

**RESPA UPDATE**  
MEMORANDUM

**Affiliated Business Relationships**

**to:** Southern Title Agent or Approved Attorney  
**from:** Eugene R. McCullough, Esquire  
Senior Vice President, Southern Title Insurance Corporation  
**subject:** Analysis of HUD Regulations- Current status of RESPA Regulations governing  
“Affiliated Business Relationships” (Formerly known as ‘Controlled Business  
Arrangements’)  
**date:** June 28, 2003

**An analysis of HUD’s June 7, 1996 policy statement on  
“Affiliated Business Relationships”**

Over the past few years, Southern Title has received numerous inquiries about the possibility of establishing an agency relationship that involves some form of a title agency, often referred to as a “Joint Venture”, with local builders, Realtors, lenders, mortgage brokers and/or similar entities who ‘can direct the business’. In almost every conversation the caller indicates that another Underwriter has been entering into some sort of relationship with a Builder\Realtor\Broker etc. and they are “losing their clients”. While simultaneously expressing the view that there must be some law or Regulation that prohibits this sort of business practice, each then acknowledges that he or she can capture, *or keep*, a block of business *if* they can find a way to let the person who controls the business to ‘get a piece of the action’. Almost everyone recognizes that it is illegal to give a “kickback” or “referral fee”, but they perceive that it’s happening daily in their marketplace and want to know how it’s done.

**Note - Please be advised that on November 15, 1996 HUD passed a final rule that changed the term “Controlled Business Arrangement” to “Affiliated Business Relationship”- (Federal Register, Volume 61, Number 222). In spite of the *name change* for the relationship discussed in this article, I will continue to refer to this relationship as a “Controlled Business Arrangement” or “CBA”.**

For those of you that feel that entry into some sort of Controlled Business Arrangement is an easy way to expand your business, you should also be aware that this course of action can be extremely risky and dangerous *unless* handled properly. First of all, in addition to subjecting you to civil penalties, current law still clearly makes it a *criminal offense* to pay “kickbacks, referral fees or other *things of value*” to a producer of business on 1-4 family residential transactions involving Federally related mortgage loans *unless* the payment is made in a manner that falls under certain specific *exemptions* to those provisions. It is very difficult, but not impossible, to meet the requirements of the exemption in order to avoid criminal sanctions under existing Federal law. This article will discuss the factors that HUD uses to determine whether an

“arrangement” is in compliance with the exemptions or deemed to be a “sham”.

In my opinion, many of the current arrangements that are actively operating today and competing in our agents’ marketplaces are illegal shams and, if scrutinized by HUD enforcement authorities, could result in civil and criminal penalties. In the past few years, civil fines as large as \$1,000,000 have resulted from HUD investigations. And, if you are found guilty of violating RESPA, there is a real chance of serving time in a Federal prison. If you don’t mind running those risks, save yourself the effort of reading the next few pages and just do whatever your competitors are doing.

For those of you who are interested in complying with the law, this article will attempt to familiarize you with the issues that you need to be aware of to make an informed decision when considering such arrangements. Generally, these “arrangements”, whether they take the form of a joint venture, general partnership, limited partnership or corporation, are all generally referred to as “Controlled Business Arrangements” (or CBA’s) [see note on page one]. Fortunately, on June 7th, 1996 HUD released a “**Statement of Policy 1996-2, Sham Controlled Business Arrangements**” that clarifies HUD’s position on *what is*, and *what is not*, a “Controlled Business Arrangement” that complies with Congress’ intent when it established an exemption to the criminal provisions for violation of the anti kickback provisions of RESPA.

If you have already decided to enter into an agency, or are considering entry into a relationship with a ‘producer of business’, this article will explain that there are ways to do so legally. However, operating *within the law* requires you to understand and comply with the RESPA and State regulations and statutes. (Please note that this article does not focus on State related prohibitions or limitations, but they should be consulted before fully evaluating any CBA.) Several states recently passed new Title Insurance statutes that will impact the way any agency was to be set up and the rates to be charged, etc., but we can help guide you through those issues.

CBAs are realities. Southern will not enter into any relationship that does not comply with current law or Regulations. I am repeatedly asked to participate in ‘Joint Ventures’ that in my opinion do not meet the tests or guidelines discussed in this article. In spite of my refusal to participate, most of these proposals do actually take place with *other* parties involved. Oftentimes the final combination of parties participating in the ‘Joint Venture’ merely are unaware of what the law and Regulations require.

This article will attempt to give you some understanding of current law and Regulations.

