

EXPERT REPORT BY FRED HAGANS

Initial Contact and Scope of Request

I was contacted by Patricia Tulinski with the Texas Attorney General's office to see if I would be willing to consult with the Attorney General's office and her regarding the legal implications of marketing agreements between American Home Shield ("AHS") and Texas real estate brokers. After determining that my firm had no conflicts, I agreed to consult with the Attorney General's office with respect to the subject marketing agreements.

Materials Reviewed and Information Provided

The opinions expressed in this report are based upon (i) a sample marketing agreement between Ebby Halliday Real Estate, Inc. and AHS, (ii) additional factual information provided to me by the Attorney General's office and (iii) excerpts from a publication by The Texas Association of Realtors ("TAR") published an article in May, 2005 entitled, "The Real Estate Settlement Procedures Act: Do's and don'ts for real estate brokers and agents." I have also reviewed the following statutes or regulations:

- The Real Estate Settlement Procedures Act of 1974 (12 U.S.C. § 2601-2617) and its implementing regulations;
- Section 303.304 of the Texas Occupation Code
- Section 32.43 of the Texas Penal Code
- Various cases and other authorities addressing the above-referenced statutes; and
- Various Texas cases and other authorities addressing a real estate broker's fiduciary duties at common law

Opinions

1. AHS's marketing agreement appears to contemplate the improper payment of a commission and thus violates Tex. Occ. Code §1303.304 because no payments are made under this marketing agreement unless a contract is sold and closed;
2. AHS's payments under the marketing agreement appear to be "kickbacks" paid in violation of the Real Estate Settlement Procedures Act of 1974 (12 U.S.C. § 2601-2617) ("RESPA")
3. The amounts of AHS's improper "commissions" or "kickbacks" are not included in the total compensation paid to the broker reported in the HUD-1 Statements and lead to false HUD-1 Statements;

4. A real estate broker's acceptance of the improper "commissions" or "kickbacks" is a violation of the real estate broker's common law fiduciary duty owed to his or her clients; and
5. The conduct encompassed in AHS's marketing agreement appears to be felonious conduct and violative of Section 32.43 of the Texas Penal Code for both the one offering the kickbacks to the fiduciary (AHS) and the one accepting the kickbacks (brokers).

BASES FOR OPINIONS

AHS is a home warranty company that has a dominant position in the home warranty market in Texas. In Texas, home warranty contracts are not regulated as insurance contracts or policies. Home warranty companies are regulated by the Texas Real Estate Commission ("TREC"). AHS markets and sells its product, in part, through Texas real estate brokers.

I have been provided with and have reviewed a sample marketing agreement between AHS and Ebby Halliday Real Estate, Inc. Such agreement provides that (i) the real estate broker will promote and sell AHS's home warranty to the broker's clients (consumers with a home warranty as part of the purchase or sale of residential real estate) and (ii) AHS will pay the broker a flat fee of \$90 per home warranty sold, with an additional \$40 per contract, yearly upon each successive renewal of the warranty. The fee is "earned" only upon the sale of an AHS warranty ("fully paid, non-canceled closed transaction").

TREC

The Texas Real Estate Commission ("TREC") regulates Texas real estate brokers and home warranty companies (referred to as "residential service companies"). Section 1303.304 of the Texas Occupation Code provides, in relevant part, as follows:

CERTAIN PAYMENTS BY RESIDENTIAL SERVICE COMPANY PROHIBITED

- (a) A residential service company **may not directly or indirectly pay**, as an inducement or compensation for the issuance, purchase, or acquisition of a residential service contract, a **commission** or other consideration to an **agent**, representative, attorney, or employee of an owner or prospective owner of a residential property for which a residential service contract has been or will be issued.
- (b) Notwithstanding Subsection (a), a residential service company may pay a reasonable amount for the sale, advertising, inspection, or processing of a residential service contract.

In my opinion, the AHS marketing agreement appears to contemplate a commission in violation of this statute since no amount is paid unless a contract is sold and closed.

RESPA

The Real Estate Settlement Procedures Act of 1974 (12 U.S.C. § 2601-2617) ("RESPA") and its accompanying Regulation X were enacted to ensure that consumers of residential real estate were provided with information sufficient to allow them to understand the nature and costs of the settlement process and to protect consumers from abusive practices that artificially inflate settlement costs. See 12 U.S.C. §2601(a). Through RESPA, Congress intended that the consumer be given sufficient information at an early enough time to permit shopping in the marketplace for the best settlement services and costs. Specifically, RESPA provides more effective advance disclosure of settlement costs to home buyers and sellers and kickbacks or referral fees are eliminated from the settlement process. See 12 U.S.C. §2601(b)(1), (2).

