

Escrow Accounts – Follow the Money

Ever since Mark Felt, the Watergate scandal informant, met Woodward and Bernstein in a dark parking garage and uttered the phrase, “Follow the Money!”, these three words have defined how to investigate any and all suspicious activity. However, this iconic message has roots that are much older than the Watergate scandal. After all, it took an IRS audit to catch Al Capone. Following the money can reveal both an indiscretion and a legitimate mistake, whether capturing a notorious gangster or merely balancing a personal checking account. A settlement provider follows the client money to ensure that it is not misplaced or misappropriated. When the money is in the escrow account it is the clients’ money, but if the money goes missing the settlement provider is responsible.

ALTA Best Practice #2

ALTA Best Practice #2 states: *Adopt and maintain appropriate written procedures and controls for Escrow Trust Accounts allowing for electronic verification of reconciliation.*

The stated purpose of this procedure is to safeguard client funds to help ensure accuracy and minimize exposure to loss. In short, “follow the money.”

There are three steps required to comply with ALTA Best Practice #2:

- 1) Have a written policy and procedure for escrow account controls;
- 2) Include in the written policy and procedure the necessary elements outlined below; and
- 3) Adhere to the written policy and procedure.

The Written Policy

There are a number of written policies that may govern how to administer an escrow account: the State Bar, the State Department of Insurance or some other regulatory body. Now, ALTA has inserted itself into the equation to bring some consistency across the national settlement landscape. The settlement provider must have a written policy that is compliant on all fronts. However, this article will focus on ALTA Best Practice #2.

While contemplating this policy and procedure on escrow accounts, everyone should consider the traditional and non-traditional threats to the escrow account. Most of the current controls on escrow account management are local controls that think locally and act locally. The controls focus on employees and the access they have to entrusted funds. One cannot abandon these proven controls that have been solid for many years. However, today settlement providers have to examine threats that do not enter the office through the door, but through the computer network. Think in a 2013 mentality: think globally, as well as locally.

What Should Be Included in the Escrow Account Controls Policy?

- a. **Federally Insured Bank.** All entrusted funds should be kept in a federally insured bank, unless written instructions from the owner of the funds instruct differently. Wherever possible, make sure that there is insurance to protect client funds. ALTA defines a Federally Insured Financial Institution as: A financial institution that has its deposits insured by an instrumentality of the federal government, including the Federal Deposit Insurance Corporation (FDIC) and National Credit Union Administration (NCUA).
- b. **Separation of Funds.** All entrusted funds should be kept in a bank account that is separate from all other funds. Do not ever commingle funds. To that end, all supporting information for the escrow account should be marked “escrow” account or “trust” account. This includes all of the checks, deposit tickets, bank statements, bank agreements and all other account related supporting documentation.

- c. **Authorized Personnel Only.** Transactions regarding entrusted funds should only be performed by authorized employees. All businesses have employees with varying levels of skill and expertise. Some employees may not have the requisite training necessary to be allowed to access the escrow account. Others may not have job requirements that necessitate access to the escrow account.

Regardless of who is permitted to access the funds, perform adequate employee training to make sure that mistakes are kept to a minimum. Additionally, before allowing any employee access to office and escrow accounts, perform a criminal background check. Subsequent checks every three years (going back 5 years) are also a requirement of this Best Practice. This process is good if only to confirm the employee was truthful about past indiscretions.

Finally, when an employee leaves, their access to the office, the escrow account and the computer should be terminated immediately. In the old days, employers would simply ask for the key to be returned. Today, employers need to get that key, but also need to terminate employee passwords, change the signature cards and change the alarm code, all as applicable.

- d. **Reconcile Escrow accounts.** Everyone likely balances their personal checking account every month. Client funds in the escrow account require at least that same level of care. This simply means that the account is prepared with trial balances, which match the checkbook and the bank statement. In the event there are open file balances, they must be documented and tracked to resolution. Additionally, there should never be any negative file balances. When all of this is complete, the monthly three-way reconciliation should be reviewed by management.

