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THE RULES OF THE RESPA ROAD: COMPLIANT STRATEGIC ALLIANCES

The prohibition of referral fees for settlement service business under Section 8 of RESPA is subject to significant exceptions for certain strategic alliances. In this article, the author describes the prohibition, and then turns to detailed discussions of exceptions for payments for goods and services and affiliated business arrangements. She closes with tips for compliant RESPA strategies.

By Holly Spencer Bunting *

It has been two years since the D.C. Circuit issued its decision in *PHH Corporation, et al. v. Consumer Financial Protection Bureau*[1] affirming the legal landscape of service arrangements between settlement service providers under the Real Estate Settlement Procedures Act ("RESPA"). It's also been nearly two and a half years since the Consumer Financial Protection Bureau ("CFPB") announced a consent order related to Section 8 of RESPA. As a result of the *PHH* decision and this lack of recent CFPB enforcement, many settlement service providers, including real estate brokers, mortgage lenders, and title insurance and closing entities, have renewed interest in creating strategic alliances or partnerships between or among companies that refer settlement service business. Interest in these alliances in an inactive enforcement environment can lead companies to push the envelope, but compliance with Section 8 of RESPA is imperative to ensure these strategic alliances do not create unnecessary legal and compliance risk.

This article discusses the referral fee prohibition under Section 8 of RESPA and two popular exceptions under Section 8 that permit certain strategic alliances. In addition, the article provides practical tips based on regulatory guidance to ensure new or existing strategic alliances comply with RESPA.

RESPA REFERRAL FEE PROHIBITION

Congress enacted RESPA in 1974 in response to concerns in the residential real estate and mortgage markets that consumers were paying higher prices to

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[1] 881 F.3d 75 (D.C. Cir. 2018) (en banc).

* *HOLLY SPENCER BUNTING is a partner in the Washington, D.C. office of Mayer Brown and a member of the Consumer Financial Services group. She focuses particular attention on assisting companies in complying with the anti-kickback requirements of RESPA, including counseling clients on the creation and operation of affiliated business arrangements, reviewing proposed and existing business relationships, and drafting disclosures under Section 8 of RESPA. Her e-mail address is hbunting@mayerbrown.com.*

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obtain a mortgage loan because of kickback and referral fee arrangements.[2] To curb those practices, Section 8(a) of RESPA prohibits any person from giving or receiving a thing of value pursuant to an agreement or understanding in return for the referral of settlement service business in connection with a federally related mortgage loan.[3] There are five elements under Section 8(a) that must be present in order for a person to violate RESPA.

First, the real estate transaction must involve a federally related mortgage loan, which essentially includes most first- or subordinate-lien residential mortgage loans.[4] If a transaction is, for example, an all-cash transaction, or the mortgage loan is obtained by the consumer for a business or commercial purpose, there is no federally related mortgage loan.

Second, a person must make a referral, which the law defines as "any oral or written action directed to a person which has the effect of affirmatively influencing the selection by any person of a provider of a settlement service . . . when such person will pay for such settlement service. . . ."[5] Based on this definition, a broad range of communication directed to consumers who will pay for settlement services could be deemed a referral, including, for instance, content on a company's website that touts the benefits of another company's product or service.

Third, the referral of business must involve settlement services. RESPA defines "settlement services" to include a long list of services typically related to the origination of a mortgage loan, like the services of a real estate broker, mortgage origination services of a broker or lender, title insurance services, the closing of a real estate transaction, appraisal services, and hazard insurance.[6] Regulation X, which is the regulation implementing RESPA, also includes a catch-all in the definition to include any services for which a buyer or seller is required to pay in connection with a federally related mortgage loan transaction.[7] Thus, if the business that is referred is a service performed in the course of the origination of a mortgage loan and is a service for which a buyer or seller typically pays, the service generally constitutes a "settlement service."

Fourth, a thing of value must be provided in return for the referred settlement service business. RESPA takes a broad view of what constitutes a thing of value to include essentially any consideration. The statute defines a thing of value as "any payment, advance, funds, loan, service, or other consideration."[8] Regulation X expands upon this definition to provide a list of specific examples of things of value, including monies, discounts, commissions, duplicate payments of a charge, stock, dividends, the opportunity to participate in a money-making program, increased equity in a parent or subsidiary entity, services of all types at special or free rates, trips, and payment of another person's expenses.[9]

Fifth, any "thing of value" provided must be pursuant to an agreement or understanding that such thing of value is provided in return for the referral of settlement service business. This agreement or understanding need not be a formal written agreement or even verbalized. Rather, if there is a practice or particular pattern of conduct that suggests a thing of value is provided in connection with referrals of settlement services, the agreement or understanding element of Section 8(a) will be easily established. As articulated in Regulation X, "[w]hen 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."[10]

If any one of these five elements is not present in an arrangement, there can be no violation of Section 8(a) of RESPA. For example, if a moving company makes cash payments to a real estate broker for the broker's consumer referrals to the moving company, there is no

[2] 12 U.S.C. § 2601.