RESPA applies to real estate agents and real estate brokers, as well as home warranty service providers. See 24 C.F.R. §3500.2 (Regulation X). Because it is a "settlement service," RESPA also applies to the provision of a home warranty during a real estate transaction. *Id.*

RESPA prohibits the following conduct:

No referral fees. No person shall give and no person shall accept any fee, kickback or other thing of value pursuant to any agreement or understanding, oral or otherwise, that business incident to or part of a settlement service involving a federally related mortgage loan shall be referred to any person. Any referral of a settlement service is not a compensable service, except as set forth in Sec. 3500.14(g). A company may not pay any other company or the employees of any other company for the referral of a settlement service business.

C.F.R. §3500.14(b).

The exception to this prohibition involves services that are "actual, necessary and distinct" from the primary services that the person provides. See C.F.R. §3500.14(g). Since, any compensation paid to the broker must be in exchange for actual, necessary, and distinct services provided in connection with the sale of a home warranty, nominal services are not compensable. See C.F.R. §3500.14(f). Regulation X specifically states: "[a] charge by a person for which no or nominal services are performed . . . is an unearned fee and violates this section." 24 C.F.R. §3500.14(c). At best, nominal services are provided by a broker in connection with a consumer's purchase of a home warranty. Further, any arguably "more-than-nominal" services are not distinct from the primary services that brokers provide, particularly given the fact that many brokers view home warranties as a means to increase the probability of a home sale, for which they are already compensated, as well as protection for the broker in the event that a new home buyer is unhappy with a malfunctioning home system (allowing the broker to "pass the buck" to AHS when a home buyer is unhappy). In short, any "more-than-nominal" services are part and parcel of the services for which brokers are already compensated.

With regard to the renewal payments, it is my opinion that no "actual, necessary, and distinct" services are being performed.

Further, a "referral" under RESPA includes any action that has the effect of affirmatively influencing the selection of a home warranty company by the consumer. Something as simple as a brochure on the broker's desk would appear to constitute a "referral" under RESPA, if the broker was paid to have the brochure available to the consumer. See 24 C.F.R. §3500.14(f). In the context of a brochure, to avoid an "exclusive" arrangement, the brokers would theoretically have to offer all brochures from other home warranty companies equally to the consumer.

An exclusive relationship or a commission-based compensation system violates RESPA (12 U.S.C. §2601). Further, any payments between a home warranty company and a broker are likewise prohibited by RESPA because any services for which payment was made would constitute nothing more than nominal services.

This conclusion is bolstered by two occurrences. First, a nationwide class-action suit was filed in Alabama, claiming that AHS's payment of commissions to the brokers violates RESPA, seeking return of the kickbacks, penalties under RESPA, and attorney fees. Second, in August 2007, the "Risk Mitigation Group" in Arlington, Texas, wrote an opinion letter to HUD's General Counsel for the Southwest Region identifying the identical kickback situation here, concluding that the conduct violates RESPA. Subsequently, in February 2008, HUD agreed with the RM Group conclusion.

Further, The Texas Association of Realtors ("TAR") published an article in May, 2005 entitled, "The Real Estate Settlement Procedures Act: Dos and don'ts for real estate brokers and agents." Under the section "[p]ayments in return for goods provided or services performed," TAR stated:

Also, the payments should not be "transactionally based." A payment for services rendered is transactionally based if the amount of the payment is determined by whether the real estate broker/agent's services resulted in a successful transaction. Payments may not be tied to the success of the real estate broker/agent's efforts, but must be a flat fee that represents fair market value.

<http://texasrealtors.com/web/7/54/magazine/issues/05/0505/columns/legal>

Incidentally, there is no "disclosure" around a RESPA violation, so it would not be possible for AHS or the brokers to disclose the payment of kickbacks to consumers to avoid liability, although at this time I am not aware of any evidence of disclosures being made to consumers. Further, any express self-serving statements made in an agreement do not control RESPA liability, if the fiction is only intended as a means to facilitate payments for the referral of business B it is the reality of the situation that controls, not the label attached to it.

Finally, and perhaps most importantly, AHS in 2006 started including an indemnity agreement in the marketing agreements that it "agrees to indemnify [broker] ... for" any violations of RESPA.

HUD-1 Statement

The HUD-1 Statement is also known as the "settlement sheet" and must be given to the borrower at or before closing. It itemizes all closing costs -- all charges imposed upon the borrower and the seller by the lender and all sales commissions, whether to be paid at settlement or outside of settlement.

The HUD-1 includes an itemization of the sales commissions, one of which is typically a percentage of the selling price of the home, shown as an exact dollar amount of compensation paid to the real estate broker. Since the amount of the kickback or commission is not included in the total compensation paid to the broker, that amount is falsely reflected on the HUD-1. Further, by not including any disclosure of the kickback or commission payment to the broker, the HUD-1 does not itemize all closing costs and sales commissions whether paid at settlement or outside of settlement. Further, it is reasonable for the consumer to conclude that no kickback or commission was paid, when the sales commission as a percentage of the sales price does not include the kickback.

