes for the policies themselves, and so if the borrower can get the insurer to get the original policy delivered at closing, there is no need for a certificate. Lenders are generally having mixed success with getting the original policies at closing, however. Third, some lenders making non-recourse loans are adding as a carve-out to the non-recourse any losses caused by the cancellation or amendment of the coverage prior to the delivery of the original policies. There has been pushback from borrowers on this point since the borrower is usually not the reason for the delay in getting the insurance policy. Fourth, some lenders and servicers have been attaching specific provisions of most concern to the lender to the insurance binder.

Conclusion

The extent of resistance to the 2006 changes to the ACORD 28 form makes it likely that some changes eventually will be made to the form that will balance the need of real estate lenders to verify the existence of insurance protecting their collateral with the need for insurers to not expand their liability beyond the terms of their policy. If changes are not made, then the demand for proof of insurance will be generate alternatives to the ACORD form.

Rod Clement is chair of the Section’s Mortgage Lending Committee. He is a member of Brunini, Grantham, Grower & Hewes in Jackson, Mississippi.

**AFFINITY RELATIONSHIPS UNDER RESPA:
MAKING MONEY THE "OLD FASHIONED WAY"[1]**

An Introduction

Affinity relationships are a wonderful means of developing a supplemental income stream. Unfortunately, many affinity relationships are implemented outside of the framework of Section 8 of RESPA.[2] Many times, this is the result of misunderstanding what RESPA requires, and what it does not. This is evident from the settlements[3] entered into by real estate brokers, mortgage brokers, lenders, title agencies, and title companies that were found by HUD to have violated Section 8 of RESPA. Section 8 of RESPA prohibits certain "kickbacks," but that does not explain when a "kickback" is illegal and when it is not.

Consumers understand "kickbacks" as rebates. You buy a product from a retailer, and the manufacturer gives you some of your money back. Businesses understand kickbacks as "referral fees." You work as my employee to find a customer for my goods and services, and you earn a commission. Both of these examples are "kickbacks," but neither example is prohibited by RESPA. Therein lays the confusion. A reasonable person does not understand why "scratching someone's back" can be an illegal kickback if it benefits both parties, and what "magic bullet" makes it a legitimate relationship.

Section 8(a) of RESPA[4] prohibits paying or receiving any fee or other thing of value (even a referral) in return for the referral of "settlement services" in a "federally related transaction." Section 8(b)[5] of RESPA states that a person cannot accept a settlement service fee, or a split of a settlement service fee, in a "federally related transaction" without providing "settlement services." Just as the commandment, "Thou shall not kill" does not elucidate the exceptions for self defense, military action, and police action, the above prohibitions do not describe the exceptions to the rule.

Most real estate professionals and home builders are looking for supplemental sources of income. Section 8(c) of RESPA[6] gives us a number of exceptions to the prohibition against kickbacks that permit such compensation. The most useful exception in Section 8(c) of RESPA is the "goods and services" exception.[7] A settlement service provider may pay for substantive goods and services, even when the payee refers consumers to the provider for settlement services. The payment must be earned for goods and services, not for the referral of mortgage loan customers, and not for services that duplicate services already provided as part of the loan origination process. Just as lenders "bundle" settlement services, real estate agents, builders, and other referral sources may "bundle" their services to benefit mortgage brokers and lenders, and receive fair compensation for these services. Mortgage brokers and lenders, to a lesser extent, may bundles services and sell these to title agencies. There are a number of ways for mortgage brokers and mortgage lenders to interact with real estate professionals, title agencies, residential builders, and others, to earn additional income by utilizing this exception. The keys to developing these affinity relationships are (a) to find a "bundle of services" that benefits both parties, and (b) to identify the market rate payable for these services. The parties must then identify the goods and services provided in a written agreement, and to pay no more than market rates for the goods and services. Any amount in excess of market rates will be inferred to be an illegal kickback for the referral of business.

Adding services to a transaction, or providing cash rebates to the borrower as part of the “bundle,” gives the borrower an incentive to choose to receive mortgage origination services or title and escrow services through the affinity relationship.[8] This drives additional compensation to the affinity partners. The result is a win-win arrangement for the mortgage professional, the affinity partner and the consumer.

Does RESPA Apply?

The first question a law professor would ask is whether the transaction is subject to RESPA. RESPA only applies to “federally related transactions.” Any person or entity originating one million dollars or more of residential mortgage loans in a calendar year that is also subject to disclosure requirements of the Truth in Lending Act (TILA) generates “federally related transactions.” Any transaction that is assisted with money from the federal government, or is insured or guaranteed by the federal government, or is sold to FNMA or FHLMC, is a “federally related transaction.” Hence, we perceive all mortgage transactions as subject to RESPA, but that is not the case. The following are exempt from RESPA:

- Typical one-time seller financing that is not valued at over one million dollars, or the seller does not engage in a sufficient number of transactions to be a “creditor” subject to TILA.[9]
- Business purpose credit transactions that are exempt from TILA. For example, a mortgage loan to an investor to acquire residential rental property is a business purpose loan that is not subject to TILA or RESPA.[10]
- Cash transactions are not subject to RESPA.

HUD also carved out other loans from RESPA by rule[11]:

- Loans secured by 25 contiguous acres are not subject to RESPA.
- Loans secured by multi-family housing (5 or more units).
- Loans secured solely by land that will not be developed for at least two years.

In contrast, some transactions that we might assume are exempt from RESPA are still subject to the anti-kickback rule:

- Construction loans if the lender makes the end loan, or the borrower buys the lot with the first draw.
- Home equity lines of credit even though certain disclosures are excused.
- Loan modifications if the note is replaced or the mortgage is amended.
- Mortgage assumptions if the lender must approve the assumption.

Discussion of these exceptions is largely an academic exercise. RESPA applies to the majority of residential mortgage transactions. For the remainder of this article, we will ignore transactions that fall outside of the scope of RESPA, and concentrate on core businesses dependent upon residential mortgage transactions.

What is an Illegal Kickback?

To understand what RESPA prohibits, you must grasp and thoroughly digest the definition of an illegal kickback. Section 8(a) of RESPA states:

> ***"No person shall give and no person shall accept any fee, kickback, or thing of value pursuant to any agreement or understanding, oral or otherwise, that business incident to or a part of a real estate settlement service involving a federally related mortgage loan shall be referred to any person."***

There are three elements to an illegal kickback: (1) a "thing of value," (2) an "agreement or understanding," and (3) a "referral." If any of these three essential elements is missing, the activity is not illegal under RESPA. Section 14 of HUD's Regulation X[12] defines each of these three elements:

Things of Value

First, a "thing of value" "includes, without limitation, monies, things, discounts, salaries, commissions, fees, duplicate payments of a charge, stock, dividends, distributions of partnership profits, franchise royalties, credits, future opportunities, chances, retained or increased earnings, increased, accounts, special or unusual contract terms, reduced rates for goods and services, increased payments for goods and services, lease or rental payments based in whole or in part on the amount of business referred, payment of another person's expenses, or reduction in credit against an existing obligation."[13] When HUD refers to a "payment," it means the giving of anything of value, whether it is money, a chance to win a prize, a referral, or some future consideration.

Lesser known examples of a "thing of value" include:

- Defraying costs that a party would ordinarily have to pay, such as the cost of mandatory continuing education courses.
- Promising to provide a referral in the future (an agreement for mutual referrals).
- Chances in a lottery or raffle (the ticket has a value, win or lose).
- Providing something that has a dual use may be a thing of value if used for two purposes (e.g. a non-dedicated fax machine).
- Promising an appraiser that he will perform the appraisal for each borrower the appraiser refers to a related lender.