[3] *Id.* § 2607(a).

[4] *Id.* § 2602(1).

[5] 12 C.F.R. § 1024.14(f).

[6] 12 U.S.C. § 2602(3).

[7] 12 C.F.R. § 1024.2.

[8] 12 U.S.C. § 2602(2).

[9] 12 C.F.R. § 1024.14(d).

[10] *Id.* § 1024.14(e).

settlement service business being referred and, thus, no violation of Section 8(a) of RESPA. Similarly, if a real estate broker refers its commercial developer-clients (and not consumers) to a title insurance agency for the examination of title and issuance of title insurance policies and the title agency treats the real estate broker to Super Bowl tickets each year, there are no federally related mortgage loans in connection with the developer's commercial real estate transactions, and Section 8 of RESPA is not applicable. Otherwise, if the five elements are present in any referral arrangement related to settlement services and residential mortgage loans, both the party giving the thing of value and the party receiving it have violated Section 8 of RESPA.

EXCEPTIONS TO SECTION 8 PROHIBITIONS

In enacting RESPA, Congress recognized that certain arrangements in which referrals of settlement service business occur do not violate Section 8. Specifically, in Section 8(c) of RESPA, Congress enumerated exceptions to the Section 8 referral fee prohibition that permit payments to be made to parties in a position to refer settlement service business.[11] These exceptions (as enumerated in Regulation X) include:

- a payment to an attorney for services actually rendered;
- a payment by a title company to its duly appointed agent for the performance of core title agent services in the issuance of a policy of title insurance;
- 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;
- 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 (Section 8(c)(2));
- distributions made according to ownership interests in an affiliated business arrangement (Section 8(c)(4));
- a payment pursuant to cooperative brokerage and referral arrangements, or agreements between real estate agents and real estate brokers;
- normal promotional and educational activities that are not conditioned on the referral of business and that do not involve the defraying of expenses that otherwise would be incurred by persons in a position to refer settlement services; and
- an employer's payment to its own employees for any referral activities.[12]

While each of these exceptions is important for the businesses that benefit from them, two of the exceptions are the most popular for strategic alliances among settlement service providers; the Section 8(c)(2) exception allowing payments for goods and services provided and the Section 8(c)(4) exception for affiliated business arrangements. The remainder of this article will focus on these important exceptions.

Payments for Goods or Services

To take advantage of the Section 8(c)(2) exception, RESPA provides for a two-part test.[13] First, the entity performing services or providing goods must provide actual, necessary, and distinct services or goods. That means the services or goods must be actually provided, necessary to the party receiving the services or goods, and distinct from services or goods already provided by the service provider. Second, the payment in return for the services or goods must be bona fide or represent fair market value. While RESPA does not define what it means to be fair market value, Regulation X is clear that the value of any referral of settlement service business cannot be part of the assessment of reasonable or fair market value.[14] Moreover, for any payment made for goods or services that exceeds fair market value, the excess portion of that payment will be presumed to be an impermissible referral fee.[15] The Section 8(c)(2) exception is the basis for advertising services agreements, office rental agreements, and co-advertising arrangements that have seen a resurgence in the marketplace.

The validity of Section 8(c)(2) was recently called into question by the CFPB in an enforcement proceeding involving PHH Corporation and captive mortgage reinsurance arrangements. In analyzing PHH's arrangements, an Administrative Law Judge at the CFPB applied the two-part test under Section 8(c)(2) to arrive at an opinion that payments for reinsurance services exceeded the fair market value of the services

[11] 12 U.S.C. § 2607(c).

[12] 12 C.F.R. § 1024.14(g)(1).

[13] 12 C.F.R. § 1024.14(g)(1)(iv).

[14] *Id.* § 1024.14(g)(2).

