THE HOMEBUILDER AND REAL ESTATE AGENT AS LOAN ORIGINATOR UNDER RESPA, SECTION 8

By J. Alton Alsup

An Analysis in Q&A Format of the Conditions Under Which Homebuilders and Real Estate Agents May Be Compensated by Mortgage Lenders for Loan Origination Services to Homebuyers

Q If RESPA doesn't permit a lender to pay referral fees, how can home building companies (the "Builder") or real estate brokers and sales agents (the "Broker") benefit from putting their customers together with mortgage lenders?

A RESPA regulations permit two particular exceptions to Section 8 prohibitions against referral fees, kick-backs, and unearned fee splits that could benefit the Builder or Broker. Section 8 of RESPA permits:

1. Payment by a lender to the Builder or Broker as its duly appointed agent or contractor for services actually performed in the origination, processing, or funding of a loan [§ 3500.14(g)(iii)];
2. Returns on ownership interests the Builder or Broker may have in an affiliate mortgage company to which the Builder or Broker refers its customers, provided that the customer is first given a required Affiliated Business Arrangement disclosure, the customer is not required to use the affiliate mortgage company, and no referral fee is paid to the Builder or Broker. [§ 3500.15.]

Q Is it enough to take the loan application of their customers, or is more required to entitle the Builder or Broker to compensation as the lender's agent or contractor?

A More is required. Significant, non-duplicative loan origination services must be performed.

The Department of Housing & Urban Development (HUD) issued its Statement of Policy 1999-1 in March, 1999 [64 F. R. 10079]regarding the legality of lender payments to a mortgage broker or other "duly appointed agent or contractor" in connection with a federally related mortgage loan and the nature and extent of services that the broker must perform to justify the payment of a fee under the RESPA Section 8 exemption permitting the payment of "reasonable compensation for services actually performed."

Mortgage Brokers are defined under RESPA regulations [Regulation X § 3500.2] to mean:

> "a person (not an employee or exclusive agent for a lender) who brings a borrower and lender together to obtain a federally related mortgage loan and who renders "settlement services" (a term itself defined in § 3500.2 to mean any service provided in connection with a prospective or actual loan settlement including counseling, taking of applications, obtaining verifications, and appraisals and other loan origination or processing services).

What is significant about this definition is not merely that it describes *those who hold themselves out as mortgage brokers*, but that it appears to incorporate the neighborhood bank, credit union, real estate broker and sales agent, home builder, financial planner, and others who are in a position to, and who do refer loans to a mortgage broker or lender with the expectation of compensation.

As espoused by its Statement of Policy, HUD does not consider a lender's payment to mortgage brokers to be illegal *per se*. HUD recognizes that methods of compensating mortgage brokers vary, and in any particular transaction a broker may receive compensation directly from the borrower, indirectly in back-funded fees paid by the wholesale lender funding the loan, or through a combination of both. In determining whether a payment by a lender to a mortgage broker is permissible under RESPA, Section 8, HUD will apply a two-part test:

> First – HUD will determine whether services were actually performed or goods or facilities were actually furnished in exchange for the compensation paid;

BROWN, FOWLER & ALSUP
8955 Katy Freeway, Suite 305
Houston, Texas 77024
Phone: 713/468-0400 • Fax: 713/468-5235

Second – If so, HUD will next determine whether the amount of the payments are reasonably related to the value of the services actually performed or the goods or facilities actually furnished.

In determining whether compensable services were actually performed, HUD will look for the types of services described in its informal opinion letter to the Independent Bankers Association of America dated February 14, 1995, (IBAA Letter) regarding what loan origination services a mortgage broker or other agent or contractor must perform to justify compensation under RESPA, Section 8. This 1995 informal opinion enumerated 13 distinct services, in addition to the taking of the loan application, that are normally performed in the origination of a residential mortgage loan. These services generally include pre-qualifying prospective borrowers to determine their eligibility for the loan and the maximum mortgage loan amount they can afford, counseling them on the home buying and financing process, collecting financial information needed to underwrite the loan, verifying the information, ordering related settlement services such as appraisals, inspections, flood determinations and legal documents, providing applicants regulatory disclosures about settlement costs and procedures, assisting them in clearing credit problems, maintaining contact with them throughout the application process, and participating in the loan closing. The IBAA Letter created a "safe harbor" of sorts in any case in which HUD finds that the mortgage broker or other lender's agent or contractor had taken the loan application and had performed at least five (5) additional services from this list of 13. In applying the two-part test, the Statement of Policy adopts this same standard for reviewing whether sufficient origination work has been performed in any case to justify compensation. Services other than these 13 may be evaluated and acknowledged as compensable by HUD if they are meaningful services akin to those set out in the IBAA Letter.

