2003

State Regulation of Real Estate Settlement Services--Letting Free Enterprise Evolve While Protecting the Public

Joyce Palomar, *University of Oklahoma College of Law*

FTC Public Workshop on Barriers to Electronic Commerce

Testimony by Professor Joyce Palomar:

State Regulation of Real Estate Settlement Services – Letting Free Enterprise Evolve While Protecting the Public

Several types of state regulations of real estate settlement service providers impact the ability to offer residential real estate lending and refinancing services nationally via the internet.

1. Laws and court rules in some states restrict the practice of law to attorneys licensed to practice within that state and include within their definition of "the practice of law" the examination of titles, preparation of deeds and mortgages, and closing of real estate transactions.

2. Insurance regulations in the majority of states require that title insurers be monoline insurers. Complementary regulations prohibit general casualty insurers, including private mortgage insurers, from insuring titles and mortgage liens.

3. Iinsurance regulations in a majority of states prohibit issuance of a title insurance policy unless an examination of the title has been performed. Regulations in some states permit only certain state-approved title insurance forms to be issued. A few states regulate the rates title insurers charge for particular coverages. Some further require that any title insurer own or operate a private title plant. And, a few states prohibit issuance of title insurance unless an abstract of the title has first been updated and certified by a licensed abstract company and examined by a licensed attorney.

<u>Each</u> of these laws and regulations poses a barrier to electronic commerce in real estate lending and refinancing in its own way and <u>each</u> has the effect of protecting one type of private real estate settlement service provider from competition by others.

1. Unauthorized practice of law rules have permitted bar associations to sue to enjoin lenders and lay title company employees from providing residential real estate settlement services. Such rules are barriers to lenders offering loans nationally over the internet because they must have a local attorney provide such services as examining the title, drafting the deed and mortgage, and supervising the closing of the real estate transaction.

2. State regulations requiring that title insurers be monoline insurers have permitted title insurers' national trade association and state insurance regulators to stop general insurers and private mortgage insurers from issuing one master policy to insure thousands of a national lender's mortgage liens on a casualty basis for

sale into the secondary mortgage market. Monoline title insurance regulations also have stopped private mortgage insurers from selling a combination private mortgage insurance/title insurance policy in home refinances. These regulations are barriers to national lending or refinancing over the internet, because the lender must obtain a separate mortgage title insurance policy from an independent title insurance company for each loan given. This is required even when the current owner is simply refinancing and the title insurer accepts no new risk, and even though the private mortgage insurer and the title insurer duplicate portions of each others' investigations as to matters such as the record title holder, mortgage liens, tax liens and court proceedings affecting the title.

3. Regulations requiring that title insurance policies be issued only after a search of the title records or an attorney's examination of a certified abstract permit bar associations and state regulators to stop lenders from self-insuring on a casualty basis against their losses resulting from inability to enforce any of the mortgage liens they accept. These regulations create barriers to electronic commerce because one or more local persons must be involved in every residential loan or refinance transaction in order to meet each state's individual requirements. In a few states, an independent title insurer, local title or abstract company, and a local attorney all must be involved in each residential real estate purchase, mortgage loan, and refinance transaction.

Though each of the preceding types of regulations of real estate settlement services does have an anti-competitive effect and pose a barrier to electronic commerce in residential real estate lending and refinancing, does that mean we should automatically denounce each? The answer is "No!" Instead, it is important that we decide how to respond to their anti-competitive effect and barrier to electronic commerce only after studying whether they are needed due to countervailing public policies. In this case, we must consider the entire scheme of state regulations and laws regarding real estate settlement service providers and ask two questions. First, what policy or purpose was each of these laws and regulations intended to serve when American states adopted them? Second, does each type of law or regulation today provide a public benefit sufficient to justify the restraint on competition and electronic commerce that it poses?

1. What purpose were these types of laws and regulations intended to serve?

In most countries of the world, real estate conveyancing and title assurance are government functions. England, Canada, Australia, Italy, Germany, China, Spain, Mexico, and countries in Eastern European and Central and South America all employ a system of "registration of rights" to real estate, rather than the U.S. system of recordation of title evidence. While nations' registration systems vary somewhat in how they achieve their purpose, they all intend to establish the rights to each parcel of real estate through registration of the ultimate conclusion that a certain party has title to a definitely described tract of land and that no encumbrance nor junior, future or contingent interests exist other than those shown in the registry.[1] Land title registration systems accomplish this by holding a judicial proceeding on the initial application to register any parcel of land. Once the judicial determination of ownership is made, all other claims to the land are purged.

A registered title is transferred by the registrar (a "public notary" in some countries) making a new entry on the register in the name of the new owner. In many countries' registration systems, no deed is utilized. It is the registrar's entry in the register that transfers the title, not an instrument of conveyance. In systems that use title certificates, the registrar also issues a new certificate. Mortgage liens and other encumbrance are added or removed by the registrar making notations in the register and on the certificate.

Few title defects occur in properly functioning government-operated land registration systems. One empirical study showed approximately one title claim against registrars in Australia and Spain for every 1000 claims filed against title insurance policies in the United States.[2] If misfeasance or negligence of the registry office causes an erroneous registration, the law provides either that government or the registry office will compensate deprived title or lien holders. A mixed solution has been adopted in many countries' Torrens registers where a public insurance fund, financed by users' fees, pays losses of right holders who were deprived of rights by a subsequent registration.

Thus, in most countries of the world, conveyancing of land and assuring titles and mortgage liens is primarily a government function. Transfer of titles, public notice of rights to land, and indemnification against title problems are provided in an integrated government scheme. Real estate contracts may be drafted by private attorneys, but they generally are not required to be part of the conveyance or insurance of titles. In the U.S., conversely, most aspects of conveyancing and title insurance have been privatized.

