STATE OF CALIFORNIA — BUSINESS, TRANSPORTATION AND HOUSING AGENCY
ARNOLD SCHWARZENEGGER, *Governor*

DEPARTMENT OF CORPORATIONS

PRESTON DUFAUCHARD
California Corporations Commissioner
Los Angeles, California

Escrow Bulletin

January 2007 ▪ Issue No. 31

Department of Corporations Personnel

Commissioner Preston DuFauchard

The Department of Corporations welcomes its new Commissioner, Preston DuFauchard. Preston DuFauchard most recently served as assistant general counsel for Bank of America, supervising securities litigation related to mergers, investment banking and broker dealer operations from 1997 to 2005. He was previously a partner in the law firm of Landels, Ripley and Diamond from 1995 to 1997 and the law firm of Brobeck, Phleger and Harrison from 1992 to 1995. Commissioner DuFauchard was an associate for Brobeck, Phleger and Harrison from 1984 to 1992. He has served as a member of the Board of Directors for the Legal Aid Society of San Francisco since 2003 and as a judge pro tem for Alameda County Small Claims Court since 1999.

Commissioner DuFauchard earned a Juris Doctorate degree from Boalt Hall School of Law at the University of California, Berkeley and Bachelor of Arts degree from Stanford University.

New Special Administrator

The Department of Corporations is pleased to announce the appointment of Kathleen Partin as the Special Administrator for the Escrow Law program. Kathleen replaces Ken Nagashima, who recently retired.

Kathleen has extensive escrow experience, having been a field examiner, specialist and, most recently, senior examiner. She was also the Acting Supervising Examiner for two and a half years while Warren Adams headed a committee that created the Department's IT program. In addition to the escrow law, Kathleen has served as a senior examiner on the California Finance and Industrial Loan Laws.

- The Department's Sacramento Office

New Senior Examiner for the Escrow Law

The Department is also pleased to announce the appointment of David Duong as Senior Examiner for the Escrow Law program. David began his career with the Department on March 2, 1999 as a field examiner on the Mortgage Banker Law. He also worked on licensing for the California Deferred Deposit Transaction Law and most recently served as a licensing specialist on the California Finance Lenders law. While new to the escrow area, David's previous banking experience is an asset to the program. ■

Staff Assignments

Questions regarding regulatory examinations, annual reports and manager approvals should be directed to the following staff members:

Warren C. Adams, Supervising Examiner	wadams@corp.ca.gov	(213) 576 7619
David Duong, Senior Examiner	dduong@corp.ca.gov	(213) 576 7621
Sepah Sanaee, Specialist	ssanaee@corp.ca.gov	(213) 576-7647

Questions regarding applications, fingerprints and reporting of new officers and directors should be directed to either Licensing Specialists Luhmen Tesoro at (213) 576-7651 or Ann Davila at (213) 576-7674. Questions regarding bonds should be directed to Specialist Tonson Lam at (213) 576-7686.

Inquiries regarding the administration of the Escrow Law on such matters as licensing, consent to transfer of company stock, change of address, surrender of licenses and departmental policy should be addressed to Special Administrator Kathleen Partin at (213) 576-7595. Kathleen can also be reached at kpartin@corp.ca.gov ■

What is a Kickback?

It seems things don't change much over the years when it comes to kickbacks. This issue has been around for a long time. The following article is an updated version from a 1981 Escrow Newsletter. While some of the schemes have changed over the years, this article covers issues that the Department continues to see today. This information should be shared with everyone at the escrow company, especially escrow officers and marketing personnel, in order to prevent violations that could result in administrative action being taken against the company.

Promotional Schemes

The California real estate market and the desire of licensees to be competitive has given rise to various promotional schemes. These schemes include discounts on escrow fees, providing flyers, food, and other things of value to those who can refer business to the escrow company. Aside from the ethical considerations and possible unfair competition, certain of these practices violate specific provisions of the Escrow Law.