HUD also recognizes in its Statement of Policy that, in addition to services, mortgage brokers may furnish goods or facilities to the lender for which the broker is entitled to compensation. For example, appraisals, credit reports, and similar documents needed to complete a loan file may be regarded as *goods* and a portion of the brokers' retail premises as *facilities* for this purpose. However, consistent with recent federal case law, the loan itself arranged by the mortgage broker cannot be regarded as a *good* that the broker can be said to sell to the lender for its market value based upon the loan's yield or other value as a secured debt instrument.

Q Under What Conditions Does RESPA Permit the Referral of a Loan or Other Settlement Service Business to an Affiliated Entity?

A Regulation X sets out a three-part "Safe Harbor" rule for Affiliated Business Arrangements, whereby certain parties (such as lenders, mortgage brokers, real estate brokers, title companies, home builders, and lawyers) may lawfully refer settlement service business to providers with whom such parties have an affiliate relationship or a beneficial ownership interest (of more than 1%).

RESPA expressly provides that an Affiliated Business Arrangement does not violate Section 8 prohibitions against referral fees if the three conditions [set out in Regulation X § 3500.15(b)(1), (2) and (3)] are satisfied. An Affiliated Business Arrangement exists when a person "who is in a position to refer" settlement service business directly or indirectly refers such business to a settlement service provider (or "affirmatively influences" the selection of such provider) with whom such person making the referral has either an *affiliate relationship* or in whom such person has a *beneficial ownership* of more than one percent (1%).

The three conditions which effectively create a "Safe Harbor" rule with respect to any referral of a settlement service in an Affiliated Business Arrangement are as follows:

A. *Written Disclosure:* The person (or entity) making the referral must provide to each person whose business is being referred (e.g. the borrower, buyer, or seller) a written disclosure on a *separate piece of paper* in a promulgated form [Appendix D to Regulation X] that sets out (i) the *nature of the relationship* between such person and the provider to whom the settlement service is being referred (explaining the ownership and/or financial interest) and (ii) an

estimated charge or range of charges generally made by the provider (using the terminology and format of the HUD-1 settlement statement). The disclosure must be provided no later than the *time of the referral* or, if the lender requires the use of a particular provider, at the *time of the loan application*.

B. *No Required Use:* The person (or entity) making the referral *may not require the use of the affiliated provider* of settlement services as a condition of the availability to the borrower of a distinct service or property (*except*, the lender may require the use of a particular attorney, credit reporting agency, or real estate appraiser to represent its interests, and an attorney may require the use of a particular title insurance company as part of representation of a client in a real estate transaction).

C. *No Referral Fee:* The person (or entity) making the referral *may not receive any payment* or other thing of value for such referral or from the business arrangement *other than a return on an ownership interest* or franchise relationship. Returns on ownership interest must be bona fide distributions of dividends or capital related to the ownership and *may not be tied in any way to the volume or value of referrals made*. But this restriction does not prohibit bona fide loans, advances, or capital contributions between affiliates so long as they are for ordinary business purposes and not tied to the volume or value of referrals made between affiliates.

Q Can a home builder or real estate broker simply form a joint venture with an existing mortgage company to make loans to its home buyer customers in order to get this RESPA exemption?

A Only if the resulting joint venture entity itself is a bona fide provider of loan origination services — and not a sham arrangement designed merely to funnel disguised referral fees to the Builder or Broker.

HUD's Statement of Policy 1996-2 [61 F.R. 29258] provides guidance on this Affiliated Business Arrangement exemption to Section 8 prohibitions against referral fees. In providing this exemption, according to this interpretive rule, Congress did not intend to promote disguised referral fee payments through sham arrangements or shell entities for which there is no bona fide business purpose. By definition, to come within the AfBA exemption, the person or entity receiving the referral must be a "provider" of settlement services. Thus, if the entity is not a bona fide "provider" of settlement services, the arrangement does not meet the definition of an Affiliated Business Arrangement and, accordingly, cannot qualify for the AfBA exemption even if the three "safe harbor" conditions of § 3500.15 are otherwise met.

