Issue Date: RESPA News Monthly

Affinity relationships under RESPA: Making money the 'old-fashioned way'

Welcome to the first installment of our new RESPA column, written by attorney Howard A. Lax of Lipson, Neilson, Cole, Seltzer & Garin, P.C. (See complete bio below). In this weekly column, Lax will explain the basics of RESPA Section 8 and describe how to establish relationships that don’t violate the law.

An Introduction

Affinity relationships are a wonderful means of developing a supplemental income stream. Unfortunately, many affinity relationships are implemented outside of the framework of Section 8 of RESPA. Many times, this is the result of misunderstanding what RESPA requires, and what it does not. This is evident from the settlements entered into by real estate brokers, mortgage brokers, and title companies who were found by HUD to have violated Section 8 of RESPA. Section 8 of RESPA prohibits certain "kickbacks," but that does not explain when a "kickback" is illegal and when it is not.

Consumers understand "kickbacks" as rebates. You buy a product from a retailer, and the manufacturer gives you some of your money back. Businesses understand kickbacks as "referral fees." You work as my employee to find a customer for my goods and services, and you earn a commission. Both of these examples are "kickbacks," but neither example is prohibited by RESPA. Therein lies the confusion. A reasonable person does not understand why "scratching someone's back" can be an illegal kickback if it benefits both parties, and what "magic bullet" makes it a legitimate relationship.

Section 8(a) of RESPA prohibits paying or receiving any fee or other thing of value (even a referral) in return for the referral of "settlement services" in a "federally related transaction." Section 8(b) of RESPA states that a person cannot accept a settlement service fee, or a split of a settlement service fee, in a "federally related transaction" without providing "settlement services." Just as the commandment, "Thou shalt not kill" does not elucidate the exceptions for self defense, military action, and police action, the above prohibitions do not describe the exceptions to the rule.

Most real estate professionals and home builders are looking for supplemental sources of income. Section 8(c) of RESPA gives us a number of exceptions to the prohibition against kickbacks.

The most useful exception in Section 8(c) of RESPA is the "goods and services" exception. A settlement service provider may pay for substantive goods and services, even when the payee refers consumers to the provider for settlement services. The payment must be earned for goods and services, not for the referral of mortgage loan customers, and not for services that duplicate services already provided as part of the loan origination process.

Just as lenders "bundle" settlement services, real estate agents, builders, and other referral sources may "bundle" their services to benefit mortgage brokers and lenders, and receive fair compensation for these services. Mortgage brokers and lenders, to a lesser extent, may bundle services and sell these to title agencies.

There are a number of ways for mortgage brokers and mortgage lenders to interact with real estate professionals, title agencies, residential builders, and others, to earn additional income by utilizing this exception. The keys to developing these affinity relationships are (a) to find a "bundle of services" that benefits both parties, and (b) to identify the market rate payable for these services. The parties must then identify the goods and services provided in a written agreement, and to pay no more than market rates for the goods and services. Any amount in excess of market rates will be inferred to be a kickback for the referral of business.

Adding services to a transaction, or providing cash rebates to the borrower as part of the "bundle," gives the borrower an
incentive to choose to receive mortgage origination services or title and escrow services through the affinity relationship. This drives additional compensation to the affinity partners. The result is a win-win arrangement for the mortgage professional, the affinity partner, and the consumer.

This column is the first in a series of sixteen segments. In the coming weeks, we will discuss the limitations of RESPA, the exceptions to the rule, and various frameworks for establishing affinity relationships that avoid violations of federal law. The sixteen segments will be organized into two broad sections. First, we will discuss the definition of a kickback, and its exceptions in an academic exercise. You must understand what is prohibited to understand what is allowed. Second, we will discuss various methods of establishing affinity relationships that do not violate RESPA.

Does RESPA Apply?

The first question a law professor would ask is whether the transaction is subject to RESPA. RESPA only applies to “federally related transactions.” Any person or entity originating one million dollars or more of residential mortgage loans in a calendar year that is also subject to disclosure requirements of the Truth in Lending Act (TILA) generates “federally related transactions.”

Any transaction that is assisted with money from the federal government, or is insured or guaranteed by the federal government, or is sold to FNMA or FHLMC, is a “federally related transaction.” Hence, we perceive all mortgage transactions as subject to RESPA, but that is not the case. The following are exempt from RESPA:

- Typical one-time seller financing that is not valued at over one million dollars, or the seller does not engage in a sufficient number of transactions to be subject to TILA.
- Business purpose credit transactions that are exempt from TILA. For example, a mortgage loan to an investor to acquire residential rental property is a business purpose loan that is not subject to TILA or RESPA.
- Cash transactions are not subject to RESPA.

HUD also carved out other loans from RESPA by rule:

- Loans secured by 25 contiguous acres are not subject to RESPA.
- Loans secured by multi-family housing (5 or more units).
- Loans secured solely by land that will not be developed for at least two years.

In contrast, some of these transactions are considered to be subject to the anti-kickback rule:

- Construction loans if the lender makes the end loan, or the borrower buys the lot with the first draw.
- Home equity lines of credit even though certain disclosures are excused.
- Loan modifications if the note is replaced or the mortgage is amended.
- Mortgage assumptions if the lender must approve the assumption.

Discussion of these exceptions is largely an academic exercise. RESPA applies to the majority of residential mortgage transactions, including those involving our readers. For the remaining segments of this column, we will ignore transactions that fall outside of the scope of RESPA, and concentrate on core businesses dependent upon residential mortgage transactions.

Next Week: What is an illegal kickback?

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What is an illegal kickback?

To understand what RESPA prohibits, you must grasp and thoroughly digest the definition of an illegal kickback. Section 8(a) of RESPA states:

“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.”

There are three elements to an illegal kickback: (1) a “thing of value,” (2) an “agreement or understanding,” and (3) a “referral.” If any of these three essential elements is missing, the activity is not illegal under RESPA. HUD’s Regulation X defines each of these three elements:

Things of value

First, a “thing of value” includes, without limitation, monies, things, discounts, salaries, commissions, fees, duplicate payments of a charge, stock, dividends, distributions of partnership profits, franchise royalties, credits, future opportunities, chances, retained or increased earnings, increased, accounts, special or unusual contract terms, reduced rates for goods and services, increased payments for goods and services, lease or rental payments based in whole or in part on the amount of business referred, payment of another person's expenses, or reduction in credit against an existing obligation.

When HUD refers to a “payment,” it means the giving of anything of value, whether it is money, a chance to win a prize, a referral, or some future consideration.

Lesser known examples of a “thing of value” include:

- Defraying costs that a party would ordinarily have to pay, such as the cost of mandatory continuing education courses.
- Promising to provide a referral in the future (an agreement for mutual referrals).
- Chances in a lottery or raffle (the ticket has a value, win or lose).
- Providing something that has a dual use may be a thing of value if used for two purposes (e.g. a non-dedicated fax machine).
- Promising an appraiser that he will perform the appraisal for each borrower the appraiser refers to a related lender.

There is no “de minimus” rule. Contrary to popular belief, a gift under $25 is not exempt from being a “thing of value,” and charitable contributions are not exempt from the rule. Nevertheless, there is a point at which the “thing of value” becomes too attenuated to identify. For example, a referral to an affiliate cannot be directly compensated. However, the referral contributes to the overall profitability of the combined enterprise, and increases the pool from which all employees are paid a bonus. The incremental increase in the referring employee’s bonus is too attenuated from the referral to be a “thing of value” paid for the referral. The point of “no return” must be evaluated on a case by case basis.
Agreement or understanding

You know an agreement exists when you see it. An agreement or understanding for the referral of settlement service business can be oral, written, or established by a practice, pattern or course of conduct. When 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. Requiring the borrower to use a particular service provider infers that an agreement or understanding exists for the referral of business.

There are several exceptions to this definition. First, the borrower cannot be a party to a kickback in his own loan transaction. Defraying the borrower’s closing costs to persuade the borrower to take a loan is not a kickback. Paying a borrower to refer friends and family is an illegal kickback. Second, some Federal Appellate Courts have ruled that unilaterally increasing the price of a third party service fee (and keeping the difference) is not an illegal kickback because there is no agreement. There is a split of opinion on this issue, with HUD and state regulators opposing this practice.

Referral

"Referral" is defined two ways. First, a referral includes any oral or written action directed to a person that has the effect of affirmatively influencing the person to use a particular settlement service provider and pay a fee for the service. Second, a referral also occurs whenever a person paying for a settlement service is required to use a particular provider of a settlement service. "Required use" means a situation in which a person must use a particular provider of a settlement service and pay their fee in order to have access to some distinct service or property.

There are exceptions that do not constitute a “referral.” First, providing a bundle of services that is significantly discounted from the cost of the individual services does not constitute a “required use” of the provider of the services. For example, a lender that negotiates with settlement service providers for substantially reduced charges so that an origination fee of $300 covers the AUS, credit report, and appraisal services does not require the use of the AUS service, credit bureau and appraiser if the ordinary actual cost of the services provided individually would be $400.

Second, a mortgage originator can buy leads if the person selling the leads does not mention the name of, or do anything to influence the consumer to contact, the broker, lender or other settlement service provider. No endorsements, no hints, no nothing. The broker or lender does all the soliciting of the lead. There are several important caveats to buying leads that will be discussed in future segments.

Illegal kickbacks are like a three-legged stool

Think of an illegal kickback as a three-legged stool. If any of the three legs are missing, the stool falls over. The same is true under RESPA. If any of the three elements of a kickback is missing, or an exception exists for one of the elements, the transaction is not illegal. Our next segment will give you examples of various transactions with a missing leg that do not offend RESPA.

Next Week: Knocking the stool over.

Previous column:

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Affinity relationships under RESPA: Knocking the stool over

Welcome to the third installment of our new RESPA column, written by attorney Howard A. Lax of Lipson, Neilson, Cole, Seltzer & Garin, P.C. (See complete bio below). In this weekly column, Lax explains the basics of RESPA Section 8 and describes how to establish relationships that don't violate the law.

Think of an illegal kickback as a three-legged stool. If any of the three legs are missing, the stool falls over. The same is true under RESPA. If any of the three elements of a kickback is missing — or an exception exists for one of the elements — the transaction is not illegal.

The three elements of an illegal kickback include: (1) an agreement, (2) a referral, and (3) something of value. If any one element is missing, the activity is not prohibited by Section 8 of RESPA. Each element must be evaluated individually.

No agreement

It is easy to presume that an agreement exists when the person making the referral receives a benefit from the recipient of the referral. It is difficult to prove that an agreement exists if (a) the thing of value does not directly benefit the party providing a referral, or (b) the thing of value does not originate from the person receiving the benefit of the referral. You need to show the existence of some independent action by one of the parties tying the payment to the referral when there is an indirect benefit.

