Title Escrow Theft and Title Insurance Fraud Whitepaper (9/20/12 draft)

I. Introduction

This white paper is intended as a tool for regulators to research methods for combating, preventing and mitigating the effects of escrow theft, title insurance theft and other forms of fraud associated with title insurance and closing services transactions. It is important to recognize regional differences in the way title insurance and closing services are provided and regulated. There are few one-size-fits-all solutions. Nor, is there a single solution to the problem for any particular jurisdiction. Therefore, a variety of methods are identified. Where practical, this paper will attempt to discuss the merits as well as the shortcomings of each identified method. The availability of proprietary solutions such as software and systems approaches will also be discussed without identification of specific providers. The ultimate goal of this paper is to identify ways to improve title insurance and closing service consumer protection.

The white paper may also be used by the title insurance and closing services industries when evaluating their own enterprise risk management and auditing guidelines for combating escrow and title insurance premium theft. These are problems that cause a great deal of expense and loss for insurers, in terms of claims, auditing, legal fees and mopping up resulting failed title agencies. In addition to direct monetary costs, the potential for reputational damage or even resulting insolvency are major concerns. Because of the unpredictability of the frequency and magnitude of these events, serious negative results to title insurers’ financial condition can result. The unnecessary and hopefully preventable expenses associated with mishandling of title insurance and closing funds are ultimately borne by customers in the form of higher title insurance premiums and closing costs.

II. Understanding Fraudulent Actions and Schemes Against Title Insurers

A. Background and Definition of the Problem

i. Title insurance and closing services have historically been a labor-intensive process with few opportunities for centralization of services within an insurer. Although direct services have grown due to increased availability of digitized courthouse records, insurers rely on a large number of licensed and unlicensed individuals who are not directly employed by the insurer for title searches, underwriting of the risk, issuance of commitments and policies, handling of funds, providing closing services and post-closing services. This decentralization, along with the large number of individuals and large number of financial transactions increases the opportunities for those that decide to operate in a dishonest or untrustworthy manner. An often repeated urban legend recounts a newspaper reporter asking gangster Willie Sutton why he
robbed banks, with the answer being, “because that’s where the money is.” Although the legend is not authenticated, that purported response could be one reason why so many cases of escrow account and title insurance premium misappropriations have taken place. In some cases, cash strapped title company\(^1\) or escrow company owners begin juggling or floating entrusted funds to cover operational costs with the hope of being able to catch up at a later date. In other cases, a gambling addiction, a financially unsustainable lifestyle, medical expenses or other situations may cause an owner or employee to use trust funds for their own purposes. This inappropriate use of funds that belong to others almost always catches up with the title or escrow company, resulting in insufficient funds in their escrow account and, ultimately, the discovery of the defalcation unless uncovered sooner via audits or other means. One thing is clear, however, the vast majority of title insurance producers and closing/escrow professionals are honest and service-oriented individuals who are devoted to providing an excellent outcome for their customers. The few individuals who do misappropriate or mishandle customer and insurer funds generate a disproportionate amount of loss [or “number of problems”]. Some problems are detected and reported by vigilant co-workers who notice irregularities, and others are uncovered as a result of consumer complaints or are revealed through title insurer oversight of its agents’ activities. Regulators can help reduce the number of misappropriations by periodic or random audits of title and escrow companies, however the large number of companies and title producers providing escrow and closing services make wide scale audits an impractical and economically unfeasible task for most states.

ii. Escrow and title insurance thefts harm consumers in a number of ways. The most obvious example of loss to consumers is instances where customer funds are outright stolen without recourse from other parties such as insurers. In some instances, closing services and title insurance are handled by separate entities, thereby reducing the likelihood that any specific title insurer will be responsible to step in and reimburse for loss of escrow funds. Further, the courts in many states have consistently ruled that title insurers are not liable for the theft of escrow funds as title companies are only their agent for title insurance purposes and not for their separately provided escrow services, leaving consumers with few means of recourse. Escrow funds subject to loss include pre-closing funds such as down payments or post-closing funds

\(^1\) For purposes of this paper, title company will refer to an entity owned or operated by a title insurance producer. Title Insurer will refer to a title insurance underwriting company.
Title Escrow Theft and Title Insurance Fraud Whitepaper (9/20/12 draft)

intended for recordation of documents, payment of title insurance premiums and disbursements necessary to clear the title. Theft of title premium frequently means no title policy is issued and the consumer does not get what he or she paid for. Since many customers don’t know exactly what to expect after closing, they may not be alarmed at not receiving a title policy. When lenders complain about not receiving a policy, the offending title company resorts to the “squeaky wheel gets the grease” method of prioritizing which policies get issued. When theft of escrow funds occurs, failure by the title company to pay off prior mortgages or release certain escrowed funds, may not surface for years or until the property is resold.

iii. Escrow, settlement fund and title insurance premium theft also harms title insurers. Reputational damage, loss of revenue, resulting claims, regulatory responses and costs associated with remediation are all adverse effects of this problem and can lead to insurer insolvency. Additionally, title insurers increasingly must expend a great deal of financial and human resources to detect, prevent and combat problems associated with these types of losses. Insurers can exercise more “hands-on” control, policies and procedures for reduction of these problems with direct operations but independent agent arrangements make surveillance and management more complicated. Most large title insurers operate with a combination of both direct operations and independent contracted agents. In many jurisdictions, closing services are also commonly performed by attorneys which complicates an insurer’s ability to obtain records to detect and prevent escrow and settlement problems.