Texas Common Law (Fiduciary Duty)

As a matter of law, a fiduciary relationship exists between a real estate agent/broker and client. *Anderson v. Griffith*, 501 S.W.2d 695, 699 (Tex. Civ. App. --Fort Worth 1973, writ ref'd n.r.e.). The fiduciary duty of real estate brokers arises by virtue of the common law interpretation of the relationship as one of principle and agent and by virtue of certain statutorily mandated duties that have been historically considered to be fiduciary in nature. *Chien v. Chein*, 759 S.W.2d 484 (Tex. App.--Austin 1988, no writ) (referring to the fiduciary duties imposed on real estate brokers by statute, Real Estate License Act, Tex. Rev. Civ. Stat. Ann. Art. 6573a § 15)

The fiduciary's duties include the duty of loyalty and utmost good faith (*Kinzback Tool Co. v. Corbett-Wallace Corp.*, 160 S.W.2d 509, 512 (Tex. 1942)); the duty of candor (*Hawthorne v. Guenther*, 917 S.W.2d 924, 935 (Tex.App.--Beaumont 1996, writ denied)); the duty of full disclosure (*Chien v. Chein*, 759 S.W.2d 484 (Tex.App.--Austin 1988, no writ)); and to refrain from self-dealing (*Dearing, Inc. v. Spiller*, 824 S.W.2d 728, 733 (Tex.App.--Austin 1988, no writ)).

The duty of loyalty is the hallmark of a fiduciary relationship, and it requires sublimation of the most human of instincts, that of self-interest. *Slay v. Burnett Trust*, 187 S.W.2d 377 (Tex. 1945).

This duty prohibits the fiduciary from using the advantage of his position to gain any benefit for himself at the expense of the beneficiary and prohibits him from even placing himself in any position in which his self-interest will or may conflict with his obligations as a fiduciary. Brokers or other fiduciaries violate the duty of loyalty if they receive or negotiate a secret commission or profit. *Kinzbach*, 160 S.W.2d at 514.

A fiduciary has much more than the traditional obligation not to make any material misrepresentations; the fiduciary has an affirmative duty to make a full and accurate confession of all his fiduciary activities, transaction, profits, and mistakes -- even when, and especially if, it hurts. *Montgomery v. Kennedy*, 669 S.W.2d 309, 312-13 (Tex. 1984). Proof of "full disclosure" is a subjective test requiring that the beneficiary have actual knowledge of all facts; proof of constructive

knowledge or a showing that the beneficiary was aware of the facts is not sufficient. *Gayneir v. Ginsberg*, 715 S.W. 2d 749, 755 (Tex.App.--Dallas 1986, writ ref'd n.r.e.). The breach of the duty of full disclosure by a fiduciary is tantamount to fraudulent concealment. *Willis v. Maverick*, 760 S.W.2d 642, 642 (Tex. 1988).

A fiduciary must obtain actual consent of the principal to act on behalf of another party or to accept a commission from another party. *Daniel v. Falcon Interest Realty Corp.*, 190 S.W.3d 177, 185 (Tex.App.--Houston [1st Dist.] 2005, no pet.). Disclosure alone is not sufficient to avoid liability for breach of fiduciary duty. *Gayneir*, 715 S.W.2d at 757.

Any self-dealing by a fiduciary, such as making a side-profit or fee as a direct or indirect result of the fiduciary relationship, will give rise to a "presumption of unfairness." *Texas Bank and Trust Co. v. Moore*, 595 S.W.2d 502, 508-09 (Tex. 1980); *Jackson Law Office, P.C. v. Chappell*, 37 S.W.3d 115, 122 (Tex.App.--Tyler 2000, pet. denied).

Texas courts recognize a cause of action for aiding and abetting a breach of fiduciary duty. *Mabrey v. SandStream, Inc.*, 124 S.W.3d 302, 316-17 (Tex.App.--Fort Worth 2003, no pet.); *Toles v. Toles*, 113 S.W.3d 899, 912 (Tex.App.--Dallas 2003, no pet.); *Elcor Chem Corp. v. Agro-Sul, Inc.*, 494 S.W.2d 204, 208-09 (Tex.Civ.App.--Dallas 1973, writ ref'd n.r.e.). There is also a cause of action available for civil conspiracy, as well as joint liability, when a fiduciary is involved with a non-fiduciary, and the non-fiduciary acts in furtherance of the conspiracy. *Paschal v. Great Western Drilling, Ltd.*, 215 S.W.3d 437, 444 (Tex.App.--Eastland 2006, pet. denied).

