

CONSOLIDATING RESIDENTIAL REAL ESTATE SERVICE PROVIDERS

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There has been a significant consolidation of residential real estate service providers nationwide in the past few years, and this trend has recently been gaining momentum in New York. Companies have been expanding and consolidating to offer key services, such as real estate brokerage, mortgage financing, title insurance and homeowners' insurance, under one roof, through "affiliated business arrangements." These arrangements allow companies to profit from diversification of services, while typically avoiding the anti-kickback provisions of the Real Estate Settlement Procedures Act ("RESPA"), 12 U.S.C. § 2601, et seq.

This article will discuss the current trend, summarize the relevant provisions of RESPA and the regulations promulgated there under, and discuss how companies can successfully structure affiliated business arrangements.



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The Consolidation Trend

Although consolidation among residential real estate service providers has been taking place nationwide for the past several years, such consolidation has been particularly noticeable in the New York metropolitan area in recent months. Several mortgage brokerage companies, mortgage banks and residential real estate brokerage companies have been forming title abstract companies to provide title insurance services, and residential real estate brokerage companies have been forming mortgage brokerage companies and mortgage banks to provide mortgage services to its clients and homeowners' insurance agencies to provide property and casualty policies.

The main impetus behind such consolidation is obvious – the opportunity to boost revenues and profitability. In addition to the opportunity to offer more services, consolidation offers an opportunity for greater client retention. For example, a real

estate broker that forms an affiliated business arrangement with a mortgage bank may be able to provide financing and, later, refinancing services, to its homebuyer-customer.

Consumers, too, have benefited from the "one-stop shopping" resulting from consolidation, as they have experienced greater convenience and control over service delivery. A recent survey co-sponsored by the Real Estate Services Providers Council, Inc. ("RESPRO"), a national trade association of affiliated settlement service providers, shows that homebuyers overwhelmingly prefer such one-stop shopping. The survey of over 2000 homebuyers found that 82% of those polled would "strongly or somewhat strongly" consider using one-stop shopping services, including real estate brokerage services, mortgage lending, title insurance, homeowners' insurance, home inspections and home warranties.

The very existence and vitality of an organization such as RESPRO, which supports laws and regulations that favor affiliated business relationships, is testament to the popularity of consolidation among settlement service providers.

Affiliated Business

RESPA was passed by Congress in 1974 in order to ensure that consumers "are provided with greater and more timely information on the nature and costs of the settlement process and are protected from unnecessarily high settlement charges caused by certain abusive practices," including the then-legal practice of kickbacks and referral fees for the referral of residential settlement services, which tend to increase the cost of such services. (12 U.S.C. § 2601).

The anti-kickback section of RESPA provides in pertinent part as follows:

(a) Business referrals

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.

12 U.S.C. § 2607 (a); 24 C.F.R. 3500.14.

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RESPA was amended in 1983 to exempt from the statute any returns on ownership interest in other settlement service providers and returns on franchised interests under the “controlled business arrangement” exemption, now called the “affiliated business arrangement” exemption. RESPA defines the term “affiliated business arrangement” as an arrangement in which

(A) a person who is in a position to refer business incident to or a part of a real estate settlement service involving a federally related mortgage loan, or an associate of such person, has either an affiliate relationship with or a direct or beneficial ownership interest of more than 1 percent in a provider of settlement services; and

(B) either of such persons directly or indirectly refers such business to that provider or affirmatively influences the selection of that provider.

12 U.S.C. § 2602(7).

RESPA’s “affiliated business arrangement” exemption permits affiliated business arrangements as long as (a) a disclosure is made of the existence of such an arrangement to the person being referred; (b) the person being referred is provided with a written estimate of the charge or range of charges generally made by the provider to which the person is referred; (c) the person is not required to use any particular provider of settlement services; and (d) the only thing of value that is received from the arrangement, other than the payments permitted by the RESPA statute, is a return on the ownership interest or franchise relationship. 12 U.S.C. § 2607(c)(4); 24 CFR 3500.15(b). The disclosures required by RESPA are to be made in the format set forth in Appendix D (“Affiliated Business Arrangement Disclosure Statement”) to the HUD regulations, 24 C.F.R. Part 3500.