B. Types of Escrow Theft

Methods by which closing funds and title insurance premiums can be misappropriated are numerous. Some of the potential methods include:

1. Use of closing funds for purposes other than as provided for in the closing instructions or contrary to the intention of the parties to the transaction. [This sounds more like a definition of “defalcation” than a “method” of stealing funds so I’m not certain it should stay in the paper]

2. Failure to issue and/or report title insurance policies and their related premium.

3. Knowing participation in fraudulent real estate transactions including falsification of documents, knowing acceptance of false documents, flipping and flopping and use of phony appraisals to inflate a property’s value.

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4. Failure to perform all services specified in the closing instructions or HUD form, such as recordation of documents or pay-off of existing liens.

5. Fraudulent activity by unlicensed or unauthorized entities.

6. Sales of products or services which purport to be title insurance or to replace title insurance but do not.

7. Engaging in check-kiting or other banking-related fraudulent schemes.

8. Acceptance of funds that are not “good funds” for the purpose of closing transactions.

9. Misrepresentation of title defects or failure to disclose title defects with the intention of burdening the title insurer with subsequent losses.

10. Cyber-fraud aimed at identity theft or misdirection of escrow funds to the accounts of unrelated parties, typically via fraudulently obtained on-line banking credentials of the title company

C. Existing Models of Insurance Laws/Regulations

NAIC Model Law #230, “Title Insurance Agent Model Act” and Model Law # 628, “Title Insurers Model Act” each contain provisions that can assist in preventing escrow and title insurance premium theft and mishandling. Model # 230 and Model #628 were not widely implemented by the states, although many states have laws which contain components of the two models.

Among other requirements, the NAIC Title Insurance Agent Model Act includes provisions that address:

- Licensing requirements
- Fidelity coverage or acceptable alternatives other than closing protection letters
- Examination of title insurance agents by the insurance department
- Required provisions for underwriting contracts with the title insurer
- Termination provisions
- Rendering of accounts to the title insurer
- Fiduciary accounts for funds owed to the title insurer
- Insurer access to records and accounts
- Separation of records for different title underwriters
- Timely submission of escrow and title claims
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- Maintenance of an inventory of policy forms or numbers
- Statements of financial condition of the title insurance agent
- Fiduciary trust accounts in a qualified financial institution for escrow and settlement funds
- Disbursement of funds only pursuant to written directions
- Good funds requirements
- Independent audits of escrow, settlement, closing and security deposit accounts, and
- Record retention requirements.

Similarly, among other requirements, the NAIC Title Insurers Model Act includes provisions that address:
- Closing or settlement protection
- Direct operations
- Requirements to have agents’ financial condition statements on file
- Annual on-site reviews of agents
- Notification of appointments and termination of agents
- Policy form or policy number inventories
- Proof of licensing
- Requirements of maintaining escrow and security deposits when the insurer operates as a closing agent, and
- Record retention requirements.

Although not comprehensive, the provisions of these two NAIC models can provide added protection against mishandling of escrow, settlement funds and title insurance premiums. Many of the provisions mentioned here are discussed in more detail within this paper. For jurisdictions that have not adopted NAIC Model Laws # 230 and # 628, but wish to incorporate specific provisions intended to address proper handling of escrows and title insurance premiums, the models can be a source for legislative language. A list of jurisdictions that have adopted each of the models’ language or related provisions is located in the NAIC’s compendium of model laws.

III. Potential Methods to Prevent Escrow Theft [This should include a balanced perspective including pros/cons and effectiveness of the different approaches. This section may also include information on which states currently regulate escrow, how they regulate it, and the effectiveness of that regulation.]
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A  Licensing
[From Carrie Vavul]

Preventing escrow theft should begin at the most basic level of regulation - licensing. As previously noted, in some states title and escrow services are provided by separate entities while in other jurisdictions, title agents may also provide escrow services in addition to title insurance. Accordingly, licensing standards should be at a level commensurate not only with the licensee’s level of involvement with an escrow account but also with their level of involvement with the insurance product itself. For the purposes of this paper the focus is on the licensee’s level of involvement with an escrow account.

The amount of money which potentially moves through a real estate escrow account is considerable. This can make escrow theft tempting to those who find themselves in a situation where they perceive an ability to misappropriate escrow funds without being discovered. Consideration should be given to setting licensing standards which can make the barriers to entry high enough that the profession is less attractive to those whose intentions are simply to be a title or escrow agent for access to large amounts of money but not so high as to discourage growth and expansion in the industry when economic conditions encourage it. Standards vary across the states from requiring title and escrow agents to be licensed with state regulatory agencies to not requiring a license at all.

Some states require agency/firms to be licensed but not individuals. In order to determine which individuals are performing escrow handling functions for which agencies it is prudent to require agencies to also license and appoint their employees who provide title and escrow services. This would be done so that, should a potential problem arise, the individual(s) responsible could more easily be identified and their license revoked to prevent re-employment within the title industry.

Consideration should also be given to requiring a separate license designation or separate license altogether for individuals who handle escrow funds versus those who simply sell title insurance but do not handle escrow transactions. If these functions are separated by licensing designations the educational requirements for individuals who handle escrow transactions could be more focused on proper account balancing techniques and theft prevention.