Take the example where a mortgage lender offers to pay for the cost of the title commitment for any borrower referred to him by a real estate salesperson. The lender's payment of a title premium defrays the seller's cost, not the Realtor's costs. The real estate salesperson is making the referral, not the seller. If there is no agreement or understanding tying the seller's benefit with the referral by the real estate salesperson, the payment is legal.

However, if the real estate salesperson used the mortgage lender’s payment to negotiate his commission (with the lender's knowledge), that action ties the payment to the referral, and the payment is an illegal a kickback.

Let's try this one more time. A mortgage broker gives coupons to builders for $1,000 off the buyer's closing costs in return for the referral of home buyers for a loan. The coupon defrays the buyer's cost, not the builder's costs. Ordinarily, the buyer cannot be a party to a kickback in his own loan, and the coupons are legal. However, if the builder uses the coupon to negotiate up his construction price, there is a kickback. Furthermore, if the mortgage lender gives the coupons only to builders who give him referrals, there may be a kickback.

Our third example demonstrates the effect that an intervening borrower will have on a referral fee. A lender pays $100 to a church for each member who closes a loan. The church advertises the loan program to its members and encourages them to borrow from the lender. If the lender writes the check to the church, it is a kickback. If the lender writes the check to the borrower, who then voluntarily signs the check over to the church, there is no kickback. The borrower cannot be a party to a kickback in his own loan transaction since the borrower is protected by RESPA. Hence, the borrower breaks the connection between the settlement service provider and the church making the referral for a fee.

Change the facts a little. The lender buys the church membership list and solicits the members. Loan officers attend the church picnic to pass out fliers advertising loan products. If the lender pays for access to the picnic (other than the cost of the meal and other activities for the loan officers), there may be a kickback. If the church endorses the lender, there may be a kickback. If the lender hires the pastor to take applications, there may be a kickback (depending on whether the pastor is a bona fide employee of the lender).

No referral
Selling leads is not an illegal kickback because there is no a referral. A lead company finds consumers who are willing to apply for a loan, but the lead company does not take any action directed at the consumer to influence the consumer to use any particular lender. Only the lenders that buy leads solicit consumers to apply for a loan. Why don’t lenders buy leads from the public at large? A lender that gives the borrower $50 for giving him the names of friends and relatives who are looking to refinance or to buy a home is purchasing a list. The borrower is not asked to do anything to influence friends and relatives to use the lender.

However, the borrower cannot refrain from telling his friends about the lender, and the lender expects this to occur. Even if the lender ordered the borrower not to solicit for the lender, the lender cannot guaranty that the borrower will refrain from making referrals. If the borrower breaks his promise, and talks about the lender after receiving his $50, both the lender and the borrower are liable for a violation of Section 8.

No thing of value

The classic example is the lender that rents space in a title agency’s building and refers borrowers to the title agency for title insurance. An illegal kickback could exist if the title agency were giving something of value to the lender. If the lender is paying market rates or above market rates for rent, it is not receiving anything of value for its referrals. If, however, the lender is paying below market rent, the difference is presumed to be a benefit for the referral of settlements service business.

The discounted value of title services was the basis of significant litigation in Michigan over the past several years. Assume that title agencies charge $25 to a builder for the owner’s title policy, and the buyer pays the remainder of the basic fee for the mortgage policy. Does the discount represent a benefit paid to the builder for referring business to the title agency?

There are good arguments on each side of this issue. The title agency has less work to write title commitments for the lots because the title agency is able to perform one search for the whole project, and then just provide an update for each lot. On the flip side, the reduced cost of the owner’s policy is an inducement for the builder to send all of his title business to the one title agency, and refer all borrowers there as well. If the title agent were truly lowering its fees due to decreased work, it would lower the basic insurance fee (to benefit the borrower and the builder).

Furthermore, title insurance is priced according to the amount of coverage. The $25 premium is not related to the level of risk assumed by the title underwriter. The implication is that the significantly discounted insurance premium is a kickback. Two large settlements occurred in Michigan cases, resulting in title companies paying tens of millions of dollars in damages for overcharging borrowers for title insurance on new construction.

Next Week: Section 8(b) of RESPA – the other shoe.

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Let us know what you think of this column! E-mail editor@respanews.com.
Affinity relationships under RESPA: Inside Section 8(b)

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Section 8(b) of RESPA - The other shoe

The "little brother" of Section 8(a) of RESPA is Section 8(b):

"No person shall give and no person shall accept any portion, split, or percentage of any charge made or received for the rendering of a real estate settlement service in connection with a transaction involving a federally related mortgage loan other than for services actually performed."

Section 8(b) prohibits a mortgage broker or a title agent from taking a fee without providing substantial services. That much was established in two HUD Statements of Policy. HUD Statement of Policy 1996-1 defined the minimal services that a mortgage broker must perform to earn a fee. HUD Statement of Policy 1998-4 defined the core title services that a title agency must perform to earn the title insurance premium. The Statement of Policy covering mortgage broker fees was needed to stem a tide of litigation that threatened to swamp the mortgage broker industry. The Statement of Policy regarding title insurance services was needed to stem business arrangements that allowed referral sources to earn a fee without providing much in the way of services.

The minimal services that a mortgage broker must perform were first espoused by HUD in an informal letter to the Independent Bankers Association of America, dated February 14, 1995. This letter identified fourteen services that a mortgage broker may perform to originate a mortgage loan. These include:

(a) Taking information from the borrower and filling out the application;

(b) Analyzing the prospective borrower's income and debt and pre-qualifying the prospective borrower to determine the maximum mortgage that the prospective borrower can afford;

(c) Educating the prospective borrower in the home buying and financing process, advising the borrower about the different types of loan products available, and demonstrating how closing costs and monthly payments could vary under each product;

(d) Collecting financial information (tax returns, bank statements) and other related documents that are part of the application process;

(e) Initiating/ordering VOEs (verifications of employment) and VODs (verifications of deposit);

(f) Initiating/ordering requests for mortgage and other loan verifications;

(g) Initiating/ordering appraisals;

(h) Initiating/ordering inspections or engineering reports;

(i) Providing disclosures (truth in lending, good faith estimate, others) to the borrower;

http://www.responline.com/65/65/3930/
(j) Assisting the borrower in understanding and clearing credit problems;

(k) Maintaining regular contact with the borrower, realtors, lender, between application and closing to apprise them of the status of the application and gather any additional information as needed;

(l) Ordering legal documents;

(m) Determining whether the property was located in a flood zone or ordering such service; and

(n) Participating in the loan closing.

These fourteen services were incorporated into a formal Statement of Policy and published by HUD on March 1, 1999. HUD's Statement of Policy required a mortgage broker to provide five services from the list above in addition to taking the loan application. HUD also recognized that services (b), (c), (d), (j), and (k) on the list above were "counseling type" services that could provide more of a substantive benefit to the lender than to the borrower. Hence, a mortgage broker's services would be closely scrutinized if the mortgage broker provided only these five "counseling services."

HUD acknowledged that these are not the only services that a mortgage broker may provide, and that some of these services may be provided through technology rather than the efforts of a mortgage broker. Nevertheless, the important principle of this Statement of Policy is that it provided a safe harbor for mortgage brokers. Mortgage brokers could earn a fee by providing a limited number of identifiable services. Furthermore, the mortgage broker's total compensation should be measured against the totality of the services provided. Class action lawsuits that separately measured the services provided to the mortgage lender and services provided to the borrower against the amount that each party paid were no longer viable.

HUD also published a Statement of Policy establishing minimum title agency services. HUD stated:

"Section 8(c)(1)(B) specifically exempts payments of a fee 'by a title company to its duly appointed agent for services actually performed in the issuance of a policy of title insurance.' A more general provision, section 8(c)(2), exempts the '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.' (See also 24 CFR 3500.14(g)(1))....."

"To qualify for a section 8(c)(1)(B) exemption, the attorney title insurance agent must 'provide his client with core title agent services for which he assumes liability, and which includes, at a minimum, the evaluation of the title search to determine insurability of the title, and the issuance of a title commitment where customary, the clearance of underwriting objections, and the actual issuance of the policy or policies on behalf of the title company.'"

More specifically, HUD defined five services that a title agent must perform to earn the entire title insurance premium:

"'Core title services' are those basic services that a title insurance agent must actually perform for the payments from or retention of the title insurance premium to qualify for RESPA's section 8(c)(1)(B) exemption for 'payments by a title company to its duly appointed agent for services actually performed in the issuance of a policy of title insurance.' In performing core title services, the title insurance agent must be liable to his/her title insurance company for any negligence in performing the services. In considering liability, HUD will examine the following type of indicia: the provisions of the agency contract, whether the agent has errors and omissions insurance or malpractice insurance, whether a contract provision regarding an agent's liability for a loss is ever enforced, whether an agent is financially viable to pay a claim, and other factors the Secretary may consider relevant.

"'Core title services' mean the following in Florida:

a. The examination and evaluation, based on relevant law and title insurance underwriting principles and guidelines, of the title evidence (as defined below) to determine the insurability of the title being examined, and what items to include and/or exclude in any title commitment and policy to be issued.

b. The preparation and issuance of the title commitment, or other document, that discloses the status of the title as it is proposed to be insured, identifies the conditions that must be met before the policy will be issued, and obligates the insurer to issue a policy of title insurance if such conditions are met.
c. The clearance of underwriting objections and the taking of those steps that are needed to satisfy any conditions to the issuance of the policies.

d. The preparation and issuance of the policy or policies of title insurance.

e. The handling of the closing or settlement, when it is customary for title insurance agents to provide such services and when the agent’s compensation for such services is customarily part of the payment or retention from the insurer.”

Controversy exists regarding core title services and retained risk, even after this guidance was published. For example, title plants provide an electronic document that mimics Schedule B of a title commitment. HUD’s position is that “if the title insurance company provides its title insurance agent with a pro forma commitment, typing, or other document preparation services, the title insurance agent is not ‘actually performing’ these services. As such, the title insurance agent would not be providing ‘core title services’ for the payments to come within the section 8(c)(1)(B) exemption.” What level of scrutiny of the title search is required before the commitment can be generated from the search document? Does the agency fulfill its obligation to provide all “core title services” if the title agent simply accepts the document provided by the search service and pushes a few keys to create the commitment?

Controversy also exists regarding the sharing of risks between insurance companies. State insurance commissioners recently fined several title insurance companies for entering into reinsurance agreements with title companies owned by builders. The reinsurance agreement paid the builders’ reinsurance companies a fee that was disproportionate to the risk that the reinsurer absorbed. The commissioners found that splitting the insurance premium, without absorbing substantial risk, violated state insurance codes and RESPA.

HUD has not officially established minimum or core services that other settlement service providers must perform to earn a fee. Therein lies a problem. Section 8(b) implies that splitting a fee by agreement is illegal if no services are performed. However, is a modicum of service all that is necessary to earn a substantial fee? Furthermore, is it illegal to take a fee without providing a service when there is no second party that knowingly splits the fee? Without guidance from HUD, the issue of what other settlement service providers must do to earn a fee was left to the courts.

