

Tough Times and Bad Choices

from the desk of David M. Touchstone

Thomas Paine, the great pamphleteer of the American Revolution once wrote “These are the times that try men’s souls” or something to that effect. Well, it’s not a life and death situation for us, but these times are pretty trying if one’s business is associated with the transfer of real estate. If you are one of the lucky ones who has not noticed, business in the local real estate community is pretty bad these days. There are simply too many service providers for the limited amount of business available.

The situation calls to mind some of the observations of Adam Smith, the Scottish economist and philosopher who taught us about “supply and demand” in his famous book, *The Wealth of Nations*. Smith theorized that in markets into which entry is easy (i.e. have low startup costs), surges of demand will eventually be met by equivalent surges of supply. In our field, this concept translates to this: when times are good, new real estate agents, new mortgage originators, new builders, and new title companies flood into the market to absorb the high demand. Eventually, a balance is reached between high demand and high supply. This convergence of high demand and high supply has the effect of bringing costs down, quality of performance up, and supply and demand into a state of equipoise. After a balance between high supply and high demand has been achieved, if demand should suddenly drop,



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then the oversupply of service providers must be reduced to return supply and demand to equipoise. That is the state in which we find our local market at this time. Unless a new and substantial market driver should suddenly appear in our local market, our market will soon have less real estate agents, less mortgage companies, less mortgage originators, less builders, and less title companies. In most cases, marginal players in all these categories will simply move on to greener pastures, and in some cases there will be consolidations (mergers and buy-outs). But there is one other category of shrinkage that needs to give all of us the willies – failure. With respect to how they impact the public, we need to give a careful consideration to the effects of business failures in the various categories of service providers.

Business failures in real estate brokerages and mortgage companies (and mortgage brokers) don't present much risk of harm to the public. If real estate brokerages go belly up, oh well, about the only harm to the public is the possible loss of a deposit put up on an unclosed purchase and maybe some inconvenience to buyers and sellers. The situation is pretty much the same when mortgage companies and mortgage brokers suddenly go out of business – not too much potential for harm to borrowers, buyers, and sellers. But builders and title companies – now those are different buckets of worms altogether.

Let's talk about title companies first. One of the functions of a title company is to act as a banker for a real estate deal. Let's take a sale as an example. First, the title company collects all the funds, say, from the first mortgage lender, the second mortgage lender, the buyer's deposit that the real estate agent brings to the closing, the "gift funds" contribution, and then the sum that the buyer brings to the closing table. All of this money is deposited into the title company's escrow account (or it is supposed to be) and then the title company proceeds to write checks in accordance with the HUD1. Usually, the largest portion of the title company's disbursement goes to pay off the seller's mortgage. What happens if the person who owns the title company has a gambling problem? Or wants to make a big splash in society and lives beyond his means? Or is just an out and out crook? If you think I am making this up, I am sorry to tell you that it has happened many, many times. About a decade ago, right here in Louisiana we had a spectacular failure of one of the larger title companies (multiple offices in the New Orleans market); this was the Charter Title debacle. The owners of Charter Title were helping them-

selves to funds out of the company escrow account. When the "you know what" hit the fan, the owners of Charter Title were discovered to have pilfered over two million dollars from the company escrow account. You might wonder how so much money could have been taken without overdraft alarms going off. This was possible due to the "float". In any checking account, including escrow checking accounts there is a time delay between the time that a deposit is made into the account and the time that the offsetting debits are paid out of the account; the resultant temporary buildup of funds is known as the "float". Because of the float, it is possible for title companies handling substantial amounts of money to have at all times a substantial balance in the escrow account; of course, this money doesn't belong to the title company as it is money that the title company is obligated to disburse in accordance with the HUD1. In addition to the float money that some crooked title companies have dipped into, there is a really nasty ploy that some title companies have utilized to stretch out their ability to rip off even more money. Instead of paying off the seller's mortgage, these crooked operators make the monthly payments on it and spend the rest of the dough as they please. You may be asking yourself, "but don't they know they will get caught?" The truth is that such crooked players always do get caught, but, ohmigosh, the damage they can do before their party is over! If they're gamblers, they think that they are just "borrowing" the money and they will return it as soon as they win enough at the blackjack table. If the title company operators are in financial trouble, they may think they'll just borrow some escrow money until times get better when they can put it back. In other instances, the title company operators are just out and out

crooks and their plan is to leave town when their house of cards is starting to get shaky.