Further, pre-licensing and continuing education requirements for license renewals should focus more intensely on proper escrow accounting procedures and how to better spot the red-flags which could indicate a co-worker, owner or employee is misappropriating escrow funds. This can be done regardless of the state’s approach to handling the licenses.

Any changes to licensing requirements must take into account the costs associated. For instance, any requirement upon an agency to report more
information to the licensing authority could result in a cost and any cost to an agency could, ultimately, result in a cost to the consumer. Similarly, when an industry is required to report information to a licensing authority the licensing authority will have to audit the information for compliance and accuracy. This requirement may result in higher costs to the states in terms of personnel and time required to maintain licensing records and carry out any administrative actions required to verify compliance or as a result of non-compliance.

B. Monitoring of Escrow Funds

States have taken different approaches to monitoring the handling of escrow funds. Some states require escrow funds to be held in a separate account designated by name and wherein funds must be segregated in a manner to permit identification of ownership on an individual basis. Often, these requirements also specify that the accounts must be reconciled on a specified calendar basis. Other states require agents’ escrow accounts to undergo an audit by a CPA which is then submitted to the state regulatory agency. Still other states require underwriters to perform audits of their agents’ escrow accounts on a periodic basis and, of those states, some have established standards for the conduct of those audits which provides uniform standards for the industry to follow. Finally, some states employ examiners or auditors to conduct their own reviews. A more detailed discussion of escrow account reviews is attached as Exhibit “A”.

Consideration must be given to the burden that the cost of auditing will place on states, title insurers and agents. As an example, CPA audits of escrow accounts can be costly to the title agent while audits of each agents’ escrow accounts by a title insurer will significantly increase its staffing, travel and training costs. Costs to either party will ultimately be passed onto the consumer in the form of higher closing costs or premium rates. If the results of such audits must be filed with the state, states must also consider the staffing requirements of reviewing the submitted audit reports and determining compliance with the requirement. Finally, it must be recognized that regular audits of an escrow account may detect some instances of theft but in many thefts the misappropriation is well hidden through the creation of fake bank statements or false wire transfer confirmations or by maintaining undisclosed escrow accounts through which funds are diverted. Such thefts often persist for a period of years and result in significant losses.

In addition to the auditing escrow accounts, consideration should be given to requiring licensees to maintain escrow accounts or funds held in trust in clearly identified accounts with banking institutions that offer Positive Pay. Under a Positive Pay system an agent transmits a list of the checks that it has issued each day to the bank. The bank matches that list with the checks that are presented against the account for payment. Only checks appearing on the submitted list will be honored for payment. If the check is not on one of the
list, the bank will advise the agent and, unless the agent gives authorization
the check will not be honored. If the list of authorized checks is maintained
by the owner of the title company, such a process can be an effective deterrent
to theft by employees but does not prevent theft by the owner him or herself,
the individuals who have traditionally perpetrated the majority of thefts.

In some states, attorneys are required to maintain their Attorney Trust
Accounts with approved banks. Banks which hold such accounts are required
by statute to report to the state’s disciplinary commission when an Attorney
Trust Account is over drawn. This is an avenue states can explore with regard
to title agency escrow accounts. [as well as requiring the title agency to
register their banking account information with the licensing authority. –
Why?]

C. Background Checks

Some states require a background check to be performed by either the
regulatory state agency or the title insurer before a title or escrow company, or
one of its employees, may conduct business. Such checks, which often
include a review of the applicant’s credit worthiness and criminal background,
may serve as a deterrent to those seeking to enter the industry for illegitimate
purposes or reveal individuals with financial demands that may cause them to
engage in inappropriate activities. Consideration should also be given to
requiring a “pre-sign” audit of a title or escrow company’s escrow account.
While these practices will help prevent individuals with a prior history of
improper activities or weak financial condition from being granted a license
or agency contract, frequently escrow thefts are perpetrated by individuals
with no criminal history and the theft, when it does occur, is often years after
the individual has been acting as a title or escrow agent.

D. Minimum Capital Requirements

Some states, particularly in the west and mid-west, require title companies to
have invested in a title plant or to have met certain other minimum financial
requirements before being granted a license. Such standards potentially help
protect escrow funds by allowing only those individuals with the financial
wherewithal to withstand personal financial and industry-wide economic
downturns to have access to other escrow funds. However, verification of
minimum capital requirements impose additional costs on title and escrow
companies to obtain annual CPA audits and additional costs on state
regulatory agencies to collect and review the results of these audits. Further,
such requirements may reduce the number of title and escrow companies who
can qualify to operate which may result in higher costs and fewer options for
consumers.
E. Software and Information Technology Solutions

In recent years, insurers and IT Vendors have developed integrated software solutions that offer real-time interaction between title insurers and title insurance agents. Solutions that integrate such title and escrow activities as policy orders, policy and endorsement issuance, search functions, accounting and administration of escrow and settlement funds can help reduce administrative costs for title insurance agents, improve record retention, reduce inadvertent mishandling of funds and provide a less expensive method for insurers to audit and oversee activities of title insurance agents.

