CARLTON FIELDS

Defalcation is a Dirty Word, But Not the End of the World

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The word "defalcation" remains one of the more frightening terms in the title insurers' lexicon. But with the proper training, preparation, and response, defalcations can be managed, and the title insurers' exposure controlled. A defalcation occurs when a title insurance agent misdirects or misappropriates funds held in trust for the parties to real estate transactions. They can cause liability for title insurers under statutes, common law, title policies, or closing protection letters. But because of that liability, the law gives title insurers all the tools they need to respond. It is just a matter of learning how to use the tools. Because real estate transactions typically involve hundreds of thousands of dollars in deposits and loan proceeds, even small title agencies can have millions of dollars flowing through their escrow accounts at any given time. Sometimes, the temptation to dip into those funds for improper purposes can prove irresistible. Sometimes, title agents simply cannot manage proper accounting, and negligent defalcation occurs. Either way, the title insurers' response should secure the remaining escrow funds to cap defalcation liability, then turn to the process of resolving all potential liabilities to the parties to the escrow, then to salvage against those responsible for the defalcation. Intentional defalcation usually results when a title agent finds itself short of operating funds, or when a third party persuades the title agent to misdirect funds. Typically, a struggling title agency may find itself unable to cover its own operating expenses, such as payroll, payroll tax liabilities, or liabilities to vendors. A title agent may try to "borrow" money from escrow to cover these shortfalls by moving money to the title agent's operating account. These title agents usually intend to "repay" the escrow account when they become able. But a failing business is a failing business, and they rarely find themselves able to do so. Instead, they become emboldened when the escrow shortage does not immediately come to light. They may move more and more money from escrow to operating until they find themselves in completely over their heads and the title insurer discovers the shortage. Title agents also sometimes find themselves bent to the will of unscrupulous clients such as mortgage brokers or developers who pressure them to move escrow funds improperly. For example, a developer may demand that the title agent distribute loan payoff funds directly to the developer, rather than to the developer's mortgage lender, promising to "take care of" making the payoff and obtaining the mortgage loan release. When a large portion of a title agent's business comes from a small number of significant clients, those clients can often wield tremendous influence over the title agent. Developers, real estate agents, and mortgage brokers

have many times used a title agent's escrow account as a "piggy bank," leaving the title agent and title insurer to clean up the mess. Consider the "give the developer the loan payoff scenario." In such a transaction, the developer sells its property to a buyer, who gets an owner's title policy. The buyer's lender gets a closing protection letter and a lender's title policy. The developer does not, of course, secure the lien release from the developer's mortgage lender. As a result, the developer's mortgage lien remains on the property. The buyer has a cloud on title not excepted from the owner's title policy. The buyer's lender's closing instructions required the title agent to make payoffs and secure the lender a first priority lien. As a result, the closing protection letter may give rise to an immediate claim. And since the buyer's lender's lien is inferior to the developer's lender's lien, the buyer's lender may wind up with a policy claim as well, if the matter impairs the value of the buyer's lender's security and results in an actual loss. In addition to this potential liability under its policies and closing protection letter, in some states, so-called "defalcation statutes" may make the title insurer directly liable to the parties for the misdirected escrow funds. Finally, parties who suffer a defalcation loss can sometimes assert common law claims under theories of actual or apparent agency, *respondeat superior*, or negligent supervision. A title insurer may learn about a defalcation when it receives a claim from the buyer or the buyer's lender in this situation. A title insurer can also learn of a defalcation through an audit of the title agency's escrow accounts. When an agent's accounts will not reconcile, or when a title agent maintains multiple escrow accounts, some hidden from the underwriter, red flags should pop up in the auditor's mind and tougher scrutiny must apply. Business interruptions, such as a natural disaster or economic disruption (like the 2008 bubble burst) also bring defalcations to light. When a title agent is "playing the float" in their escrow account, keeping a defalcation under wraps depends upon a steady flow of new funds into the escrow account. When the flow contracts, the agent loses the ability to continue to play the diminishing float, and the defalcation emerges into view. When a title insurer discovers a defalcation, the most urgent response is to secure the escrow account to prevent further defalcation. Many title insurance agency agreements give title insurers a contract right to do this. Even if the agency agreement does not provide this right, a title insurer will usually have a solid argument to obtain an immediate injunction or the appointment of a receiver from a court. When the title insurer suspects intentional defalcation, and has already obtained evidence of missing funds, that relief can sometimes be obtained *ex parte* in order to prevent a fraudster title agent from making off with the remaining escrow money before it can be secured. After securing the escrow funds, the title insurer should try to minimize disruption of the title agent's business in order to minimize reputational risk. The title insurer or the receiver should continue to close transactions that are "in the pipeline," or should farm those transactions out to other title agents who can handle them smoothly, with a minimum of fuss and inconvenience for the parties. The title insurer should then work to determine the exact amount of the escrow shortage, so that the title insurer can pin down its maximum potential liability. Tracing the escrow shortage back to its original source can help identify all of the title insurer's potential liabilities from the defalcation. That exercise can also help identify potential sources of salvage recovery, such as the identity of those who benefitted from the defalcation, or other title insurance underwriters who may have liability. The title insurer should

coordinate claims on the title agent's errors and omissions policy, fidelity bonds, or other insurance or bonds that may be in place. Some bonds are designed to cover losses from intentional defalcation. Other bonds exclude criminal acts, escrow liabilities, or liabilities caused by an agency's principals. For these reasons, the title insurer should be extremely careful with the language used in these claims until all the facts are known. Once the escrows have been secured and the liability reduced to a certainty, the title insurer should pursue salvage. Contract claims under the agency agreement typically survive cancellation of the agent, and can provide for recovery not only of the missing escrow money, but the title insurer's cost of response and cleanup. Title insurers may also have unjust enrichment or similar equitable or quasi-contractual remedies. If third parties have benefited from the defalcation, the title insurer may have either direct or subrogated claims against those parties. In addition, the title insurer may alert law enforcement to the defalcation. In most jurisdiction, misdirection or misappropriate of trust funds is a serious criminal offense. Prior to the 2008 recession, criminal prosecution could be difficult to obtain, since law enforcement was focused more on terrorism than on financial crimes – but in the wake of the bursting of the real estate bubble, prosecutors and law enforcement agencies focused far more on economic crime and became adept at prosecuting these types of offenses. When a title agent is prosecuted, a title insurer can typically obtain a restitution order that can result in a stream of payments from the perpetrator. Restitution is typically non-dischargeable in bankruptcy, ensuring that payments may go on for years, no matter what the guilty try to do to evade making them. Finally, title insurers have become far more proactive in recent years in taking a prophylactic approach. Title insurers now train title agents on the seriousness of defalcations, and sometimes require better insurance and bonding than in the past. In the world of defalcations, a dollar of prevention can be worth a pound of cure. Carlton Fields offers training and prevention programs for title insurers and agents, as well as rapid defalcation response. Once the title insurer understands the tools at its disposal, title agent defalcations, while still costly, need not be nearly as frightening.

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