Next Week: Back to Court

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Affinity relationships under RESPA: Markups and junk fees

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Back to Court

Once litigation subsided over mortgage broker fees, borrowers increasingly challenged miscellaneous lender compensation. Borrowers claimed that document preparation fees greatly exceeded the actual cost of preparing closing documents, underwriting fees exceeded the cost charged by automated underwriting systems, credit report fees exceeded the cost of the credit report, and that some lenders were making excessive profits from "junk fees." These claims took two forms.

First, borrowers claimed that lenders cannot make a profit from third party services. These profits are termed "markups." Second, borrowers claimed that lenders cannot charge excessive fees, far above the cost or the value of services provided. These profits are termed "overcharges" or "overages." HUD supported markup and overcharge claims in amicus briefs filed in various borrower lawsuits.

Markups

HUD and the Department of Justice enforce an informal policy that a settlement service provider cannot earn a fee without providing substantial services. HUD will take action against a lender or title agency that marks up third party settlement service fees passed on to the borrower. Markups typically occur when a service provider (typically a credit bureau) bills a lender monthly for services, or the actual cost (e.g. the recording fee) is determined after the closing. Charges for online credit reports vary (typically ranging from $8 to $15). The lender may have no idea what the credit report costs at the time of closing and, therefore, the lender charges the borrower a flat fee that is the average cost of the credit report. Title agents also charge flat fees for recording documents since they do not know until just before the closing how many pages are in the deed and mortgage.

HUD believes that each borrower should pay no more than the actual cost for third party services. Hence, anyone who paid $12 for an $8 credit report is entitled to a refund. HUD has fined several lenders for these infractions. While some fines have been substantial, many fines imposed by HUD were a few thousand dollars per lender – amounts too small to be economically worthwhile to contest.

Consumers have been less successful arguing to a court that they should receive compensation for fee markups. The Fourth, Seventh, and Eighth Circuit Courts of Appeals held that Section 8(b) clearly and unambiguously does not prohibit mark-ups.

These courts held that:

- There is no violation of RESPA when there is no agreement or understanding between the credit bureau and the lender, or between the title agent and the Register of Deeds, that the lender would keep the difference between the charge to the borrower and the actual cost of the service.
- Section 8 requires a court to find two parties guilty. The only other party to the transaction is the borrower, but the borrower cannot be a party to a kickback in the borrower’s own loan. Holding the borrower liable under a statute designed to protect the borrower leads to an absurd result.

Later court decisions by the Eleventh Circuit and the Second Circuit Courts of Appeals deferred to the arguments espoused by HUD to hold that a markup could be a kickback.
However, if the service provider can show that it rendered some service that can be compensated (and there is no overlap of other compensation or fee for the service), then there is no kickback. In theory, a lender or a title agent can earn a fee for almost anything. Enforcement of HUD’s position has been limited in the past few years. Instead, state regulators have fined lenders for marking up credit reports on the basis that state laws expressly limit fees collected for third party services to the actual cost of these services.

There are several means of avoiding this issue:

- Raise the origination fee to bundle the origination of the loan with the credit report fee, and show the flat fee to the credit bureau or to the Register of Deeds as an estimated POC payment.
- Charge a credit review fee instead of a credit report fee, and show the flat credit report fee as an estimated POC payment.
- Increase the closing fee to include the cost of recording documents, and show an estimated POC payment to the Register of Deeds.
- Charge a recording service fee in addition to the fee charged by the Register of Deeds.

All of these methods are being used to level out the cost of services. However, a more prevalent practice creeping into the market is to increase “junk” fees rather than to bundle fees. HUD has, in effect, opened a Pandora’s Box by making a mountain out of a molehill. Consumers are now paying more for incremental services than they did by paying an average amount for the cost of the third party service.

**Overcharges and Overage**

HUD and the Department of Justice have also argued, unsuccessfully to this point, that an excessive fee violates Section 8(b) of RESPA. HUD’s argument, asserted in Statement of Policy 2001-1, is that “A single service provider . . . may be liable under Section 8(b) when it charges a fee that exceeds the reasonable value of goods, facilities, or services provided.” HUD’s argument is based on a statement in Regulation X: “If the payment of a thing of value bears no relationship to the goods or services provided, then the excess is not for services or goods actually performed or provided.” In HUD’s view, too many points, an oversized document preparation fee, or too high of a yield spread premium, is a fee split—the borrower is charged a reasonable fee for services, and the borrower is charged an additional amount for which the borrower receives no benefit.

However, the 1973 legislative history of RESPA indicates that Congress rejected an explicit price control proposal when RESPA was enacted. Instead, it directed HUD to report to Congress on “whether Federal regulation of the charges for real estate settlement services in federally related mortgage transactions is necessary and desirable.” Congress took no further action regarding price controls. Thus the courts rejected HUD’s argument since it was based on a HUD rule which was not supported by RESPA.

**Next Week: Exceptions to the Rule**

**Previous columns:**

**Affinity relationships under RESPA: Making money the ‘old-fashioned way’**

**Affinity relationships under RESPA: What is an illegal kickback?**

**Affinity relationships under RESPA: Knocking the stool over**

**Affinity relationships under RESPA: Inside Section 8(b)**

Howard A. Lax is a corporate law attorney with the Bloomfield Hills, Mich.-based firm Lipson, Neillson, Cole, Seltzer & Garin, P.C. His practice concentrates on financial institutions consumer compliance and regulatory affairs, and real property law. Mr. Lax earned his J.D., cum laude, from Wayne State University's School of Law and holds a bachelor's degree from the University of Michigan. Active in the legal community, he is a member of the State Bar of Michigan's Business Law Section and is a member of the governing council of the Real Property Law Section. He also publishes a bimonthly legal newsletter for the mortgage banking industry. Contact Howard A. Lax at
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Let us know what you think of this column! E-mail editor@respanews.com.
Affinity relationships under RESPA: Exceptions to the rule

Welcome to the sixth installment of our new RESPA column, written by attorney Howard A. Lax of Lipson, Neilson, Cole, Seltzer & Garin, P.C. (See complete bio below). In this weekly column, Lax explains the basics of RESPA Section 8 and describes how to establish relationships that don’t violate the law.

Exceptions to the Rule

Every rule has its exceptions, including Section 8 of RESPA. Five principal exceptions to the kickback rule (in addition to the “missing stool leg” concept discussed in previous columns) are used to create affinity relationships between settlement service providers:

1. Payments for rendering services or providing goods.

Section 8(c) of RESPA allows payments for bona fide services and goods actually received, regardless of whether the party receiving the payment refers business to the party paying for the services and goods. These services and goods typically take the form of subleases, desk licenses, joint advertising, marketing services, and other miscellaneous services. There are several caveats to this exception:

a. The services or goods must be bona fide. Simply stating that services and goods will be provided is not sufficient.

b. The services and goods must be provided on a commercially reasonable basis. A real estate broker that rents a conference room for loan closings, or subleases space as an executive office suite, must provide the same amenities and services that a conference center or an executive office suite would provide.

c. The services or goods must be utilized. A lender or a title agency cannot rent space from a real estate broker that the lender or title agency does not intend to use.

d. The payment must be commensurate with the services rendered or the goods provided. If the marketplace rents conference rooms by the hour, a real estate agent may rent a conference room by the hour—but not at a flat rate per closing.

e. No part of the compensation can be for the referral of business. A clause agreeing to refer business to each other is illegal since a “lead” is a thing of value.

HUD will presume that any markup of third party services and goods by a person in a position to refer settlement service business is a payment for the referral of business. If a real estate broker sublets a bare office to a lender, the rent should be based on actual cost, and should not be marked up. Services and charges for services provided by a referral source should be uniform. Real estate brokers should not charge a higher desk license fee to a lender simply because the lender may make a significant profit from referrals. Furthermore, office services provided to a lender under a desk license should be comparable to the office services provided to a real estate salesperson with a desk license.

A real estate broker may charge more than its cost per square foot to sublet an office to a lender or title agent if the real estate broker provides extra services on a commercially reasonable basis.

A real estate broker may provide mail, copying, fax, reception, conference rooms, etc., in addition to renting an office to a mortgage lender. If the real estate broker provides these services on a commercially reasonable basis, e.g. comparable to the service provided in an executive office suite, the real estate broker may price the subleased office comparable to the cost of space in a local executive office suite.
If services provided to a lender are the same as are provided to a real estate salesperson with a desk license, the real estate broker should justify the license fee based on the market rate for the desk license. If the mortgage lender will use fewer services than a real estate salesperson, reduce the desk license fee accordingly.

It is imperative that a lender or other settlement service provider should never pay a premium for introductions or referrals to business opportunities.

Similarly, a mortgage company or a title agency should not pay for “make work” that has little or no value. For example, marketing agreements that require the “service” of real estate salespersons to attend educational programs, or that require “access” to real estate professionals, are questionable at best. What is the utility of such a “service”? Marketing efforts should be justified under the education and marketing exception discussed below.

2. Affiliated Business Arrangements

The owners of a mortgage company, title agency, real estate brokerage, and/or other settlement service providers may earn a profit from a bona fide business investment, even when some of the profit is generated through leads sent to the business, provided that:

a. The borrower must receive a copy of an Affiliated Business Arrangement Disclosure at the time a referral is made to an affiliated business. The model form of this disclosure must be used to create a disclosure for each affiliate (do not delete Section B. of the model form, and settlement service fees should be expressed in dollars, not percentages). An acknowledgement in the disclosure must be executed by the borrower no later than at closing, and the signed disclosure must be retained for five years.

b. You cannot require the borrower to use the services of an affiliated business. An exception allows a lender to require a borrower to pay for the services of an affiliated appraisal company or credit bureau, or an attorney who represents the lender.

c. The profits of the affiliated business must be distributed according to percentage ownership, and percentage ownership should be determined by percentage of capital invested. Capital investment requirements cannot be reduced based on the expectation of leads generated for the affiliated business.

d. The affiliated business must be a living, breathing entity that performs services or provides goods, and earns income commensurate with these services and goods. Shell (or sham) affiliated business arrangements are prohibited by HUD Statement of Policy 1996-2. This Statement of Policy will be discussed in greater detail in a later column.

Remember also that HUD Statements of Policy 1996-4 and 1999-1 apply to an affiliated title agency and mortgage brokerage. Hence, an affiliated business must have at least one bona fide employee to perform substantive services. Fee splitting based on a split of substantive services is difficult and often runs afoul of secondary market or insurance underwriter requirements.