F. Enhanced Regulatory Oversight

In most jurisdictions, title insurance business makes up a relatively small proportion of the total business of insurance in the state. When problems such as escrow theft occur the time and resources for dealing with the aftermath can be significant. It is important that regulators remain diligent in their duties to oversee this line of business. Important measures that can be taken include:

- Making best efforts to promote sound and strong title insurance laws and regulations within the jurisdiction
- Having sufficient staff persons who are trained and knowledgeable about the intricacies of title insurance and settlement services
- Maintaining an open channel of communication with title insurers, title insurance agents and applicable associations
- Maintaining a reasonable and visible schedule for conducting examinations or other types of oversight activities of both title insurers and title insurance agents
- Identify and address potential gaps in regulation of entities that may perform closing services
- Having a clear plan of action on how to respond to cases of defalcation. In addition to assisting with remediation for customers, regulators should be prepared to coordinate or make referrals to applicable law enforcement for subsequent action if warranted.

G. Preventing Theft by Third Parties

Positive Pay

Stand-alone computers
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Updated virus protections

Dual signatures on checks/dual wire authorizations

H. Other Recommendations

Standards for trust accounts, including permissible investments and a prohibition on sweep accounts

Good funds requirements

Statutory whistleblower protections

Consumer education

• Encourage consumers to request a CPL if available
• Encourage consumers to work with trusted companies
• Encourage consumers to request copy of agent’s fidelity/surety/other bonding

Include a review of escrow practices as part of market conduct examinations

Enhanced requirements for underwriter-agent contracts to make an agent responsible for escrow theft on a contractual basis.

Timeliness requirements for policy issuance

Guidelines on agency ownership and affiliated business

IV. Potential Tools to Mitigate Loss Due to Escrow Theft

A. Mitigating Loss to Consumers due to Escrow Theft

Despite efforts to prevent theft of escrow funds, the number of individuals with access to these funds, the amount of funds that are typically held in escrow and
Title Escrow Theft and Title Insurance Fraud Whitepaper (9/20/12 draft)

the difficulty of providing constant, thorough oversight over those funds makes it likely that thefts will continue to occur. For this reason, states should consider means of protecting consumers against these losses. Some methods of protection include:

i. Closing Protection Letters
Closing Protection Letters (CPLs) contractually obligate a title insurer to indemnify certain parties to a real estate transaction for the improper actions of the title insurer’s agent in the conduct of closing the real estate transaction. Key coverages typically include:

- Loss due to fraud, dishonesty or negligence of the title insurance agent,
  and
- Loss due to failure to comply with the closing instructions of the lender.

In recent years, an increasing number of states have approved or required a separate premium for CPL coverage but in other states no separate premium is paid for a CPL and because of this it is often not considered to be the business of title insurance and/or subject to regulation by state insurance department officials.

The most common type of CPL is that provided to mortgage lenders. Unlike lenders, sellers and buyers of real estate are often not in the real estate business and are unsophisticated in such matters. As a result, sellers are rarely afforded coverage under a CPL even though the seller’s proceeds and other funds are at risk from improper or illegal acts of the title agent. Some letters do protect buyers/borrowers in addition to the lender but because the content of these letters are often not regulated by the states, buyers are not guaranteed coverage. Other parties, such as real estate sales agents and mortgage loan originators (who are owed a commission), surveyors, and property inspectors are also typically not protected by any type of CPL. Some states do regulate the content of CPLs and require CPL coverage to be given to or offered to buyers and sellers but most states do not. Further, because sellers are unlikely to be an insured under a title insurance policy, the issuance of such letters to a seller may violate title insurer monoline restrictions. Additional information on closing protection letters is attached as Exhibit “B”.

ii. Underwriter strict liability

A limited number of states have adopted requirements that hold title insurers responsible for the escrow and settlement activities of their appointed agents. Strict liability placed on title insurers for the actions of their agents can provide incentive for more thorough insurer audits of its agents, and more thorough and quick resolution of problems that might arise. However, use of
such requirements could be unsustainable at current or similar premium levels as an insurer’s limit of liability is unknown and rates must reflect this additional potential risk, which may result in a substantial increase in costs to consumers. This standard can also add barriers for small or new title agencies obtaining contracts with title insurers and will increase the potential for insurer insolvency. Additionally, not all closing and settlement activities are performed by agents that are affiliated with the title insurer so such a standard will offer little to no protection for consumers harmed in these instances. Finally, such a standard could have the unintended consequence of making an insurer liable to an insured for loss of funds even when the insured or an employee or agent of the insured may have participated in the theft. Because the responsibility for many escrow thefts are case specific, it is may be better to allow the courts to determine liability of the parties. A strict liability standard seems to be more acceptable in jurisdictions where problems are less prevalent or where transactional volume is low.

iii. Bonds and Insurance

Some states require agents/agencies to maintain a fidelity and/or surety bond or an irrevocable letter of credit. Fidelity bonds cover theft by employees while surety bonds provide protection against theft by owners and principals of a title or escrow company. In general, the amount of coverage available to a title or escrow company is relatively low due to the cost of coverage, and with regard to surety bonds, the requirement is that the bonded owner or principal have assets at least equal to the amount of the bond. While such bonds are useful in covering small thefts of escrow funds and for serving as a partial source of recovery in larger thefts, often the amount of coverage is negligible in relation to the size of many thefts that have occurred within the title and escrow industries. Therefore, they should not be relied on as the sole means of protecting consumers and title insurers.