Most of the countries with the preceding public land title conveyancing and registration systems did not begin them until the 19th and 20th centuries. They adopted them wholesale after changes in government, or, after centuries with no written land title recording system at all. For example, England adopted Her Majesty's Land Registry System in 1926, and was able to learn at that point from the weaknesses in older recording systems such as ours.

---

[1] The next two pages of this paper are condensed from Joyce Palomar, TITLE INSURANCE LAW, Ch. 21 (1994 & Annual Supplements, West Group Publishing). Because of space constraints, the extensive footnotes have not been reproduced here and the reader is referred to that work for citations to authorities utilized.

[2] Benito Arrunada, *Property Enforcement and the Organization of Consent*, Universitat Pompeu Fabra, Economics and Business Working Paper Series 564, December 2001. (http://www.econ.upf.es/cgi-bin/onepaper?564).

The U.S. began its system of public recording of title evidence as early as 1627. As weaknesses in the system were revealed, free enterprise stepped in to fill the gaps, instead of the government. Private attorneys developed expertise in searching burgeoning indexes of land records organized only alphabetically by grantors' and grantees' names. When it became apparent that title defects might exist that even a careful examination of the public records could not uncover, private title insurance developed.

As real estate transactions increased exponentially in the U.S. because of the increasing population, the ability of the majority of our citizens to purchase their own homes, and the growing economy, states imposed regulations on these private businesses to ensure that titles to land would remaind sufficiently secure to stimluate investment for land development and land use. For example, monoline title insurance regulations, regulations requiring title insurers to own title plants, and regulations barring issuance of insurance policies on land titles unless a reasonable title examination is first performed all impose on private title insurance companies the role of eliminating title risks that the government fills in the rest of the world. Imposing obligations on consumers to use private attorneys in the real estate transactions also was intended to reduce title defects.

A few places in the U.S., like Cook County, Illinois, attempted to adopt the new registration systems they observed in other nations, but over time those involved with real estate transactions observed that the lesser government involvement of the old recording system along with conveyancing by private attorneys and indemnification from private ttile insurance companies actually was faster and more responsive to new developments in real estate finance and transfer.

Using private enterprise to supplement our bare bones recording system has made our land title system sufficiently secure to permit commerce involving transfer of land and use of land to flourish. Our public recording system would not have been adequate on its own to accomplish that result, but adding to it private risk elimination services and private contracts of indemnification against loss has made our system just as secure as more modern registration systems. An unexpected added benefit is that using private enterprise to reduce title risks and transfer titles, rather than a government office, has permitted the flexibility, creativity, speed, and responsiveness to commerce that has made our modern methods of real estate finance the model that the rest of the world follows.

2. Do these regulations today sufficiently protect the public to justify their restraint on competition and electronic commerce?

In the context of rules against the unauthorized practice of law that prohibit lay provision of real estate settlement services, state courts, the Department of Justice, and the Federal Trade Commission all have suggested that they should not be continued unless evidence establishes that they protect the public from harm sufficiently to warrant their anti-competitive effect. Though I do believe that such rules were originally adopted to protect both individual consumers and the integrity of our land titles generally, I agreed that empirical evidence should be sought to determine whether today these rules protect the public from harm sufficiently to warrant their continuation. In 1999, I published in the Connecticut Law Review a study comparing numbers of claims filed due to title problems in states requiring attorney involvement in residential real estate transactions to claims filed for title problems in states where title insurance companies perform the title examination, drafting of instruments, and closing of residential real estate transactions. The empirical evidence suggested that the public did *not* sustain significantly greater losses from title defects in states where non-attorney title company employees perform title examinations, draft deeds and mortgages, and supervise residential real estate settlements.

I propose that as to each of the types of real estate settlement service regulations above, empirical evidence be sought as to whether they continue to provide a public benefit sufficient to justify their anti-competitive effect and the barrier they pose to electronic commerce.

For example, at first glance, it is difficult to see any direct benefit to consumers from requiring individual title examinations when they simply refinance their own home mortgage loans. Since the property has not changed hands since the homeowner purchased it, there is an assumption that the benefit does not outweigh the anti-competitive effect and the barrier to electronic commerce that results from preventing national lenders from self-insuring against losses from refinanced mortgage liens or from stopping general insurers or private mortgage insurers from insuring refinanced mortgage liens on a casualty basis. Yet, we need to consider whether the public could be harmed indirectly. Title insurance companies contend that they will go out of business if lenders are permitted to self-insure or if general insurers are able to insure mortgage liens on a casualty basis in refinance transactions. Title insurers say this would take the "cream" of their business from them. They contend that if these other insurers are permitted to take the cream of their business without bearing the cost of meeting all the regulations imposed on title insurers – i.e., the costs of creating and maintaining title plants, training personnel to perform title examinations, charging only regulated rates, et cetera -- then title insurers will not be able to earn enough from the remaining, higher risk residential and commercial real estate transactions to stay in business or to maintain their title plants and trained personnel. Since private title insurance companies in the U.S. provide the title security that governments provide elsewhere, without them, commerce involving land development and land use would be severely stifled. This is a fearsome possibility. Yet, is it reality?

As the FTC considers the anti-competitive effect and barrier to electronic commerce posed by individual state regulations on the provision of real estate settlement services, the FTC also must gather empirical evidence as to whether the public obtains a benefit or is protected from harm by each of those existing regulations sufficient to warrant their cost. We cannot assume the correctness of dire warnings from industries that fear losing a competitive advantage if a regulation is removed; yet, at the same time, the risk to commerce involving development or use of land is too great to assume that the regulations are no longer needed, without empirical study and proof.