There is no "de minimis" kickback that escapes scrutiny under RESPA. Contrary to popular belief, a gift under $25 is not exempt from being a "thing of value," and charitable contributions are not exempt from the rule. Nevertheless, there is a point at which the "thing of value" becomes too attenuated to identify. For example, a referral to an affiliate cannot be directly compensated. However, the referral contributes to the overall profitability of the combined enterprise, and increases the pool from which all employees are paid a bonus. The incremental increase in the referring employee's bonus is too attenuated from the referral to be a "thing of value" paid for the referral. The point of "no return" must be evaluated on a case by case basis.

Agreement or Understanding

You know an agreement exists when you see it. An agreement or understanding for the referral of settlement service business can be oral, written, or 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. Requiring the borrower to use a particular service provider infers that an agreement or understanding exists for the referral of business.[14]

There are several exceptions to this definition. First, the borrower cannot be a party to a kickback in his own loan transaction. Defraying the borrower's closing costs to persuade the borrower to take a loan is not a kickback. Paying a borrower to refer friends and family is an illegal kickback. Second, some Federal Appellate Courts have ruled that unilaterally increasing the price of a third party service fee (and keeping the difference) is not an illegal kickback because there is no agreement.[15] There is a split of opinion on this issue, with HUD and state regulators opposing this practice.

Referral

"Referral" is defined two ways. First, a referral includes any oral or written action directed to a person that has the effect of affirmatively influencing the person to use a particular settlement service provider and pay a fee for the service. Second, a referral also occurs whenever a person paying for a settlement service is required to use a particular provider of a settlement service. "Required use" means a situation in which a person must use a particular provider of a settlement service and pay their fee in order to have access to some distinct service or property.[16]

There are exceptions that do not constitute a "referral." First, providing a bundle of services that is significantly discounted from the cost of the individual services does not constitute a "required use" of the provider of the services. For example, a lender that negotiates with settlement service providers for substantially reduced charges so that an origination fee of $300 covers the automated underwriting system fee (AUS), credit report, and appraisal services does not require the use of the AUS service, credit bureau and appraiser if the ordinary actual cost of the services provided individually would be $400.[17]

Second, a mortgage originator can buy leads if the person selling the leads does not mention the name of, or do anything to influence the consumer to contact, the broker, lender or other settlement service provider. No endorsements, no hints, no nothing. The broker or lender does all the soliciting of the lead. There are several important caveats to buying leads, such as the requirement that financial institutions must maintain the confidentiality and security of non-public consumer information (with certain exceptions).[18]

<u>Illegal Kickbacks Are Like a Three Legged Stool</u>

Think of an illegal kickback as a three legged stool. If any of the three legs are missing, the stool falls over. The same is true under RESPA. If any of the three elements of a kickback is missing, or an exception exists for one of the elements, the transaction is not illegal. Each element must be evaluated individually.

No Agreement

It is easy to presume that an agreement exists when the person making the referral receives a benefit from the recipient of the referral. It is difficult to prove that an agreement exists if (a) the thing of value does not directly benefit the party providing a referral, or (b) the thing of value does not originate from the person receiving the benefit of the referral. You need to show the existence of some independent action by one of the parties tying the payment to the referral when there is an indirect benefit. Take the example where a mortgage lender offers to pay for the cost of the title commitment for any borrower referred to him by a real estate salesperson. The lender's payment of a title premium, defrays the seller's cost, not the realtor's costs. The real estate salesperson is making the referral, not the seller. If there is no agreement or understanding tying the seller's benefit with the referral by the real estate salesperson, the payment is legal. However, if the real estate salesperson used the mortgage lender's payment to negotiate his commission (with the lender's knowledge), that action ties the payment to the referral, and the payment is an illegal a kickback.

Let's try this one more time. A mortgage broker gives coupons to builders for $1000 off the buyer's closing costs in return for the referral of home buyers for a loan. The coupon that defrays the buyer's cost, not the builder's costs. Ordinarily, the buyer cannot be a party to a kickback in his own loan, and the coupons are legal. However, if the builder uses the coupon to negotiate up his construction price, there is a kickback. Furthermore, if the mortgage lender gives the coupons only to builders who give him referrals, there may be a kickback.

Our third example demonstrates the effect that an intervening borrower will have on a referral fee. A lender pays $100 to a church for each member who closes a loan. The church advertises the loan program to its members and encourages them to borrow from the lender. If the lender writes the check to the church, it is a kickback. If the lender writes the check to the borrower, who then voluntarily signs the check over to the church, there is no kickback. The borrower cannot be a party to a kickback in his own loan transaction since the borrower is protected by RESPA. Hence, the borrower breaks the connection between the settlement service provider and the church making the referral for a fee.

Change the facts a little. The lender buys the church membership list and solicits the members. Loan officers attend the church picnic to pass out fliers advertising loan products. If the lender pays for access to the picnic (other than the cost of the meal and other activities for the loan officers), there may be a kickback. If the church endorses the lender, there may be a kickback. If the lender hires the pastor to take loan applications, there may be a kickback (depending on whether the pastor is a bona fide employee of the lender).

No Referral

Selling leads is not an illegal kickback because there is no a referral. A lead company finds consumers who are willing to apply for a loan, but the lead company does not take any action directed at the consumer to influence the consumer to use any particular lender. Only the lenders that buy leads solicit consumers to apply for a loan. Why don't lenders buy leads from the public at large? A lender that gives the borrower $50 for giving him the names of friends and relatives who are looking to refinance or to buy a home is purchasing a list. The borrower is not asked to do anything to influence friends and relatives to use the lender. However, the borrower cannot refrain from telling his friends about the lender, and the lender expects this to occur. Even if the lender ordered the borrower not to solicit for the lender, the lender cannot guaranty that the borrower will refrain from making referrals. If the borrower breaks his promise, and talks about the lender after receiving his $50, both the lender and the borrower are liable for a violation of Section 8.

No Thing of Value

The classic example is the lender that rents space in a title agency's building and refers borrowers to the title agency for title insurance. An illegal kickback could exist if the title agency were giving something of value to the lender. If the lender is paying market rates or above market rates for rent, it is not receiving anything of value for its referrals. If, however, the lender is paying below market rent, the difference is presumed to be a benefit for the referral of settlements service business.

The discounted value of title services was the basis of significant litigation in Michigan over the past several years.[19] Assume that title agencies charge $25 to a builder for the owner's title policy, and the buyer pays the remainder of the basic fee for the mortgage policy. Does the discount represent a benefit paid to the builder for referring business to the title agency? There are good arguments on each side of this issue. The title agency has less work to write title commitments for the lots because the title agency is able to perform one search for the whole project, and then just provide an update for each lot. On the flip side, the reduced cost of the owner's policy is an inducement for the builder to send all of his title business to the one title agency, and refer all borrowers there as well. If the title agent were truly lowering its fees due to decreased work, it would lower the basic insurance fee (to benefit the borrower and the builder). Furthermore, title insurance is priced according to the amount of coverage. The $25 premium is not related to the level of risk assumed by the title underwriter. The implication is that the significantly discounted insurance premium is a kickback. Large settlements occurred in Michigan cases, resulting in title companies paying tens of millions of dollars in damages for overcharging borrowers for title insurance on new construction.

Section 8(b) of RESPA – The Other Shoe

The "little brother" of Section 8(a) of RESPA is Section 8(b):[20]

> "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 real estate settlement service in connection with a transaction involving a federally related mortgage loan other than for services actually performed."

Section 8(b) prohibits a mortgage broker or a title agent from taking a fee without providing substantial services. That much was established in two HUD Statements of Policy. HUD Statement of Policy 1999-1[21] defined the minimal services that a mortgage broker must perform to earn a fee. HUD Statement of Policy 1996-4[22] defined the core title services that a title agency must perform to earn the title insurance premium. The Statement of Policy covering mortgage broker fees was needed to stem a tide of litigation that threatened to swamp the mortgage broker industry.[23] The Statement of Policy regarding title insurance services was needed to stem business arrangements that allowed referral sources to earn a fee without providing much in the way of services.