Let's talk about a real case of title company defalcation right here in our region – Fern Avenue Title which folded in a rather dramatic and catastrophic way in the fall of 2006. Let me first say, that to my knowledge, nothing definitive is on any official record concerning the facts of the Fern Avenue Title failure. What I know of this situation has come from talking to lots of people, as many as I could, so that I could assemble the most accurate picture possible. Fern Avenue Title was organized by two gentlemen who presumably had been licensed in the state of Louisiana as lawyers. It turned out that only one of these gentlemen was, in fact, a licensed Louisiana lawyer. In all probability, the real attorney was duped by the fake attorney, just as everyone else was. The fake attorney, Greg McIntyre, passed himself off as having been licensed in Mississippi. He even faked up a nice bar certificate to hang on his wall. Greg presented himself in court on a number of occasions as an attorney and represented clients in court. When the facts came out, Greg wasn't licensed as a lawyer anywhere and wasn't even a *notary public*. Sometimes, I wonder how many deeds and mortgages Greg notarized. Well, eventually somebody noticed that the books at Fern Avenue Title didn't balance, Greg skedaddled out of town, and an audit disclosed that over \$600,000.00 was missing from the escrow account. Let's pause here a minute: how does it affect the public when a very large sum of money is missing from a title company's escrow account? Well, it means that sellers' mortgages that are supposed to be paid off from the sale proceeds don't get paid. It means that people who are refinancing their home

don't get the old mortgage paid off and, therefore, now have two mortgages that they are *legally obligated* to pay, the old mortgage that should have been paid off and the new mortgage representing the money they just borrowed. This kind of failure generates other problems. I am personally familiar with one situation in which the closing took place at Fern Avenue Title, this time everybody did get paid (including the seller's mortgage), but Fern Avenue Title never filed the deed at the courthouse, and in all the confusion the deed got lost. The seller balked at signing a new deed and it took the buyer months of work and worry to straighten this mess out, problems with filing his homestead exemption, etc.

What's the bottom line here? Choose wisely when deciding where the deal should close. Not all title companies are the same. But how can you tell the good ones from the bad ones? There is no sure fire way you can tell, but there are lots of little pointers that can help you make good decisions. How long has the company been here? It just makes sense that companies that have been here a good while and haven't gone under or appeared on the public radar for improprieties are more likely to behave properly than folks who just opened up shop and who have no track record. How big is the company? Logic tells us that a company which has numerous persons working in it will not be a very good candidate for fraud; there are just too many eyes and ears around for someone to pull theft off. Our company is a good example of what I am referring to. When we handle a closing, the escrow officer generates the checks, then two other persons have to sign the checks, then another person processes all mail away payoffs and delivery payoffs, then another person follows up on the

cancellation of the seller's mortgage and would become aware if it hadn't been paid off, then two other persons balance the escrow account every month. Count 'em; that's a minimum of seven persons who would have to be in on the ripoff. If you contrast that against a small office in which one person produces the checks, signs the checks, and makes the mortgage payoff, then you can see where your best odds lay. Then there's the matter of audits. A few years back, in the wake of the Charter Title disaster, the Louisiana legislature enacted the Louisiana Title Insurance Act, a set of statutes that, more or less, comprehensively regulates both the title companies (agents) and the title *insurance* companies (i.e. the companies that actually issue title insurance policies). To ease comprehension here, I will refer to the two groups as "agents" and "insurance companies". For example, First Commerce is an agent of Fidelity Title Insurance Company. Under the Louisiana Title Insurance Act, the insurance companies are legally required to perform onsite audits of the agents, during which the escrow account and the ledger balances are supposed to be tested. The law requires that these audits must occur at least once every three years. I don't know about the small agents; I think some of them are audited only once every three years. Big agents like us, however, are audited no less than annually. In our case, we write policies on three insurance companies; therefore, we are audited at least three times a year, at different times of the year, by different auditors who are testing different things. So in three years, we are audited no less than nine times, whereas a small agent writing for one company may be audited only once. Hence, bigger companies are safer; bigger companies are very frequently audited by very sophisticated auditors. You

can be pretty sure that if anything significant is amiss, the insurance companies' auditors will find it. Another tip here is to find out how many insurance companies the agent writes for; the more insurance companies, the more audits. Therefore, it is wise to look for an agent who writes for multiple insurance companies. One other thing you can do to identify strong title agents and avoid weak ones is to ask around; ask other persons you trust what they know about the competence and integrity of the various title agents operating in our area and choose accordingly.