## **Historical Review of the Transformation of RESPA and the HUD Regulations**

It's helpful to have a basic understanding of the history of RESPA as it relates to the issue of Controlled Business Arrangements in order to understand how the June 7, 1996 Regulations impact existing CBA's. (Please note that whenever appropriate, I have taken the liberty of quoting the actual Statute or HUD regulation. These will be indicated by bold print.)

### **1974- Passage of RESPA, the Statute**

The REAL ESTATE SETTLEMENT PROCEDURES ACT (RESPA) is codified at 12 USC 2601, et seq, and was first passed in 1974 by Congress. At Section 2607(A) Congress specifically stated that it intended to eliminate kickbacks and referral fees that tend to unnecessarily increase the costs of settlement services. The Department of Housing and Urban Development (HUD) is charged with the responsibility of formulating Regulations to provide substance to this type legislation. Unfortunately, Regulations designed to 'flesh out' the Congressional intent often have not been released on a timely basis and this has forced the public to rely on it's own, often self serving and ultimately incorrect, interpretation of what would be permissible.

### **1976- Passage of 1st HUD Regulations**

The most significant portion of the Regs that continue to impact CBA's today was contained in Section 3500.14(B), first passed in 1976, and is entitled "No Referral Fees". The Regulation states the following: (Italicized words in parentheses are my comments):

**No person shall give and no person shall accept** (*Note- both the giver and the receiver have liability*) **any fee, kickback, or other thing of value** (*Note- that "thing of value" is a broadly defined term*) **pursuant to any agreement or understanding** (*Note- that "agreement or understanding" is a broadly defined term*), **oral or otherwise, that business incident to or part of a settlement service involving a federally related mortgage loan shall be referred to any person. Any referral of a settlement service is not a compensable service** (*Note- that referrals are not prohibited, only the compensation paid for the referral is prohibited*) **except as set forth in 3500.14 (g)(2). A company may not pay any other company or the employees of any other company for the referral of settlement service business.**

Obviously, the above quoted Regulation prohibits payments of ‘any fee, kickback or thing of value’. The term fee and kickback are encompassed in the definition of *thing of value*. Section 3500.14 (d) defines a "thing of value" as broadly as possible. It states that:

**"Thing of value" is broadly defined by section 3(2) of RESPA (12 U.S.C. 2602(2) to include any payment, advance, fund, loan, service, or other consideration. Under section 8 of RESPA (12 U.S.C. 2607), a thing of value can take many forms including, but not limited to, monies, things, discounts, salaries, commissions, fees, duplicate payments of a charge, stock, dividends, distributions of partnership profits, franchise royalties, credits representing monies that may be paid at a future date, the opportunity to participate in a money-making program, retained or increased earnings, increased equity in a parent or subsidiary entity, special bank deposits or accounts, special or unusual banking terms, services of all types at special or free rates, sales or rentals at special prices or rates, lease or rental payment based in whole or in part on the amount of business referred, trips and payment of another person's expenses, or reduction in credit against an existing obligation. The term "payment" is used throughout 3500.14 and 3500.15 as synonymous with the giving or receiving any "thing of value" and does not require transfer of money.**

It appears that HUD has made a list of all the key words or terms used by those in the settlement industry who have attempted to justify that their particular method of doing business as not being a "kick-back". (It is important to remember that both of the forgoing Regs continue to remain in full force today and you are only allowed to operate contrary to these provisions if you can justify that your operation is a “qualified CBA” and therefore “exempt” for these prohibitions.)

## **1976-1981 HUD Evaluates Need for CBA Exemption**

The above quoted Regulations are clearly in line with the 1974's Congressional intent of “eliminating kickbacks and referral fees” that it felt tended to unnecessarily increase the costs of settlement services. However, after their initial passage in 1976, HUD began to receive questions from the industry asking if referrals between ‘affiliated settlement service providers’ violated RESPA. Hearings were held in 1981 to consider amendments to the then current Regs. Had RESPA remained unamended, the issues addressed in this article would not exist. However, as a result of these hearings, in 1983 Congress amended RESPA to allow “Controlled Business Arrangements” to be exempt from the penalty provisions of Section 8 if they met certain requirements.

