

THE REFERRAL OF CONTROLLED TITLE BUSINESS IN KANSAS: A STATE LAW MEETS FEDERAL PREEMPTION UNDER GRAMM-LEACH-BLILEY

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In 1989 the Kansas Legislature enacted HB 2502, which significantly restricted the ability of banks, real estate companies and independent mortgage brokerage firms from referring customers to affiliated title insurance companies. Specifically, the law prohibits a title insurer from receiving more than 20% of its gross operating revenue in a six-month period from an affiliated or “controlled” title insurance producer, such as a bank or real estate broker (“controlled business statute”). Such prohibition has survived four subsequent attempts at repeal and a legal challenge to its constitutionality. This article examines the background surrounding the implementation of the controlled business statute, including the reasons advanced for and against its original passage and for its subsequent retention and repeal. Although the scope of this article is restricted to Kansas law, the issue is one of national significance, as most jurisdictions have some sort of prohibition against controlled business, and one of the main challenges to the continued viability of such laws is federal preemption by the Gramm-Leach-Bliley Act of 1999 (“GLB”).¹ As discussed in detail below, the Kansas Insurance Department (“KID”) has recently concluded that GLB preempts the Kansas controlled business statute regarding the title insurance activities of banks.

The original impetus for a controlled title insurance law began in 1986 when the KID began to receive a number of complaints alleging that certain real estate agents and mortgage lenders were receiving illegal inducements, rebates, and other advantages in the sale or placement of title insurance. The allegations were the subject of an investigation by the KID that ultimately resulted in the issuance of several consent orders and fines. The frequency of such complaints eventually aroused the attention of the news media, which, in turn, generated significant consumer interest. Further creating consumer suspicions about fraudulent title insurance practices was the formation in 1988 of the title insurer Wichita Title Associations (“WTA”). WTA was created by a collaboration of five of the largest Wichita real estate sales companies with several leading lending institutions, and the company quickly obtained 25 percent of the Wichita title insurance market. In response to the consumer complaints and to avoid the implementation of prior approval of title insurance rates, the KID created a title insurance study group to review the issues of title insurance rate regulation and trade practices, and to make recommendations regarding such issues. The prohibition on the volume of controlled business contained in HB 2502 was one of such recommendations.²

HB 2502 contained two restrictions regarding controlled business. The first restriction, which had the support of the real estate industry, prohibits a title insurer or title agent from accepting an order for title insurance when it believes the applicant was referred by a producer of title insurance, unless the producer has disclosed to the buyer, seller and lender its financial interest in the insurer or agency.³ As noted above, the second, more controversial restriction prohibits title insurers and title insurance agents, that operate in counties of over 10,000 persons, from accepting orders for title insurance business or from receiving any premium in connection with any title insurance transaction, if:

The title insurer or title agent knows or has reason to believe that the transaction will constitute controlled business for that title insurer or title agent, and 20% or more of the gross operating revenue of that title insurer or title agent during the six full months immediately preceding the month in which the transaction takes place is derived from controlled business.⁴

Pursuant to subsequent regulations promulgated by the KID, controlled business was defined as any portion of a title insurer’s or title agent’s business that was referred by a title insurance producer, or an associate of such producer, when that producer has a financial interest in the title insurer or agency.⁵ As used in such regulation, financial interest means:

Any direct or indirect interest, legal or beneficial, where the holder is or will be entitled to one percent or more of the net profits or net worth of the entity in which such interest is held. Notwithstanding the foregoing, an interest of less than one percent or any other type of interest shall constitute a “financial interest” if the primary purpose of the acquisition or retention of that interest is the financial benefit to be obtained as a consequence of that interest from the referral of title business.⁶

During the committee hearings and debate on HB 2502, the proponents of such legislation testified that controlled business practices were anti-competitive, encouraged poor title insurance underwriting practices, and increased title insurance costs.⁷ The opponents testified that HB 2502 was in effect special legislation designed to eliminate WTA's market advantage and that such legislation would be harmful and detrimental to consumers, as it would work a restraint of trade and thus restrict market choice for title insurance. The opponents also alleged that the findings of the title insurance study group were insufficient to conclude that controlled business practices were detrimental to consumers.⁸

Despite the strong objections of the opponents, the bill passed the legislature with the controlled business prohibitions and was approved by the Governor. Subsequent to such enactment, WTA filed a lawsuit in the Sedgwick County District Court seeking a temporary injunction against the enforcement of the controlled business statute and any subsequent regulations by the Commissioner of Insurance, as well as a declaratory judgment that the controlled business statute was unconstitutional.⁹ The trial court eventually ruled that the controlled business statute violated several provisions of the United States and Kansas Constitutions, and enjoined the Commissioner of Insurance from enforcing the law. The district court's ruling was appealed to the Kansas Supreme Court, as reported in the case *Guardian Title Company and Wichita Title Associates, Inc. v. Bell*.¹⁰ In *Bell*, the Court reviewed the trial court's holding that: 1) The term controlled business was void for vagueness because it was not defined in statute; 2) The legislature can not delegate to an administrative agency the task of defining an unconstitutionally vague term because to do so violates the separation of powers doctrine of the Kansas Constitution; and 3) The classification exempting counties of 10,000 persons or less from the controlled business prohibition violated the equal protection clause because it was not rationally related to a legitimate state purpose.