One final point on title companies, buyers have the option of buying an owner's title insurance policy at the closing. If the buyer purchases an owner's title insurance policy and the title agent steals the escrow money, then the title insurance company will have to make sure the buyer gets a good title and that means the title insurance company will be responsible for paying off the seller's mortgage and any other lien holders. These dangerous times we are passing through are just one more good reason for you to suggest to your buyer that he buy an owner's title insurance policy. Think about it: what if you refer the buyer to a title agent who steals the money and then you compound the error by telling the buyer that he really doesn't need an owner's title insurance policy? Who is the buyer going to sue?

Now, let's talk about builders. The old expression "robbing Peter to pay Paul" comes to mind. This is how most builders get into trouble. It starts when they have insufficient working capital. If a builder underbids a house, or has all sorts of unforeseen things happen during construction that make him go way over budget, or has too many speculative houses on which he is paying the

bank interim interest sitting unpurchased for too long, he may get turned financially upside down. Although it is illegal to do so, many builders try to “build their way out of it”. What this means is that they take funds that are intended for the construction of house B and use those funds to pay suppliers and laborers for house A. If this situation goes on long enough, the builder runs out of funds, can’t borrow any more, and simply defaults on paying for the last house or the last houses (depending on how many he has been building). Oftentimes, the picture is a little more nuanced; for instance, the builder may pay most but not all of the suppliers. Whatever the case, when builders don’t pay people they owe, we end up hearing that dreaded word: “lien”. Material suppliers and laborers have up to 60 days (in some cases 70 days) after “substantial completion” of the house (or any other construction) to file a lien. Let’s examine this in the context of a factual scenario I have seen on many occasions. Builder has been a little slow in getting the house completed; maybe there has been a lot of rain or maybe he just doesn’t like to rush. Buyers are getting antsy to move into the house, so as soon as Builder knocks out the punch list (and sometimes even before he has worked the punch list), Buyers set up the closing at the title company, us, in this case. We check title and there are no problems, so we go ahead and close the deal out. Buyers move in and everybody is happy. But what if Builder doesn’t pay everybody he owes on that particular house? Most suppliers don’t want to file liens right away; they think it is rude and bad business to file liens prematurely. So, typically, they wait about 30 days from the time that they completed delivery of the supplies to the house. In our little scenario, this means the unpaid supplier may file his lien

AFTER the closing. Now, obviously, we can’t catch a lien in our title search if it hasn’t been filed yet. Many real estate agents operate under the comfortable delusion – *and it is a delusion* – that buyers are insulated from liens filed on unpaid builder debts which are filed after the deed has been recorded. If you don’t remember anything else from this article, remember this: buyers can get stuck holding the bag and have to pay off the builder’s debts *even though the liens are filed after the deed is recorded*.

How can you protect your buyer from this danger? Well there are a couple of things you can do. First, you can simply wait to close until at least 60 days have transpired from substantial completion. This strategy can be enhanced by having the owner of the property (usually the builder) record into the mortgage records a certificate of substantial completion; this will help out if later there is an argument about when the house was substantially complete and when the clock started ticking on the 60 days. If you are assisting a future homeowner with a contract in which the builder will build a custom house for the homeowner, you might consider suggesting that the contract contain a completion bond. Having a completion bond will increase the cost of the project, but it sure is a nice protection for the homeowner. Finally, you should insist that your buyer purchase an owner’s title insurance policy at closing; this will protect the buyer against all the normal title problems and will also protect him against unfiled materialmen and laborer liens.

It’s always a dangerous world out there, and these days it’s even more dangerous. Remember what our mothers taught us: “A stitch in time saves nine”. Use your head and be cautious.