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HUD's RESPA Interpretive Rule: It's Time to Reevaluate Your Marketing Arrangements

The payment of transactionally-based marketing fees by home warranty companies to real estate brokers and agents has been attacked by the U.S. Department of Housing and Urban Development ("HUD" or "Department") pursuant to an interpretive rule published on June 25, 2010 under the Real Estate Settlement Procedures Act ("RESPA").¹ By its terms, the interpretive rule appears to be limited to service arrangements where home warranty companies pay real estate brokers and agents on a per-transaction basis for the performance of administrative and marketing services related to the sale of home warranty products. But, in crafting its interpretation, HUD fails to identify the particular facts upon which it relies, which raises questions about the scope of the rule and whether HUD is trying to send a message about its view of marketing agreements across settlement service industries.

So, what does that mean for you? If you are a real estate broker or agent and have marketing arrangements with home warranty companies that are predicated on transactionally-based compensation, this interpretive rule could fundamentally change your arrangements. If you are a mortgage lender or a title insurance company that maintains marketing agreements with other settlement service providers, you should pay close attention to the issues raised in this interpretive rule. Although the interpretive rule took effect immediately upon publication on June 25, 2010, HUD is soliciting public comments on the scope and clarity of the rule through July 26, 2010. This client alert, therefore, summarizes HUD's interpretive rule and identifies some of the issues that could have significant implications for real estate brokers and agents, home warranty companies, and, if HUD seeks to extend the interpretive rule's principles beyond transactionally-based marketing arrangements, other settlement service providers.

I. Background

Section 8(a) of RESPA prohibits any person from giving or receiving a thing of value in exchange for the referral of settlement service business. The statute, however, provides a number of exceptions to this prohibition, including an exception for goods or facilities actually provided and services actually performed. Section 8(c)(2) states that "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" does not violate Section 8 of RESPA.² This exception is the basis for marketing and service arrangements across settlement service industries, including arrangements between home warranty companies and real estate brokers and agents. As long as one settlement service provider performs actual, necessary, and distinct services on behalf of another settlement service provider, the provider may receive reasonable compensation for these services.

II. Interpretive Rule

Using these requirements under Section 8(c)(2), the interpretive rule addresses those services that a real estate broker or agent may lawfully perform for a home warranty company in return for compensation under RESPA and those services that could trigger a Section 8 violation. Stated differently, at least in the context of arrangements predicated on transactionally-based compensation, HUD considers certain services performed by real estate brokers and agents to be akin to referral activities, which means that Section 8 of RESPA prohibits compensation for these services. Other services, however, may qualify as actual, necessary, and distinct services, which allow real estate brokers and/or agents to be compensated for their performance. We discuss the contents of HUD's interpretive rule in more detail below.

A. Improper Referral Fee Arrangements

As an initial matter, HUD identifies certain arrangements in the interpretive rule that may indicate a payment from a home warranty company to a real estate broker/agent is unlawful under RESPA in the context of transactionally-based marketing agreements.³ First, if the compensation that a real estate broker or agent receives from a home warranty company is contingent on an exclusive arrangement to provide services only to that home warranty company, HUD suggests without explanation that this compensation may be a prohibited referral fee. Second, if the home warranty company's payments to the real estate broker or agent are based on, or adjusted according to, the number of home warranties that are purchased as a result of the broker's or agent's referrals, this, too, may indicate a violation of Section 8(a) of RESPA. HUD, however, acknowledges that if payments are, in fact, made for compensable services, the arrangement is lawful, and the existence of an exclusive arrangement or per-transaction fees would not be indicators of an impermissible referral arrangement.

B. Compensable and Non-Compensable Services

So, what services does HUD consider to be compensable services? As it relates to marketing services performed by real estate brokers or agents

to promote the home warranty company's product pursuant to transactionally-based marketing arrangements, HUD states that "a home warranty company's compensation of a real estate broker or agent for marketing services that are directed to particular homebuyers or sellers would be a payment that violates Section 8 of RESPA."⁴ HUD reasons that a "real estate broker and agent hold positions of influence in the real estate transaction, [and] a homebuyer or seller is more likely to accept the broker's or agent's promotion or recommendation of a settlement service provider."⁵ Thus, if a real estate broker or agent makes verbal "sales pitches" to particular buyers or sellers about the benefits of a particular home warranty product or distributes a home warranty company's promotional material to buyers or sellers at its office or open houses, HUD considers these services to equate to referral activities, for which RESPA prohibits the broker or agent from receiving compensation.