In enforcement actions to determine whether the entity receiving referrals is a bona fide provider of services or a mere sham, HUD evaluates and balances a number of factors in light of the specific facts regarding the arrangement:

- Whether its capital and net worth are sufficient;
- Whether it employs its own staff;
- Whether it manages its own affairs;
- Whether it maintains a separate office of business; or, if not, pays market value rents;
- Whether it provides substantial services (i.e., essential functions);
- Whether it performs all the substantial services itself;
- If contracting out some of the services, whether it contracts services with an independent third party or an affiliate, and, if contracting with an affiliate, whether it pays only the reasonable value of goods or services received;
- Whether it actively competes in the marketplace for business (or confines itself exclusively to its affiliate business sources); or
- Whether it sends business exclusively to one of the providers that created it.

Even if the entity is found to be a bona fide provider of settlement services when HUD evaluates these factors, that finding does not end the inquiry. Questions may still exist as to whether the entity complies with the three conditions of the Affiliated Business Arrangement exemption (e.g., whether the consumer in fact received an Affiliated Business Arrangement Disclosure Statement or was not required to use the affiliated entity receiving the referral) Regarding the third of these three conditions: that the "only thing of value" that comes from the arrangement (other than permissible payments for services rendered) may be a "return on ownership interest," HUD evaluates the following additional factors in making this determination:

- Has each owner (or participant) made an investment of its own capital (or instead received a "loan" from an entity receiving the benefit of the referrals)?
- Have the owners (or participants) received their ownership interests based on fair value contributions (or were they based on expected referrals to be made by the referring owner)?
- Are the dividends or other distributions made in proportion to the ownership interests (or do distributions vary to reflect the amount of referred business)?
- Are the ownership interests in the new entity free from tie-ins to referrals of business (or are there adjustments to ownership interests based on the amount of business referred)?

If HUD determines that any of the purported "returns on ownership" include payments that vary by the amount of the actual, estimated or anticipated referrals or include payments that have been adjusted on the basis of previous referrals, then these distributions are subject to further analysis as violations under RESPA, Section 8.

Q Can the Builder or Broker Offer a Consumer a Financial Incentive To Use an Affiliate's Services Without Creating a "Required Use" which Violates this Affiliated Business "Safe Harbor" Test?

A Optional packages or combinations of settlement services may be offered to the borrower at discounts without violating the prohibitions against requiring the use of a settlement service provider in an Affiliated Business Arrangement.

The definition of "required use" [Reg. X, §3500.2] expressly provides that the offering of discounts or rebates to consumers for the purchase of multiple settlement services does not constitute a required use of such services. Any package or discount, however, 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 recouped through the charging of higher costs elsewhere in the settlement process.

Q Is the Builder or Broker permitted to pay its own salesmen for referring home buyer customers to an affiliated mortgage company?

A Builders, Yes; Brokers, No. Bona fide employees (but not independent contractors) may be compensated for referral activity by their employer under current regulations. Typically, a home builder's salesmen are W-2 employees, while a real estate broker's sales agents are independent contractors.

Section 8 of RESPA [Regulation X § 3500.14(g)(vii)] currently exempts from its prohibitions an employer's payment to its own employees for any referral activities, including by implication referrals made by such employees to an affiliate of the employer that is subject to an Affiliated Business Arrangement. Any payment made by the affiliate benefiting from such an employee referral either to the employee or to the employer as compensation for the referral of settlement service business, however, is strictly prohibited and a clear violation of Section 8. HUD relies on the general prohibitions of Section 8(a) to prosecute subterfuge payments between affiliates for the referral of business.

[**NOTE**: A Final Rule published June 7, 1996, (61 F.R. 29238) purportedly withdrew this broad exemption and replaced it with two narrower exemptions that would allow employers to compensate only certain managerial employees and employees who do not perform settlement services for making referrals to affiliated mortgage companies. Under this rule, salesmen (who by definition perform a settlement service) would not be eligible for referral compensation. This revised rule, originally scheduled to be effective October 7, 1996, was postponed by Congress, however, until at least July 31, 1997, as part of the Omnibus Consolidations Appropriations Act, enacted September 30, 1996. A Proposed Rule published May 9, 1997, [62 F.R.25740] sought to clarify this rule in certain respects and to add a so-called "like provider" exemption to those espoused in the June 7, 1996, Final Rule, but no action has been taken on either of these rules since.]

BROWN, FOWLER & ALSUP
8955 Katy Freeway, Suite 305
Houston, Texas 77024
Phone: 713/468-0400 • Fax: 713/468-5235