3. Secondary Market Sales

Prices paid by investors and borrowers to mortgage broker/lenders in table funded transactions must be commensurate with the level of work that the broker/lender provided toward originating the loan and completing the transaction. Mortgage brokers do not “own” an application or a loan, and the borrower is not anyone’s “property.” However, premium prices paid by an investor to buy a loan from a lender are beyond the oversight of HUD. A lender’s ownership of a loan is established by two factors, both of which must be present:

a. The lender used its own money, either from its assets or from a warehouse line of credit, to fund or purchase the loan. However, a lender should not fund a loan with a warehouse line of credit that is provided by the loan purchaser, especially when the warehouse line can only be used to fund loans sold to the warehouse lender. These arrangements blur the line between a table funded loan and a true secondary market transaction. The potential penalties for a violation of Section 8 of RESPA are so harsh (triple damages, costs, attorneys fees, fines, and incarceration for a year) that it is not worth the risk to “test” a secondary market relationship in which the investor and its affiliates fund the closing and purchase the loan.

b. The lender holds the loan long enough to establish title to the loan. Ownership of a loan for at least one day is necessary. Many lenders take a conservative approach, and hold the loan for at least two or three days
after funding before selling the loan to an investor.

4. **Educational and marketing expenditures.**

Ordinary educational and marketing expenditures are exempt from scrutiny under RESPA, provided that the expenditure is referral neutral and it does not defray costs ordinarily incurred by the recipient. A weekend retreat and education program provided for real estate professionals, or tickets to a sporting event or a golf outing, are acceptable, provided that the invited target audience is based on bona fide business criteria (such as all of the real estate agents operating in a geographic area), and the invitation is not conditioned on the past, present, or future referral of business. Providing a free CLE course required for licensure would not be permitted because it is a cost that the recipient would ordinarily incur.

The hard part of marketing is being referral neutral. Rewarding builders with golf outings and sports tickets for referrals is prohibited. You can beg, but you cannot blackmail, bribe, compensate, extort, manipulate, reward, payoff, shakedown, or threaten referral sources to make referrals. Please also note that some state licensing laws prohibit gifts and other expenditures to obtain leads.

Next Week: *Bona fide payments to employees*

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**Previous columns:**

- Affinity relationships under RESPA: Making money the 'old-fashioned way'
- Affinity relationships under RESPA: What is an illegal kickback?
- Affinity relationships under RESPA: Knocking the stool over
- Affinity relationships under RESPA: Inside Section 8(b)
- Affinity relationships under RESPA: Markups and junk fees

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**Tell us what you think of this column! E-mail** editor@respanews.com
Affinity relationships under RESPA: Bona fide employment

Welcome to the seventh installment of our new RESPA column, written by attorney Howard A. Lax of Lipson, Neilson, Cole, Seltzer & Garin, P.C. (See complete bio below). In this weekly column, Lax explains the basics of RESPA Section 8 and describes how to establish relationships that don’t violate the law.

Exceptions to the Rule

Every rule has its exceptions, including Section 8 of RESPA. Five principal exceptions to the kickback rule (in addition to the “missing stool leg” concept discussed in previous columns) are used to create affinity relationships between settlement service providers. In last week’s column we took a look at the first four, which included:

1. Payments for rendering services or providing goods
2. Affiliated business arrangements
3. Secondary market sales
4. Educational and marketing expenditures

Here we take an in-depth look at number five: Bona fide employment.

5. Bona Fide Employment.

Section 14(g)(iv) and (vii) of HUD’s Regulation X permit:

“(iv) 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;” and

“(vii) An employer’s payment to its own employees for any referral activities.” (emphasis added)

Settlement service providers should be able to hire pure “finders” and “rainmakers” that have no responsibilities other than to generate new clients for a settlement service business and its affiliates. However, HUD gave us a different message in a settlement agreement with Znet Financial. HUD fined Znet for paying $400 to real estate salespersons for each application for credit completed for Znet. Znet claimed that the real estate salespersons were employees being paid bona fide compensation, but HUD disagreed.

This settlement sends a clear message that certain employees must perform substantive services (similar to a mortgage broker’s services) to earn bona fide compensation. That is not what the rule says, but that is how HUD enforces its rule. HUD will only allow an employer to compensate bona fide employees. Furthermore, compensation may only be paid for settlement services benefiting the employer. For example, HUD will allow a company to compensate employees for referring new business to their employer, but HUD will fine a company for paying compensation to employees for referring business to the employer’s affiliate.

HUD evaluates twenty factors outlined in IRS Revenue Ruling 87-41 to determine whether a person is a “bona fide” employee or an independent contractor. Unfortunately, we do not know how many of these factors must be satisfied under HUD scrutiny, or which factors weight more heavily than others. The twenty factors are:

i. **INSTRUCTIONS.** A person who is required to comply with other persons’ instructions about when, where, and how he or she is to work is ordinarily an employee. HUD will ask whether the employer has the right to require compliance with instructions.
ii. **TRAINING.** HUD will ask whether the employer trains employees by requiring an experienced employee to work with a new employee, by corresponding with employees, by requiring employees to attend staff meetings, or by using other methods, and whether the employer wants work performed in a particular manner.

iii. **INTEGRATION.** An employee must necessarily be subject to a certain amount of control by the owner of the business. Integration of the employee's services into the employer's operations generally shows that the employee is subject to direction and control of the employer.

iv. **SERVICES RENDERED PERSONALLY.** HUD will ask what services must be rendered personally by the employee to accomplish the required work and to achieve the expected results.

v. **HIRING, SUPERVISING, AND PAYING ASSISTANTS.** Management responsibility for hiring, supervising, and paying assistants shows control over employees on the job. Independent contractor status is indicated if the employee hires, supervises, and pays assistants to do work for the employee. HUD will examine a written employment contract to determine whether the person is an employee who follows management direction, or whether the person is an independent contractor who provides materials and labor and under which the contractor is only responsible for the attainment of a result.

vi. **CONTINUING RELATIONSHIP.** HUD will ask whether there is a continuing relationship between the employee and employer. A continuing relationship may exist where work is performed at frequently recurring although irregular intervals.

vii. **SET HOURS OF WORK.** Set hours of work indicate employer control of the employee. Part time employees should have regular work hours, and all employees subject to minimum wage or overtime requirements should complete time sheets to document regular hours.

viii. **FULL TIME REQUIRED.** True employment is indicated if (a) the employee must devote substantially full time to the employer's business, (b) the employer controls the amount of time the employee spends on the job, or (c) the employer restricts the employee from doing other gainful work. An independent contractor is free to work when and for whom he or she chooses.

ix. **DOING WORK ON EMPLOYER’S PREMISES.** The employer presumably controls the employee's activities if work is performed in the employer's offices, especially if the work could be done elsewhere. Work done off the premises of the employer, such as originating loans from home, indicates some freedom from control. However, this fact by itself does not mean that the person is not an employee. Control over the place of work is also indicated when the employer has the right to compel the employee to travel a designated route, to canvass a territory within a certain time, or to work at specific places as required.

x. **ORDER OR SEQUENCE SET.** The fact that an employee must perform services in the order or sequence set by the employer shows that the employee is not an independent contractor. Often, the employer does not set the order of the services or sets the order infrequently. It is sufficient to show control, however, if the employer retains the right to establish a sequence of job functions.

xi. **ORAL OR WRITTEN REPORTS.** A requirement that the employee submit regular or written reports to a manager or main office indicates a degree of employer control.

xii. **PAYMENT BY HOUR, WEEK, MONTH.** Payment by the hour, week, or month generally points to an employer-employee relationship, provided that this method of payment is not just a convenient way of paying a lump sum agreed upon as the cost of a job. Payment made by the job or on a straight commission generally indicates that the worker is an independent contractor.

xiii. **PAYMENT OF BUSINESS AND/OR TRAVELING EXPENSES.** An employer ordinarily pays employee business and/or traveling expenses. An employer, to be able to control expenses, generally retains the right to regulate and direct employee business activities.

xiv. **FURNISHING OF TOOLS AND MATERIALS.** Employers ordinarily furnish significant tools, materials, and other equipment (e.g. laptop and loan origination software) to allow employees to complete their work.

xv. **SIGNIFICANT INVESTMENT.** Persons that invest in employer facilities that are not typically maintained by employees (e.g. computer system leases) tend to be independent contractors. On the other hand, lack of
investment in the employer’s business indicates dependence on the employer for such facilities and, accordingly, the existence of an employer-employee relationship. Special scrutiny is required with respect to home offices.

xvi. **REALIZATION OF PROFIT OR LOSS.** A person who can realize a profit or suffer a loss as a result of the person’s services (in addition to the profit or loss ordinarily realized by employees) could be an independent contractor (or a partner), but the person who cannot is an employee. For example, if a person is subject to a real risk of economic loss due to significant investments or a bona fide liability for expenses, such as salary payments to unrelated employees, that factor indicates that the person is an independent contractor. The risk that an employee will not receive payment for his or her services, however, is common to both independent contractors and employees, and thus does not constitute a sufficient economic risk to support treatment as an independent contractor.

xvii. **WORKING FOR MORE THAN ONE FIRM AT A TIME.** If an employee performs services for several unrelated firms at the same time, that factor generally indicates that the person is an independent contractor. However, a person who performs services for related employers may be an employee of each business.

xviii. **MAKING SERVICE AVAILABLE TO GENERAL PUBLIC.** The fact that a person makes his or her services available to several firms on a regular and consistent basis indicates an independent contractor relationship.

xix. **RIGHT TO DISCHARGE.** The right to discharge an employee is a factor indicating an employee-employer relationship. An employer exercises control through the threat of dismissal, which causes the employee to obey the employer’s instructions. An independent contractor, on the other hand, cannot be fired so long as the independent contractor produces a result that meets the contract specifications.

xx. **RIGHT TO TERMINATE.** If the employee has the right to end his or her relationship with an employer at any time he or she wishes without incurring liability, that factor indicates an employer-employee relationship.

**Other exceptions**

Several other exceptions are listed in the statute and regulation; however, these exceptions have not been used to establish affinity relationships between different types of settlement service providers. These include:

a. **Cooperative brokerage arrangements.** HUD will not examine the split of bona fide real estate broker commissions. Real estate professionals are subject to RESPA in all other respects.

b. **The split of title premiums between the title agent and the title underwriter.** HUD will not question whether a typical 80%-20% split is reasonable.

c. **Bona fide attorney fees.**

HUD has authority to create other exemptions, but that is unlikely.

**Next Week: Wrapping Up the Law – Special Rules for Title Agents and Litigation**

Previous columns:

- Affinity relationships under RESPA: Making money the ‘old-fashioned way’
- Affinity relationships under RESPA: What is an illegal kickback?
- Affinity relationships under RESPA: Knocking the stool over
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Affinity relationships under RESPA: The consequences of Section 9

Welcome to the eighth installment of our RESPA column, written by attorney Howard A. Lax of Lipson, Neilson, Cole, Seltzer & Garin, P.C. (See complete bio below). In this weekly column, Lax explains the basics of RESPA Section 8 and describes how to establish relationships that don’t violate the law.

