THE LEGAL DESCRIPTION

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# Do affiliated business arrangements violate fiduciary duty laws?

Now that affiliated business arrangements (AfBAs) have captured the attention of the Government Accountability Office (GAO), some of the more vocal opponents of AfBAs are speaking out against what they believe has become a widespread, acceptable business practice designed to force them out of the market.

The recent proliferation of affiliated business relationships has created confusion regarding an agent's loyalties and duties, according to **Douglas Miller** of Minneapolis-based Title One Inc., who gave some of the most passionate testimony at last month's Congressional hearing on competition in the title insurance industry.

Homebuyers are often completely reliant on a real estate broker for expertise and advice on all aspects of a real estate transaction , including finding a title company, Miller said, but the agent knowingly places their client in a position of complete vulnerability and then "takes financial advantage" of them by sending them to an in-house title company.

Attorney **Jeremy D. Friedman** of Downs Brill Whitehead & Sage in Coral Gables, Fla. acknowledged that AfBAs might be hurting smaller companies such as Title One, but he said that the Affiliated Business Arrangement Disclosures required under the Real Estate Settlement Procedures Act (RESPA) satisfy the parties' obligation to the consumer.

But  Miller says there is a bigger obligation.

"They are fiduciaries," Miller insisted. "That is what they do. What they should never do is exploit that unique relationship of trust for profit, especially secret profit."

Miller admitted that his argument may seem radical, but cited the proliferation of AfBAs in the Minneapolis area and the resulting cutthroat competition as the driving force behind his cause.

"I'm not just whining that I'm getting beat up and people are using fair business practices," Miller said. "My competition is no longer the title company next door. Most of them aren't even real title companies. My competition is now Realtors who have this incredible influence over their clients. How do you compete with that when they're giving them tainted advice?"

Friedman asserted that he believes the AfBA Disclosure forms satisfy the parties' fiduciary duties to the consumer.

"As long as you have disclosure and the ability to choose which broker you're going to use, that's not improper," Friedman said. "I don't think that a title company has an obligation to define every broker in the area in order to find the best price. As long as there is disclosure, if they are being advised of that, I believe that satisfies their fiduciary duty."

**RESPA not enough**

Currently, the only legal analysis done prior to setting up an AfBA is analysis under RESPA. But there's a loophole in RESPA, Miller said.

"Large title insurance underwriters and small title agents approach Realtors, mortgage companies and builders ... to start their own sham title companies," he said. "They set up hundreds of these 'title companies' for no other purpose but to pay referral incentives to their silent partner real estate professional members.

"It makes no sense and has caused a perverted sort of competition in which the underwriter or title agent is setting up companies to do services that they already perform," Miller continued. "Bottom line: They are not true, stand-alone businesses. They are referral conduits."

Because bad players prey on that loophole, one must look beyond RESPA for remedy, Miller argued.

"The liability being risked even with RESPA-compliant referral incentives to fiduciaries has yet to be understood by many people, including attorneys," Miller said. "What I'm saying is that there are entire other bodies of law out there."

Self-dealing, unfair business practices, anti-competitive business practices, conspiracy to defraud, unjust enrichment and interference with a fiduciary relationship are just a few, Miller said.

"I don't believe anyone is looking to the common law of agency, the anti-trust implications, theories of fraud or other sources of law for additional legal requirements," he said. "That oversight may be putting the entire real estate industry in jeopardy."

**Disclosures not enough either**

As Friedman pointed out, currently, in order to engage in AfBAs, settlement service professionals rely on client-signed Affiliated Business Arrangement Disclosure forms to satisfy RESPA requirements — but those forms are often presented to a client in a flurry of other papers, when a client is overwhelmed with other decisions, Miller said. The disclosures also come nowhere near to obtaining the informed consent of their clients, he argued.

"Imagine what would need to be said in order to fully disclose a real estate agent's and real estate brokerage's conflict of interest in referring their client to an in-house title company with significantly higher fees," Miller said. "Disclosure of the conflict of interest needs to be made at first substantive contact, before the client begins to rely upon the agent for their expertise.

"The fiduciary must disclose if their in-house title company is more expensive than others and by how much," he said. "They must disclose the names of other title companies that they know are less money and if they provide similar services and products. They may not omit information because it is not favorable. In fact, if the agent is being pressured by a manager to use the in-house title company, then that information must also be disclosed."