Some states also require title and escrow companies to maintain errors and omissions (e & o) insurance coverage. While e & o is generally available in larger amounts of coverage and at more affordable rates than fidelity or surety bonds, their coverage is limited to unintentional errors or omissions rather than the intentional theft of funds by an agency owner or employee. Nonetheless, some escrow losses do occur as a result of unintended negligence and such insurance may serve as a source of recovery in such instances.

iv. Guarantee Fund

B. Mitigating Loss to Insurers Due to Escrow Theft
During the recent economic downturn, at least five title insurers were forced to cease conducting business or were deemed insolvent due in full or part to losses arising from theft of escrow funds, including what was at the time the nation’s fifth largest title insurer with capital and surplus in excess of $130,000,000. To ensure the financial viability of title insurers, especially as states may seek to impose greater liability on them for theft of funds by their agents, consideration should be given to methods for funding or covering these losses.

i. Closing Protection Letter Fees

In recent years, several states have by statute authorized title insurers to impose a fee for providing closing protection or have dictated the amount of the fee that may be charged. Typically, these statutes also dictate what coverage can be provided under such a letter and the parties that must be offered or given protection. Other states have permitted the filing of fees for this coverage without specific enabling legislation. In either instance, generally these fees are exempted from contractually commission arrangements to ensure that the entire fee is paid to the insurer. Such fees provide a source of funds to pay for escrow losses and, because they are exempted from agent commissions, provide coverage at a much lower cost than if the charge for this risk were included within the title insurance premium itself. Further, states that require title insurers to perform audits of its agents should consider such fees to offset the cost of performing audits which may improve the quality of the audits conducted. CPL fees can also be useful in enabling insurers to afford the cost of fidelity bond coverage over the acts of their agents. However, absent a requirement to use the funds for the purpose of auditing agents, to purchase fidelity bond coverage or to set these funds aside for payment of escrow losses, the revenue generated by these letters could be paid out in the form of employee compensation or dividends to shareholders with little added benefit to consumers.

iii. Fidelity Bonds

In recent years, bonding companies have begun to offer coverage to title insurers against loss caused by theft of funds by their authorized title companies. These bonds can be a useful source of recovery in the event of a theft, however, the cost of these bonds, especially in amounts sufficient to cover most thefts can be prohibitively expensive. As a result, even when a company has a bond, it may not cover all losses the insurer may incur. Further, loss payments under a fidelity bond may take up to a year or more and any payment is subject to verification by the bonding company that the insurer complied with its signing and oversight procedures as outlined in its application for coverage. If the loss was significant, it could place an insurer at risk of insolvency despite the potential recovery under the bond at a future date. Finally, for many years these bonds were generally not available due to extensive losses suffered in the late 1980s and early 1990s. The continued
Title Escrow Theft and Title Insurance Fraud Whitepaper (9/20/12 draft)

availability of these bonds is not guaranteed and, therefore, should not be relied on as the primary source of recovery for title insurers.

iv. Increased Capital and Surplus Requirements

Consideration should be given to increasing capital and surplus requirements as a condition for authorizing a title insurer to conduct business in a state in order to better ensure that the insurer will have funds sufficient to meet escrow losses. While such increased requirements will ensure that more funds are available for these losses, it will likely lead to fewer title insurers qualifying to conduct business in a state which will reduce choice to consumers and potentially increase title insurance rates. More importantly, an insurer who qualifies under the increased requirements could suffer an escrow loss in an amount that causes it to no longer meet that state’s requirements, leading to potential issues related to notification of insureds and the issuance of replacement policies. Finally, if the insurer conducted most of its business in the state, the inability of the insurer to continue business in that state may cause it to become insolvent or unable to continue as a going concern.

v. Escrow Loss Reserve

Although all states have statutory or unearned premium reserve requirements, these reserves are only available to pay losses when an insurer ceases to conduct business, becomes insolvent or is placed into receivership. As a result, existing SPR requirements are not responsive to covering large escrow losses suffered by an on-going entity. Accordingly, consideration should be given to requiring a separate reserve specifically established to pay escrow theft losses in lieu of increased capital and surplus requirements. Such a reserve could be funded by a CPL fee, as discussed above, or by having a portion of the existing premium set aside solely for payment to the insurer before calculation of commissions. The funds in reserve would then be available for withdraw to pay escrow theft losses as they occur or as the funds are released over time pursuant to a withdraw schedule. To ensure that the reserve remains adequate to respond to escrow losses, a minimum amount of reserve should be considered that, once reached by the insurer, cannot be released other than to pay escrow losses. By paying for escrow theft losses through a reserve, a company is less likely to drop below state mandated capital and surplus requirements thus enabling it to continue as a going company and is better assured to have funds available to pay its escrow theft loss obligations. Finally, because the nation’s four largest publicly traded insurers generally have sufficient funds to meet their escrow theft losses, consideration should be given to waiving the reserve requirement for companies that maintain a specified amount of surplus as regards policyholders.
Title Escrow Theft and Title Insurance Fraud Whitepaper (9/20/12 draft)

[Other possible topics to address]

V. Conclusions/Recommendations

EXHIBIT A

Independent Audits Overview
On an annual basis, independent audit laws and regulations may require title insurance agents or agencies that handle escrow, settlement, closing, or security deposit accounts submit a filing to their regulator which would require an independent review of its escrow, settlement, closing, and security deposit accounts. Independent audits of title agents’ depository accounts can be a useful tool for regulators to monitor to determine if title agents are performing best practices within their agency. In addition, these audits provide useful data to the regulator that may indicate that a problem exists or an early warning sign of potential problems within the accounts. Statutory guidelines for the completion of the audits ensure the audits are completed in a timely and concise manner. In addition to the audit, the filing would require supplementary information to be submitted to the regulator. The following sections will provide additional information regarding the requirements/guidelines of the independent annual audit in addition to any regulator follow-up that may be needed in response to the audit.