[15] *Id.*

performed.[16] However, after PHH appealed that decision to the Director of the CFPB, then-Director Richard Cordray issued an opinion taking the position that Section 8(c)(2) was not an exception to the referral fee prohibitions in Section 8 of RESPA, and to the extent referrals were made from PHH to mortgage insurance companies, any reinsurance premium payments made by those mortgage insurance companies to PHH's affiliate for mortgage reinsurance services could not be justified under RESPA, even if services were actually performed.[17]

The D.C. Circuit heard arguments on appeal in *PHH v. CFPB* and, on January 31, 2018, ultimately deemed Section 8(c)(2) to be a valid exception to Section 8 of RESPA. The court, in analyzing the language of the statute, effectively endorsed the two-part test to determine compliance and held that Section 8(c)(2) permits payments for goods or services, *even if the service provider makes referrals to the party paying for goods or services*.[18] With former Director Cordray's RESPA interpretation overturned, strategic alliances involving service arrangements were back in vogue.

Affiliated Business Arrangements

Congress added the affiliated business arrangement exception to RESPA in 1983 to permit persons to own an interest in a settlement service provider, make referrals to that business, and receive profit distributions without violating Section 8 of RESPA. An "affiliated business arrangement" is defined as "an arrangement in which (1) 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 (2) either of such persons directly or indirectly refers such business to that provider or affirmatively influences the selection of that provider."[19]

Such an arrangement is permissible under Section 8 only if the affiliated business arrangement meets the requirements of a three-prong statutory safe harbor.[20] First, the person making a referral to the affiliated business arrangement must provide a disclosure to the consumer being referred at or before the time of the referral that explains the ownership or financial interest between the affiliated business and the person making the referral, provides an estimate of the charges generally made by the affiliated business, and includes a statement informing the consumer that he/she is not required to use the affiliated business for settlement services.[21] Second, the person making the referral to its affiliated business cannot require the consumer to use the affiliated business (except in limited circumstances for a lender and an attorney).[22] Third, the only thing of value that can be received from the affiliated business arrangement is a return on the person's ownership interest in the business (or other payments otherwise authorized under RESPA, including payments for services provided according to Section 8(c)(2)).[23] If any one of these three requirements is not met, the affiliated business arrangement will not comply with Section 8(c)(4) and any profit distributions made to owners in the affiliated business will violate Section 8 of RESPA.

In addition to these statutory requirements, regulators have scrutinized whether an affiliated business arrangement is structured and operated like a bona-fide, stand-alone business. In response to concerns in the 1990s that persons were creating sham affiliated business arrangements to take advantage of the Section 8(c)(4) exception, the U.S. Department of Housing and Urban Development ("HUD") (the former RESPA regulator), issued a Policy Statement identifying 10 factors that it weighed in its analysis of whether an affiliated business arrangement was compliant with RESPA.[24] While the absence of any one factor was not determinative to whether HUD viewed an affiliated business arrangement as bona fide under the law, the factors became required standards for any affiliated

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[16] *In the Matter of PHH Corporation et al.,* Recommended Decision, Administrative Proceeding No. 2014-CFPB-0002 (Nov. 25, 2014), *available at* https://files.consumerfinance.gov/f/documents/201411_cfpb_recommend-decision-final_205.pdf.

[17] *In the Matter of PHH Corporation et al.*, Decision of the Director, Administrative Proceeding No. 2014-CFPB-0002 (Jun. 4, 2015), *available at* https://files.consumerfinance.gov/f/201506_cfpb_decision-by-director-cordray-redacted-226.pdf.

[18] 881 F.3d 75 (D.C. Cir. 2018) (en banc) (emphasis added).

[19] 12 U.S.C. § 2602(7).

[20] 12 U.S.C. § 2607(c)(4).

[21] 12 C.F.R. § 1024.15(b)(1).

[22] *Id.* § 1024.15(b)(2).

[23] *Id.* § 1024.15(b)(3).

[24] Statement of Policy 1996-2 Regarding Sham Controlled Business Arrangements, 61 Fed. Reg. 29258 (June 7, 1996).

business arrangement to be deemed compliant. These factors included: (1) sufficient capitalization to operate the business; (2) dedicated employees; (3) separate office space; (4) the ability to manage itself; (5) the performance of substantial services of the type typically performed by the business at issue; (6) actively competing for business in the general marketplace; (7) whether the entity subcontracts substantial services to its owners or performs the work itself; (8) whether the entity pays fair market value for any subcontracted services; and (9) whether the entity sends business exclusively to its owners.