The minimal services that a mortgage broker must perform were first espoused by HUD in an informal letter to the Independent Bankers Association of America, dated February 14, 1995. This letter identified fourteen services that a mortgage broker may perform to originate a mortgage loan. These include:

> (a) Taking information from the borrower and filling out the application;
> (b) Analyzing the prospective borrower's income and debt and pre-qualifying the prospective borrower to determine the maximum mortgage that the prospective borrower can afford;
> (c) Educating the prospective borrower in the home buying and financing process, advising the borrower about the different types of loan products available, and demonstrating how closing costs and monthly payments could vary under each product;
> (d) Collecting financial information (tax returns, bank statements) and other related documents that are part of the application process;
> (e) Initiating/ordering VOEs (verifications of employment) and VODs (verifications of deposit);
> (f) Initiating/ordering requests for mortgage and other loan verifications;
> (g) Initiating/ordering appraisals;
> (h) Initiating/ordering inspections or engineering reports;
> (i) Providing disclosures (truth in lending, good faith estimate, others) to the borrower;

(j) Assisting the borrower in understanding and clearing credit problems;
(k) Maintaining regular contact with the borrower, realtors, lender, between application and closing to apprise them of the status of the application and gather any additional information as needed;
(l) Ordering legal documents;
(m) Determining whether the property was located in a flood zone or ordering such service; and
(n) Participating in the loan closing.

These fourteen services were incorporated into HUD Statement of Policy 1999-1 published on March 1, 1999. HUD's Statement of Policy required a mortgage broker to provide five services from the list above in addition to taking the loan application. HUD also recognized that services (b), (c), (d), (j), and (k) on the list above were "counseling type" services that could provide more of a substantive benefit to the lender than to the borrower. Hence, a mortgage broker's services would be closely scrutinized if the mortgage broker provided only these five "counseling services."

HUD acknowledged that these are not the only services that a mortgage broker may provide, and that some of these services may be provided through technology rather than the efforts of a mortgage broker. Nevertheless, the important principle of this Statement of Policy is that it provided a safe harbor for mortgage brokers. Mortgage brokers could earn a fee by providing a limited number of identifiable services. Furthermore, the mortgage broker's total compensation should be measured against the totality of the services provided. Class action lawsuits that separately measured the services provided to the mortgage lender and services provided to the borrower against the amount that each party paid were no longer viable.

> HUD's Statement of Policy 1996-4 established minimum title agency services:
>
> "Section 8(c)(1)(B) specifically exempts payments of a fee 'by a title company to its duly appointed agent for services actually performed in the issuance of a policy of title insurance.' A more general provision, section 8(c)(2), exempts the '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.' (See also 24 CFR 3500.14(g)(1).)….
>
> "To qualify for a section 8(c)(1)(B) exemption, the attorney title insurance agent must 'provide his client with **core title agent services for which he assumes liability, and which includes, at a minimum, the evaluation of the title search to determine insurability of the title, and the issuance of a title commitment where customary, the clearance of underwriting objections, and the actual issuance of the policy or policies on behalf of the title company.**'"

More specifically, HUD defined five services that a title agency must perform to earn the entire its portion of title insurance premium (typically 70% to 85% of the premium) without scrutiny of the split between the agency and the underwriter:

> “’Core title services’ are those basic services that a title insurance agent must actually perform for the payments from or retention of the title insurance premium to qualify for RESPA’s section 8(c)(1)(B) exemption for ‘payments by a title company to its duly appointed agent for services actually performed in the issuance of a policy of title insurance.’ In performing core title services, the title insurance agent must be liable to his/her title insurance company for any negligence in performing the services. In considering liability, HUD will examine the following type of indicia: the provisions of the agency contract, whether the agent has errors and omissions insurance or malpractice insurance, whether a contract provision regarding an agent's liability for a loss is ever enforced, whether an agent is financially viable to pay a claim, and other factors the Secretary may consider relevant.
>
> “’Core title services’ mean the following in Florida:
> a. The examination and evaluation, based on relevant law and title insurance underwriting principles and guidelines, of the title evidence (as defined below) to determine the insurability of the title being examined, and what items to include and/or exclude in any title commitment and policy to be issued.
> b. The preparation and issuance of the title commitment, or other document, that discloses the status of the title as it is proposed to be insured, identifies the conditions that must be met before the policy will be issued, and obligates the insurer to issue a policy of title insurance if such conditions are met.
> c. The clearance of underwriting objections and the taking of those steps that are needed to satisfy any conditions to the issuance of the policies.
> d. The preparation and issuance of the policy or policies of title insurance.
> e. The handling of the closing or settlement, when it is customary for title insurance agents to provide such services and when the agent's compensation for such services is customarily part of the payment or retention from the insurer.”

Controversy exists regarding core title services and retained risk, even after this guidance was published. For example, title plants provide an electronic document that mimics Schedule B of a title commitment. HUD’s position is that “if the title insurance company provides its title insurance agent with a pro forma commitment, typing, or other document preparation services, the title insurance agent is not ‘actually performing’ these services. As such, the title insurance agent would not be providing ‘core title services’ for the payments to come within the section 8(c)(1)(B) exemption.” What level of scrutiny of the title search is required before the commitment can be generated from the search document? Does the agency fulfill its obligation to provide all “core title services” if the title agent simply accepts the document provided by the search service and pushes a few keys to create the commitment?

Controversy also exists regarding the sharing of risks between insurance companies. State Insurance Commissioners recently fined several title insurance companies for entering into reinsurance agreements with title companies owned by builders. The reinsurance agreement paid the builders’ reinsurance companies a fee that was disproportionate to the risk that the reinsurer absorbed. The Commissioners found that splitting the insurance premium, without absorbing substantial risk, violated state insurance codes and RESPA.

HUD has not officially established minimum or core services that other settlement service providers must perform to earn a fee. Therein lays a problem. Section 8(b) implies that splitting a fee by agreement is illegal if no services are performed. However, is a modicum of service all that is necessary to earn a substantial fee? Furthermore, is it illegal to take a fee without providing a service when there is no second party that knowingly splits the fee? Without guidance from HUD, the issue of what other settlement service providers must do to earn a fee was left to the courts.

Back to Court

Once litigation subsided over mortgage broker fees, borrowers increasingly challenged miscellaneous lender compensation. Borrowers claimed that document preparation fees greatly exceeded the actual cost of preparing closing documents, underwriting fees exceeded the cost charged by automated underwriting systems, credit report fees exceeded the cost of the credit report, and that some lenders were making excessive profits from "junk fees." These claims took two forms. First, borrowers claimed that lenders cannot make a profit from third party services. These profits are termed "markups." Second, borrowers claimed that lenders cannot charge excessive fees, far above the cost or the value of services provided. These profits are termed "overcharges" or "overages." HUD supported claims in *amicus* briefs filed in various borrower lawsuits that markups and overcharges violate RESPA.

Markups

HUD and the Department of Justice enforce an informal policy that a settlement service provider cannot earn a fee without providing substantial services. HUD will take action against a lender or title agency that marks up third party settlement service fees passed on to the borrower. Markups typically occur when a service provider (typically a credit bureau) bills a lender monthly for services, or the actual cost (e.g. the recording fee) is determined after the closing. Charges for online credit reports vary (typically ranging from $8 to $15). The lender may have no idea what the credit report costs at the time of closing and, therefore, the lender charges the borrower a flat fee that is the average cost of the credit report. Title agents also charge flat fees for recording documents since they do not know until just before the closing how many pages are in the deed and mortgage.

HUD believes that each borrower should pay no more than the actual cost for third party services. Hence, anyone who paid $12 for an $8 credit report is entitled to a refund. HUD has fined several lenders for these infractions. While some fines have been substantial, many fines imposed by HUD were a few thousand dollars per lender – amounts too small to be economically worthwhile to contest.

