Title Insurance Affiliated Business Arrangements

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The Center for Economic Justice

CEJ is a non-profit consumer advocacy organization dedicated to representing the interests of low-income and minority consumers as a class on economic justice issues. Most of our work is before administrative agencies on insurance, financial services and utility issues.

On the Web: www.cej-online.org

Why CEJ Works on Insurance Issues

Essential Financial Security Tool for Individual and Community Economic Development: CEJ Works to Ensure Access and Fair Prices for These Essential Products and Services, particularly for Low- and Moderate-Income Consumers.

Primary Institution to Promote Loss Prevention and Mitigation: CEJ Works to Ensure Insurance Institutions Maximize Their Role in Efforts to Reduce Loss of Life and Property from Catastrophic Events.

Why Do Lenders, Realtors, Homebuilders Enter into AfBA?

Title Insurance markets are characterized by Reverse Competition. Reverse Competition describes a market structure in which insurers/agents compete not for the business of the consumer paying the premium, but for the business of the real estate professional in the position to steer the consumer to the insurer or agent.

Reverse Competition is a Well-Accepted Regulatory Concept

"Reverse competition" means competition among insurers that regularly takes the form of insurers vying with other for the favor of persons who control, or may control, the placement of the insurance with insurers. Reverse competition tends to increase premiums or prevent the lowering of premiums in order that greater compensation may be paid to persons for such business as a means of obtaining the placement of business. In these situations, the competitive pressure to obtain business by paying higher compensation to the persons overwhelms any downward pressure consumers may exert on the price of insurance, thus causing prices to rise and remain higher than they would otherwise."

NAIC Credit Personal Property Model Act, Section 3(X)

Professor Jack Guttentag
"Referrals Are Pervasive in the Home Mortgage Market"

Real estate and mortgage transactions involve a large number of diverse players who sell services that consumers purchase. Since they are in the market very seldom, consumers typically don't know who all the players are, or even what they do. They are thus heavily dependent on referrals from those who have this knowledge.

Lenders usually select the appraiser and credit reporting agency on home purchases, and all third party service providers on a refinance. Mortgage insurers are always selected by the lender. Realtors and builders have referral power on home purchase transactions, referring consumers to lenders and to title agencies.

Guttentag: Referrals Are a Concern Because

The . . . reason is a concern that referral fees raise the cost to the client. If service providers have to pay referral fees, they are going to charge more in order to cover that cost. This is the major concern with regard to referral fees in the home mortgage market. It is why referral fees in this market were made illegal under the Real Estate Settlements Procedures Act (RESPA). Congress was offended by high mortgage settlement costs and the prevalence of referral fees, which they saw as related. The rationale of the restrictions imposed by RESPA is that "kickbacks or referral fees... tend to increase unnecessarily the costs of certain settlement services . . . ." (RESPA, Section 2601 (a)).

Guttentag: Referral Fees and Referral Power

Referral fees are payments made by service providers to other parties as quid pro quo for referring customers. Referral power is the ability to direct a client to a specific vendor. Referral power is based on specialized information possessed by the referrer, and the authority of the referrer in the eyes of the client. Regulatory efforts to reduce settlement costs to borrowers by eliminating referral fees have not worked largely because they have left referral power unchanged.

When there is referral power, service providers compete not for the favor of consumers but for the favor of the referral agents. Such competition raises the costs of service providers, which are passed on to the consumer. If regulations eliminate referral fees but referral power is left untouched, service providers will find other ways to market themselves to the same referrers. The resulting expenses could well be higher than the referral fees.

Guttentag: RESPA Does Not Prohibit AfBA

RESPA does not prevent a firm in one industry from entering another industry, even when the express purpose is to exploit referral power. For example, a Realtor or lender can establish their own title company and refer business to that company, which can be a joint venture or an entity wholly owned by the referrer.

RESPA

(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.

RESPA

(c) Fees, salaries, compensation, or other payments

Nothing in this section shall be construed as prohibiting

(4) affiliated business arrangements so long as

(A) a disclosure is made of the existence of such an arrangement to the person being referred and, in connection with such referral, such person is provided a written estimate of the charge or range of charges generally made by the provider to which the person is referred

(B) such person is not required to use any particular provider of settlement services, and

(C) the only thing of value that is received from the arrangement, other than the payments permitted under this subsection, is a return on the ownership interest or franchise relationship, or

HUD Statement of Policy on Sham AfBAs

The Department will consider the following factors and will weigh them in light of the specific facts in determining whether an entity is a bona fide provider:

(1) Does the new entity have sufficient initial capital and net worth, typical in the industry, to conduct the settlement service business for which it was created? Or is it undercapitalized to do the work it purports to provide?

(2) Is the new entity staffed with its own employees to perform the services it provides? Or does the new entity have ``loaned'' employees of one of the parent providers?

(3) Does the new entity manage its own business affairs? Or is an entity that helped create the new entity running the new entity for the parent provider making the referrals?

(4) Does the new entity have an office for business which is separate from one of the parent providers? If the new entity is located at the same business address as one of the parent providers, does the new entity pay a general market value rent for the facilities actually furnished?

(5) Is the new entity providing substantial services, i.e., the essential functions of the real estate settlement service, for which the entity receives a fee? Does it incur the risks and receive the rewards of any comparable enterprise operating in the market place?

(6) Does the new entity perform all of the substantial services itself? Or does it contract out part of the work? If so, how much of the work is contracted out?