## **1983- Amendment of RESPA to include a CBA Exemption**

The term "controlled business arrangement" was first coined in Section 461 of the Housing and Urban - Rural Recovery Act of 1983 which defined a CBA as an arrangement:

**In which (A) a person who is in the position to refer business incident to or part or 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))**

The passage of the 1983 amendment permitting CBA's was not intended to change Congress's objective with the passage of RESPA- to prohibit kickbacks and referral fees and impose criminal penalties on those who paid or received them. This amendment was designed to recognize that there *could be* a method of operation between related parties to a real estate settlement, in which monies could flow and still not be violative of the anti kickback provisions of RESPA. Congress looked to HUD to develop regulations to clarify acceptable guidelines; however, in spite of the amendment being passed in 1983, no formal HUD guidelines were implemented until late 1992.

## **1992- Regs establish a "3 Point Safe Harbor" Test for CBA's**

In November 1992, HUD issued its first regulation covering controlled business arrangements, 57 FR 49599 (Nov. 2, 1992), codified at 24 CFR 3500.15. That rule acknowledged the exemption to the penalty provisions of Section 8 for CBA's and *allowed referrals* of business to an affiliated settlement service provider so long as:

- (1) The consumer receives a written disclosure of the nature of the relationship and an estimate of the affiliate's charges;
- (2) the consumer is not required to use the controlled entity; and
- (3) the only thing of value received from the arrangement, other than payments for services rendered, is a return on ownership interest.

If the CBA did not meet all 3 of the forgoing, it did not achieve the exemption status and would be in violation and subject to all penalty provisions.

The passage of this 3 point "safe harbor" test was welcome refuge for those who were already in a CBA or considering one. Although the Regs went into fairly substantial detail with regard to each of these 3 points, there were still many unanswered questions on what would, and what would not, meet HUD's approval. Hundreds of seminars were held immediately after the pronouncement and the growth of CBA's mushroomed nationwide. Unfortunately, many of those who entered CBA's with the full intent to comply with the Regs began to find that

compliance with one or more of the 3 safe harbor points was more difficult to achieve than they originally thought. Many others entered CBA's with a poor understanding of what the Regs required. As a result the types of CBA's that began to appear began to draw complaints from the public and industry alike.

## **1996- HUD Evaluates CBA's In Operation Nationwide**

Many complaints included arrangements that were wholly-owned by a referring entity. An example of such a complaint involved an arrangement promoted by a mortgage broker to real estate brokers to help them set up a wholly owned mortgage brokerage subsidiary. The mortgage broker claimed that the real estate broker "CAN EARN HUNDREDS OR EVEN THOUSANDS OF DOLLARS EACH MONTH WITHOUT INVESTING ANY MONEY OR CHANGING [HIS OR HER] CURRENT BUSINESS PRACTICES. The mortgage broker's pitch was that "MY CURRENT STAFF CAN WORK FOR MY COMPANY AND ALSO FOR YOURS. The real estate broker's new company "CAN USE MY INVESTORS, MY OFFICE, MY PHONES, MY COPY MACHINES, MY PROMOTIONAL MATERIAL \*\*\* YOUR COMPANY WILL HAVE NO OVERHEAD OTHER THAN THE TAXES DUE ON THE INCOME YOU GENERATE AND THE BANK FEES FOR THE MONEY ACCOUNTS YOUR COMPANY MUST HAVE. THE ENTIRE ANNUAL EXPENSES CAN BE COVERED ON THE FIRST LOAN YOUR COMPANY CLOSSES \*\*\* I CAN MANAGE YOUR COMPANY AT THE SAME TIME I MANAGE MINE SO YOU WON T HAVE ANY TIME INVESTMENT EITHER. HUD's concern about these and similar complaints prompted the Department to issue a Statement of Policy on June 7th, 1996.

## **June 7, 1996- HUD Develops New CBA Compliance Test**

The Regulations were amended to clarify HUD's interpretation of the intent of Congress in this area so that CBA's, such as the ones above, could be easily evaluated. HUD stated the purpose of the new Regs as follows:

**(T)o give guidance to interested members of the public on the application of RESPA and its implementing regulations to these issues, the Secretary, pursuant to Section 19(a) of RESPA and 24 CFR 3500.4(a)(1)(ii), hereby issues the following Statement of Policy. Congress did not intend for the controlled business arrangement ("CBA") amendment to be used to promote referral fee payments through sham arrangements or shell entities. H.R. Rep. 123, 98th Cong., 1st Sess. 76 (1983). The CBA definition addresses associations between providers of settlement services. 12 U.S.C. 2602(7). In order to come within the CBA exception, the entity receiving the referrals of settlement service business must be a "provider" of settlement service business. If the entity is not a bona fide provider of settlement services, then the arrangement does not meet the definition of a CBA. If an arrangement does not meet the definition of a CBA, it cannot qualify for the CBA exception, even if the three conditions of Section 8© are otherwise met. 12 U.S.C.**