In discussing the vagueness argument, the Court noted that other parts of HB 2502, as well as the legislative testimony, clearly indicate that the term "controlled business" signifies business that has been referred to the title insurer by a producer of title business who has a financial interest in the insurer. Since the definition of controlled business was not void for vagueness, the Court further held that the legislature had given the KID sufficient standards for rulemaking, and therefore the separation of powers doctrine was not violated. As to the issue of equal protection, the Court noted that generally only one or two title insurers are available in smaller counties, and therefore most title insurers must be tied to another financial entity in order to survive in the less populated counties. Thus the exception for controlled business in counties of 10,000 persons or less was rationally related to the goal of promoting the availability of title insurance in such counties. Upon the exhaustion of judicial relief, WTA and other producer-owned title insurers were forced to cease operating in Kansas.

Attempts at repeal of the controlled business statute were subsequently made during the 1991, 1996, 1998 and 2001 legislative sessions.¹¹ The 2001 legislation, HB 2209, was introduced at the request of the Kansas Association of Realtors. HB 2209 would have repealed the controlled business statute as well as implemented several consumer protection and notification requirements that mirrored those contained in the federal Real Estate Settlement Procedures Act ("RESPA").

The conferees that testified in favor of HB 2209 reiterated many of the same arguments that had been made in opposition to the enactment of the controlled business statute. Such proponents noted that the title insurance industry's contention that repeal of the controlled business statute would destroy competition in the title industry is false, as little competition currently exists in the industry. The proponents noted that title companies do not compete for consumers by distinguishing themselves in the marketplace; they compete by going to the producers of business (real estate agents and lenders) to get them to refer business. Therefore, such lack of competition would exist irrespective of whether real estate agencies and mortgage brokers owned title insurers.¹²

Although most of the issues previously raised by the proponents of HB 2209 were the same issues advanced in previous years, one new issue was raised in light of the passage of GLB, namely that such law has preempted the applicability of the controlled business statute regarding the title insurance activities of financial institutions. The KID, in direct opposition of its original testimony in 1989, presented testimony in support of the repeal of the controlled business statute.¹³ Such position was based upon an opinion that the agency had recently issued to a Kansas bank holding company that contemplated entering into a joint venture arrangement with a title insurance company. Upon the completion of the transaction the holding company would own a title agency, whereby it would sell title insurance to its mortgage customers. In holding that the joint venture could proceed, the KID opined that

the Kansas controlled business statute was preempted by GLB and unenforceable against title agencies affiliated with depository institutions.¹⁴

In concluding that the controlled business statute is preempted, the KID noted that Section 104 of the GLB describes in complex fashion the operation of state law in regulating the business of insurance. Specifically, Section 104(d)(1) states:

Except as provided in paragraph (3), and except with respect to insurance sales, solicitation, and cross marketing activities, which shall be governed by paragraph (2), no State may, by statute, regulation, order, interpretation, or other action, prevent or restrict a depository institution, or an affiliate thereof, from engaging directly or indirectly, either by itself or in conjunction with an affiliate, or any other person, in any activity authorized or permitted under this Act and the amendments made by this Act.

Since the joint venture in question concerned the sale of insurance, the KID analyzed Section 104(d)(2)(a), which states:

In accordance with the legal standards for preemption set forth in the decision of the Supreme Court of the United States in *Barnett Bank v. Nelson* 517 U.S. 25 (1996), no State may, by statute, regulation, order, interpretation, or other action, prevent or significantly interfere with the ability of a depository institution, or an affiliate thereof, to engage, directly or indirectly, either by itself or in conjunction with an affiliate or any other person, in any insurance sales, solicitation, or crossmarketing activity.

The KID opined that the above provisions expressly preempted the Kansas controlled business statute, as such law significantly interferes with the ability of a depository institution or affiliate to engage in title insurance sales. In reaching its conclusion, the KID analyzed the thirteen “safe harbors” of permissible state insurance regulation upon the activities of depository institutions and concluded that none of such provisions protected the Kansas controlled business statute from preemption.

As part of its preemption analysis, the KID also analyzed Section 104(c) of GLB. Such section addresses the ability of a state to regulate depository institutions and their affiliates, and specifically states:

Except as provided in paragraph (2), no State may, by statute, regulation, order, interpretation, or other action, prevent or restrict a depository institution, or an affiliate thereof, from being affiliated directly or indirectly or associated with any person, as authorized or permitted by this Act or any other provision of Federal law.

The KID noted that although the controlled business statute does not explicitly prevent or restrict a depository institution or affiliate from owning a title insurance agency, the operating revenue restrictions act as a disincentive to such affiliations. Therefore, such provision may also preempt the controlled business statute.