Consumers have been less successful arguing to a court that they should receive compensation for fee markups. Three Circuit Courts of Appeals held that Section 8(b) clearly and unambiguously does not prohibit mark-ups.[24] These courts held that:

- There is no violation of RESPA when there is no agreement or understanding between the credit bureau and the lender, or between the title agent and the Register of Deeds, that the lender would keep the difference between the charge to the borrower and the actual cost of the service.
- Section 8 requires a court to find two parties guilty. The only other party to the transaction is the borrower, but the borrower cannot be a party to a kickback in the borrower's own loan. Holding the borrower liable under a statute designed to protect the borrower leads to an absurd result.

Later court decisions by three different Courts of Appeals deferred to the arguments espoused by HUD to hold that a markup could be a kickback.[25] However, if the service provider can show that it rendered some service that can be compensated (and there is no overlap of other compensation or fee for the service), then there is no kickback. In theory, a lender or a title agent can earn a fee for almost anything. Enforcement of HUD's position has been limited in the past few years. Instead, state regulators have fined lenders for marking up credit reports on the basis that state laws expressly limit fees collected for third party services to the actual cost of these services.

There are several means of avoiding this issue:

- Raise the origination fee to bundle the origination of the loan with the credit report fee, and show the flat fee to the credit bureau or to the Register of Deeds as an estimated POC payment.
- Charge a credit review fee instead of a credit report fee, and show the flat credit report fee as an estimated POC payment.
- Increase the closing fee to include the cost of recording documents, and show an estimated POC payment to the Register of Deeds.
- Charge a recording service fee in addition to the fee charged by the Register of Deeds.

All of these methods are being used to level out the cost of services. However, a more prevalent practice creeping into the market is to increase "junk" fees rather than to bundle fees. HUD has, in effect, opened a Pandora's Box by making a mountain out of a molehill. Consumers are now paying more for incremental services than they did by paying an average amount for the cost of the third party service.

Overcharges and Overages

HUD and the Department of Justice have also argued, unsuccessfully to this point, that an excessive fee violates Section 8(b) of RESPA. HUD's argument, asserted in Statement of Policy 2001-1,[26] is that "A single service provider . . . may be liable under Section 8(b) when it charges a fee that exceeds the reasonable value of goods, facilities, or services provided." HUD's argument is based on a statement in Regulation X: "If the payment of a thing of value bears no relationship to the goods or services provided, then the excess is not for services or goods actually performed or provided." In HUD's view, too many points, an oversized document preparation fee, or too high of a yield spread premium, is a fee split – the borrower is charged a reasonable fee for services, and the borrower is charged an additional amount for which the borrower receives no benefit. However, the 1973 legislative history of RESPA indicates that Congress rejected an explicit price control proposal when RESPA was enacted. Instead, it directed HUD to report to Congress on "whether Federal regulation of the charges for real estate settlement services in federally related mortgage transactions is necessary and desirable."[27] Congress took no further action regarding price controls. Thus the courts rejected HUD's argument since it was based on a HUD rule which was not supported by RESPA.

Exceptions to the Rule

Every rule has its exceptions, including Section 8 of RESPA. Five principal exceptions to the kickback rule (in addition to the "missing stool leg" concept discussed previously) are used to create affinity relationships between settlement service providers:

1. Payments for rendering services or providing goods.

Section 8(c) of RESPA allows payments for bona fide services and goods actually received, regardless of whether the party receiving the payment refers business to the party paying for the services and goods.[28] These services and goods typically take the form of subleases, desk licenses, joint advertising, marketing services, and other miscellaneous services. There are several caveats to this exception:

a. The services or goods must be bona fide. Simply stating that services and goods will be provided is not sufficient.

b. The services and goods must be provided on a commercially reasonable basis. A real estate broker that rents a conference room for loan closings, or subleases space as an executive office suite, must provide the same amenities and services that a conference center or an executive office suite would provide.[29]

c. The services or goods must be utilized. A lender or a title agency cannot rent space from a real estate broker that the lender or title agency does not intend to use.

d. The payment must be commensurate with the services rendered or the goods provided. If the marketplace rents conference rooms by the hour, a title agency may rent a conference room from a real estate agent by the hour – but not at a flat rate per closing.

e. No part of the compensation can be for the referral of business. A clause agreeing to refer business to each other is illegal since a "lead" is a thing of value.

HUD will presume that any markup of third party services and goods by a person in a position to refer settlement service business is a payment for the referral of business. If a real estate broker sublets a bare office to a lender, the rent should be based on actual cost, and should not be marked up.[30] Services and charges for services provided by a referral source should be uniform. Real estate brokers should not charge a higher desk license fee to a lender simply because the lender may make a significant profit from referrals. Furthermore, office services provided to a lender under a desk license should be comparable to the office services provided by a real estate broker to its real estate salespersons with a desk license.

A real estate broker may charge more than its cost per square foot to sublet an office to a lender or title agent if the real estate broker provides extra services on a commercially reasonable basis. A real estate broker may provide postage, copying, fax, reception, conference rooms, etc., in addition to renting an office to a mortgage lender. If the real estate broker provides these services on a commercially reasonable basis, e.g. comparable to the service provided in an executive office suite, the real estate broker may price the subleased office comparable to the cost of space in a local executive office suite. If services provided to a lender are the same as are provided to a real estate salesperson with a desk license, the real estate broker should justify the license fee based on the market rate for the desk license. If the mortgage lender will use fewer services than a real estate salesperson, reduce the desk license fee accordingly. It is imperative that a lender or other settlement service provider should never pay a premium for introductions or referrals to business opportunities.

Similarly, a mortgage company or a title agency should not pay for "make work" that has little or no value. For example, marketing agreements that require the "service" of real estate salespersons to attend educational programs, or that require "access" to real estate professionals, are questionable at best. What is the utility of such a "service"? Marketing efforts should be justified under the education and marketing exception discussed below.

2. Affiliated Business Arrangements

The owners of a mortgage company, title agency, real estate brokerage, and/or other settlement service providers may earn a profit from a bona fide business investment,[31] even when some of the profit is generated through leads sent to the partially owned business, provided that:

a. The borrower must receive a copy of an Affiliated Business Arrangement Disclosure at the time a referral is made to an affiliated business. The model form of this disclosure[32] must be used to create a disclosure for each affiliate (do not delete Section B. of the model form, and settlement service fees should expressed in dollars, not percentages). An acknowledgement in the disclosure must be executed by the borrower no later than at closing, and the signed disclosure must be retained for five years.

b. A person cannot require the borrower to use the services of an affiliated business. An exception allows a lender to require a borrower to pay for the services of an affiliated appraisal company or credit bureau, or an attorney who represents the lender.

c. The profits of the affiliated business must be distributed according to percentage ownership, and percentage ownership should be determined by percentage of capital invested. Capital investment requirements cannot be reduced based on the expectation of leads generated for the affiliated business.

d. The affiliated business must be a living, breathing entity that performs services or provides goods, and earns income commensurate with these services and goods. Shell (or sham) affiliated business arrangements are prohibited by HUD Statement of Policy 1996-2.[33]

Remember also that HUD informal policies and HUD Statements of Policy 1996-4 and 1999-1 require any title agency, mortgage brokerage, or other settlement service business to provide substantive services. Any settlement service business must have at least one bona fide employee to perform substantive services. Fee splitting between affiliated businesses based on a split of substantive services is difficult and often runs afoul of secondary market or insurance underwriter requirements.

