

AFFILIATED BUSINESS ARRANGEMENTS

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As I am writing this article, I have before me an Inman News Release announcing the New York Attorney General and the New York Insurance Department are investigating the title insurance industry with respect to RESPA violations involving illegal kickbacks. I am certain this investigation will reveal affiliated business arrangements which in fact are nothing more than a disguised effort to provide referral fees to real estate brokers, attorneys and other providers of real estate settlement services. As I have indicated previously in this in column, affiliated business arrangements (ABA's) are a lawful and valid means by which real estate brokers can expand their businesses by offering additional services such as title abstract services, mortgage brokerage services or mortgage banking services. The key to whether or not your conduct with respect to an ABA is lawful is whether in fact you are expanding into a new business or merely disguising a referral fee from leads generated by your real estate brokerage business. This article will explore that question.

An ABA typically involves a situation where a new business entity, usually a corporation or limited liability company, is created to enter into a business, usually a title agency or a mortgage business. This new business has two or more principals. One is a real estate broker and a second is somebody who already operates as either a title agency or a mortgage business. As I have stated before, such business arrangements are lawful and all principals can lawfully be paid the fair value of any services they perform for the ABA as well as partake in the profits generated. When such entities (ABA's) come under scrutiny, various tests are applied to see whether or not the new entity is a legitimate business or just a device to funnel illegal referral

fees to one or more of the principals.

The first level of this inquiry involves three elements: The first is whether or not any required affiliated business arrangement disclosures have in fact been properly made to consumers. The second element is whether consumers are provided a choice as to whom they employ for their title or mortgage business. In other words, that there is no required use of the new entity placed upon a consumer dealing with one of the principals. The third element is that no principal receives anything of value other than payments for services rendered or participation in the profits of the entity. HUD has established specific tests which they apply in determining each of the above issues and before you enter into an ABA, it is recommended that you consult with your attorney to make sure that your new entity complies with these tests.

Assuming you pass these three tests, the next level for inquiry is whether or not this is a legitimate business entry or just a disguised referral mechanism. In this regard, HUD provides a 10-prong test. The prongs of the test are as follows:

1. Does the new entity have sufficient initial capital and net worth, typical in the industry, to conduct the business for which it was created?
2. Is the new entity staffed with its own employees?
3. Does the new entity manage its own business affairs?
4. Does the new entity have an office for business, separate from those of its parents? If not, does it pay market value rent?
5. Is the new entity providing substantial services; i.e., the essential functions of the real estate settlement service for which the entity receives compensation? Does it

- incur the same risks as any other settlement service providers of the same type?
6. Does the new entity perform all of the work itself? How much is contracted out?
 7. Does the new entity contract out work to a parent, affiliated provider or entity that helped create the controlled entity? If so, does the new entity itself provide any functions that are of value to the settlement process?
 8. Does any party to which services are contracted out perform them for a less than market value fee, such that the reduced charge might constitute a thing of value for the referral of that business by the new entity to that party?
 9. Is the new entity actively competing in the market place for business? Does it receive business from other sources than its parents?
 10. Is the new entity sending business exclusively to one of its parents?

It is not necessary that the new entity meets all 10 of the above items on the above list. Rather, whether or not the entity is considered involved in a sham ABA will be based upon the overall effect of applying these tests to the way the business actually is conducted and the profits are actually shared. In entering into an ABA, each of the above 10 tests have to be addressed and a decision made with respect to the results of applying each one of the tests to the business model, an informed judgment must be made as to the overall application of the ten tests when applied to the business model. It is highly recommended that an attorney and perhaps an accountant be consulted in this process.

A perfect ABA would be one in which all of the partners receive an ownership interest in the new entity commensurate with their investment in the business. By that I mean if somebody contributes 15 percent of the capital of the new entity, their ownership interest is 15 percent of

the entity. One in which the entity occupies its own office space, hires its own employees and purchases

its own business infrastructure. This perfect entity then goes out to compete for business. The entity not only solicits business from one of its principals but also from other available sources.

When ABA's are not done correctly, they may be in violation of RESPA. RESPA violations may result in both regulatory and criminal punishment, so be careful when someone suggests to you the formation of an ABA. Check out the business model for yourself and be cautious. A lot of people will tell you a deal is RESPA compliant when, in fact, it is not.

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