(7) If the new entity contracts out some of its essential functions, does it contract services from an independent third party? Or are the services 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, does the new entity provide any functions that are of value to the settlement process?

(8) If the new entity contracts out work to another party, is the party performing any contracted services receiving a payment for services or facilities provided that bears a reasonable relationship to the value of the services or goods received? Or is the contractor providing services or goods at a charge such that the new entity is receiving a ``thing of value'' for referring settlement service business to the party performing the service?

(9) Is the new entity actively competing in the market place for business? Does the new entity receive or attempt to obtain business from settlement service providers other than one of the settlement service providers that created the new entity?

(10) Is the new entity sending business exclusively to one of the settlement service providers that created it (such as the title application for a title policy to a title insurance underwriter or a loan package to a lender)? Or does the new entity send business to a number of entities, which may include one of the providers that created it?

Federal/State Actions to Enforce RESPA, State Laws

- Developer Captive Reinsurance Arrangements
- Free Software, Office Space, Supplies
- Cash Payments and Prizes

Dozens of enforcement actions over the years, multiple times with the same title insures.

Carter v. Welles-Bowen: U.S. Sixth Circuit Court of Appeals

HUD was never allowed to evaluate affiliated businesses by these criteria, or require them to satisfy any other test of its legitimacy. The court said that an affiliated business arrangement only needs to meet three bare requirements listed in the statute in order to be given safe harbor from RESPA's anti-kickback provisions.

To have an additional requirement that the arrangement not be a sham amounted to a fourth, government-agency-imposed requirement not in the statute. An agency is not allowed to create such additional requirements, the court ruled. Therefore, the sham test was ruled invalid, and Welles Bowen Realty's relationship with Welles Bowen Title was ruled to qualify as an affiliated business arrangement, without even considering the characteristics that would seemingly indicate that it was little more than a conduit for referral money.

CFPB – Borders & Borders: US District Court Western KY From Order Denying Motion for Summary Judgment

Borders & Borders, PLC is a small, family-owned law firm focusing on residential real estate closings in Louisville, Kentucky. J. David Borders established the firm in 1971, and his two sons, John, Jr. and Harry Borders, now manage the business. Lenders hire the Borders to prepare real estate conveyance and mortgage documents and conduct closings. The Borders do not represent borrowers. Over the years, the Borders have developed strong relationships with local real estate brokers and agents, mortgage brokers, lenders, and other real estate professionals. Some years ago, the Borders entered into nine joint ventures with some of these real estate professionals (“the Joint Venture Partners”). These joint ventures (“the Title LLCs”) were Kentucky limited liability companies that served as title insurance agents for two title insurance companies.

The individual Borders defendants owned 50 percent of each Title LLC and the Joint Venture Partners owned the remainders. From 2006 to 2011, the Borders referred borrowers to these Title LLCs in connection with real estate closings. When the borrowers purchased title insurance from the Title LLCs, the Title LLCs received 80 percent commission on the insurance premium, and the remaining 20 percent went to the title insurance companies. Then, the Borders and the Joint Venture Partners received profit distributions as returns on ownership interests in the Title LLCs. Aye, there's the rub.

The CFPB believes that this process is illegal. Specifically, the CFPB alleges that these "profit distributions" were really just kickbacks paid for referrals. Its concerns spring in part from the nature of the Title LLCs—the Borders provided the initial capitalizations for most Title LLCs, and the funding only covered the Title LLCs' Errors and Omissions insurance.

Allegedly, the Joint Venture Partners often did not contribute any initial capitalization funds. Each Title LLC had but one staffer, an independent contractor whom was simultaneously shared by all the Title LLCs and concurrently employed by Borders & Borders. The Borders—or their agents or employees—managed the Title LLCs, and the nine Title LLCs did not have office spaces, email addresses, phone numbers, nor could they function without the Borders. The Title LLCs did not advertise to the public, and all of their business came from the Borders' referrals. The CFPB doubts that these Title LLCs did any substantive work: It alleges that the Borders, not the Title LLCs, (1) researched and reported the condition of the title; (2) reviewed title reports and decided what conditions and exceptions should be included in a title commitment to issue title insurance; (3) resolved the conditions on the title commitment in order to issue the title insurance; (4) prepared insurance closing letters; (5) prepared title insurance commitments; and (6) conducted closings.

To effectuate this arrangement, whenever a Joint Venture Partner made an initial referral of closing or settlement services to the Borders involving a federally related mortgage loan, the Borders would arrange for the title insurance on the underlying transaction to be processed by the particular Title LLC co-owned by the Joint Venture Partner who referred the business to the Borders. The profits that the Title LLC supposedly generated were then split amongst the Borders and the Joint Venture Partners. According to the CFPB, this system assured that the referring Joint Venture Partner was compensated for the initial referral. The Borders received substantial payments from the Title LLCs, purportedly from ownership interests, on top of significant fees for closing services.

Why are Fair Lending, Other Consumer Organizations and Independent Title Agents Opposed to AfBA

- Referral Fee by another name; precisely the type of referral fees RESPA says is bad, particularly as interpreted by 6th Circuit.
- Adds expenses (for administering the AfBA and excess profit) without adding any needed capacity, thereby raising or preventing the reduction of title prices.
- Anti-competitive: Reinforces the referral power of lenders, realtors, homebuilders and attorneys;
- Anti-competitive: Disadvantages independent title agents opposed to pay-to-play.