Special title agent rules lead to special litigation

Some of the usual avenues of developing business are not available to title agencies. Section 9 of RESPA states:

“No seller of property that will be purchased with the assistance of a federally related mortgage loan shall require directly or indirectly, as a condition to selling the property, that title insurance covering the property be purchased by the buyer from any particular title company.”

This means that one of the title agent’s best sources of referral business — the form purchase agreement given to the seller — cannot specify that the buyer will use a particular title agent to purchase the mortgagee title insurance policy.

Furthermore, some state laws and rules prohibit or restrict affinity relationships by (a) limiting the amounts that title agencies and underwriters can spend on marketing, (b) prohibiting rebates to insured parties or reductions in filed rates, or (c) prohibiting payments for leads. Hence, title agencies and companies engage in joint ventures to generate referral business more than other service providers.

Joint ventures between title agencies and real estate brokers work well, provided that there is a sufficient volume of referrals to make the joint venture profitable. The real estate broker partner refers sellers to the affiliated title agency to purchase the owner’s policy. The title agency charges the seller the basic title insurance premium (less any reissue credits), and charges the buyer a “split premium” or “simultaneous issue” premium for the lender’s policy.

For example, if the basic premium for a $100,000 policy is $500, and both the owner’s policy and the lender’s policy were purchased from the same agency, the seller pays $500 for the owner’s policy and the buyer pays 40 percent of the basic premium for the lender’s policy ($200, or less if the mortgage loan is less than the purchase price). If the seller and the buyer purchase title insurance from different title agencies, each party would pay $500 for their policy.

The buyer, faced with the choice of paying $200 or $500 for the same policy, would choose the seller’s agency to simultaneously issue the lender’s policy. The title agency that issues the lender’s policy must close the loan so that the lender receives a first lien letter, closing protection letter, and final policy without standard exceptions. Hence, the buyer was usually locked into the real estate agent’s affiliated title agency without any contractual requirement to use that agency.

This scenario changed as lenders established their own joint ventures with title companies. Most title underwriters now offer simultaneous issue premiums for the lender’s policy that allow lender affiliated title agencies to effectively compete with real estate broker affiliated title agencies. The lender will direct borrowers to an affiliated title agency to issue the lender’s policy and close the loan. The borrower pays the same premium to the lender’s affiliated title agency that would be charged by the agency issuing the owner’s policy. Sometimes the lender’s affiliated title agency will charge a below market closing fee to entice the borrower to use its services.

Competition led to modest range wars in certain markets. Some real estate brokers and their favored title agencies began charging a documentation fee to the buyer if the buyer permitted the lender’s title agency to close the transaction.
Section 9 of RESPA prohibits sellers from directly or indirectly requiring borrowers to use a specific title agent. Litigation ensued, alleging that the documentation fee is a condition of selling the property that indirectly requires the buyer to use the seller's preferred title agency.

Recently, a Minnesota real estate broker was attacked for violating fiduciary duties to its customers. Revising the title commitment order form and real estate broker advertisements to specify that real estate brokers and title agencies are independent contractors (comparable to the Mortgage Origination Agreement used by mortgage brokers) may address some state law issues, but it will not resolve RESPA claims. The result of this litigation may not be known for several years.

Reduced title premiums as kickbacks

Several creative insurance company affinity programs have ended in litigation. These are worth noting, simply to point out how these programs failed despite the best intentions of the parties. Please note that these matters were settled without any admission of wrongdoing.

Builders were routinely charged $25 (a rate filed with and approved by the insurance commissioner) for an owner's policy rather than the split premium that Joe Seller would pay. The buyer of the new home would pay the full basic premium for the lender's title policy, less the $25 paid by the builder. Title companies might argue that the $25 fee was fair because little work is required to issue all of the owners' policies for a new subdivision. All of the lots are derived from a parent parcel with a common title history, and the agent merely changes the lot number to issue a commitment. Buyers can argue that they should receive a similar discount for the lender's title policy. If it takes little work to issue a policy for the builder, why does it cost so much more to issue the policy for the lender?

Buyers alleged that the heavily discounted title insurance premium for the owner's policy was an illegal kickback given to the builder for referring the builder's business to the title agency. Title agencies countered that any title agency had access to the $25 rate and, therefore, $25 was the market rate for the owner's policy purchased by a builder. This litigation settled without a trial.

Profit sharing and premium splits

Profit sharing programs and insurance premium splits in three affinity programs were attacked on the basis that the split favors a referral source, or the payment violates state law.

First, private mortgage insurance companies offered to sell "Performance Notes" to lenders that purchased PMI policies. The Performance Notes paid interest at a rate based on the payment performance of the lender's loan portfolio. OCC Interpretive Letters 833 and 834, and an informal HUD opinion under RESPA, authorized national banks to purchase these notes. Lenders steered borrowers to purchase mortgage insurance from companies that offered "Performance Notes." The more policies the insurer issued to the lender's borrowers, the more notes a lender could purchase.

Performance Notes were phased out because (a) the New York Insurance Commissioner stated in Insurance Department Circular Letter No. 2 that Performance Notes violated state insurance laws by sharing insured risk with unlicensed entities, and (b) Performance Notes faced increasing litigation under RESPA.

Second, private mortgage insurance companies offered secondary mortgage pool insurance to lenders to replace the fees paid to investors for "special" servicing rights. In "ordinary" servicing, the lender makes principal and interest payments when the borrower defaults. The lender is repaid if and when the secured property is foreclosed and sold. Investors offered "special" servicing contracts to lenders (for a fee) that required the investor to take the risk that a foreclosure sale of the property would not recoup all principal and accrued interest. Investors accepted pool insurance policies in lieu of special servicing fees. Litigation against the mortgage insurers alleged that unreasonably low pool insurance premiums were illegal kickbacks for the referral of individual mortgage insurance policies.

Third, title companies encouraged builders to establish reinsurance companies. The concept was simple — split the risk of loss and the title insurance premium with the builder's reinsurance company. However, the builders' reinsurance companies assumed little risk and were paid a significant portion of the premium. State regulators, and later HUD, entered into settlements with these title companies and builders.

All of these affinity programs failed because they skirted one of the "golden rules" of affinity relationships. Payments to someone in a position to refer settlement services must be commensurate with the substantive services or goods provided, or the risk absorbed. The difference between the payment (or discount) and the market value of the service or
goods is presumed to be a kickback for the referral of settlement service business.

Next Week: The Golden Rules of Affinity Relationships

Previous columns:

1. Affinity relationships under RESPA: Making money the 'old-fashioned way'
2. Affinity relationships under RESPA: What is an illegal kickback?
3. Affinity relationships under RESPA: Knocking the stool over
4. Affinity relationships under RESPA: Inside Section 8(b)
5. Affinity relationships under RESPA: Markups and junk fees
6. Affinity relationships under RESPA: Exceptions to the rule
7. Affinity relationships under RESPA: Bona fide employment

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Affinity relationships under RESPA: The golden rules

Welcome to the ninth installment of our RESPA column, written by attorney Howard A. Lax of Lipson, Neilson, Cole, Seltzer & Garin, P.C. (See complete bio below). In this weekly column, Lax explains the basics of RESPA Section 8 and describes how to establish relationships that don't violate the law.

The Golden Rules of Affinity Relationships

From HUD’s rules, informal opinions, and policy statements, we notice four threads arising from Section 8 of RESPA.

First, there is a distinction between payments for services to a person in a position to refer settlement service business and payments to a person who will not be in a position to refer settlement service business. RESPA does not impact business relationships when no referrals are made.

For example, a newspaper can make a profit by selling advertising to a mortgage lender, since it is not in a position to refer business to the lender. Contrast the newspaper with a real estate broker selling advertising space in its newsletter. The real estate broker is in a position to make referrals. Hence, a real estate broker should not make a profit selling newsletter advertising space to a lender because this could be inferred as a kickback for past or subsequent referrals. Conversely, a real estate broker may make a profit selling advertising space to a cell phone provider, since the cell phone provider is not in a position to make referrals for settlement services.

Second, there is a distinction between payments for settlement services and payments for other goods and services provided by a person in a position to refer settlement services.

A payment for settlement services is measured in terms of the amount of work performed to complete the transaction, and whether the amount paid is commensurate with the work for that service. A payment for other services is measured in terms of the value of the goods and services sold, i.e. are the goods and services provided in a commercially reasonable manner, and is the price commensurate with the market rate for such goods and services.

A person providing mortgage broker services must earn his fee by providing substantive services – the more services, the higher the fee. A real estate salesperson selling ice cream bars to lenders at a real estate broker’s open house would be judged based on the market price for the goods and services, and not on the wholesale cost of the ice cream and how hard he worked.

Third, lip service is not compensable. A person that is in a position to refer settlement services must provide substantive services to profit from these services. A mortgage broker receiving services from a real estate broker must utilize the services, or the payment is not for providing the services. For example, rent paid by a mortgage broker to a real estate broker for an office that is never used or is not available will be inferred to be for the referral of business and not for the office space.

Finally, HUD would like to stop markups of settlement service fees, upselling interest rates, and overages on origination costs to limit consumer mortgage loan costs. So far, court decisions are split on whether RESPA prohibits markups, and courts have found that RESPA does not prohibit high prices so long as the lender provides substantial services to earn a fee. Borrowers and their attorneys will continue to challenge profits made from markups, and high profits made from providing services, so long as they have support from HUD and the potential payoff from a court victory is significant.

Look Into the Crystal Ball

Whenever you plan an affinity relationship, step back and examine the plan from an independent viewpoint. Look into your crystal ball, and ask how the affinity relationship could unexpectedly end. Better yet, ask your legal counsel to look for minefields that you may have missed. Always leave yourself the opportunity to wind up the relationship on a commercially reasonable basis if the business association does not provide the expected result.
Above all, do not take that chance that nobody will ever attack your business plan. Litigation costs often exceed the judgment that follows. More RESPA litigation is as sure to follow as night follows day. Examples of practices that are ripe for litigation include:

- **Appraiser Markups** – Some appraisers charge a higher fee to customers of certain brokers and lenders to make up for the fact that they are not paid if the loan does not close. An appraiser should not rob Peter because Paul did not pay his fee.
- **Marketing Agreements** – Some title agents pay real estate professionals to attend their “educational programs.” Attending these programs is deemed to be a “service” provided to the title agent. Ordinary education and marketing expenditures that are not based on the referral of business and that do not defray costs that a referral source would ordinarily pay are acceptable. However, attendance at a sales presentation is not a commercially reasonable “service.”
- **Buy-Sell Agreements** – Some joint ventures include a buyout provision in which the buyout price is based on profits from continuing referrals.
- **Joint Venture Subcontracts** – An affiliated business arrangement may be challenged when the work done by the joint venture is disproportionate to the portion of the fee or insurance premium retained by the joint venture. Beware of joint ventures in which all of the employees are leased from the owners’ businesses. Does the joint venture provide any services if it has no employees?
- **Junk Fees** – RESPA does not regulate prices for settlement services. However, charging a closing fee and an additional fee for essentially the same service could be a violation of Section 8(b) of RESPA.
- **Volume Discounts** – HUD, in its Statements of Policy regarding lender paid broker fees, asserted that it has not approved higher yield spread premiums based on the volume of loans brokered to a lender.
- **Internal Distributions of Costs and Income** – In theory, holding companies and their wholly owned subsidiaries are subject to the same rules as any other affiliated business arrangement. Internal accounting should reflect the actual costs and income of each subsidiary. In theory, attributing greater income (or reduced costs) to a subsidiary that provides referrals to its affiliates could be interpreted as a kickback, even when the parent organization operates under a consolidated balance sheet.
- **Mergers and Acquisitions** – A mortgage broker or lender cannot “own” a borrower. Lockouts, non-compete clauses and non-solicitation clauses that are ancillary to an employment agreement or an asset sale agreement usually do not violate RESPA. However, pricing the sale of a mortgage broker’s or lender’s hard assets based on the volume of business that will be generated from its pipeline could be interpreted as a kickback for the referral of business.