The canon of professional ethics adopted by TREC states that a real estate broker or salesperson, while acting as an agent for another, is a fiduciary. Special obligations are imposed when such fiduciary relationships are created. 22 Texas Administrative Code § 531.1. The rule states that the real estate agent must be "faithful and observant" of the client's trust and be "scrupulous and meticulous" in carrying out duties. *Id.* at § 531.1(2). The rule summarizes the duties of all fiduciaries and states that the real estate agent must place no personal interest above that of the client. *Id.* at 531.1(3). Finally, one of a real estate broker's duties as a fiduciary is to convey to the principal all information that the broker has knowledge of that may affect the principal's decision. *Id.* at 535.2(b).

Setting aside all other legal implications or theories, under a purely common law fiduciary duty analysis, the real estate brokers cannot accept a "commission" from AHS, because the brokers must satisfy their duty of loyalty and make full disclosure. This is an affirmative duty to make a full and accurate confession of all activities, transactions, and profits. If challenged, the fiduciary must prove that the client had actual subjective knowledge of all facts (activities, transactions, profits, and the like), not that the facts were simply disclosed.

Given the AHS marketing agreement, the fiduciary broker would have to disclose, at the very minimum the terms of the marketing agreement including the following: (1) I will get paid \$XX by AHS as a commission on the sale of your AHS contract; (2) I am not telling you about the many other home warranty products that could be in your best interest to purchase because AHS is paying me not to tell you about them; (3) if I convince you to purchase AHS's contract, I will also get paid

\$XX each year that you renew the contract; (4) I am being paid to tell you that AHS's product is better than the other competing products available to you, whether I believe it or not.

Not only would these types of explicit disclosures have to be made, but the fiduciary would have to prove that the consumer had actual knowledge of every factBnot that disclosure was madeBbut that the consumer had actual subjective knowledge and actually understood all the facts, relationships, and implications, yet still decided to go ahead with the purchase.

Of course, this scenario is limited to the breach of fiduciary duty, as RESPA and the other statutes do not recognize even the possibility of an adequate disclosure.

Texas Commercial Bribery Statute

The Texas Commercial Bribery Statute provides:

- a. For purposes of this section:
 - (1) "Beneficiary" means a person for whom a fiduciary is acting.
 - (2) "Fiduciary" means:
 - (A) an agent or employee;
 - (B) a trustee, guardian, custodian, administrator, executor, conservator, receiver, or similar fiduciary;
 - (C) a lawyer, physician, accountant, appraiser, or other professional advisor; or
 - (D) an officer, director, partner, manager, or other participant in the direction of the affairs of a corporation or association.
- (b) A person who is a fiduciary commits an offense if, without the consent of his beneficiary, he intentionally or knowingly solicits, accepts, or agrees to accept any benefit from another person on agreement or understanding that the benefit will influence the conduct of the fiduciary in relation to the affairs of his beneficiary.
- (c) A person commits an offense if he offers, confers, or agrees to confer any benefit the acceptance of which is an offense under Subsection (b).
- (d) An offense under this section is a state jail felony.

- (e) In lieu of a fine that is authorized by Subsection (d), and in addition to the imprisonment that is authorized by that subsection, if the court finds that an individual who is a fiduciary gained a benefit through the commission of an offense under Subsection (b), the court may sentence the individual to pay a fine in an amount fixed by the court, not to exceed double the value of the benefit gained. This subsection does not affect the application of Section 12.51(c) to an offense under this section committed by a corporation or association.

Tex. Penal Code § 32.43.

In short, this statute appears to render the conduct encompassed in AHS's marketing agreement a felony, for both the one offering the kickbacks to the fiduciary (AHS) and the one accepting the kickbacks (brokers). Under this statute, there need only be a benefit offered to a fiduciary to induce or in any way alter the course of conduct of a fiduciary to a beneficiary. See Jackson v. Radcliffe, 795 F.Supp 197, 206 (S.D. Tex. 1992).

The fact that AHS attempts to indemnify the brokers from RESPA liability in the marketing agreements evidences its actual knowledge that the agreement may constitute an illegal kickback arrangement. It is fairly reasonable to conclude that AHS knows that the broker has a fiduciary relationship with the consumer and that AHS is asking the broker to violate that duty in exchange for a fee. In fact, when the Texas Attorney General explicitly described the marketing agreements as a violation of the broker's fiduciary duty to the consumer, AHS continued the marketing arrangements with the brokers nonetheless.

Background and Qualifications

Attached hereto is a true and correct copy of my curriculum vitae.

Reservation of Rights

The opinions set forth herein are preliminary and are based upon limited information. I reserve the right to amend, supplement or withdraw any opinion expressed herein if subsequent investigation, information or research changes any of my opinions set forth herein.

Very truly yours,

HAGANS BURDINE MONTGOMERY & RUSTAY, P.C.



Fred Hagans

FH/lc
Attachments