The CFPB never formally adopted the HUD Policy Statement once it became responsible for RESPA, but its enforcement actions have signaled that the CFPB considers the same 10 factors to be part of its analysis of a compliant affiliated business arrangement. Even after the Sixth Circuit determined that the Policy Statement factors do not carry the force of law,[25] the CFPB continued to pursue affiliated business arrangements based on allegations that the businesses were not bona fide. Thus, in those states not covered by the Sixth Circuit (all states except Kentucky, Michigan, Ohio and Tennessee), the 10 factors for bona fide providers of settlement services continue to define the standards for compliant affiliated business arrangements under RESPA. With significantly less CFPB enforcement activity with respect to affiliated business arrangements since 2017, these businesses remain a popular strategic alliance among settlement service providers.

TIPS FOR COMPLIANT STRATEGIC ALLIANCES

As companies consider strategic alliances like advertising services agreements, office rental agreements, and affiliated business arrangements, it is important to remember that violators of Section 8 are potentially subject to stiff penalties. In addition to criminal penalties of up to one year in prison and/or a $10,000 fine, consumers can sue for an amount equal to three times the cost of the settlement service.[26] Federal and state regulators also have the authority to pursue Section 8 violations, and the CFPB has an expansive arsenal of penalties. As a result, the stakes are high for any arrangement structured under the exceptions to Section 8. In structuring services agreements, affiliated business arrangements and other strategic alliances to avoid the risk of these penalties, settlement service providers should carefully navigate the rules of the RESPA road.

For those companies entering into advertising services agreements, office rental agreements, or any other agreement for goods or services, those arrangements should be structured to comply with the two-part test under Section 8(c)(2). That includes requiring the service provider in the strategic alliance to perform actual, necessary, and distinct goods or services, and the recipient of those goods or services to pay no more than fair market value. As it relates to advertising services agreements, regulators have provided guidance to assist companies in structuring these arrangements to comply with RESPA.[27] Notably:

- The entity performing the advertising services (which, often, is a real estate broker, home builder, or mortgage company) should direct its advertising services to the general public. Regulators have indicated in the past that sales pitches and other direct-to-consumer solicitations for a particular company or product are akin to referrals and are not services for which an entity can be legally compensated under RESPA. Regulators have indicated that advertising to the general public can be a compensable service.

- An advertising services agreement should be memorialized in a written agreement. Regulators have indicated that evidence to support a determination that compensable services have been performed includes a contract that specifies the services to be performed, as well as documentation by the service provider that it performed the services.

- Avoid exclusive agreements. Guidance issued by regulators suggests that, in evaluating whether payments under a services agreement violate RESPA, regulators will consider whether the compensation for the services provided is contingent on an arrangement that prohibits the service provider from performing services for other companies.

- It is a best practice to disclose the existence of a paid services agreement to the consumer. Again, regulators have suggested that such a disclosure is a factor regulators would consider in determining whether a services agreement is compliant with RESPA.

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[25] *Carter v. Welles-Bowen Realty, Inc.,* 736 F.3d 722 (6th Cir. 2013).

[26] 12 U.S.C. § 2607(d).

[27] *See e.g.,* 75 Fed. Reg. 36271 (Jun. 25, 2010); 75 Fed. Reg. 74620 (Dec. 1, 2010).

- Make payments tied specifically to the value of the services actually performed and do not adjust those payments based on the number of transactions referred. Regulators have warned that adjustments to payments under a services agreement based on referrals of business can be an indicator that an arrangement is an unlawful kickback, and the CFPB has targeted strategic alliances in its enforcement actions for that exact practice.

Similar rules of the road apply to office rental agreements, where regulator guidance has focused on structuring these strategic alliances like arms-length lease agreements.[28] In particular:

- Payments for the lease of office or desk space should reflect the fair market value for the space and services received under the lease or sublease. Regulators have acknowledged that "the market value of the rental space may include an appropriate proportion of the cost for office services actually provided to the tenant, such as secretarial services, utilities, telephone, and other office equipment."[29] In addition, regulators have stated that the rental rate must be based on a general market value, rather than a market rate among settlement service providers. This means that fair market value is the rent that a non-settlement service provider would pay for the same amount of space and services in the same or a comparable building.

- Rental payments should not be tied to the number of transactions referred. Regulators have explicitly stated in the past that "[i]f the rental payment is conditioned on the number or value of the referrals made, then [a regulator] will consider the rental payment to be for the referral of business in violation of Section 8(a)."[30]

- The agreement should be memorialized in a written agreement that identifies the physical space leased under the agreement, as well as the additional services and equipment provided under the lease.