Enforcement by HUD

In 1996, HUD, the main enforcer of RESPA, issued a “Policy Statement on Sham Controlled Business Arrangements” (the “Policy Statement”) setting forth the factors that HUD uses to determine whether a joint venture or other affiliated business arrangement is a “sham” or a “bona fide” provider of settlement services under RESPA. (Statement of Policy 1996-2, June 7, 1996). In the Policy Statement, HUD defines a “joint venture” as a “special combination of two or more legal entities which agree to carry out a single business enterprise for profit, and for which purpose they combine their property, money, effects, skill and

knowledge.” The Policy Statement also applies to other forms of affiliated business arrangements, such as limited partnerships, limited liability companies, wholly owned corporations, or combinations thereof.

The factors set forth by HUD in the Policy Statement are not individually determinative, but are considered together in determining whether a RESPA violation has occurred. The factors considered by HUD include: (1) Whether the new entity has sufficient initial capital and net worth, typical in the industry, to conduct the settlement service business for which it was created; (2) Whether the new entity is staffed with its own employees to perform the services it provides; (3) Whether the new entity manages its own business affairs; (4) Whether the new entity has an office for business which is separate from one of the parent providers, and if the new entity is located at the same business address as one of the parent providers, whether it pays a general market value rent for the facilities actually furnished; (5) Whether the new entity is providing substantial services, i.e., the essential functions of the real estate settlement service, for which the entity receives a fee, and whether it incurs the risks and receives the rewards of any comparable enterprise operating in the market place; (6) Whether the new entity performs all of the substantial services itself, and how much, if any, of the work is contracted out; (7) If the new entity contracts out some of its essential functions, whether it contracts services from an independent third party, or whether the services are contracted from a parent, affiliated provider or an entity that helped create the controlled entity. If the new entity contracts out work to a parent, affiliated provider or an entity that helped create it, whether the new entity provides any functions that are of value to the settlement process; (8) If the new entity contracts out work to another party, whether the party performing any contracted services receives a payment for services or facilities provided that bears a reasonable relationship to the value of the services or goods received; (9) Whether the new entity actively competes in the market place for business, and receives or attempts to obtain business from settlement service providers other than one of the settlement service providers that created the new entity; and (10) Whether the new entity sends business exclusively to one of the settlement service providers that created it, or whether the new entity sends business to a number of entities, which may include one of the providers that created it.

HUD also sets forth in the Policy Statement the factors that it will consider when assessing whether a payment is a return on ownership interest or a payment for referrals of settlement

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service business, as follows: (1) Has each owner or participant in the new entity made an investment of its own capital, as compared to a “loan” from an entity that receives the benefits of referrals?; (2) Have the owners or participants of the new entity received an ownership or participant’s interest based on a fair value contribution? Or is it based on the expected referrals to be provided by the referring owner or participant to a particular cell or division within the entity?; (3) Are the dividends, partnership distributions, or other payments made in proportion to the ownership interest (proportional to the investment in the entity as a whole)? Or does the payment vary to reflect the amount of business referred to the new entity or a unit of the new entity?; and (4) Are the ownership interests in the new entity free from tie-ins to referrals of business? Or have there been any adjustments to the ownership interests in the new entity based on the amount of business referred?

The RESPA statute sets forth the consequences of violating its provisions, which include criminal and civil penalties and a private right of action to enforce the provisions of RESPA.

