How To Reduce The Risk Of Stolen Escrowed Funds For Closings

forbes.com/sites/joshuastein/2023/05/19/risks-of-using-local-independent-escrow-companies-instead-of-national-title-insurance-companies

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Escrow arrangements create some risk of theft. It's safer to rely on a large national title insurance company.

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Whenever any real estate changes hands or gets refinanced, the closing typically happens through some form of third-party escrow. The seller or borrower signs the transfer or mortgage documents and gives them to a trusted third party, the “escrowee.” The buyer or new lender gives the escrowee some money. The escrowee then makes sure the closing conditions are satisfied and records the documents. Finally, the escrowee releases the purchase price or loan proceeds and everyone lives happily ever after.

This all works really well as long as the escrowee doesn’t take the money and run. Sometimes that happens, though, as shown in a recent Washington State case.

There, the parties used a small local escrow company to handle the closing of a new loan intended to refinance an old loan. The new lender wanted comfort that the escrow company would properly handle the loan proceeds and the closing. Long before closing, the lender demanded a “closing protection letter,” a confirmation from Commonwealth Land Title Insurance Company, a national title insurance company, that the lender’s funds and the closing would be properly handled by the “Settlement Agent.” The closing protection letter identified the Settlement Agent as another title insurance company, Ticor Title Company.

When the time came to close, the small local escrow company instructed the lender not to wire funds to Ticor Title Company, but instead to wire funds to the small local escrow company, presumably for convenience, speed, and simplicity to facilitate the closing. The lender complied. The small local escrow company then stole the money.

The lender eventually received a policy of title insurance covering the lender’s mortgage, as if it had been recorded and properly funded. On its face, that policy insured the lender that it held a valid lien. But, because the small escrow company had stolen all the money from the closing, the premium for the policy had never been paid.

The lender sued Ticor and Commonwealth under the closing protection letter and the title insurance policy. The lender lost on both counts.

The court easily rejected the lender’s claim against Commonwealth Title under the closing protection letter. That’s because the CPL identified Ticor Title Company as the Settlement Agent covered by the CPL. The CPL didn’t say anything about the small escrow company. When the lender decided to wire funds to the small escrow company rather than to Ticor Title Company, the lender lost the protection that the CPL would have delivered.

In claiming under the title insurance policy, the lender argued that the policy insured the lender as the holder of a valid mortgage lien. If the lender didn’t hold a valid mortgage lien because the loan proceeds never went to the borrower, the lender thought that was a risk covered by the title insurance policy. The court didn’t agree, because no one had ever paid the premium on the title insurance policy, so the policy never became effective.

The case teaches a couple of small lessons—and one larger one—for participants in real estate transactions.

As the first small lesson, if a party to a real estate transaction goes to the trouble of obtaining a closing protection letter, they should make sure they wire funds to the Settlement Agent identified in the CPL, and not to someone else. As the second small lesson, anyone obtaining title insurance should make sure their title insurance premium is actually paid. Without that, a very impressive looking policy of title insurance may give them nothing more than a few sheets of paper with which to wrap fish.

As the larger lesson, little screwups can happen, like the little screwups that happened here. They can then become big screwups. These screwups would have been avoided entirely if the lender had insisted on having a direct arrangement with a national title insurance company for the handling of escrowed funds. The lender wouldn't have had to take any risks of the type that ended up arising in this particular case.

Considered from another perspective, it often helps to follow a famous ancient legal principle: "Keep it simple, stupid."