By contrast, given the requirements of Section 8(c)(2) of RESPA, HUD acknowledges that real estate brokers and agents may perform compensable services in compliance with RESPA if the services are actual, necessary, and distinct from the primary services provided by a real estate broker or agent. For instance, if a real estate broker or agent performs the following services on behalf of a home warranty company, the services may qualify as compensable services: (i) conduct actual inspections of the items to be covered by the warranty to identify pre-existing conditions that could affect home warranty coverage; (ii) record serial numbers of the items to be covered; (iii) document the condition of covered items; and (iv) report to the home warranty company regarding inspections.⁶ Moreover, HUD identifies certain facts that may further support a determination that a real estate broker or agent performs compensable services on behalf of a home warranty company. If the services to be performed by a real estate broker are specified in a contract, the real estate broker documents the services provided to the home warranty company, the services actually performed are not duplicative of the services typically performed by a real estate broker, and the real estate broker is the legal agent of the home warranty company, HUD suggests these facts may support a real estate broker's or agent's performance of lawful

and compensable services under Section 8 of RESPA.⁷ If the real estate broker also discloses its relationship with the home warranty company to the consumer and makes clear that the consumer may purchase a home warranty product from other providers, this may provide further evidence of a lawful services arrangement.

C. Reasonable Compensation

Finally, even if a real estate broker or agent performs compensable services as part of an arrangement with a home warranty company, the interpretive rule reminds us that Section 8(c)(2) requires the compensation paid by the home warranty company to the real estate broker or agent to be reasonably related to the value of the services actually performed.⁸ Although the interpretive rule quotes heavily from HUD's policy statement regarding compensation paid to mortgage brokers, HUD has not provided meaningful guidance as to what it means to pay or receive reasonable compensation. Generally, a payment must bear a reasonable relationship to the market value of goods or services, and the market price cannot include the value of the referral. Any fee paid that is more than the fair market value of the services performed could qualify as an impermissible referral fee under RESPA.

III. Unanswered Questions

Read narrowly, the interpretive rule states the obvious—namely, that a settlement service provider cannot pay a fee for the successful referral of a real estate settlement service. The imprecision, however, with which HUD crafted this interpretation leaves us questioning what the Department is really trying to say. While the interpretive rule purports to draw a clear division between permissible and impermissible payments made by home warranty companies to real estate brokers and agents in the context of certain services arrangements involving transactionally-based compensation, the interpretive rule also raises a number of questions about the scope of HUD's interpretations, the permissibility of marketing services that are not directed to particular homebuyers or sellers, and the implications for other types of marketing and services arrangements. We explore some of these issues in more detail below.

Scope. First, given the title of the interpretive rule (Real Estate Settlement Procedures Act: Home Warranty Companies' Payments to Real Estate Brokers and Agents) and the specific references to home warranty companies and real estate brokers/agents throughout the document, HUD's interpretation appears to apply only to transactionally-based payments made by home warranty companies to real estate brokers and agents. However, in addressing permissible and impermissible payments between home warranty companies and real estate brokers/agents, HUD identifies certain factors that are not unique to home warranty service arrangements. For instance, HUD suggests that the existence of an exclusive arrangement or payments on a per-transaction basis could be evidence of an unlawful referral fee arrangement. Yet, marketing and service arrangements between real estate brokers and lenders or lenders and title insurance agencies often include these components for efficiency and accountability purposes. And, HUD provides no explanation as to why exclusivity by itself raises legal issues. Given the prevalence of these factors in arrangements across settlement service industries, further clarification from HUD would be helpful.

Moreover, the interpretive rule outlaws payments for marketing services that are directed to particular homebuyers or sellers. HUD's reasoning is that real estate brokers and agents are in a unique position of influence with consumers. But, what makes real estate agents any more influential than loan officers, builder sales representatives, title agents, lawyers, or other persons that come into contact with buyers and sellers in the residential home buying process? The lack of any real difference means that lenders who distribute title agency brochures directly to their customers and receive payment for this service could be in danger of performing impermissible referral fee activities. That being said, it is important to remember that, even if such activity rises to the level of a referral, RESPA does not prohibit referrals, merely payment for referrals. Query whether HUD would have focused on this element at all if transactionally-based compensation had not been involved?

Compensable Marketing Services. Second, HUD's interpretive rule is clear that marketing services performed by real estate brokers and agents that are directed to particular homebuyers or sellers are not compensable services under RESPA, and the Department gives two examples of these types of services – verbal “sales pitches” and the distribution of promotional materials at a broker's or agent's office or open house. Presumably, therefore, marketing services performed by real estate brokers/agents that do not promote home warranty products to particular homebuyers or sellers are actual and necessary services for which the real estate broker or agent may be compensated.