Referral Fees

Section 17420 of the Escrow Law provides in part, that except for the normal compensation of a licensee's own employees, it shall be a violation for any person subject to the Escrow Law to pay over to any other person any commission, fee, or other consideration as compensation for referring, soliciting, handling, or servicing escrow customers or accounts.

Broadly construed, this Section would prohibit the giving of any consideration by a licensee to a party as an inducement for receiving an escrow, and is not limited to the payment of money.

Thus, advertising, reduction or waiver of escrow fees, distribution of forms, offering of trips, lotteries, rent free vacation accommodations, or other compensation may be a violation of the Escrow Law.

Advertising

Questions have arisen as to whether an escrow agent licensee may subscribe to advertising in (1) a Realty Board publication, (2) a Regional Realty publication, or (3) an individual Realtor publication.

In Release 14-L, dated June 29, 1970, the Commissioner interpreted Section 17420 as it relates to the "purchase of advertising space." In essence, the Release states that when an individual real estate broker solicits or requires an escrow agent to insert or pay for advertising in listing books or other publications distributed by the broker, expressly or impliedly as a condition for future business, under these circumstances, the purchase of advertising constitutes payment to the broker of consideration as compensation for referring escrow customer or accounts. This is so whether the publication is for the internal use of the real estate broker and the broker's personnel, or if the publication is given a wider distribution.

The Release further stated that nothing in the Release was intended to preclude advertising by licensed escrow agents in the publications of broadly based

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organizations of licensed real estate brokers such as local real estate boards or multiple listing services. The Release does appear to preclude advertising in publications of a licensed broker entity, including multi-office operations, under circumstances as described above.

Fee Preferences

The Department of Corporations, along with other regulatory agencies, have determined that kickbacks, rebates, and referral fees can have a deteriorating effect upon the integrity of an industry when such practices become accepted as a way of doing business. The consumer is generally the ultimate loser because hidden costs and secret profits result in higher fees.

Traditionally, escrow fees have not been subject to regulation, but instead are determined by the competitive rate established in a particular market area. However, the giving of discounts or other consideration in conjunction with escrows, when viewed in light of Section 17420, may constitute a violation of the Escrow Law.

Fee preferences take many forms. In some instances, the fee is waived or reduced for one of the principals to the escrow but not the other, or a reduction in escrow fee is offered for repeat business to buyers who subsequently decide to sell.

The Department has taken the position that an escrow agent shall not waive or discount escrow fees to a real estate broker or sales person when such person is a principal to an escrow transaction. Such offers extended to a preferred class of customer are made to induce referral of future business when the sales person can exert control over where the escrow will be placed. [The exertion of such control over the placing of the escrow may also be a violation of the Real Estate Settlement Procedures Act (RESPA) where the consideration involved falls under the provisions of this act.]

Nothing heretofore stated is intended to preclude the free negotiation of escrow fees by escrow agent licensees and principals to escrows where the escrow was not induced by the offer of a reduced or discounted escrow fee. Therefore, where a departure is made from the scheduled fees resulting from negotiation, all parties are aware of the fee being charged, and the fees are clearly disclosed in the escrow instructions, there is no apparent violation of Section 17420.

Builders

By the same token, when an escrow agent negotiates with a builder to handle all escrows within a tract at a fixed fee per escrow, the buyers are not charged more than the scheduled fee, and full disclosure is made of the fee arrangement, no exception is taken. The builder is a principal to the escrow, and the fixed fee per escrow is justified because generally less work is required to process tract escrows.

This position is distinguished from the position respecting real estate sales persons in that any future business obtained from the builder will ordinarily be based upon past satisfactory service of the escrow agent, the builder will be the principal seller in such future transactions, and will not be "referring or soliciting" escrow customers or accounts. Any disagreement between the builder and buyer as to where the escrow is to be placed should be worked out by the principals as a part of the negotiations for the sale.