There are many ways to make money without running afoul of these golden rules. In the coming weeks we will explore in detail some of the practices that mortgage brokers, mortgage lenders, title agencies, and other settlement service providers may utilize to increase their business opportunities through affinity relationships.

**Next Week: Joint Advertising**

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**Previous columns:**

1. Affinity relationships under RESPA: Making money the ‘old-fashioned way’
2. Affinity relationships under RESPA: What is an illegal kickback?
3. Affinity relationships under RESPA: Knocking the stool over
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Affinity relationships under RESPA: Joint advertising

Welcome to the tenth installment of our RESPA column, written by attorney Howard A. Lax of Lipson, Neilson, Cole, Seltzer & Garin, P.C. (See complete bio below). In this weekly column, Lax explains the basics of RESPA Section 8 and describes how to establish relationships that don’t violate the law.

Joint Advertising

Section 8 of RESPA permits:

(iv) 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.

(vi) 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 or business incident thereto.

Both of these exceptions are used to justify joint advertising.

Mortgage lenders, real estate professionals and other settlement service providers may advertise their services jointly, cooperatively, or in the same forum. Many of the more creative forms of joint advertising constitute referrals. If a referral is an essential part of joint advertising (e.g. handing out business cards with mortgage broker and title agency information on opposite sides), then the parties must rely upon the goods and services exception. Hence, it is essential that a referral source pays for its fair share of the cost of advertising ("...bona fide compensation ...for services actually performed").

It is likewise imperative that the parties pay their fair share for joint advertising when the marketing exception is invoked. If a lender agrees to pay for the entire cost of a real estate broker’s newsletter in return for placing an ad in the newsletter, the lender defrays costs that the real estate broker would ordinarily incur. This benefit will be presumed to be for the referral of business. The same problem impacts mortgage broker or title agency sponsorship of real estate broker promotional events. Sponsorship cannot be so great that the promotion of the real estate professional greatly outweighs the promotion of the mortgage broker’s loan products or the title agency’s services.

For example, a mortgage broker is not permitted to pay for a brunch at a real estate professional’s open house if the only benefit that the mortgage broker will receive is the right to leave brochures on a table at the open house. The benefit of the sponsorship derived by the real estate professional greatly exceeds the benefit derived by the mortgage broker, and the cost to the mortgage broker probably exceeds the mortgage broker’s cost to distribute brochures in similar types of forums. The benefit received by the real estate broker will be presumed to be a kickback for the referral of business to the sponsor of the event.

A closer case involves payment for a brunch at a real estate open house, where the mortgage broker’s loan officers meet one on one with real estate professionals and customers attending the open house to promote loan products. HUD could scrutinize the amount exchanged for the opportunity to meet with customers to determine whether the benefit to the real estate professional exceeds the benefit to the mortgage broker. Is this a normal educational and promotional event (exempt from RESPA scrutiny), or a benefit paid for the referral of business?

The determining factors may be (a) whether the expenditure by the mortgage broker defrays costs that the real estate professional would ordinarily incur, or (b) whether the real estate broker refers customers to the mortgage broker. If the real estate professional ordinarily serves food at these events, defraying the real estate broker’s catering costs would not fall under the marketing exemption. Likewise, if the real estate broker refers customers to the mortgage broker in the
next room, you could argue that the mortgage broker's payment was conditioned on referrals.

Window displays, kiosks, and pamphlets are common forms of ads placed in referral source business locations. However, placing these media in a real estate broker or mortgage broker shop is not going to generate the type of revenue that the referral source may want. The advertiser cannot pay more than pass through costs or market rates for the space to place the ad. The pass through cost of a foot or two or floor space or window space, or the market rate for preparing an advertising kiosk, is going to be minimal. Hence, joint advertising is usually one facet of a comprehensive affinity relationship.

Other examples of joint advertisements include:

- Flyers and web sites developed by a lender and a real estate professional advertising both entities' services should be paid for by each party in relation to the relative space that each business is given in the flyer or web site for their material. For example, if a lender takes a full page ad in a real estate broker's four page flyer, the lender should pay one quarter of the cost of producing, printing, stuffing, and mailing the flyer. If a lender and a title agency create a joint newspaper display ad, the cost of the ad should be split based on the ratio of space advertising each business.

- CD business cards ("hockey rinks") are about the same size as a conventional business card, hold about 50 MB of data, and are read by a computer's CD-ROM drive. This is more than enough space to include a lender's electronic loan application form, initial disclosures and instructions, as well as a real estate broker's sample purchase agreement, listing agreement, and disclosures. Each CD card can hold up to five minutes of MPEG videos explaining the advertising process and the lender's loan programs, or how to prepare a home for sale. If you need more video space, business card DVDs hold 330 MB. The card label may include contact information for both businesses. The cost for these business cards should be split based on the amount of data that each settlement service business places on the card and the amount of label space used by each business. Please note that an Affiliated Business Arrangement Disclosure must be provided when the two businesses on the card are affiliated.

- Post-closing marketing (birthday cards, anniversary cards, etc.) send by third party marketing companies to the customer in the name of the mortgage broker and real estate broker.

The forum for joint advertising should be selected on a referral neutral basis to avoid the appearance that marketing payments are conditioned on the referral of business. The decision to select one entity for joint advertising efforts while denying another entity the same opportunity cannot be made on the basis of past referrals or a promise of future referrals. For example:

- A mortgage lender should not choose to participate in newsletters distributed by real estate professionals on the basis that the real estate professionals provided referrals to the mortgage lender in the past, or promise to do so in the future.

- The level of payments made by a mortgage lender should not be based upon the record of referrals received from a real estate professional. A mortgage lender should not pay for a full page advertisement in newsletters of real estate professionals who have referred business to it in the past, but only pay for a business card size ad when real estate professionals do not refer business.

- Settlement service providers should offer participation in an advertising venture based upon some reasonable business criteria. For example, joint advertising may be limited to real estate professionals in the mortgage lender's principal market areas, or to the top 25 real estate professionals in terms of market size in a particular geographic region. The offer should be extended to interested real estate professionals that satisfy referral neutral selection criteria regardless of whether or not the real estate professionals previously or in the future refer any business to the mortgage lender.

- Settlement service providers may negotiate an exclusive marketing arrangement as part of service contract that prohibits the other party from marketing the products of competing service providers (a "lockout clause"). For example, a title agency subleasing in a real estate broker's office may prohibit subleasing to competing title agents.

In recent years, "lockout clauses" have morphed into "preferred provider agreements" that discourage or prohibit referrals to other providers of similar services. These agreements are usually couched in terms of a real estate broker or a mortgage broker providing a bundle of services to a lender or title agency in return for service fees. Preferred provider agreements must be carefully examined to determine whether commercially reasonable services are provided, and whether the fee is commensurate with the services provided. The bundle of services pledged in a preferred provider agreement should include services already provided as part of a real estate broker's or mortgage originator's duties. Double payments for services may violate Section 8(b) of RESPA.

Preferred provider agreements should not require "phantom" services that are not commercially reasonable, such as
“access” to referral sources, or services that are rarely used. For example, it is not commercially reasonable to pay for a license to use a conference room on a monthly basis or on a per loan basis. HUD would interpret the arrangement as a kickback.

The core feature in a preferred provider agreement is a clause prohibiting referrals to competing settlement service providers. If the services of the business receiving a payment are required to complete the transaction, prohibiting referrals to competitors is tantamount to an agreement to make referrals to the “preferred provider.” Just as compensation for referrals is prohibited, compensating third parties for not making referrals to competitors should also be prohibited.

Mortgage lenders should be careful about paying for advertising services by an entity that will be referring borrowers to them. HUD has expressed some trepidation in informal opinions regarding arrangements where mortgage lenders pay real estate professionals to advertise the lender’s current interest rate information. HUD seems to distinguish between paying for a flyer, promotion or other goods and services provided by a third party, and paying an entity to make direct referrals to the mortgage lender's products. The mortgage broker or lender may be safer if it pays the real estate broker for leads, and then solicits these consumers itself.

Next Week: Purchasing Lists

Previous columns:

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2. Affinity relationships under RESPA: What is an illegal kickback?
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Affinity relationships under RESPA: Leads, lists and gifts

Welcome to the eleventh installment of our RESPA column, written by attorney Howard A. Lax of Lipson, Neilson, Cole, Seltzer & Garin, P.C. (See complete bio below). In this weekly column, Lax explains the basics of RESPA Section 8 and describes how to establish relationships that don’t violate the law.

Purchasing lists

HUD approved the purchase of leads in two informal opinions dated January 26, 1989, and March 24, 1994. The 1994 opinion stated that the seller of leads cannot refer consumers to the service provider, nor may the seller endorse the services of the service provider.

Each person visiting a real estate broker’s office is usually looking for a home that will require financing and title insurance. Guest lists (lists of visitors to a real estate professional office) may be sold as lead lists, so long as (a) the purchase of the list or the amount paid is not conditioned or based on the number of loans generated from the leads, (b) the seller does not endorse the buyer’s services (i.e., there is no referral), and (c) state law does not protect the confidentiality of consumers entering a real estate broker’s office. Note that financial privacy rules promulgated under the Gramm-Leach-Bliley Act do not apply to real estate brokers. Financial privacy rules inhibit a mortgage broker or a mortgage lender from selling leads.

Mortgage lenders may also pay to be on a list distributed by real estate professionals who advertise lender’s rates and loan products, so long as the purchase of the list or the amount paid is not conditioned or based on receiving referrals. The amount paid for this benefit must be limited to its market value, and not based upon the level of business generated by the referrals. The market value of this type of advertising may be diminutive and, therefore, this service is usually added to a larger affinity arrangement between real estate brokers and lenders.