Exemption Defined
In certain instances, a title agent may be exempt from filing an independent audit if they don’t handle escrow funds, if they only handle a small number of transactions per month and/or if they had an audit by one of their underwriters. In lieu of the independent audit, the agent may be required to complete and submit an exemption form, in addition to any supplementary forms to the regulator.

Required Filing Forms for Supplementary Information
Every title agent and agency may be required to complete necessary forms as a part of their annual filing. The form contains data fields for information that would be useful to the regulator. Possible information that can be collected by the regulator is listed below:

1. Agent/Agency Contact Information
   a. Name
   b. National Producer Number
   c. Business Contact Information
   d. Residential Contact Information
   e. Preferred Mailing, E-Mail and Phone
2. Supplementary Insurance Information
   a. Errors and Omission Insurance Coverage
   b. Surety Bond Coverage
3. Depository Account Information
   a. Listing of all depository accounts used by agent/agency
      i. Name of Account
      ii. Account Type (Directed Funds, IOTA, Non-IOTA, Premium Trust, Operating, Other)
     iii. Account Number
        iv. Depository Institution and Address
     v. Date Opened and Closed
4. Determination of Filing Status
   a. Questions to Determine Status
      i. Do you handle funds that are required to be deposited into an Interest on Trust Account (IOTA) in your name?
ii. If yes, have you had an audit by one of your underwriters?
iii. Provide name of underwriter that completed audit.
iv. Did you average five or less transactions per month during the review period?

b. Exempt Status
   i. Handle funds that are deposited into an IOTA which isn't in your name.
   ii. Handle funds that are deposited into an IOTA which is in your name AND one of your underwriters completed an audit on your IOTA AND you average five or less Ohio transactions per month.

c. Non-Exempt Status
   i. If the agent is not exempt, they required to submit an Independent Annual Review.
   ii. Must be completed by a Certified Public Accountant (CPA).
   iii. Must include a copy of the CPA Report of the Agreed Upon Procedures as outlined in the laws, rules and/or regulations

5. Agent/Agency Explanations
   a. All findings in the CPA Report should be fully explained.
   b. All other issues in the filing should be explained.

Independent Annual Review
An Independent Annual Review (IAR) of an agent’s escrow, settlement, closing, and security deposit accounts must be completed by a Certified Public Accountant. In addition to being a CPA, the independent reviewer of the account shall be qualified in the following manner:

(1) The independent reviewer may not be an employee of a title insurance company nor may the reviewer be an employee of or hold an ownership interest in:
   a. The business entity being reviewed,
   b. In any affiliates of the business entity being reviewed,
   c. In any owners of the business entity being reviewed, or
   d. Any financial institution or its affiliate in which one or more escrow accounts subject to review under this rule are held.

The IAR can be based upon agreed upon procedures as defined in the “Statements on Standards for Attestation Engagements” issued by the “American Institute of Certified Public Accountants”. Where no exceptions are found as a result of applying the procedure, the statement “no exceptions” should be noted. Where a procedure cannot be completed because the required information is unavailable, the statement “information unavailable” should be noted and explained in detail. The procedures can include, but are not limited to the following:

(a) Obtain from the agent a listing of all agent depository institution accounts existing at any time during the review period, including operating and other non-fiduciary accounts
   i. Report as specific findings all non-IOTA escrow accounts
   ii. Report as a specific finding all non-IOTA escrow accounts in which any interest, in the form of cash or earnings credits, is retained by the agent.

(b) Test the agent’s three-way reconciliations
   i. Foot reconciliation and any supporting schedules;
   ii. Compare depository institution balance per reconciliation with depository institution statement
(iii) Compare book balance per reconciliation with control account such as check book balance
(iv) Compare reconciled balances to the open escrow trial balance of the same date
(v) Review the agent’s open escrow trial balance for the two monthly periods.
(vi) Verify deposits in transit
(vii) Verify outstanding checks by tracing to the subsequent month’s depository institution statement.
(viii) Report the amount and the agent’s description of other reconciling items
(ix) Verify the agent has avoided checks procedure.
(x) Determine the timing of the preparation of the three-way and depository institution reconciliations for each of two months tested.
(xi) Review the escrow depository institution account statements for the sample months for the presence of negative daily balances, if provided on the statement, and depository institution charges for non-sufficient funds or overdraft charges.
(xii) For each escrow account, select a haphazard sample (as defined in the “American Institute of Certified Public Accountants Audit Sampling Guide”) of twenty canceled checks and/or outgoing wire transfers per month for the sample two month periods and report the following:
   
