

Defalcation: The Scariest Word in Title Insurance

By Frank Starr, Esq.

Nothing commands the attention of everyone in the title insurance industry like the word "Defalcation". Even the slightest suggestion that one has occurred, draws the instant attention of everyone, from the CEO of the underwriter involved to the most junior clerical staff. Unlike a loss on a single policy, defalcations often involve losses in the millions on a number of policies. Defalcations also require thousands of man-hours to investigate and settle the resulting claims.

In this article I will attempt to answer three questions about defalcations:

- What is a defalcation?
- How does it occur?
- What to look for to prevent it from happening.

What is a defalcation? A defalcation is defined as "an act of embezzling; failure to meet an obligation; misappropriation of trust funds or money held in any fiduciary capacity; failure to properly account for such funds." Black's Law Dictionary, 375(5th ed. 1979). Or simply defined, a defalcation is the negligent or criminal act of a settlement agent or attorney acting as a fiduciary in a real estate transaction which results in loss of funds intended to be applied to that transaction. A defalcation can be perpetrated by an approved real estate settlement attorney, a paralegal in the attorney's office, a title insurance agent acting as settlement agent, a title insurer or any of their employees.

How does a defalcation occur? Defalcations commonly occur when an attorney or real estate settlement agent intentionally fails to pay off a preexisting lien(s) against the property and instead "borrows", misappropriates, or steals the funds intended for that purpose and uses them for their own personal benefit. To cover the fraud, the attorney or settlement agent will often continue to make monthly payments to a prior lender to keep the loan current in order to avoid detection. The fraud often starts small, with the theft of funds from a single closing. It then "snowballs" as the defalcator is forced to use funds from other closings to make the payments on the loans that were not paid off previously.

In a small number of instances, the attorney or settlement agent is negligent in failing to reconcile their trust or escrow account. The shortage comes to light when there are insufficient funds to cover outstanding checks. Another way this can happen is when monies to fund a loan or closing were never deposited into the account or the loan was never funded by the lender. "Negligent" defalcations are much rarer than intentional ones.

How to detect potential defalcators. The following is a list of characteristics that experience has shown are "Red Flags" for attorneys and agents involved in past defalcations:

- Delegates too much responsibility to staff or paralegal
- Unconcerned attitude about closing issues or claims
- Chronic health problems, either themselves or immediate family members
- Poorly organized
- Stretched too thin/always too busy
- Understaffed/ frequent staff changes
- Difficult to reach/won't return phone calls
- Sloppy work product/doesn't complete post closing work
- Change in lifestyle/ extravagant lifestyle
- Family problems
- Poor reputation in the professional community
- Incompetent
- Addiction to alcohol, drugs, or gambling
- Poor business manager
- Fails to reconcile trust/ escrow account(s)
- Solo practitioner
- High percentage of B&C lenders as clients/high cancellation rate
- High A/R as a % of total work done
- NSF trust or escrow account checks
- Premiums paid from operating or personal checking account
- Handwritten HUD-1 statements or other closing documents
- Evasive when asked about title or financial matters
- Losses in the stock or real estate markets
- Operating cash flow or credit problems

While the foregoing list is by no means exhaustive, two or more of these traits were present in every defalcation I can remember. In most instances, a number were present.

To prevent defalcations, we must rely on those of you that have day to day contact with the approved attorneys and agents. You are the ones in the best position to detect the

early warning signs and report them to the Claims Department or your supervisor. Never assume that something is too trivial or insignificant to report. While one problem or "Red Flag" may seem harmless by itself, when viewed with other information it may prevent a defalcation from happening.

REMEMBER, THE CHEAPEST CLAIM IS THE ONE NEVER HAPPENED!

I would like to acknowledge and thank James L. Windsor and John Valdivielso for allowing me to draw extensively from excellent book, "Virginia Title Insurance Claims Manual."