3. Secondary Market Sales

Prices paid by investors and borrowers to mortgage broker/lenders in table funded transactions must be commensurate with the level of work that the broker/lender provided toward originating the loan and completing the transaction. Mortgage brokers do not "own" an application or a loan, and the borrower is not anyone's "property." However, premium prices paid by an investor to buy a loan from a lender are beyond the oversight of HUD.[34] A lender's ownership of a loan is established by two factors, both of which must be present:

a. The lender must use its own money, either from its assets or from a warehouse line of credit, to fund or purchase the loan. However, a lender should not fund a loan with a warehouse line of credit that is provided by the loan purchaser, especially when the warehouse line can only be used to fund loans sold to the warehouse lender. These arrangements blur the line between a table funded loan and a true secondary market transaction. The potential penalties for a violation of Section 8 of RESPA are so harsh (triple damages, costs, attorneys fees, fines, and incarceration for a year) that it is not worth the risk to "test" a secondary market relationship in which the investor and its affiliates fund the closing and purchase the loan.

b. The lender must hold the loan long enough to establish title to the loan. Ownership of a loan for at least one day is necessary. Many lenders take a conservative approach, and hold the loan for at least two or three days after funding before selling the loan to an investor.

4. Educational and marketing expenditures.

Ordinary educational and marketing expenditures are exempt from scrutiny under RESPA, provided that the expenditure is referral neutral and it does not defray costs ordinarily incurred by the recipient.[35] A weekend retreat and education program provided for real estate professionals, or tickets to a sporting event or a golf outing, are acceptable, provided that the invited target audience is based on bona fide business criteria (such as all of the real estate agents operating in a geographic area), and the invitation is not conditioned on the past, present, or future referral of business. Providing a free CLE course required for licensure would not be permitted because it is a cost that the recipient would ordinarily incur.

The hard part of marketing is being referral neutral. Rewarding builders with golf outings and sports tickets for referrals is prohibited. You can beg, but you cannot blackmail, bribe, compensate, extort, manipulate, reward, payoff, shakedown, or threaten referral sources to make referrals. Please also note that some state licensing laws prohibit gifts and other expenditures to obtain leads.[36]

5. Bona Fide Employment.

Section 14(g)(iv) and (vii) of HUD's Regulation X permit:

"(iv) A payment to <u>any</u> person of a bona fide salary or compensation or other payment for goods or facilities actually furnished or for services actually performed;" and

"(vii) An employer's payment to its own employees for <u>any</u> referral activities." (emphasis added)

Settlement service providers should be able to hire pure "finders" and "rainmakers" that have no responsibilities other than to generate new clients for a settlement service business and its affiliates. However, HUD gave us a different message in a settlement agreement with Znet Financial. HUD fined Znet for paying $400 to real estate salespersons for each application for credit completed for Znet. Znet claimed that the real estate salespersons were employees being paid bona fide compensation, but HUD disagreed.

This settlement sends a clear message that certain employees must perform substantive services (similar to a mortgage broker's services) to earn bona fide compensation. That is not what the rule says, but that is how HUD enforces its rule. HUD will only allow an employer to compensate bona fide employees. Furthermore, compensation may only be paid for settlement services benefiting the employer. For example, HUD will allow a company to compensate employees for referring new business to their employer, but HUD will fine a company for paying compensation to employees for referring business to the employer's affiliate.[37]

HUD evaluates twenty factors outlined in IRS Revenue Ruling 87-41 to determine whether a person is a "bona fide" employee or an independent contractor. Unfortunately, we do not know how may of these factors must be satisfied under HUD scrutiny, or which factors weight more heavily than others. The twenty factors are:

i. **INSTRUCTIONS**. A person who is required to comply with other persons' instructions about when, where, and how he or she is to work is ordinarily an employee. HUD will ask whether the employer has the right to require compliance with instructions.

ii. **TRAINING.** HUD will ask whether the employer trains employees by requiring an experienced employee to work with a new employee, by corresponding with employees, by requiring employees to attend staff meetings, or by using other methods, and whether the employer wants work performed in a particular manner.

iii. **INTEGRATION**. An employee must necessarily be subject to a certain amount of control by the owner of the business. Integration of the employee's services into the employer's operations generally shows that the employee is subject to direction and control of the employer.

iv. **SERVICES RENDERED PERSONALLY**. HUD will ask what services must be rendered personally by the employee to accomplish the required work and to achieve the expected results.

v. **HIRING, SUPERVISING, AND PAYING ASSISTANTS**. Management responsibility for hiring, supervising, and paying assistants shows control over employees on the job. Independent contractor status is indicated if the employee hires, supervises, and pays assistants to do work for the employee. HUD will examine a written employment contract to determine whether the person is an employee who follows management direction, or whether the person is an independent contractor who provides materials and labor and under which the contractor is only responsible only for the attainment of a result. HUD will also ask whether "employees" hire their own assistants, and how the assistants are compensated.

vi. **CONTINUING RELATIONSHIP**. HUD will ask whether there is a continuing relationship between the employee and employer. A continuing relationship may exist where work is performed at frequently recurring although irregular intervals.

vii. **SET HOURS OF WORK**. Set hours of work indicate employer control of the employee. Part time employees should have regular work hours, and all employees subject to minimum wage or overtime requirements should complete time sheets to document regular hours and a continuing employment relationship.

viii. **FULL TIME REQUIRED**. True employment is indicated if (a) the employee must devote substantially full time to the employer's business, (b) the employer controls the amount of time the employee spends on the job, or (c) the employer restricts the employee from doing other gainful work. An independent contractor is free to work when and for whom he or she chooses.

ix. **DOING WORK ON EMPLOYER'S PREMISES**. The employer presumably controls the employee's activities if work is performed in the employer's offices, especially if the work could be done elsewhere. Work done off the premises of the employer, such as originating loans from home, indicates some freedom from control. However, this fact by itself does not mean that the person is not an employee. Control over the place of work is also indicated when the employer has the right to compel the employee to travel a designated route (e.g. who makes out of town travel arrangements for business trips?), to canvass a territory within a certain time, or to work at specific places as required.

x. **ORDER OR SEQUENCE SET**. The fact that an employee must perform services in the order or sequence set by the employer shows that the employee is not an independent contractor. Often, the employer does not set the order of the services or sets the order infrequently. It is sufficient to show control, however, if the employer retains the right to establish a sequence of job functions. In mortgage lending, the sequence of events in the origination of a loan is determined largely by state and federal disclosure requirements.

xi. **ORAL OR WRITTEN REPORTS**. A requirement that the employee submit regular or written reports to a manager or main office indicates a degree of employer control.

xii. **PAYMENT BY HOUR, WEEK, MONTH**. Payment by the hour, week, or month generally points to an employer-employee relationship, provided that this method of payment is not just a convenient way of paying a lump sum agreed upon as the cost of a job. Payment made by the job or on a straight commission generally indicates that the worker is an independent contractor.

xiii. **PAYMENT OF BUSINESS AND/OR TRAVELING EXPENSES**. An employer ordinarily pays employee business and/or traveling expenses. An employer, to be able to control expenses, generally retains the right to regulate and direct employee business activities.

xiv. **FURNISHING OF TOOLS AND MATERIALS**. Employers ordinarily furnish significant tools, materials, and other equipment (e.g. laptop and loan origination software) to allow employees to complete their work.

xv. **SIGNIFICANT INVESTMENT**. Persons that invest in employer facilities that are not typically maintained by employees (e.g. computer system leases) tend to be independent contractors. On the other hand, lack of investment in the employer’s business indicates dependence on the employer for such facilities and, accordingly, the existence of an employer-employee relationship. Special scrutiny is required with respect to home offices.

xvi. **REALIZATION OF PROFIT OR LOSS**. A person who can realize a profit or suffer a loss as a result of the person’s services (in addition to the profit or loss ordinarily realized by employees) could be an independent contractor (or a partner), but the person who cannot is an employee. For example, if a person is subject to a real risk of economic loss due to significant investments or a bona fide liability for expenses, such as salary payments to unrelated employees, that factor indicates that the person is an independent contractor. The risk that an employee will not receive payment for his or her services, however, is common to both independent contractors and employees, and thus does not constitute a sufficient economic risk to support treatment as an independent contractor.

xvii. **WORKING FOR MORE THAN ONE FIRM AT A TIME**. If an employee performs services for several unrelated firms <u>at the same time</u>, that factor generally indicates that the person is an independent contractor. However, a person who performs services for related employers may be an employee of each business. As a general rule, state licensing laws dictate that an employee of a financial services company may only work for one licensee.

xviii. **MAKING SERVICE AVAILABLE TO GENERAL PUBLIC**. The fact that a person makes his or her services available to several firms on a regular and consistent basis indicates an independent contractor relationship.

xix. **RIGHT TO DISCHARGE**. The right to discharge an employee is a factor

indicating an employee-employer relationship. An employer exercises control through the threat of dismissal, which causes the employee to obey the employer's instructions. An independent contractor, on the other hand, cannot be fired so long as the independent contractor produces a result that meets the contract specifications.
xx. **RIGHT TO TERMINATE**. If the employee has the right to end his or her relationship with an employer at any time he or she wishes without incurring liability, that factor indicates an employer-employee relationship.