   (a) Checks or wire transfers one thousand dollars or greater payable to the agent or to its affiliates or owners which do not correspond to fee amounts reflected in the documents in the related file
   (b) Checks or wire transfers with no file reference
   (c) Any checks on which the check date is more than sixty days prior to the depository institution clearing date
   (d) If canceled checks or images of checks are available, endorsements not consistent with the payee and/or alterations to canceled checks.
   (e) Checks signed by other than authorized check signer
   (c) List all states for which the agent conducts settlements
   (d) Have the agent complete and certify the annual review supplementary form as prescribed by the superintendent for listing required insurance coverage information

Independent Review Findings

As a result of an IAR, findings and/or exceptions may be identified by the CPA. Findings can be a useful tool for a regulator to help determine if there are any inconsistencies in title agent’s depository accounts. Since the CPA only performs testing on a sampling of data from the compliance period, a finding should be further evaluated by a regulator to determine if a larger problem exists. The following findings should be further evaluated by a regulator:

1. Three way reconciliation not completed by agent
2. Negative escrow trial balances
3. Other reconciling items
4. No voided check procedure
5. Checks or wire transfers to the agent that don’t correspond with closing file
6. Outstanding checks over 30 days
Title Escrow Theft and Title Insurance Fraud Whitepaper (9/20/12 draft)

7. Deposits in transit over 30 days
8. Negative daily balance in escrow account

When an agent submits their filing, they have the opportunity to provide an explanation for each finding/exception that was identified. While an explanation may be useful to determine the extent of a potential problem, further evaluation may need to be completed. Quite often, a title agent may need to provide to the regulator a more detailed explanation, copies of bank statements, closing files and other documents in order to fully determine if a larger problem exists.

EXHIBIT B

From Brett Barrett

OVERVIEW

A “Closing Protection Letter” is an indemnification agreement where a title insurer indemnifies a mortgage lender or purchaser against actions of the settlement agent in connection with real estate closings. The title insurance agent, known in some states as a title insurance producer, typically fulfills two roles. The first role is as an agent of the title company in issuing a title insurance policy. The second role is during closing as a settlement agent or escrow agent. In some states the two roles are fulfilled by separate title and escrow companies. In the second role the title insurance producer owes a fiduciary duty to both the buyer and the seller of the property and is not an agent of the title company under traditional agency law. To protect against fraud and misdeeds of the escrow agent, a mortgage lender will often require the title company to issue a Closing Protection Letter to the lender.

A Closing Protection Letter typically provides protection in two situations. First, Closing Protection Letters protect against fraud, dishonesty or negligence of the settlement agent as it relates to the status of title. If the settlement agent misappropriates the money and fails to pay off a previous lien then the title company will be liable for the actions of the settlement agent. Second, Closing Protection Letters protect against failure of the settlement agent to comply with the written closing instructions of the lender to the extent they relate to the status of the title. The primary function of the Closing Protection Letter is to indemnify against loss caused by the settlement agent.

STATUTORY DEFINITIONS
“Insurance”, the “business of insurance”, “insurance business”, and “title insurance” are generally defined in each state’s code. Whether a closing protection letter qualifies as insurance or title insurance is largely a matter of applying the applicable state law.

**CLOSING PROTECTION LETTERS ARE PROBABLY NOT A FORM OF TITLE INSURANCE**

While some state courts have no published decisions regarding Closing Protection Letters, other courts from around the country have issued rulings discussing Closing Protection Letters and their legal ramifications. Insurance contracts are held to be indemnity agreements, but indemnity agreements are not necessarily insurance contracts. Some courts imply that Closing Protection Letters are integrated into and become part of a title policy because they are typically only issued by insurers that also issue the title insurance. Other courts have found that Closing Protection Letters do not fall under their states statutory definition of title insurance. A few cases have discussed the implications Closing Protection Letters and whether they are insurance. Closing protection letters are form letters which are issued to a lender by a title/escrow company.

Most court decisions issued recently have held that Closing Protection Letters are not a form of insurance nor are they a part of the title policy. They are considered a separate indemnification agreement protecting the lender. (See *Bergin Financial, Inc. V. First American Title Co.* 397 Fed.Appx 119 (6th Cir. 2010) citing *Ticor Title Ins. Co. V. Nat’l Abstract Agency, Inc.*, 2008 WL 2157046 at *5.) (See also *New Freedom Mortg. Corp. V. Globe Mortg. Corp.*, 281 Mich.App 63 (Mich. 2008) holding that not collecting funds due to seller at closing was not sufficient to trigger the protection of a Closing Protection Letter).

Additionally, the 6th Circuit also held that in the absence of a closing protection letter, the title/escrow company may not be liable for the closing agent’s actions. *Bergin Financial*, 394 Fed.Appx at 125 (holding that the closing agent was not acting under the authority of First American when a closing protection letter was not issued).

**SOME COURTS HAVE HELD THAT TITLE INSURANCE POLICIES IMPLICITLY PROTECT AGAINST FRAUD OF SETTLEMENT AGENT AND THEREFORE CLOSING PROTECTION LETTERS ARE INCLUDED IN THE POLICY.**

In two older companion cases from New Jersey, the court held that the Closing Protection Letter and the title insurance policy were integrated and were not separate policies. See *Clients’ Security Fund of the Bar of New Jersey v. Security Title and Guaranty Co.*, 134 N.J. 358, 377 (1993); and *Sears Mortgage Copr. V. Rose*, 134 N.J. 326, 350-352 (1993). Additionally, in Wisconsin a court held that the arbitration clause of the title insurance policy covered a dispute

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1Additionally, in Utah, Title Insurers are required to keep Errors and Omissions Insurance (or a bond of equal value), which may provide some of the same protections as a closing protection letter, depending on the policy terms. UCA §31A-23a-203.5

While most recent cases have held that Closing Protection Letters are separate from title insurance policies, there are still cases in which the Closing Protection Letter was found to be included in the title insurance policy.