Lenders extended the concept of buying leads to establish affinity relationships with unions, religious organizations, and other associations. A mortgage lender may purchase a membership list at a market rate in order to mail advertising or solicit loans from the entity’s members. The mortgage lender may mention in its advertising material that preferred or discounted loan products are available to all members of the organization. However, the seller of the list may not endorse the lender or make referrals to the lender.

The purchaser of a list will be tempted to place advertising with the seller of the list (e.g. buying a page in a newsletter or paying the seller to stuff the lender’s ads in its mailings to its members). However, the advertisement could be deemed to be a referral. If the organization sells its goodwill to all who are willing to pay for it, then the mortgage lender may pay for the goodwill of the organization without regard to the business that will be derived from that goodwill. Endorsements by famous persons or by a local organization (AARP) may be permitted if properly structured. If, on the other hand, placing an advertisement in a union or religious organization newsletter is a first time event, the concurrent advertisement and sale of the organization’s membership list is more likely to be deemed a referral than a true advertisement, even with a disclaimer in the advertisement. Lenders should evaluate whether purchasing a list or joint advertising will lead to more business, and choose one or the other marketing plan.

Payment for a membership list should be on a flat fee or per name basis, and not based on the number of applications that are received from a mailing to the membership list. Modifying the price of the list based on the amount of business garnered will appear to be a kickback. A community group may charge a fee for updating the list sold to a mortgage lender, but the payment must be commensurate with the cost of providing the update.

Some lenders pay an incentive to members of a target organization to distinguish the loans offered to members from loans available to the general public. Paying a premium to the borrower to induce the borrower to accept a loan is
acceptable under RESPA. Hence, a mortgage lender can provide a gift, bonus check, or other remuneration to the borrower at his or her closing, even though the borrower is a member of a community organization that cooperates with the mortgage lender.

The bonus check paid to the member is often donated to the organization. Please note that the bonus must be paid to the borrower, and any donation must be truly voluntary. If the bonus is payable jointly to the borrower and the organization, or the check does not pass through the borrower’s hands, then the lender is making a payment to the organization that will be presumed to be a kickback for the referral of business.

Please be aware that some state insurance laws prohibit payments for leads. This prevents title agents from buying lists. However, a mortgage broker business that is affiliated with a title agent may be able to purchase leads and membership lists. The title agency will benefit from the business referred from its affiliate, provided that the referral is made without providing direct or indirect compensation for the referral.

Gifts, Largess and Junkets

Most settlement service providers are not limited in the amount that they may pay for entertainment. The settlement service provider’s marketing plan should spend similar amounts for solicitations of entities or persons without regard to the amount of prior or future business referred to the lender. Unless prohibited by state law, a title agency or a mortgage broker may take real estate salespersons on a golf outing to try to obtain additional business for the title company from the real estate salespersons. Salespersons must be selected for the event on a referral neutral basis. The golf outing cannot be a reward for the referral of business.

Private mortgage insurance companies have sponsored weekend retreats and seminars, bestowing thousands of dollars in food and lodging on executives of mortgage companies. Invitees are selected on the basis that they are the PMI company’s target market, and not on the basis of past or future business referrals. The program becomes illegal if the PMI company states or indicates that a mortgage company executive will not be invited again unless the amount of business with the PMI company increases. Similarly, if the mortgage company executive determines that the PMI company is only inviting executives of those lenders that provide substantial business for the PMI company, and excluding similarly situated lenders who do little or no business with the PMI company, then the executive should decline the invitation for the event.

There is No Such Thing as a De Minimis Kickback

Many years ago, HUD’s enforcement division informally advised settlement service providers that gifts of up to $25.00 in value in any calendar year could be provided as a reward for referrals of settlement service business without fear of prosecution by HUD. This practice allowed a title agency, for example, to send a box of candy with the title company’s logo to a mortgage company during the winter holidays. There is no basis in RESPA to permit any de minimis level of referral fee. Holiday gifts should be distributed to potential referral sources on a referral neutral basis.

Next Week: Leases and Service Contracts

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Affinity relationships under RESPA: Office rentals and incentive payments

Welcome to the twelfth installment of our RESPA column, written by attorney Howard A. Lax of Lipson, Neilson, Cole, Seltzer & Garin, P.C. (See complete bio below). In this weekly column, Lax explains the basics of RESPA Section 8 and describes how to establish relationships that don’t violate the law.

Renting Office Space and Support Services

Locating a title agency or a mortgage broker in a real estate broker’s office serves two purposes. First, the real estate broker’s clients may receive better, faster service if the real estate broker watches over the title agent’s and mortgage broker’s work (and the title agency or mortgage broker receives more referrals for better service).

Second, renting out empty offices or desks reduces the real estate broker’s overhead and allows the title agency or mortgage broker to share in any discounts that the real estate broker negotiated with its landlord. Title agencies, mortgage brokers, and lenders may rent office space and/or office support services from real estate brokers for a regular rental period (monthly), but not on a transient (per closing) basis. Licensing a desk space or conference room is sometimes expedient for both the mortgage broker needing a local conference room to take applications, and the real estate professional needing an on site mortgage broker to prequalify buyers. Rental fees or desk fees paid to real estate professionals must be based on the market value of the rental space and services provided.

The market value of the rental space cannot be based upon the value of the residential transactions occurring or arising out of the office. Rent charges based on a gross percent of business, or which adjust based on loan volume, are illegal if paid to a referral source. Per use rental fees are also illegal. HUD specifically disapproved of a $100 fee paid by a title company to a real estate broker to use a closing room because the method of compensating the real estate broker was not commercially reasonable. A reasonable conference center would charge for use of a conference room by the hour. HUD does not set market rates and settlement service providers do not set market rates. Only the market can set market rates. At the same time, rents and license fees paid to referral sources should not be “excessive,” since HUD will infer that the “excess” is for the referral of borrowers.

The rules are different for landlords that cannot refer settlement service business. Rent paid for office or retail space may be based on loan volume instead of general market values if the landlord or an affiliated entity is not in a position to refer settlement service business to the tenant, and the landlord does not refer settlement service business (i.e. one of the “legs” of a kickback – a referral – is missing from the equation).

For example, a shopping mall lease may require percentage rent from a mortgage broker (we are assuming that the landlord would be foolish enough to accept percentage rent from a mortgage broker). A settlement service provider may also enter into an exclusive rental agreement whereby the landlord agrees not to rent to any competing business. See HUD Statement of Policy 1996-3.

Settlement service providers commonly use three sublease arrangements. First, a settlement service provider may pay for space at cost. If a real estate broker is paying $25 per square foot plus CAM charges for space, a title agency or mortgage broker subleasing a spare office from the real estate broker should pay no more than $25 per square foot plus CAM charges. Any profit earned by the real estate broker without providing additional services is presumed to be for the referral of settlement service business.

Second, a settlement service provider may pay for office space plus commercially reasonable services at market rates. If a title agency or mortgage broker rents a furnished office from a real estate broker, with equipment, postage, copying, reception services, telephone and fax services, etc., included in the package, rent for space plus a bundle of services should be priced within the range of the rents for an executive office in the vicinity of the rented space. The title agency or mortgage broker should survey rental fees charged for executive offices in the vicinity to support the rent paid to a real estate broker.

Third, a settlement service provider may rent a conference room for occasional use, but the services and facilities rented should be commensurate with other commercially available facilities. For example, a hotel will rent a meeting room by
the half day. Similarly, a real estate broker can rent out a meeting room for the same price and timer period. The real estate broker should also offer a catering service similar to what the hotel would offer. A conference center will rent a meeting room by the hour. If a real estate broker rents out a conference room by the hour, the services provided by a conference center should also be provided by the real estate broker.

Any rental agreement or space license should be documented in writing so that there is no inference that any portion of the rent or license fee is for the referral of settlement service business. Mortgage lenders should consider FHA rules, and settlement service providers should consider state laws and local ordinances, when renting space. For example Chapter 2 of FHA Handbook 4060.1 requires clearly demarcated offices for an FHA approved mortgagee separate from other businesses.

Incentive Payments to Bona Fide Employees

A settlement service provider may pay incentives to its employees for making referrals to generate business for itself. Incentives may only be paid to "bona fide employees" of the settlement service provider. Structuring employment to compensate referrals is illegal because the employment is not "bona fide," and the level of work and time devoted by the "employee" to the employer is minimal when compared to a regular employee. HUD objected to Re/Max agents receiving commissions from Znet Financial because the agents worked irregularly, and they did not perform services required of bona fide loan officers. A settlement service provider can impose quotas on bona fide employees for generating new business for the employer, and impose disincentives for failing to originate sufficient business.

HUD promulgated restrictions in 1996 on payments to employees for referring business to an employer. Implementation of the rule was delayed indefinitely by Congress. See 61 FR 58472-58479 (11/15/96).

All compensation for work as a loan officer must be paid on a W-2 basis, even when performed by licensed real estate professionals. IRS Technical Advice Memorandum 9648003 (August 9, 1996) states that commissions earned by real estate salespersons to originate mortgage loans should be paid on a W-2 basis if the income is paid by a single entity that controls when and under what terms the loan is originated. Rules and informal bulletins in many states indicate that a loan officer should be a W-2 employee of a licensee to be exempt from having to obtain his or her own mortgage broker license.

Employment relationships with a mortgage broker or lender should be documented in writing. HUD may presume that an illegal relationship exists if there is no written employment agreement (guilty until proven innocent). In addition, a written employment agreement is necessary to establish an extended pay period (e.g. a monthly pay period) for determining overtime and minimum wage liability, and to define whether an employee is entitled to residual income for loans that close after termination of employment.

The exception permitting incentives for inside employees does not carry over to agents, contractors, affiliates, etc. A settlement service provider may not pay incentives or impose obligations for referrals to an affiliated entity. The last sentence of Section 14(b) of HUD's Regulation X states, "A company may not pay any other company or the employees of any other company for the referral of settlement service business." Any real estate agent that wishes to earn income for originating a loan through an affiliate of the real estate broker must be a bona fide employee of the affiliate, or the real estate agent must broker the loan in compliance with HUD Statement of Policy 1999-1 and state law.

Miscellaneous Income

Settlement service providers tend to add miscellaneous fees to transactions to boost income. The most common added fee is a documentation fee. Section 12 of Regulation X prohibits a settlement service provider from charging a borrower for the cost of preparing consumer disclosures. This does not prohibit the mortgage lender from charging a loan documentation fee, or prevent an attorney from charging a fee for preparing a deed, provided that the fee is charged for preparing the loan and closing documents, or for preparing deeds and other legal documents, and the fee is not charged for preparing Truth-in-Lending or RESPA disclosures, or for preparing the HUD Settlement Statement. Please also remember that an Affiliated Business Arrangement Disclosure must be provided to the client at the time that an attorney is engaged if the attorney intends to refer the client to the affiliated settlement service provider.