Other exceptions

Several other exceptions are listed in the statute and regulation; however, these exceptions have not been used to establish affinity relationships between different types of settlement service providers. These include:

a. <u>Cooperative brokerage arrangements.</u> HUD will not examine the split of bona fide real estate broker commissions. Real estate professionals are subject to RESPA in all other respects.

b. <u>The split of title premiums between the title agent and the title underwriter.</u> HUD will not question whether a typical 80%-20% split is reasonable if the title agency performs all core title services.

c. <u>Bona fide attorney fees.</u>

HUD has authority to create other exemptions, but that is unlikely.

Special Title Agent Rules Lead to Special Litigation

Some of the usual avenues of developing business are not available to title agencies. Section 9 of RESPA[38] states:

> ***"No seller of property that will be purchased with the assistance of a federally related mortgage loan shall require directly or indirectly, as a condition to selling the property, that title insurance covering the property be purchased by the buyer from any particular title company."***

This means that one of the title agent's best source of referral business - the form purchase agreement given to the seller - cannot specify that the buyer will use a particular title agent to purchase the mortgagee title insurance policy.

Furthermore, some state laws and rules prohibit or restrict affinity relationships by (a) limiting the amounts that title agencies and underwriters can spend on marketing, (b) prohibiting rebates to insured parties or reductions in filed rates, or (c) prohibiting payments for leads. Hence, title agencies and companies engage in joint ventures to generate referral business more than other settlement service providers.

Joint ventures between title agencies and real estate brokers work well, provided that there is a sufficient volume of referrals to make the joint venture profitable. The real estate broker partner refers sellers to the affiliated title agency to purchase the owner's policy. The title agency charges the seller the basic title insurance premium (less any reissue credits), and charges the buyer a "split premium" or "simultaneous issue" premium for the lender's policy. For example, if the basic premium for a $100,000 policy is $500, and both the owner's policy and the lender's policy were purchased from the same agency, the seller pays $300 for the owner's policy and the buyer pays 40% of the basic premium for the lender's policy ($200, or less if the mortgage loan is less than the purchase price). If the seller and the buyer purchase title insurance from different title agencies, each party would pay $500 for their policy.

The buyer, faced with the choice of paying $200 or $500 for the same policy, would choose the seller's agency to simultaneously issue the lender's policy. The title agency that issues the lender's policy must close the loan so that the lender receives a first lien letter, closing protection letter, and final policy without standard exceptions. Hence, the buyer was usually locked into the real estate agent's affiliated title agency without any contractual requirement to use that agency.

This scenario changed as lenders established their own joint ventures with title companies. Most title underwriters now offer simultaneous issue premiums for the lender's policy that allow lender affiliated title agencies to effectively compete with real estate broker affiliated title agencies. The lender will steer borrowers to an affiliated title agency to issue the lender's policy and close the loan. The borrower pays the same premium to the lender's affiliated title agency that would be charged by the agency issuing the owner's policy. Sometimes the lender's affiliated title agency will charge a below market closing fee to entice the borrower to use its services.

Competition lead to modest range wars in certain markets. Some real estate brokers and their favored title agencies began charging a documentation fee to the buyer if the buyer permitted the lender's title agency to close the transaction. Section 9 of RESPA prohibits sellers from directly *or indirectly* requiring borrowers to use a specific title agent. Litigation ensued, alleging that the documentation fee is a condition of selling the property that indirectly requires the buyer to use the seller's preferred title agency.

Recently, a Minnesota real estate broker was attacked for violating fiduciary duties to its customers. Revising the title commitment order form and real estate broker advertisements to specify that real estate brokers and title agencies are independent contractors (comparable to the Mortgage Origination Agreement used by mortgage brokers) may address some state law issues, but it will not resolve RESPA claims. The result of this litigation may not be known for several years.

Flying Too Close to the Sun

Profit sharing programs and insurance premium splits in three affinity programs were attacked on the basis that the split favors a referral source, or the payment violates state law. These are worth noting, simply to point out how these programs failed despite the best intentions of the parties. Please note that these matters were settled without any admission of wrongdoing.

First, private mortgage insurance companies offered to sell "Performance Notes" to lenders that purchased PMI policies. The performance Notes paid interest at a rate based on the payment performance of the lender's loan portfolio. OCC Interpretive Letters 833 and 834, and an informal HUD opinion under RESPA, authorized national banks to purchase these notes. Lenders steered borrowers to purchase mortgage insurance from companies that offered "Performance Notes." The more policies the insurer issued to the lender's borrowers, the more notes a lender could purchase. Performance Notes were phased out because (a) the New York Insurance Commissioner stated in Insurance Department Circular Letter No. 2 that Performance Notes violated state insurance laws by sharing insured risk with unlicensed entities, and (b) Performance Notes faced increasing litigation under RESPA.

Second, private mortgage insurance companies offered secondary mortgage pool insurance to lenders to replace the fees paid to investors for "special" servicing rights. In "ordinary" servicing, the lender makes principal and interest payments when the borrower defaults. The lender is repaid if and when the secured property is foreclosed and sold. Investors offered "special" servicing contracts to lenders (for a fee) that required the investor to take the risk that a foreclosure sale of the property would not recoup all principal and accrued interest. Investors accepted pool insurance policies in lieu of special servicing fees. Litigation against the mortgage insurers alleged that unreasonably low pool insurance premiums were illegal kickbacks for the referral of individual mortgage insurance policies.[39]

Third, title companies encouraged builders to establish reinsurance companies. The concept was simple – split the risk of loss and the title insurance premium with the builder's reinsurance company. However, the builders' reinsurance companies assumed little risk and were paid a significant portion of the premium. State regulators, and later HUD, entered into settlements with these title companies and builders.[40]

All of these affinity programs failed because they skirted one of the "golden rules" of affinity relationships. Payments to someone in a position to refer settlement services must be commensurate with the substantive services or goods provided, or the risk absorbed. The difference between the payment (or discount) and the market value of the service or goods is presumed to be a kickback for the referral of settlement service business.

Next: Part 2: Making it Work

---

[1] This article discusses portions of Sections 8 and 9 of RESPA, 12 U.S.C. 2607 and 12 U.S.C. 2608, in relation to marketing and other affinity relationships between mortgage brokers, mortgage lenders, title agencies, real estate brokers, other settlement service providers, and other parties involved in residential transactions. This article by no means provides a complete discussion of these statutes, or the various inventions that settlement service providers create to attract business.

This article is presented in two parts. Part 1 discusses the practical implications of Sections 8 and 9 of RESPA, and portions of HUD's Regulation X (24 CFR Part 3500) for settlement service providers. Part 1 will discuss the definition of a kickback, and its exceptions in an academic exercise. You must understand what is prohibited to understand what is allowed. Part 2 will discuss practical considerations for implementation of various marketing and affinity arrangements with regarding to the restrictions and exceptions imposed by these statutes and regulations. In plain English, Part 2 will discuss various methods of establishing affinity relationships that do not violate RESPA. Please note that this article is adapted from a weekly column previously published in RESPANews.com (http://www.respanews.com).

