

Date of Hearing: July 6, 2015

ASSEMBLY COMMITTEE ON BANKING AND FINANCE

Matthew Dababneh, Chair

SB 736 (Vidak) – As Amended May 5, 2015

**SENATE VOTE:** 40-0

**SUBJECT:** Escrow agents

**SUMMARY:** States that, whenever possible, the Commissioner of the Department of Business Oversight (commissioner) shall utilize the services of private individuals with prior escrow experience to act as conservator, receiver or liquidator in cases in which the Commissioner must take possession of the property and business of an escrow agent due to insolvent conditions of escrow law violations. Specifically, **this bill:**

- 1) Allows the Commissioner to redirect up to \$125,000 in penalty revenue to compensate conservators, liquidators or receivers.
- 2) Provides authority for the Commissioner to utilize all or a portion of an escrow agents surety bond and any assets remaining following conservation, liquidation or receivership of that escrow agent to compensate the agent's conservator, liquidator or receiver.
- 3) Makes various technical changes.

**EXISTING LAW:**

- 1) Requires each escrow agent to maintain a surety bond equal to \$25,000, \$35,000, or \$50,000, depending on the size of its prior year's average annual trust fund obligations (Financial Code Section 17202).
- 2) Authorizes the commissioner to take possession of the property and business of an escrow agent, as specified, when it appears to the commissioner that an escrow agent is in an insolvent condition; is conducting escrow business in an unsafe or unauthorized manner; has violated its charter or any law of the State of California; refuses to submit its books, papers and affairs for inspection by an examiner; neglects or refuses to observe any order of the commissioner made pursuant to the Escrow Law or its regulations, as specified; or any officer, director, stockholder, trustee, or attorney of an escrow agent has embezzled, sequestered, or willfully diverted the assets or trust funds of such escrow agent, has permitted its tangible net worth to be lower than the minimum required by law, or has failed to comply with the bonding requirements of the Escrow Law (Financial Code Section 17621).
- 3) Establishes the Escrow Agents' Fidelity Corporation (EAFC; Fidelity Corporation; Financial Code Section 17300), establishes the purpose of EAFC as indemnifying its members against loss, as specified (Financial Code Section 17310), and requires each licensed escrow agent to participate as a member in EAFC (Financial Code Section 17312). Requires EAFC to provide fidelity coverage to its members based on their monthly average escrow liability per licensed location. The minimum coverage that must be provided by EAFC for each licensed location is \$1,000,000, and the maximum coverage for each licensed location is \$5,000,000

(Financial Code Section 17314).

- 4) Provides that the General Fund consists of money received into the Treasury and not required by law to be credited to any other fund (Government Code Section 16300). Because of this rule, penalty revenue collected by the Department of Business Oversight (DBO) and other state departments and agencies reverts to the General Fund, if not otherwise redirected to a specific use.

**FISCAL EFFECT:** According to the Senate Appropriations Committee, redirection of penalty revenue up to \$125,000 annually.

**COMMENTS:**

Existing law specifies the procedures required to respond to the failure of an escrow agent in order to prevent the loss of escrow trust funds. These authorities allow:

- 1) DBO to wind-down and liquidate a failed escrow company.
- 2) DBO to petition a court to place a failed escrow company into receivership.
- 3) DBO to appoint a conservator, liquidator, or receiver.

In addition to the authorities mentioned above, the Escrow Law requires that every licensed company must obtain a surety bond to ensure that DBO and its representatives are compensated in the event the company is placed into conservatorship or receivership. Finally, every company licensed under the Escrow Law must obtain a fidelity bond that provides insurance against theft of trust funds.

SB 736 is a response to a problem that was brought to the Legislature's attention during the fall of 2014, when a real estate broker contacted several legislative offices, expressing great dissatisfaction with the way in which DBO and EAFC had handled a matter involving two of his former real estate clients. The real estate broker's clients were an older couple that placed their home on the market in October of 2010 and entered into a sales agreement that would have netted them \$154,000 in profit – money they planned to use in their retirement. Unbeknownst to the broker or his clients, the company selected to handle the real estate escrow by the purchaser of his clients' home was about to fail, and the owners of that company were about to flee the country with an unknown amount of client money. The first indication that the clients had that anything was amiss was when the check for \$154,000 that they had received from First Southwestern Escrow (FSE) bounced due to insufficient funds in the escrow company's account.

Unfortunately, EAFC rejected the claim claiming that the conservator appointed by DBO failed to submit the proof of loss claim within the statutorily prescribed deadline. DBO prepared to appeal the rejection, believing that its submission was timely, but ultimately opted to settle with EAFC in lieu of challenging the rejected claim before an administrative law judge. The settlement netted those with claims against the roughly \$700,000 in trust funds with which FSE's owners absconded, \$0.41 on the dollar.

After selling their home in October of 2010, the real estate broker's clients received their 41% payout in October of 2014. Although a criminal case alleging 11 felony counts against FSE's principals was opened in the matter by the Alameda County Real Estate Fraud Unit within the

Alameda County District Attorney's Office, prosecution of FSE's owners will be impossible, unless those individuals can be compelled to return to the United States to face the charges against them.

### **Private conservators/liquidators/receivers**

Private conservators/liquidators/receivers do not have to juggle multiple jobs when serving in that capacity (DBO employees appointed as conservator/liquidator/receiver have to continue to do their regular DBO jobs as escrow examiners while also acting as conservators/liquidators/receivers); private conservators/liquidators/receivers may have specialized expertise in winding down failed entities; and money paid out by EAFC to private conservators/liquidators/receivers can be paid out to claimants far faster than it can if a DBO employee is appointed as conservator/liquidator/receiver (a function of State Administrative Manual rules which apply to the payment of money by state departments and agencies to private individuals).

On the basis of information provided by DBO, there were 20 instances during the past 10 years in which an escrow agent was conserved, liquidated, or placed into receivership. Private individuals handled 15 of those cases; DBO employees handled five. By increasing the amount that can be paid to private conservators/liquidators/receivers may lead to an increase in the use of private parties carrying out these duties rather than DBO employees.

The items contained within SB 736 would add efficiency to the process of handling failed escrow companies, but it is unclear whether these changes would have changed the outcome in the FSE case.

### **Prior Legislation**

AB 1679 (Harkey, 2014) would have eliminated the commissioner's ability to rule on an appeal of an EAFC claim denial filed by a successor in interest following a conservation or liquidation proceeding involving a failed escrow agent, when a DBO employee acted as that successor in interest.

### **REGISTERED SUPPORT / OPPOSITION:**

#### **Support**

None on file.

#### **Opposition**

None on file.

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