The reconciliation is the old school way to “follow the money,” but still vital to the protection of the escrow account. The new school way includes a timeliness that increases the security and detection. ALTA Best Practice #2 calls for the daily reconciliation of receipts and disbursements and the three-way reconciliation within ten (10) days of the receipt of the bank statement. Once it is performed, the three-way monthly reconciliation must also be electronically available for verification by the settlement agent’s title insurance underwriter. The more sets of eyes on the money the better. Together, everyone can help protect the entrusted funds.

- e. **Separation of Duties.** Traditionally, when addressing separation of duties, settlement providers think about separating check writing from check signing authority or separating wire preparation from wire approval authority. Both of these practices are recommended for prudent and practical escrow controls. For compliance with the requirements of Best Practice #2, the reconciliation of the escrow account should be performed by someone without any disbursement authority over the account. This simple precaution adds a math checker for a simple mistake, and a watchful eye for a greater indiscretion. Whether there is a simple error in math, a wayward employee or a cyber-attack, the employee following the money should not have access to the money.
- f. **Block International Access.** Think globally and be concerned with new threats that do not walk in the door. Anyone who has ever paid by check on the phone has experienced the convenience of Automated Clearing House (“ACH”) transactions. All that is needed is a routing number, a checking account number and a phone. Just think how convenient and easy that would be for a criminal. There is no place for an ACH transaction on the escrow account. They can easily be blocked by merely requesting it from the bank.

Another easy protection is an International Wire Block. How often is it necessary to wire funds overseas – outside the jurisdiction of United States or local law enforcement? Requiring additional confirmation before allowing the bank to wire funds to a foreign country may not be an unreasonable hindrance to daily operations. Simply ask the bank to implement the precaution.

- g. **Positive Pay.** Positive Pay is available at most every bank. This protection requires a little more effort than merely requesting it from the bank, but it is worth the effort. Would it not be great if the bank would check with the settlement provider before clearing any escrow account checks? Positive Pay provides the opportunity to communicate electronically with the bank to pre-approve any check that will be presented for payment.

With Positive Pay, as checks are written on the escrow account in the settlement production software, it creates a file that includes every check that is written and uploads it electronically at the bank. The bank then compares every check that comes in the door against the pre-approved list. If the check is not on the list, the bank contacts the settlement provider for approval. No check gets paid unless the bank has approval. In the old days, it would require a phone call on every check. With the technology available today, the settlement provider can enable this communication by pressing a couple of buttons. Additionally, most Positive Pay connections to the bank are outside of other online banking functions.

Follow the Policy Locally for Global Deterrence

When Mark Felt uttered those immortal words, “Follow the Money,” no one could have possibly anticipated the global threats that face escrow accounts today. Computers occupied entire buildings, not the palm of the hand. Today, no one can fully anticipate the global threats that are going to exist ten years from now. The old threats still exist, and everyone must continue to be diligent in choosing and training employees. But new threats are emerging every day, as any criminal anywhere in the world armed with only an internet connection can ruin a business. Continue to be diligent on all fronts to protect client money. Anyone can get “hacked.” Whether checking for wrongdoing or a simple mistake, the policies and procedures required for compliance with ALTA Best Practice #2 are not only designed to protect client money, they are designed to protect the settlement provider.

Some may assert that many of these policies may alter the manner in which settlement providers do business and may make the daily routine more inconvenient or may increase the time spent on the trust account. All are true. But whatever inconvenience the settlement provider may experience will be exponential to the “would be” criminal in the office or in the computer network. By following these policies, the settlement provider is protecting client entrusted funds from disappearing and protecting themselves from a financial disaster.

For more information about the American Land Title Association (ALTA) Best Practices and how to comply, please visit <http://alta.org/bestpractices>.