[2] 12 U.S.C. 2607

[3] All of the published settlement agreements between HUD and various settlement service providers are available at HUD's web site. Some settlement agreements are not published at all, and some settlements are simply announced through a press release.

[4] 12 U.S.C. 2607(a)

[5] 12 U.S.C. 2607(b)

[6] 12 U.S.C. 2607(c)

[7] 12 U.S.C. 2607(c)(2) states, "Nothing in this section shall be construed as prohibiting…the 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…"

[8] Providing a true discount to the borrower for a bundle of settlement services has the added advantage of eliminating the restrictions on the "required use" use of an affiliated settlement provider. Section 15(b)(2) of HUD's Regulation X, 24 C.F.R. 3500.15(b)(2) prohibits anyone from requiring the use of an affiliated settlement service provider if the borrower will be required to pay for the service. However, Section 2(b) of HUD's Regulation X, 24 C.F.R. 3500.2(b) states:

> "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."

Hence, a lender can require its borrowers to use an affiliated title agency to obtain the lender's title policy and for the closing of a loan if the title agency offers a package of closing costs that bundles the title insurance premium, closing fee, and recording fees at a significant discount to the cost of these services if priced separately.

[9] 12 CFR 226.2(a)(17) states:

> *Creditor* means: (i) A person (A) who regularly extends consumer credit[3] that is subject to a finance charge or is payable by written agreement in more than 4 installments (not including a downpayment), and (B) to whom the obligation is initially payable, either on the face of the note or contract, or by agreement when there is no note or contract.
> [3] A person regularly extends consumer credit only if it extended credit (other than credit subject to the requirements of §226.32) more than 25 times (or more than 5 times for transactions secured by a dwelling) in the preceding calendar year. If a person did not meet these numerical standards in the preceding calendar year, the numerical standards shall be applied to the current calendar year. A person regularly extends consumer credit if, in any 12-month period, the person originates more than one credit extension that is subject to the requirements of §226.32 or one or more such credit extensions through a mortgage broker.

[10] See 12 C.F.R. 226.3(a) and the Official Staff Commentary to that section of Federal Reserve Board Regulation Z in Supplement I to 12 CFR Part 226 for the definition of business purpose credit.

[11] Section 5 of HUD's Regulation X, 24 C.F.R. 3500.5

[12] 24 C.F.R. 3500.14

[13] 24 C.F.R. 3500.14(d)
[14] 24 C.F.R. 3500.14(e)
[15] Courts of Appeals for Fourth, Seventh, and Eighth Circuits held that a markup of a third party fee without an agreement with the third party is not illegal. See Boulware v. Crossland Mortgage Corp., 291 F.3d 261 (4th Cir. 2002); Echevarria v. Chicago Title & Trust Company, 256 F.3d 623 (7th Cir. 2001); and Haug v. Bank of America, N.A., 317 F.3d 832 (8th Cir. 2003). The Second, Third, and Eleventh Circuits held that identifying a third party in agreement with the markup is not needed to find a violation of Section 8(b) of RESPA. See Kruse v. Wells Fargo Home Mortgage, Inc., 383 F.3d 49 (2d Cir. 2004); Santiago v. GMAC Mortgage Group, Inc., 417 F.3d 384 (3d Cir. 2005); and Sosa v. Chase Manhattan Mortgage Corp., 348 F.3d 979 (11th Cir. 2003). None of these courts has held that an overcharge or an excessive fee for services rendered is prohibited by RESPA.
[16] 24 C.F.R. 3500.14(f)
[17] See endnote 7.
[18] See FTC financial privacy disclosure rules at 16 C.F.R. Part 313, and FTC information security rules at 16 C.F.R. Part 314. Similar rules were promulgated by federal banking regulators for depository institutions, and by states for insurance entities, pursuant to Article V of the Gramm Leach Bliley Act.
[19] See the settlement agreement in Jergess v. TransNation Title Insurance Company, E.D. Mich., S.D. Consolidated Case No.: 00-72124 (February 8, 2006).
[20] 12 U.S.C. 2607(b)
[21] 64 F.R. 10080 (3/1/1999). The 1999-1 Statement of Policy was supplemented by HUD Statement of Policy 2001-1, 66 F.R. 53052 (10/18/2001).
[22] 61 F.R. 49397 (9/19/1996)
[23] Over 100 class action lawsuits were filed against lenders claiming that the yield spread premium paid to brokers violated RESPA. HUD Statement of Policy 1999-1 did not stop the lawsuits since the first Court of Appeals to examine this issue after HUD issued its Statement, Culpepper v. Irwin Mortgage Corp. (Culpepper III), 253 F.3d 1324 (11th Cir. 2001), cert. denied, 122 S. Ct. 930 (2002), interpreted HUD's policy very narrowly. HUD's Statement of Policy 2001-1 (66 F.R. 53052 (10/18/2001))expressly rejected the narrow interpretation in Culpepper III. Courts of Appeals issuing opinions following the 2001 Statement supported HUD's interpretation of Section 8 of RESPA regarding lender paid broker fees and rejected the opinion in Culpepper III. See, e.g., Glover v. Standard Federal Bank, 283 F.3d 953, 963-965 (8th Cir. 2002); Schuetz v. Banc One Mortgage Corp., 292 F.3d 1004, 1007. (9th Cir. 2002); O'Sullivan v. Countrywide Home Loans, Inc., 319 F.3d 732, 738 (5th Cir. 2003).
[24] See Endnote 11.
[25] See Endnote 11.
[26] 66 F.R. 53052 (10/18/2001)
[27] See Kruse v. Wells Fargo Home Mortgage, Inc., 383 F.3d 49 (2d Cir. 2004). See also the discussion in Martinez v. Wells Fargo Bank, N.A., Case No . C-06-03327 RMW (N.D. CA, San Jose Div. 3/30/2007)

[28] 24 C.F.R. 3500.14(g) states, in part:

> (g) Fees, salaries, compensation, or other payments. (1) Section 8 of RESPA permits…
>
> (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;…

[29] See the HUD settlement with Metropolitan Title Company.
[30] A real estate broker that owns a building may rent space to a title agency at market rates since it is not just subletting the space that it rents.
[31] 24 C.F.R. 3500.15
[32] Appendix D to 24 C.F.R. Part 3500
[33] 61 F.R. 29258 (6/7/1996)
[34] 24 C.F.R. 3500.5(b)(7) states:

> "(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 Sec. 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 Sec. 3500.2.)"

[35] 24 C.F.R. 3500.14(g)(vi)
[36] See, for example, Michigan Office of Financial and Insurance Services Bulletin No. 2001-07-INS. But see Chicago Title Ins. Co. v. Butler, 770 So. 2d 1210, 1214 (Fla. 2000), in which the Court held that statutes prohibiting rebates of commissions paid to insurance agents were an unconstitutional infringement on the public's right to effective bargaining power with those from whom they seek to purchase services.
[37] See the HUD settlements with Coldwell Banker Residential Real Estate, Inc., and with Prudential Locations, LLC.
[38] 12 U.S.C. 2608. See also 24 C.F.R. 3500.16.
[39] Several lawsuits were filed on December 17, 1999 in U.S. District Court for the Southern District of Georgia against Mortgage Guaranty Insurance Company, PMI Mortgage Insurance Company, Republic Mortgage Insurance Company, and United Guaranty Corporation. One of these lawsuits was dismissed on the basis that state laws, not federal laws, regulate insurance activities. Marie Pedraza, et al. v. United Guaranty Corp., et al., No. 99-239, slip op. (S.D. Ga. Aug. 14, 2000). One lawsuit was filed in the Eastern District of Texas, Moore v. Radian Group, Inc. et al., and another in North Carolina. See also the order in Barnes v. Republic Mortgage Insurance Company, Case No. CV199-240 (S.D. GA 2/5/2003) denying class certification. One of these cases lead to litigation between the mortgage insurance company and its professional liability insurance carrier over who would foot the $1.4 million bill for defense of these various lawsuits (the mortgage insurer won). See PMI Mortgage Insurance Company v. American International Specialty Lines Insurance Company, 394 F.3d 761, (9th Cir. 2005).
[40] See, e.g., the settlement between HUD and AHT Reinsurance, Inc.