**2607(c)(4)(A-C). Therefore, subsequent compliance with the CBA conditions concerning disclosure, non-required use and payments from the arrangement that are a return on ownership interest, will not exempt payments that flow through an entity that is not a provider of settlement services.**

With the guidance of the new Regs, we now can see that HUD has made it clear that the old “3 point safe harbor” test was no longer a valid method of evaluating CBA’s compliance with the Regs. Today, the first question that must be asked of any CBA is “*Is the entity receiving the referrals of settlement service business a “provider” of settlement services?*” (“Settlement Services” is defined in the Regs at 3500.2(16)). Even under the 1992 Reg amendments, HUD made it clear that if the entity performed no substantive settlement services, the arrangement would not qualify for the CBA exemption status. (Appendix B to part 3500, Illustration # 10).

Unfortunately, the pre-1996 Regs did not address the situation where an entity performed *some, but not all* the settlement services the entity was capable of performing. It is now clear that in HUD’s opinion if the new entity does not provide a *significant* number of the services that are required to be rendered in a settlement, the arrangement could fail to qualify as a CBA- even if it does comply with the previously established “3 point safe harbor” test This gives rise to the question “*How do you determine whether an entity that does provide settlement services provides enough services to qualify as a ‘bona fide CBA’ entitled to exemption status?*”. The Regs state:

**When assessing whether such an entity is a bona fide provider of settlement services or is merely a sham arrangement used as a conduit for referral fee payments, HUD balances a number of factors in determining whether a violation exists and whether an enforcement action under Section 8 is appropriate. Responses to the questions below will be considered together in determining whether the entity is a bona fide settlement service provider. A response to any one question by itself may not be determinative of a sham controlled business arrangement. 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  
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?**

Only after answering these questions and reviewing the overall results will HUD conclude that the entity involved in the CBA qualifies as a "bona fide provider of settlement services". However, merely meeting this test is still not enough to qualify for the CBA exemption. The CBA must now be evaluated to insure compliance with the "3 point safe harbor" test that was established in the 1992 Regs. For this review, the Regs state:

**Issues may arise concerning whether the consumer received a written disclosure concerning the nature of the relationship and an estimate of the controlled entity's charges at the time of the referral. 12 U.S.C. Sec. 2607(c)(4)(A); 24 CFR 3500.15(b)(1). Other issues may arise**

**concerning whether the referring party is requiring the consumer to use the controlled entity. 12 U.S.C. Sec. 2607(c)(4)(B); 24 CFR 3500.15(b)(2). Still another area that may arise concerns the third condition of the CBA exception, whether the only thing of value that comes from the arrangement, other than permissible payments for services rendered, is a return on ownership interest or franchise relationship. 12 U.S.C. Sec. 2607(c)(4)(C); 24 CFR 3500.15(b)(3). Section 3500.15(b)(3)(ii) of the regulations provides that a return on ownership interest does not include payments that vary by the amount of actual, estimated or anticipated referrals or payments based on ownership shares that have been adjusted on the basis of previous referrals. When assessing whether a payment is a return on ownership interest or a payment for referrals of settlement service business, HUD will consider the following questions:**

- (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?**
- (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?**

**Responses to these questions may be determinative of whether an entity meets the conditions of the CBA exception. If an entity does not meet the conditions of the CBA exception, then any payments given or accepted in the arrangement may be subject to further analysis under Section 8(a) and (b). 12 U.S.C. Sec. 2607(a) and (b).**

## **Conclusion**

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The new Regs make it clear that evaluations of CBA's will be much more comprehensive than in the past. These Regs are fair warning to all who operate CBA's. If you intend to operate within the law, you now have a clear set of guidelines to help justify your compliance. Those who decide to "take their chances" are probably now unable to utilize the often cited "I didn't understand" defense. With the threat of criminal sanctions, including incarceration in the Federal prison, as the possible result, a correct understanding of what the law requires is prudent.

In addition to the RESPA regulations discussed above, you should be aware of the fact that substantial revisions of RESPA are currently being considered by Congress. These changes involve the concept of 'Bundling of Services' and, if passed, will have a profound effect on the way title insurance agencies operate. The material on that issue can be requested and I will be glad to go over those proposals as well.

If you have any questions or would like a complete copy of the June 7, 1996 Regulations, the November 15, 1997 Regulations, or the proposed RESPA changes please contact **Eugene R. McCullough at Southern Title Insurance Corporation, 222 South Peters Road,, Knoxville, Tennessee 37923**. Our phone number is 1-800-505-7842.