Next Week: Brokering Loans and Reverse Secondary Market Transactions

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10. Affinity relationships under RESPA: Joint advertising
11. Affinity relationships under RESPA: Leads, lists and gifts

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Affinity relationships under RESPA: Brokering loans to partners

Welcome to the thirteenth installment of our RESPA column, written by attorney Howard A. Lax of Lipson, Neilson, Cole, Seltzer & Garin, P.C. (See complete bio below). In this weekly column, Lax explains the basics of RESPA Section 8 and describes how to establish relationships that don’t violate the law.

Brokering Loans to Affinity Partners

Our prior column discussed how a referral source may defray costs by sharing advertising venues, offices, and services with settlement service providers. Allowing real estate brokers, builders, and home improvement contractors to broker loans increases the level of compensation that these referral sources may earn in a residential transaction. The more services that a mortgage broker performs, the more money a mortgage broker may earn.

One could argue that the premium earned in a secondary market transaction may be split based on the percentage of services the broker and lender each perform to originate the loan. If an affinity partner is willing to do substantial loan origination work, it can reap substantial benefits from its customer base.

Some real estate brokers, builders, and home improvement contractors give their customers an incentive to use an affinity partner lender to obtain financing. Upgrades in new homes, seller buydowns, seller concessions, and home warranties are often used to entice buyers to use the builder’s or the real estate broker’s affiliated lender or to allow the builder or real estate broker to broker a mortgage loan.

HUD discusses this option in a FAQ on its web site:

Question: A builder is offering to pay my closing costs or give me an upgrade package only if I agree to use his mortgage company. Is this legal under RESPA?

Answer: Yes. While a builder cannot require you to use a mortgage company with whom he is affiliated, a builder is allowed to offer you a discount if you use a specific company. Under RESPA, the builder cannot charge you more for the home if you do not use his affiliated mortgage company.

HUD issued an informal opinion dated May 20, 1988, stating that a builder cannot refuse to pay buyer closing costs or discount points when the buyer used another title agency or mortgage company. According to HUD, refusing to pay points or other closing costs when the buyer uses a non-affiliated settlement service provider “in effect, is requiring the use of the settlement service providers” in violation of Section 15(b)(2) of Regulation X.

The lessons we learn from the HUD FAQ and the HUD informal opinion are:

- Non-affiliated settlement service providers may pay closing costs or provide other incentives to borrowers who use an affinity partner’s services. For example:
  - A builder can pay the borrower’s closing costs if the borrower accepts a loan from its preferred lender.
  - A mortgage company can pay the borrower’s closing fee if the mortgage company’s preferred title agency closes the loan and issues the title policy.

- **However**, if the affinity partners are “affiliated,” then the affinity partners may not provide incentives to borrowers who use the other partner’s services if the partners will refuse to provide these incentives to borrowers who use competing settlement service providers. The converse is not true — a settlement service provider may provide incentives to borrowers to use its services. For example, consider various coupon programs:
  - A mortgage company may give coupons to its customers stating that the mortgage company will pay the closing fee of a specific unaffiliated title agency (the above example).
  - A mortgage company may give coupons to its customers stating that the mortgage company will pay the borrower’s closing fee, no matter which title agency closes the loan. Paying the borrower’s closing fee whether or not the title agency is affiliated with the mortgage company eliminates the inference that borrower must use the mortgage company’s affiliated title agency.
  - A mortgage company may not hand out coupons stating that the mortgage company will pay the closing fee of only a specific affiliated title agency. HUD would interpret these coupons as a requirement that the borrower use the mortgage company’s affiliated title agency.
  - A mortgage company may not increase its origination fee if the borrower does not use its affiliated title
agency. HUD would interpret the increased fee as a requirement that the borrower use the mortgage company’s affiliated title agency.

- A mortgage company may hand out coupons stating that an affiliated title agency will waive its normal closing fee. Note the difference between these coupons and others described above. The title agency is providing a discount rather than allowing the mortgage company to pay the closing fee. The title agency should distribute these coupons to affinity partners and non-affinity partners on a referral neutral basis.

- An “affinity relationship” exists when there is an agreement for advertising or other marketing purposes between two companies (this is my definition). An “affiliation” exists (according to RESPA and HUD’s Regulation X) if:
  - The partners have a common owner (direct or beneficial ownership of 1% of both partners is all that is needed to make the partners “affiliates”), or
  - The partners are controlled by “associates”, or
  - The partners are parties to a franchise agreement.

- A company or person cannot raise its prices to pay for an incentive given to a consumer to use the services of its affinity partner, and the affinity partner receiving the referral cannot reimburse the other partner for the cost of the incentive.

Remember that Section 9 of RESPA prohibits a seller from requiring the borrower to use any title agency if the buyer will pay the title insurance premium. Hence, a real estate broker or builder cannot provide incentives to a buyer to use any affinity partner title agency or provide disincentives to buyers who choose a competing title agency. It does not matter whether the real estate broker or builder is affiliated with its affinity partner title agency.

Remember also that buyer incentives and party affiliations must be disclosed to the seller, buyer, mortgage broker, lender, and investor, so that there is no allegation of fraud. Furthermore, some investors and mortgage insurers (e.g. FHA) prohibit the property seller and real estate broker from acting as a mortgage broker due to a perceived conflict of interest.

Teaching an affinity partner how to originate loans is not as hard as affinity partners may imagine. Loan applicant welcome packages, branch startup kits, and online or in-house training are often used to teach basic loan origination skills. Some states exempt residential builders, home improvement contractors, and/or real estate brokers from some or all mortgage broker licensing requirements. Larger developers may employ an experienced loan officer to provide the level of services necessary to earn a substantial yield spread premium. An employee of the builder or real estate broker may also serve an apprenticeship at the partner’s mortgage broker’s or lender’s office to learn how to originate loans.

Allowing a referral source to act as a mortgage broker is less controversial when the affinity partner is a mortgage lender rather than a mortgage broker. HUD’s Statement of Policy 1999-1 states that a lender can pay a fee to a mortgage broker for services rendered if the broker takes an application and performs at least five additional services identified by HUD (refer to our fourth installment of this column for a discussion of HUD Statement of Policy 1999-1). Investors take a dim view of two mortgage brokers sharing a yield spread premium, since HUD has not explained how two brokers can split responsibility for taking an application.

Real estate brokers face two additional issues when brokering loans. First, real estate brokers cannot share loan origination income with their franchisor. Section 8(b) of RESPA prohibits taking a fee or a split of a fee for settlement services without doing any work. An exception in Section 8(c) of RESPA permits payments pursuant to cooperative brokerage and referral arrangements or agreements between real estate agents and brokers. This exception does not extend to loan broker arrangements.

Second, IRS rules require withholding of employment taxes from income earned for originating loans. Most real estate agents do not like to originate loans since taxes must be withheld from loan officer income. This issue is solved by grossing up loan origination commissions. If the real estate broker intends to pay 25 basis points in commissions to its real estate agents for loan originations, the real estate broker can announce that its real estate agent will receive 20 basis points per closed loan, and the broker will pay all withholding taxes.

Next Week: Reverse Secondary Market Transactions.

Previous columns:

1. Affinity relationships under RESPA: Making money the 'old-fashioned way'
2. Affinity relationships under RESPA: What is an illegal kickback?
3. Affinity relationships under RESPA: Knocking the stool over
4. Affinity relationships under RESPA: Inside Section 8(b)
5. Affinity relationships under RESPA: Markups and junk fees
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9. Affinity relationships under RESPA: The golden rules
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12. Affinity relationships under RESPA: Office rentals and incentive payments

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Affinity relationships under RESPA: Reverse secondary market transactions

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Reverse Secondary Market Transactions

Many mortgage brokers try to form affinity relationships with depository institutions to broker loans in states where the mortgage broker is not licensed to originate loans. Individual loan officers may resign from working for a mortgage broker and become bona fide employees of a depository institution. There is no legitimate path for an unlicensed mortgage broker company to "borrow" a bank's license or to legally share loan origination income with a depository institution.

However, mortgage lenders that have access to a warehouse line of credit may reverse the traditional roles of the larger investor and the smaller lender to originate loans for depository institution customers. These arrangements take advantage of the secondary market transaction exception found in Section 8(c) of RESPA. Section 5(b)(7) of HUD's Regulation X states:

"Secondary market transactions. A bona fide transfer of a loan obligation in the secondary market is not covered by RESPA and this part, except as set forth in section 6 of RESPA (12 U.S.C. 2605) and Sec. 3500.21. In determining what constitutes a bona fide transfer, HUD will consider the real source of funding and the real interest of the funding lender...."

For example, Community Bank A ordinarily denies credit to less credit worthy customers because it does not offer subprime loans. To better serve these customers, Community Bank A enters into a Loan Processing Agreement with Mortgage Company B in which Mortgage Company B agrees to process loan applications for a fixed market rate per loan. The processing fee must be paid for each application. Waiving the fee when the loan does not close could be interpreted as a thing of value in return for the referral of business. Community Bank A either provides disclosures to its applicants, or arranges for Mortgage Company B to mail disclosures to applicants in the name of the Bank.

Mortgage Company B also enters into a Mortgage Loan Purchase Agreement with Community Bank A to purchase any loan that it processes and approves. Mortgage Company B negotiates a modification of its warehouse loan agreement so that it can use its warehouse line of credit to buy loans from Community Bank A in addition to funding loans from other lenders. Mortgage Company B also negotiates changes to its investor agreements (if needed) so that it may sell third party loans to these investors.

When a loan is processed and approved by Mortgage Company B, Community Bank A originates and funds the loan (i.e. the Bank is the "real source of funding"). The Bank holds the loan for two at least days to establish that the Bank has a real interest in the loan as the funding lender. The Bank sells the loan to Mortgage Company B and earns a small premium. Mortgage Company B uses it line of credit to purchase the loan, and it holds the loan for at least two days before it sells the loan to its investor in a secondary market transaction. The effect of this relationship is that the Bank earns a fee equivalent to a yield spread premium for originating the loan without having to perform substantial work as a mortgage broker.

Several thorny issues, such as assigning liability for mortgage fraud, errors in loan origination, early payment defaults, and loan prepayments that result in recapture of the sale premium, must be resolved in drafting the Loan Processing Agreement and the Mortgage Loan Purchase Agreement. Legal counsel should be engaged from the beginning of affinity relationship discussions between a depository institution and a mortgage lender so that this arrangement is properly documented. Nevertheless, reversing the roles of the parties in this manner allows a depository institution to better serve its customers and share in the income generated from loans to its customers without retaining experienced personnel to process and sell mortgage loans. The mortgage lender receives referrals, and shares income generated by originating loans, without violating RESPA.

Next Week: Affiliated Business Arrangements

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