HUD’s enforcement of RESPA, including the anti-kickback provisions, has been particularly active in recent months. HUD has beefed up its RESPA enforcement staff, and has stated its intent to crack down on RESPA violations. Indeed, HUD has been investigating numerous cases involving allegations of “sham” business arrangements, and in July 2003 announced four settlement agreements involving alleged violations of the anti-kickback provisions of RESPA. One of the settlements involved TitleVentures.com, a title insurance agency located in Tennessee which, according to HUD, established dozens of sham title insurance companies for the purpose of paying kickbacks to real estate and mortgage brokers in five states for the referral of title business. The purported bogus title companies had few or no employees, no office space, and did little or no title work, while collecting 80% of title insurance premiums paid by borrowers.

Potential Roadblocks

Notwithstanding RESPA’s safe harbor for affiliated business arrangements, certain kickbacks and referral fees are not allowable under state law. In particular, New York Insurance Law § 6409(d) prohibits title insurance companies from compensating any person or entity for the referral of title insurance business. The statute provides in pertinent part that

[n]o title insurance corporation or any other person acting for or on behalf of it, shall make any rebate of any portion of the

fee, premium or charge made, or pay or give to any applicant for insurance, or to any person, firm, or corporation acting as agent, representative, attorney or employee of the owner, lessee, mortgagee or the prospective owner, lessee, or mortgagee of the real property of any interest therein, either directly or indirectly, any commission, any part of its fees or charges, or any other consideration or valuable thing, as an inducement for, or as compensation for, any title insurance business...

In addition, the recently-enacted New York Banking Law §6-1, which became effective April 1, 2003, prohibits kickbacks to mortgage brokers with respect to “high-cost” home loans. Banking Law §6-1 (2)(p). Because these New York statutes provide greater protection to consumers than the RESPA statute, they are not preempted by RESPA. (see 12 U.S.C. § 2616).

The creator of an affiliated business arrangement must also ensure that all relevant statutes and regulations applicable to the type of business that is being created are reviewed and complied with. For example, if a real estate brokerage company creates an affiliated business arrangement in order to provide mortgage services, it must be sure to comply with the dual disclosure requirement under the New York State banking regulations. (General Regulations of the Banking Board, § 38.12).

Practical Suggestions

Regardless of the form of entity created, it is imperative for the creator of an affiliated business arrangement to become familiar with the relevant RESPA provisions and regulations, as well as any relevant state or local laws.

The creator of an affiliated business arrangement must ensure that the entity is a bona fide provider of settlement services and is not considered a “sham” arrangement under the guidelines set forth by HUD. It is important to ensure that the affiliate or joint venture:

- Is adequately capitalized and is not a mere shell. The entity should have sufficient initial capital and net worth, typical in the industry, to perform the type of services that it is to provide.
- Is staffed with its own employees (and not “loaned” employees) to perform the services that it provides.
- Performs (rather than contracts out) meaningful and necessary settlement services. If work is contracted out, it

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should be minimal and contracted out to an independent third party, and the party performing any contracted services should receive payment for the services provided that bears a reasonable relationship to the value of the services received.

- Manages its own business affairs.
- Actively competes in the marketplace for new business.
- Pays fair value for any services to be provided by its creator or its partners, such as management services, support services or office space.
- If renting space from an affiliate or joint venture partner who might make referrals, does not pay rent that takes into account the value of the settlement provider's business or reflects a premium for the location in the settlement service provider's office.
- Does not refer business exclusively to one of the settlement service providers that created it, but sends business to a number of entities, which may include one of the providers that created it.

In addition to ensuring that the entity is not a "sham," the creator of an affiliate business arrangement must ensure that the requisite Affiliated Business Arrangement Disclosure Statement is provided to the person being referred, and that the only thing of value that is received from the arrangement, other than the payments permitted by the RESPA statute, is a return on the ownership interest or franchise.

In conclusion, as more and more companies are realizing, there is unlimited opportunity for greater revenues and profits through consolidation of residential real estate services. Although there are a myriad of rules and regulations that must be complied with in order to properly structure an affiliated business arrangement, the time and resources spent in structuring such an arrangement may well be worthwhile.