The KID also reviewed Section 303 of GLB, which addresses the sale and underwriting of title insurance by national banks, state banks and their affiliates, and prohibits national banks from underwriting or selling title insurance, except in states where state banks are authorized by statute to sell title insurance. The KID noted that nothing in that section prohibits or addresses subsidiaries or affiliates of a financial holding company from engaging in title insurance, and therefore was not applicable in the instant case.

In concluding that the controlled business statute was preempted by GLB, the KID noted that such preemption was limited only to depository institutions, and therefore it technically could continue to enforce such prohibition against title companies not affiliated with banks. In researching its opinion, the KID contacted the National Association of Insurance Commissioners (“NAIC”), which confirmed its preemption analysis with regards to the Kansas controlled business statute. Furthermore, the NAIC noted that the Title Insurance Agent Model Act, adopted in 1995, contains a controlled business prohibition that conflicts with the “prevent or significantly interfere” standard set forth in Section 104(d)(2)(A) of GLB.¹⁵ Since Kansas was the first state to determine that GLB preempts a state controlled business statute, the KID stated in its opinion letter that it would share such analyses with other jurisdictions.

Opponents of HB 2209 reiterated many of the same arguments expressed during testimony in support of the enactment of the controlled business statute, including the contention that controlled business would lead to monopolies and decrease consumer options for title insurance. They further argued that the parameters and significance of the “prevent or significantly interfere” standard contained in GLB are unclear and must be resolved through litigation, and that at the very least, Kansas may continue to regulate the title insurance activities of non-bank entities.¹⁶ They also made issue of the inconsistent positions taken by the real estate industry regarding financial modernization, as the industry supports the ability of realtors to sell title insurance at the same time that it opposes the ability of banks from acting as real estate brokers.¹⁷ Despite the support of the KID, HB 2209 failed to advance out of the House Insurance Committee.

Conclusion

In 1989 Kansas enacted its controlled business statute and became the first state to require that no more than 20% of a title insurer’s business be derived from affiliated title insurance producers. Although the merits of such legislation have been discussed and debated in the years since its enactment, the passage of GLB in 1999 has significantly changed the analysis of the statute’s continued viability, as a strong case can be made that it is preempted under GLB. Whether the legislature will heed the advice of the Kansas Insurance Department and repeal such prohibition this legislative session remains to be seen, but the actions taken by the legislature will undoubtedly be noticed by other states that are dealing with such issues of federal preemption.¹⁸

Endnotes

1. Pub. Law 106-102, Nov. 12, 1999, 113 Stat. 1381.
2. *See, e.g.*, Testimony of Dick Brock, Kansas Insurance Department, before the House Committee on Insurance, March 2, 1989, attachment 3, pg. 2.
3. K.S.A. § 40-2404(14)(e).
4. K.S.A. § 40-2404(14)(f).
5. K.A.R. § 40-3-43(f).
6. K.A.R. § 40-3-43(c).
7. *See, e.g.*, Testimony of George E. Burkett, Kansas Land Title Association, before the House Committee on Insurance, March 2, 1989, attachment 5, p.1.
8. *See, e.g.*, Testimony of Karen McClain France, Kansas Association of Realtors, before the House Committee on Insurance, March 2, 1989, attachment 6, p.2.
9. *See* Op. Kan. Att’y Gen. No. 89-64 (May 22, 1989), where the Kansas Attorney General addressed many of the same issues raised in the lawsuit. The Attorney General concluded that the statute did not violate any constitutional provisions.
10. 248 Kan. 146 (1991).
11. On January 21, 2003, the Kansas Association of Realtors introduced legislation to repeal the controlled business statute.
12. *See, e.g.*, Testimony of Karen France, Kansas Association of Realtors, before the House Committee on Insurance, February 13, 2001, attachment 1, p. 5.
13. *See, e.g.*, Testimony of Kathy Greenlee, General Counsel, Kansas Insurance Department, before the House Committee on Insurance, February 13, 2001, attachment 2, p. 1.

14. Letter from Kathy Greenlee, General Counsel, Kansas Insurance Department, to Michael Lochmann, Esq., Stinson, Mag & Fizzell (February 1, 2001).
15. Title Insurers Model Act § 13 (National Association of Insurance Commissioners 1995).
16. *See, e.g.*, Testimony of Roy Worthington, Kansas Land Title Association, before the House Committee on Insurance, February 13, 2001, attachment 4, p.2.
17. The National Association of Realtors has lobbied the Department of Treasury and the Congress to prohibit banks from engaging in the real estate business, and is actively supporting S. 98 and H.R. 111, which prohibit financial holding companies and national banks from engaging in real estate activities.
18. *See, e.g.*, Op. Tenn. Atty. Gen. No. 02-013 (February 1, 2002), where the Tennessee Attorney General held that the provisions of Tennessee law that prohibited a title insurance agency from receiving more than 40% of its gross operating revenues from controlled business, as well as prohibited a bank holding company from owning an insurance agency, were preempted by GLB. The Tennessee Land Title Association and two independent title insurance agencies have filed a lawsuit in the Middle District of Tennessee challenging the entry of banks into the title insurance business.