- The office space leased under the agreement should actually be used. In past enforcement cases, HUD indicated that in conference room rentals where the conference room was rarely used, it examined whether a facility had actually been provided under the agreement and determined the room rental to be a sham arrangement designed to pay referral fees.[31]

- Exclusive arrangements in which other companies not renting space are "locked out" and prevented from accessing the lessor's office should be avoided. Regulators have indicated that "lock out" arrangements raise the question of whether the rental arrangement is bona fide under RESPA.

Finally, as it relates to the formation of affiliated business arrangements, the business must comply with the three-part statutory safe harbor under Section 8(c)(4) and be structured in the vast majority of states based on the factors indicative of a bona fide business.[32] Notably:

- The person with an ownership or other financial interest in an affiliated business arrangement that refers consumers to the business must provide the affiliated business disclosure in connection with every referral. Appendix D to Regulation X provides a model affiliated business disclosure that should be used to comply with the disclosure requirement.[33]

- Companies also should be aware of state laws that may require additional information to be disclosed as part of the affiliated business disclosure. For example, under Virginia law, if a person's ownership interest in an affiliated settlement service provider is greater than one percent, the affiliated business disclosure must include the percentage of ownership. If the person making the referral owns more than 50 percent of the affiliated business, Virginia law requires that the disclosure state that the affiliated business is a subsidiary of the person making the referral.[34]

- Owners in an affiliated business arrangement must not require a consumer to use the affiliated business as a condition of the consumer having access to a particular product or service. However, the definition of "required use" makes clear that owners

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[28] Statement of Policy 1996-3, Rental of Office Space, Lock-outs, and Retaliation. 61 Fed. Reg. 29264 (June 7, 1996).

[29] 61 Fed. Reg. at 29265.

[30] *Id.* at 29266.

[31] *Id.*

[32] 12 U.S.C. 2607(c)(4); 12 C.F.R. § 1024.15; 61 Fed. Reg. 29258 (June 7, 1996).

[33] 12 C.F.R. Part 1024, App. D.

[34] Va. Code § 55.1-905.

may offer discounts or incentives to encourage the consumer to elect to purchase the products or services of the affiliated business.[35] Any such discounts or incentives must be true discounts that are not made up by higher prices elsewhere in the transaction.

- Profit distributions to the owners of an affiliated business must be made strictly according to ownership interests in the business. A return of ownership interest does not include: (1) any payment that has no apparent business motive other than to distinguish among recipients of payments based on the amount of their actual, estimated, or anticipated referrals; (2) any payment that varies based on the amount of referrals by the different recipients of similar payments; or (3) any payment based on an ownership share that has been adjusted according to previous referrals by recipients of similar payments.[36]

- The owners of an affiliated business should invest sufficient initial capital typical in the industry to conduct the settlement service business for which the affiliated business arrangement was created. Regulators have not defined what they deem to be sufficient initial capital, but generally the owners of an affiliated business should consider the amount of capital necessary to start and initially operate the business, as well as whether state licensing laws dictate a required amount of net worth.

- An affiliated business should have its own employees that perform the substantial services provided by the business. Those employees should work from the affiliated business's own office space, for which the affiliated business pays fair market value rent.

- If the affiliated business is a title insurance agency, the employees of that title agency should perform "core title agent services," which include "the evaluation of the title search to determine the insurability of the title, the clearance of underwriting objections, the actual issuance of the policy or policies on behalf of the title insurance company, and, where customary, issuance of the title commitment, and the conducting of the title search and closing."[37]

- The affiliated business should be capable of managing itself and may subcontract the performance of certain administrative services that support the overall management of the business to an owner or third-party service provider. If it is necessary to subcontract out administrative services, the affiliated business should pay fair market value for those services.

- The affiliated business should market itself to the general public and attempt to obtain business from sources other than the referrals of its owners.

CONCLUSION

Strategic alliances among settlement service providers can be effective for the business of real estate brokers, mortgage lenders, title insurance entities, and other companies. RESPA permits these arrangements based on the exceptions to Section 8's prohibitions, but settlement service providers must carefully structure these strategic alliances to comply with the requirements of Section 8(c)(2), Section 8(c)(4), Regulation X, and other guidance provided by regulators. Even if Section 8 of RESPA does not appear to be an enforcement priority for the CFPB today, strategic alliances that do not comply with the law always put settlement service providers at risk for penalties or lawsuits. ■

[35] 12 C.F.R. § 1024.2(b).

[36] 12 C.F.R. § 1024.15(b)(3)(ii).

[37] 12 C.F.R. § 1024.14(g)(3).