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TITLE INSURANCE: CLOSING PROTECTION LETTERS

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1. WHAT ARE CLOSING PROTECTION LETTERS AND WHY DO YOU NEED THEM?

A closing protection letter (CPL) by a title insurer indemnifies the addressee, who may include a lender, seller, borrower, or buyer, against loss because of failure of the named issuing title insurance agent of the title insurer to comply with certain written closing instructions that relate to the title or lien of the lender, and because of fraud or dishonesty of the issuing title insurance agent in handling funds and documents, to the extent relating to the title or lien of the lender, as provided in the CPL. The CPL has never been designed to deal with or confirm for the lender collateral issues such as "compliance with applicable laws and regulations" in general or to indemnify broadly for fact finding.

An underwriting agreement authorizes the title insurance agent only to issue title insurance forms and collect premiums for such forms on behalf of the title insurer in the jurisdiction as stated in the contract. The underwriting agreement does not authorize the title insurance agent to act on behalf of the title insurer in the closing, settlement, or abstracting, and always disclaims any such authority. However, in a few of the states, such as Florida, the title insurer may be responsible for the loss of escrow funds because of defalcation by the title insurance agent. Only rarely does the underwriting agreement authorize the title insurance agent to perform any act on behalf of the title insurer in connection with the claims. Case law has generally upheld the principle that the title insurance agent is not the agent for the closing or settlement services. Given the limits in the underwriting agreement and in much of case law, it has become vitally important for lenders, buyers, sellers, and borrowers to consider the CPLs for additional protection when dealing with title insurance agents, because of the risk of defalcation, fraud, and certain closing errors.

Often real estate transactions are closed by the Issuing Agent or Approved Attorney of a title insurer. Of necessity, lenders must deposit large sums with the Issuing Agent or Approved Attorney for disbursal at the closing. Since the Issuing Agent or Approved Attorney may not have substantial financial assets, there is a risk that the Funds may be lost through the Issuing Agent or Approved Attorney's theft, dishonesty, fraud, misappropriation, or failure to follow the closing instructions. Lenders seek to shift the risk to the Issuing Agent or Approved Attorney's title insurer, and the title insurers have responded by issuing CPLs. Periodically, a title insurer will issue a CPL in connection with a closing conducted by a party that is not a title insurance agent; this procedure may be based, in part, upon the execution of a non-agent agreement. Common examples that evidence the need for CPLs include the following: the funds are wired by the lender to the settlement agent, but the funds are not used after the closing to discharge a prior mortgage; the settlement agent fails to pay the closing costs and to provide the net proceeds to a seller, if applicable; or the funds are wired by the lender to the settlement agent but are not returned after the closing fails to take place.[1] Other concerns can include mingling of escrow and operational funds and unauthorized investment of escrow funds,

A significant number of fraudulent schemes have involved the financing of residences, many of which may involve coverage of CPLs. The schemes often involve: (1) appraisers that submit appraisals at grossly inflated values in property-flipping schemes (somewhat eased by the possibility that comparables within a close distance relate to Land that is not at all comparable); (2) misrepresentations of the borrowers' financial information, identity, and other data; and (3) false and inaccurate information or documentation submitted by settlement agents, such as false HUD-1s (Settlement Statements) that do not correctly reflect the source of the purchaser's Funds.[2] Examples of red flags that may suggest fraud: the "seller" is not the record owner of the Land, the "purchaser" is not the person that will ultimately

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1 Fid. Nat'l Title Ins. Co. v. OHIC Ins. Co., 275 Ga. App. 55, 619 S.E.2d 704 (Ga. 2005).

2 Freedom Mortg. Corp. v. Burnham Mortg., Inc., No. 03 C 6508, 2006 U.S. Dist. LEXIS 10538 (N.D. Ill. Mar. 13, 2006), *summary judgment granted by* 2008 U.S. Dist. LEXIS 54465 (N.D. Ill. July 11, 2008), *reversed by and remanded by* 569 F.3d 667 (7th Cir. Ill. 2009), *on remand at, count dismissed at, partial summary judgment granted by, and costs and fees proceeding at* 720 F. Supp. 2d 978 (N.D. Ill. 2010), *motion denied by* 2010 U.S. Dist. LEXIS 120204 (N.D. Ill. Nov. 12, 2010); Walsh Sec., Inc. v. Cristo Prop. Mgmt., Ltd., No. 97-3496 (WGB), 2006 U.S. Dist. LEXIS 2242 (D.N.J. Jan. 20, 2006).

purchase the Land (the ultimate purchaser), the contract is amended to change the sales price, or the buyer receives cash at an acquisition closing. Commitments may be tampered with in flip transactions to show the intermediate purchaser as the record owner of the Land. Some settlement agents have given the net proceeds in the second transaction of a flip to the intermediate purchaser who then secures the checks to give to the ultimate purchaser for the down payment and to the initial seller for the purchase of the Land. Settlement agents may give a large portion of the proceeds to a mortgage broker and fail to disclose such disbursement on the HUD-1 (Settlement Statement) or Disbursement Sheet.

In *FDIC v. Home Connection Mortgage*, several examples of inaccuracies and errors by title companies were alleged:

- **Inaccurate Cash at Closing (ICAC)—title company inaccurately stating on line 303 of the HUD-1 the amount of cash paid by the buyer at closing**
- **Failure to Inform Lender of Immediate Prior Sale (FLIP)—failing to inform the bank that the seller acquired the property less than one year prior to the closing for an amount substantially lower than price being paid by buyer**
- **Excessive Real Estate Commission (ERC)—broker receiving a commission in excess of the amount reported on HUD-1**
- **Disguised Purchase (DP)—title company omitting all information about the seller on the HUD-1 and identifying buyer as the existing title holder on the title commitment so that the transaction appears to be a refinancing**
- **Seller Not in Title (SNIT)—title company incorrectly stating on the title commitment that the seller is the current title owner**
- **Disguised Disbursement (DD)—title company incorrectly identifying a disbursement on the HUD-1 so as to disguise an unauthorized payment to a person or entity**
- **Unauthorized Disbursement (UD)—title company disbursing payment to a person or entity not authorized by the bank**
- **Failure to Disclose Payment (FDP)—title company failing to disclose on the HUD-1 disbursements made at closing.[3]**

To reduce the likelihood of fraudulent flips, HUD adopted regulations that apply to FHA-insured mortgages. Property resold within 90 days or less following the date of acquisition by the seller is not eligible for an FHA-insured mortgage. Re-sales between 91 days and 180 days after the acquisition are eligible, subject to an appraisal review and additional documentation, if the resale price is 100 percent over the purchase price.[4]

Although a title insurance agent may have fidelity insurance or an escrow security bond, many do not.

The Texas Title Insurance Guaranty Act is set forth in Chapter 2602 of the Texas Insurance Code, and offers some protection to lenders, buyers, and sellers. An unpaid claim is a covered claim if unpaid because of a shortage of trust funds or escrow account of a title insurance company or title insurance agent.[5] However, the amount of a Covered Claim under the Act against trust funds or a title policy may not exceed $250,000.[6] The Texas Title Insurance Guaranty Association does not cover all matters that may be addressed by the CPL if the title insurance agent is insolvent.

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[3] FDIC v. Home Connection Mortg., No. 07-14045, 2008 U.S. Dist. LEXIS 70806 (E.D. Mich. Sept. 18, 2008).
[4] 24 C.F.R. § 203.37a.
[5] Tex. Ins. Code § 2602.252.
[6] Tex. Ins. Code § 2602.256.

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