Defending Liberty
Pursuing Justice

ABA SECTION OF REAL PROPERTY, PROBATE AND TRUST LAW
RPPT eREPORT
NEWS, PRACTICE UPDATES AND MEMBER BENEFITS

Real Property Article

This Issue's Table of Contents

OPTIONS: FIRST REFUSAL RIGHTS COULD BE THORNY

By Harris Ominsky *

A right of first refusal means that a recipient has the right to meet an outsider's offer when the seller puts the property up for sale. These rights sound simple and on the surface do not seem to be much of a sacrifice by the optionor, but frequently they are the subjects of litigation.

A recent Maryland appellate court decision held that the optionor may be guilty of bad faith when it contracts to sell property to a third party subject to a condition that has the primary purpose of frustrating the optionee's rights. That is particularly true when the added condition to the third-party sale would be of little benefit to the optionor. *Bramble v. Thomas*, 2007 WL 49255 (Md., Jan. 8, 2007).

In that case Bramble, a company mining sand and gravel, had acquired the parcel it was working on for its business. It had also obtained an assignment of a right of first refusal on an adjacent property owned by "Lanes." The right of first refusal gave Bramble the right to acquire the property by matching any offer that Lanes intended to accept. Lanes were required to tender such an offer to Bramble within thirty days, and Bramble was required in the agreement to match both the price and the terms of the intended sale.

A Bramble of Offers

The dispute revolves around an attempted sale by Lanes of the optioned parcel to a local real estate broker named Thomas for $105,000, and a condition in the proposed sale prohibiting mining on the optioned parcel. When Bramble received the proposed agreement, it accepted the price with one major deviation. It excluded the mining restriction.

After that, without responding to Bramble's acceptance, Lanes renegotiated with Thomas to sell the property to Thomas for $120,000. Lanes then tendered this contract to Bramble. Bramble indicated that its earlier acceptance of a $105,000 offer constituted a binding contract, and that therefore the renegotiated contract was a nullity that did not affect Bramble's rights. Bramble then retendered its acceptance of the first offer for a price of $105,000, this time including the mining restriction. This acceptance was more than thirty days after the original tender of the first Thomas offer, and so was technically not in compliance with the right of refusal.

Lanes then asserted that they could not sell to anyone because of the confusion, and attempted to return a deposit that Thomas had paid them. Thomas countered by suing to nullify the first Bramble acceptance because it did not comply with the use right, and also sought to enforce its other rights against Lanes.

The trial court granted summary judgment for Thomas, holding that Bramble's original acceptance did not comply with the terms of the refusal right, and Bramble then appealed.

In light of the litigation, the right of first refusal, which seems simple on the surface, had become a costly and thorny issue for Bramble. It may not escape the reader that there is a certain Dickensian quality to the name of ”Bramble”, one of the major characters in the somewhat complex plot that has unfolded here.

Appellate Wisdom

On appeal, the Maryland Appellate Court reversed the lower court and found that the summary judgment was inappropriate because a genuine issue of fact existed. The issue was whether the first Thomas contract was tendered to Bramble in bad faith because of the insertion of a condition that was of no consequence to the parties except to frustrate Bramble's rights under the option. Thomas argued that the restriction against mining was material because the property was worth less with the restriction than without it. Therefore, Bramble would be getting a windfall if it would be able to acquire the property for the $105,000 price without the restriction.

The appellate court, in a well-researched opinion, cited conflicting precedents in various jurisdictions about whether this type of option may be exercised if accepted with variations from the triggering offer where the variations “constitute no substantial departure” from the offer. The court held, however, that whether the omission was material was not necessary to its decision in this case. It stated that there was a genuine issue here of whether the Lanes and Thomas inserted “in bad faith,” the no-mining clause as a “poison pill” to discourage Bramble from exercising its right of first refusal. The court characterized the original contract that created the refusal right as a contract, which Lanes had a duty to carry out in “good faith.” It held that the optionor “should not be permitted to engage in a subterfuge or devious means to prevent the other party from performing, and then use that as an excuse for failing to keep its own commitment.”

The court said that when the case goes to trial, Bramble would have the burden to show that the no-mining condition was inserted in bad faith, and then that burden would shift to Thomas and Lanes to counter that. Bramble had argued that the mining restriction was inserted at the request of Thomas, in order to impede the exercise of the refusal right. Thomas was a real estate broker, knew of Bramble's use of the property, and would have no apparent reason to desire such a restriction on its own rights. Since it seems that the Lanes were selling out all of their property at that location, it is not apparent why they would have any reason to include a restriction on mining. Of course, that restriction might have value, and the Lanes may have been looking to sell that right in the future to Bramble or some other party, which would give them additional income to the $105,000 price for the property.

Frustrating Rights of First Refusal

While options of first refusal seem simple, the *Bramble* case is just one factual situation indicating how thorny they can be. For example, the court cited an earlier case where the option or included the option parcel in a proposed sale of a larger parcel, and then requested that the optionee match the price for the larger parcel.

It also cited a case where the optionors received an offer from a third party to buy their property for $200,000.00, which consisted of a combination of the offerors' home stated to be worth $48,000, with the balance to be paid in cash. When the optionee attempted to exercise its right of first refusal, it matched the $200,000 price but conditioned the acceptance with an offer to pay $50,000 of that price with any piece of real estate of the seller's choice with a value of up to $50,000. In that case the court held that the optionee had not exercised effectively its right of first refusal because the optionors were acting "in good faith" even though the inclusion of "unique consideration" made it impossible for the optionee to match exactly the terms of the triggering offer.

The casebooks are populated with many versions of offers to sell by optionors, which tend to frustrate or defeat options of first refusal. For example, in a Wyoming case, a court barred the optionor from selling the optioned property as part of a larger sale; and in *Halyak v. A. Frost, Inc.*, the Pennsylvania Superior Court held that a landlord could not defeat the right of a tenant which had been given the right of first refusal to lease other space in the building. In that case, the landlord had offered another tenant a lease for new space, conditioned on the other tenant's obligation to surrender its occupied space. The landlord claimed that the designated space it had demanded in return was a key component to the transaction, because the landlord could lease that surrendered space at a much higher rental. Since the optionee could not possibly surrender the other space he did not occupy, he could not meet that part of the offer. See OMINSKY, REAL ESTATE LORE, PP. 329-331 (AMERICAN BAR ASSOCIATION, 2005).

Some of these issues may be headed off by proper drafting of rights of first refusal. However, for cases where that has not worked, the *Bramble* decision is trying to strike a balance between two clashing concepts. One requires an optionee to "match exactly the terms of a triggering offer (i.e., a lack of materiality of the omitted terms is no defense)." On the other hand, the bad-faith rule prohibits adding "bad faith terms to the triggering offer which are intended to nullify the right of first refusal."

This should prove to be a difficult balance for future courts to implement in dealing with rights of first refusal, particularly because a proper ruling seems to depend on getting into the head of the optionor.

- The American Bar Association has recently published Mr. Ominsky's new book, *Real Estate Lore, Modern Techniques and Everyday Tips for the Practitioner*.

This page was printed from: http://www.abanet.org/rppt/publications/ereport/2007/3/rpOminsky.shtml

Close Window