**CLOSING PROTECTION LETTERS DIFFER FROM STATUTORY DEFINITIONS OF TITLE INSURANCE**

The courts which have held that Closing Protection Letters are not title insurance have focused on a few defining features of title insurance. First, a Closing Protection Letter’s protection is different in kind than traditional title policy protection. Second, title companies do not collect premiums for Closing Protection Letters to be placed in separate accounts to cover potential losses. Third, there is a lack of distribution of risk.

In cases in Virginia and Alabama courts found that Closing Protection Letters fall outside the state’s statutory definitions of title insurance noting that title insurance covers different risks than Closing Protection Letters. See *Carstensen v. Christland Corp.*, 442 S.E.2d 660 (Va. 1994); and *Metmor Financial, Inc. v. Commonwealth Land Title Ins. Co.*, 645 So.2d 295 (Ala. 1993). Both cases noted that title insurance protects against actions in the past, while a Closing Protection Letter protects against future actions by the settlement agents. *Carstensen* 442 S.E.2d 660, 665; also *Metmor* 645 So.2d 295, 297. In *Metmor*, the Alabama Supreme Court noted a lack of risk spreading and the fact that no premiums were collected or deposited into a separate fund to cover losses. *Id*. The court stated that it was “clear that the closing service letter is not a title insurance policy.” *Id*.


**CLOSING PROTECTION LETTERS ARE GENERALLY HELD TO NOT BE PROHIBITED BY MONOLINE RESTRICTIONS**

Companies that issue title insurance may also be restricted from selling other forms of insurance. If a Closing Protection Letter is found to be another type of insurance, such as fidelity insurance, then the title company may be in violation for offering a the Closing Protection Letter.

The two New Jersey cases cited above, *Sears* and *Clients’ Security*, discuss this issue. In *Sears*, the court stated that the Closing Protection Letters protection was clearly an incident to the
issuance of title insurance and that the title company “cannot now claim that such coverage is impermissible.” 634 A.2d 74, 86 (N.J. 1993). In Clients’ Security, the court stated that the obligation to indemnify was “implicit in title insurance.” 634 A.2d 90, 97 (N.J. 1993). In Utah, the problem of monoline restriction is likely not an issue. The Utah Code imposes liability on title companies for the actions of title insurance producers. See U.C. § 31A-23a-407. Section 407 codifies the indemnification that Closing Protection Letters are meant to protect. It would be difficult to argue that a title company is restricted from issuing a Closing Protection Letter when the Utah Code already imposes liability.

DO CLOSING PROTECTION LETTERS PROTECT BORROWERS, OR SIMPLY LENDERS?

Generally Closing Protection Letters are utilized to protect the interests of lenders, but they could be issued to protect persons other than lenders in real estate transactions. The American Land Title Association (ALTA) Closing Protection Letter example (revised 12-1-2011) allows a lender, its assignee, a purchaser of an interest in land, or a lessee of an interest in land to be covered. The language in the ALTA example appears to exclude certain parties from coverage, including sellers of real estate and borrowers in a refinance. However, this is only one example of a Closing Protection Letter and others could, in theory, allow for borrower protection. At least one state, Missouri, requires a separate Closing Protection Letter to be issued to both the buyer and seller in a real estate transaction. Closing Protection Letters are generally not automatically issued, and are typically only issued at closing when requested by the lender. While it seems logical to charge for additional indemnification, it may be unfair to charge the borrower/buyer when he or she isn’t the one explicitly and solely receiving the protection of a Closing Protection Letter.

CONCLUSION

As can be seen from the foregoing cases, the law surrounding closing protection letters is not clear. Some courts have found that the protections afforded by the closing protection letter are integrated into the title policy or already a part of the policy. Other courts have found that the closing protection letter is not a title policy and that it protects against different risks. Standing alone, the closing protection letter likely does not fall under Utah’s definition of “title insurance” because it does not protect against loss “by reason of liens or encumbrances upon, defects in, or the unmarketability of the title to the property, or invalidity or unenforceability of any liens or encumbrances on the property.” The letter protects against fraud or failure to follow closing instructions. Standing alone the closing protection letter likely would be considered “fidelity insurance” but as it is only provided in conjunction with issuance of a companion title policy it should not be viewed in isolation. The fact remains, though, that the protections afforded in a Closing Protection Letter are different in kind from the protections of a title policy and a Closing Protection Letter does not fall under the statutory definition of title insurance. As such a Closing Protection Letter is likely not title insurance.

The NAIC Title Insurers Act contains provisions, in Section 6, which permit title insurers to issue closing or settlement protection if not contrary to existing laws. The provisions only permit such closing or settlement protection for actions of the insurer’s named agent and prohibit the insurer from providing coverage which purports to indemnify against any other improper actions.
Some regulators have expressed the opinion that any premium charged for closing protection letters should be remitted in full to the underwriting carrier and that appropriate reserves must be established for the coverage. At least one consumer advocate expressed the opinion that lenders who require such coverage could pay the CPL premium rather than the real estate buyer.