Miller went so far as to say that if such a full disclosure were to be made to consumers about using an in-house title company, consumers would not select the in-house title company in most instances.

The AfBA Disclosure forms currently in use also do not protect settlement service professionals from costly lawsuits, he said. In his testimony before Congress, Miller cited two cases where a proliferation of real estate agency relationships created the possibility for confusion regarding an agent's loyalties and duties.

**The impact of the Edina cases**

At issue in *Dismuke v. Edina Realty Inc.* (1993) and *Bokusky v. Edina Realty Inc.* (1993), two class

action lawsuits in Minnesota that together cost Edina more than $18.2 million, was the question of whether Edina, the fourth largest real estate broker in the United States, had adequately informed sellers for whom it was a listing agent of its legal status in transactions where Edina also represented the buyers.

Although the company's disclosure forms satisfied Minnesota's statutory requirements, the court ruled in both cases that Edina did not satisfy the more stringent common law requirements of undivided loyalty and complete disclosure and granted the plaintiffs summary judgment.

According to "Does It Matter Whom an Agent Serves?" a 1998 white paper by Emory University professors **Christopher Curran** and **Joel Schrag**, the real estate brokerage industry immediately recognized its vulnerability to large judgments in litigation arising from confusion over the nature of real estate agency relationships. In November 1993, the National Association of Realtors (NAR) asked legislatures to preempt the common law of agency in real estate transactions and replace it with statutory requirements that clarify the duties and disclosure requirements owed by real estate agents to their clients. Within the next two years, 13 states changed their laws.

In particular, brokers in Georgia responded to changes in the state's law by shifting from a seller's agency regime, where agents serve at the interests of sellers, to a buyer's agency regime, where agents represent the interests of buyers. Using data from the Atlanta real estate market, Curran and Schrag concluded that this shift effected a decline in real estate prices and efficiencies in the search process.

Such a case is extremely attractive to class action attorneys, Miller argued, who are looking for a case in which they can easily prove damages and uniformity in practices and win summary judgment.

"They've got all the criteria they need," Miller said. "Just like the Edina case, you're talking about a lawsuit that's going to change everything. It may not come from the government. It may end up coming from, unfortunately, the private sector."

**Conflicting views**

**Marc Savitt**, member of the National Association of Mortgage Brokers' Board of Directors and the group's Consumer Protection Committee chair, a longtime crusader against sham AfBAs, said he supports any argument worth looking into.

"Whatever it takes is what we should do," Savitt said. "I can understand Doug's frustration, and I support looking for any avenue to get this thing fixed. The marketplace works when everyone knows the rules, follow the rules and rule breakers are prosecuted."

**Arthur Sterbcow**, president of Latter and Blum Inc. in New Orleans and vice chair of the Real Estate Service Providers Council Inc. (RESPRO) said that he does not want legitimate, law-abiding, affiliated business models to get thrown out with the bath water because competitors don't like losing business fairly.

"What I heard at the Congressional hearing was Mr. Miller's testimony trying to keep a competitive business model out of the marketplace," Sterbcow said.

Miller's testimony neglected to mention abuses by non-affiliated title companies that engage in kickbacks and illegal referral fees, he added.

"As I testified before Congress, RESPRO members see too much illegal activity by both non-affiliated business entities and affiliated business entities," Sterbcow said. "Most of the illegal tactics and abuses I see in my market area in Louisiana are from non-affiliated title and mortgage businesses. Sometimes it is due to ignorance and sometimes it is deliberate.

One particularly skeptical attorney requesting to speak on background said, “I think that Mr. Miller may have an agenda that is designed to get rid of his competition using any bizarre angle he can think of based upon his testimony. It doesn’t seem based upon his comments that he is worried as much about consumers’ wallets, but rather, more about his business model being eroded by legitimate AfBAs.”

Miller is expecting such criticism, though, and considers the fight worth it.

“I think that everybody in the industry who’s involved in affiliated business has opened themselves up to liability for some gigantic class action lawsuits,” Miller said. “But if I can’t do a lawsuit because it will destroy my business, I need the government to do it, or the consumer needs to do it on a class action basis. By taking away my right to compete, they’re not just hurting me, they’re hurting the consumer. At some point, the pendulum’s going to swing too far and the whole thing’s going to come crashing down.”

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