

Responding to a Defalcation

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Background Defalcations in real estate transactions have risen dramatically in recent years, both in frequency and in the amount of money taken. Title insurers oftentimes are forced to analyze a multitude of highly complex transactions to try to unravel the fraud, and make a series of highly sensitive and liability-ridden decisions concerning how to best respond in a very short period of time. This article examines certain best practices title insurers may follow when responding to defalcations under such circumstances. **What is a Defalcation?** A defalcation is a misappropriation of trust funds by a person acting in a fiduciary capacity. It is the “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). **How do Defalcations Occur?** Title agents receive substantial monies in trust to be held until a transaction is closed, at which time agents are to disburse the monies to pay off prior liens and vendors, pay sales proceeds to the seller, etc. When a title agent misappropriates trust funds, there will be a shortfall at the closing unless the title agent covers it up in some fashion. There are any number of ways agents have tried to hide defalcations. Agents sometimes make monthly payments to a lender with a pre-existing lien to keep the account that should have been paid off current, and thereby avoid or postpone detection of the misappropriation. Other times agents use new monies they receive in connection with transactions that are scheduled to be closed in the future, to pay off the prior liens or to pay sellers their sales proceeds. Other times agents create multiple bank accounts to hide monies and confuse auditors, fabricate bank statements, create duplicate settlement statements with different disbursements shown, or forge lien releases. Given the volume of transactions agents handle, and the sophistication of some frauds, a defalcation may “roll over” and remain undetected for months or years. Often the fraud involves the use of monies from multiple unrelated transactions. Since agents typically commingle trust funds from multiple transactions into a single escrow account, “untangling” or tracing the missing monies can often take extensive time and effort. **If a Defalcation Is Suspected** Time is of the essence when a defalcation is suspected. Some agents cooperate with the insurer, confess to the misappropriation and explain how to trace the missing monies. Often, however, agents deny any wrongdoing and the insurer is forced to decide based on incomplete information whether the agent has been deceitful, was taken advantage of, or was merely negligent. Moreover, the insurer is forced to decide where the missing monies went without the assistance of the agent. In such instances, quick judgments may be necessary to determine how forcefully to exercise rights to inspect the agent’s books and records over the agent’s objection, whether to immediately cancel the agent or

permit it to continue to close pending transactions, and whether to seek a court-appointed receiver to secure possession of the agent's computers and records, and prevent access to bank accounts. These decisions, if made timely and correctly, can save the insurer huge sums of money. For example, preventing a criminal agent from deleting files or moving monies out of its bank accounts can result in enormous savings. On the other hand, interfering with an innocent agent's legitimate business if it turns out there are explanations for the suspected missing funds, or acting prematurely or too aggressively in pursuing assets, can potentially lead to other litigation. *See, e.g., American Nat'l Title & Escrow of Fla., Inc. v. Guarantee Title & Trust Co.*, 748 So. 2d 1054 (Fla. 4th DCA 1999). In many cases it will be necessary to analyze all relevant transaction files and bank accounts utilizing an auditor or accountant to trace the missing money, have an examiner determine the status of title on all affected properties, "lock-down" all computers and files so nothing is deleted or removed, interrogate the principals and all involved employees, perform asset searches on the suspected perpetrators, identify any third parties who may have been involved as co-conspirators, accommodators to the fraud, beneficiaries or victims and question them, determine whether other title insurance underwriters may share in any responsibility or liability, review all relevant errors and omissions policies, surety policies and fidelity bonds so appropriate notices are timely given to the proper parties, and give appropriate notice to regulators and law enforcement. Oftentimes immediate injunctive relief is required to freeze bank accounts or attach properties while this investigation is continuing. It is important to carefully evaluate what claims to allege, as it will be easier to obtain relief under some causes of action than others. *See M.I. Indus. USA, Inc. v. Attorneys' Title Ins. Fund, Inc.*, 6 So. 3d 627 (Fla. 4th DCA 2009). As part of this process, title insurers are frequently called upon to pick up the pieces of the title agency and make immediate decisions as to what unreleased liens to pay off, which documents to record, and which pending transactions to close. A determination should also be made as to whether to terminate the agency relationship, and consideration should be given as to what notice needs to be given to lenders and other parties who may have been issued closing protection letters. All of these decisions may need to be made quickly, often based on incomplete information, and the insurer's liability can be significantly greater or less depending on the choices it makes and how quickly it makes the right ones.

An Insurer's Liability for a Defalcation An insurer may have exposure for missing funds that were supposed to be used for other purposes pursuant to closing protection letters, commitments and policies. In Florida, title insurers are also statutorily liable for defalcations of funds held in trust by a licensed agency. Fla. Stat. § 627.792. When an agent represents two or more title insurers, liability is borne by the title insurer upon which the title policy was issued prior to the defalcation. If no such policy existed, each title insurer represented by the agent at the time of the defalcation shares the same proportion of the liability that the premium remitted to it by the agency during the one-year period before the illegal act bears to the total premium remitted to all title insurers by the agency. Fla. Stat. § 627.792. Since attorney agents are not "licensed title insurance agents" under Florida law, the statute making title insurers liable for agency defalcations is not applicable to attorney agents. *Hechtman v. Nations Title Ins. of N.Y., Inc.*, 840 So. 2d 993 (Fla. 2003). If the funds held by the agent were not held for the purpose of closing a real estate transaction or the issuance of a title policy, but instead were just held

as an escrow agent, the statute making title insurers liable for the defalcation is not applicable. *Cohen v. Chicago Title Ins. Co.*, 53 So. 3d 331 (Fla. 3d DCA 2010); *Winkler v. Lawyers Title Ins. Corp.*, 41 So. 3d 414 (Fla. 3d DCA 2010). **Recoupment** Claims may be available under an insurer's fidelity bond, against the title agent, against co-conspirators and other third parties who participated in the wrongdoing or were beneficiaries of the misappropriated monies, and possibly against the bank at which the settlement agent maintained its accounts. The agent may also have its own fidelity insurance policy or surety bond. If the insurer has not incurred an actual loss as a result of the defalcation by the time of trial, its claims against the wrongdoer may be deemed premature or brought by the wrong party. *Fito v. Attorneys' Title Ins. Fund, Inc.*, No. 3D10-1737, 2011 WL 3477019 (Fla. 3d DCA Aug. 10, 2011). If criminal or regulatory proceedings are instituted against the wrongdoers, restitution orders can be entered. **Conclusion** Defalcations often present some of the most complicated and high-exposure issues that title insurers will face. Indeed, they have caused such high losses that some insurers in just the past couple of years have had to surrender their certificates of authority and cease writing new policies due to such frauds. It is most unfortunate that in addition to the traditional risks of title defects, which are what title insurers should consider the principal risks of their business, title insurers must also deal with unethical and criminal agents.

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