However, by nature, all marketing services are ultimately directed to consumers who will purchase a home warranty product. So, what exactly is the difference between non-compensable marketing services directed to particular homebuyers or sellers and presumably compensable marketing services not directed to particular homebuyers or sellers? Will HUD allow home warranty companies to compensate real estate brokers/agents who market the home warranty company through general advertisements in an internal magazine, banner advertisements on a website, or signage posted on the walls of a real estate broker's office or open house? The answer may well be that generalized marketing services that are not directed to a particular customer in connection with a specifically contemplated transaction do not constitute a referral of a real estate settlement service.

Agency Relationship. Third, HUD's interpretive rule states that a real estate broker/agent that performs services for a home warranty company as the company's legal agent is evidence that compensable services have been lawfully performed by the real estate broker or agent under Section 8 of RESPA. Such an agency relationship essentially means that the home warranty company will assume all legal responsibility for the services performed and representations made by the real estate broker or agent in connection with the home warranty product. At the same time, the real estate broker/agent gains the authority to step into the shoes of the home warranty company and act on behalf of the home warranty company as principal. If HUD considers an agency relationship to be an important indicator of a RESPA-compliant services arrangement, why

would the Department prohibit real estate brokers and agents from receiving compensation for marketing services directed to particular homebuyers or sellers? If a home warranty company can engage in these services on their own behalf, then a person or entity acting as an agent of the principal should be able to perform the same marketing services without violating RESPA. After all, one cannot make a referral to itself.

Change in Compensation Structure. Fourth, the interpretive rule emphasizes the statutory elements of Section 8 of RESPA, which requires a thing of value to be given or received in return for the referral of settlement service business in connection with a federally-related mortgage loan. HUD's interpretation also seems to assume that all marketing services performed by real estate brokers and agents for home warranty companies will be performed in connection with a federally-related mortgage loan. In other words, a homebuyer will obtain a mortgage loan to purchase the property and either the borrower or seller will pay for the home warranty as part of the costs needed to settle the transaction. By extension, any services performed by the real estate broker/agent in return for a portion of the home warranty fee would be provided in connection with a federally-related mortgage loan. But, is it possible to change the compensation structure for home warranty products to avoid Section 8 RESPA concerns altogether? If a consumer pays for a home warranty product before a transaction closes or after the home has been purchased, arguably the settlement service is not provided in connection with a federally-related mortgage loan. This means that any payments made to real estate brokers or agents in return for services performed to market or sell home warranty products may fall outside the required statutory elements of Section 8 of RESPA. If this can be accomplished, home warranty arrangements that currently call for per-transaction fees to be paid to real estate brokers and agents for marketing and administrative services may still comply with RESPA.

Class Action Litigation. Finally, a concern of any settlement service provider is the threat of class action litigation, as consumers are authorized to seek up to treble damages in connection with violations of Section 8 of RESPA. But, HUD appears to recognize this threat and states in the

interpretive rule that it “will review evidence on a case-by-case basis to determine whether compensation provided was a kickback for a referral or a legal payment for the compensable services.” The practical effect of this language appears to be that private class actions targeting per-transaction arrangements between home warranty companies and real estate brokers/agents would be difficult to pursue if each payment must be individually analyzed.

IV. Conclusion

HUD’s interpretive rule is likely to result in changes to certain per-transaction marketing and services arrangements between home warranty companies and real estate brokers and agents. At the same time, the language used by HUD in its interpretation

raises questions about the Department’s view of marketing agreements, which you may want to consider. As HUD is accepting comments on the interpretive rule through July 26, 2010, if any of the questions and issues raised by HUD’s interpretation is significant for your business, you may also want to consider the submission of public comments.

We would be happy to assist you in evaluating current marketing arrangements and agreements or preparing public comments to HUD’s interpretive rule. If you have any questions about HUD’s RESPA interpretation, please contact Phillip L. Schulman at (202) 778-9027 / phil.schulman@klgates.com or Holly Spencer Bunting at (202) 778-9853 / holly.bunting@klgates.com.

¹ 75 Fed. Reg. 36271 (Jun. 25, 2010).

² 12 U.S.C. § 2607(c)(2).

³ See 75 Fed. Reg. at 36272.

⁴ Id.

⁵ Id.

⁶ Id. at 36272, n.2.

⁷ Id. at 36272.

⁸ 75 Fed. Reg. at 36272-36273.

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