Repeat Business

Another area of apparent concern is the solicitation of repeat business from buyers in escrows upon the subsequent resale of the property originally placed in escrow. These discount coupons offer a reduction in escrow fees if the previous buyer sells through the same escrow company.

It seems apparent that such solicitation is made with the intent of securing future escrow business. It is not quite as clear as to whether this type of solicitation is a violation, raising the question of whether potential customers are capable of referring or soliciting themselves in violation of Section 17420.

In any event, since escrow agents generally have fee schedules, it would appear that the problem, if any, would not exist if the schedule for repeat escrow business were included as a part of the regular fee schedule (or a separate repeat business fee schedule prepared) and such schedule included with other documentation sent to the parties at the close of escrow. ■

Annual Report Issues

In 2002, the laws and rules regarding the escrow examination cycle and the annual report requirements were changed. For many companies, this meant that they would receive less frequent regulatory examinations. The annual report requirements were amended to cover the areas of concern that would normally have been brought to the Department's attention during the course of regulatory examinations. As a consequence, it takes longer for us to review each of these reports. Our hope is that you will find the following information useful and will share it with your CPA.

Before an escrow company hires a CPA to complete its annual audit, they should make sure the CPA understands the requirements of the Escrow Law. The report will not be acceptable unless it contains the required information and statements outlined in the blue audit report instructions, the most current version of which is dated 2-02. The audit report instructions are mailed to each licensee with their annual report reminder letter. The CPA should also be aware of the filing deadline and the consequences to the escrow company if the report is filed late (monetary penalties, shorter examination cycle and possibly suspension of the escrow license).

The following areas appear to create the most confusion:

1. The required comments regarding transactions covered and not covered by EAFC (refer to page 2 part 2 (H)(i, ii, iii, iv) of the blue pamphlet). It is important that the CPA read Section 17312 (FC) to understand which transactions are covered by EAFC. Unless the CPA states that the company only handles EAFC covered transactions, two statements are needed: one that states the company does or doesn't handle transactions listed in Section 17312 (FC) and one that states the company does or doesn't handle transactions **not** listed in Section 17312. In addition, even if the statement is made that the company handles transactions listed in Section 17312, a separate statement is needed regarding whether or not the company is a member of EAFC.

Statements are also needed regarding separate fidelity bonding and the separation of books and records if the company handles both covered and non-covered transactions. Copies of the bank reconciliations, outstanding check lists and trial balances are needed for both the EAFC and non-EAFC covered transactions.

2. The additional information that must be included by the CPA cannot be disclaimed in the report. The additional procedures do not have to be part of the CPA's opinion**,** but a statement must otherwise be made that the supplementary data has been subjected to the audit procedures applied in the audit of the financial statements.

3. Required statements regarding the trust account (refer to page 2 part (3) (A) and (B)). The CPA must clearly state that the individual escrow liability accounts**,** meaning the escrow trial balance and controlling account, also called the manual daily control, have been reconciled to the escrow trust account as of the balance sheet date. A statement must be made regarding whether or not there were any debit balances in the escrow liability as of the balance sheet date. If debit balances did exist, a full explanation of the nature and cause of the debit balances must be included in the auditor's comments along with an explanation of how each was corrected.

If any debit balance was not resolved as of the audit report date, then the CPA must make a positive statement stating that the debit balance has not been resolved as of the report date.

4. The report must include copies of the trust account bank reconciliations for each location as of the balance sheet date (refer to page 2 item 2(F), (G)). There must be a detailed description of all adjustments**,** and copies of the outstanding check list and the trial balance. A separate reconciliation is needed for each office. Reconciliations must also be provided for any interest bearing and dormant trust accounts. It is acceptable for the CPA to include the licensee's copies, however, the CPA must state how and when each adjustment was corrected and whether or not the adjustment created a debit balance.

If a debit balance was created, a statement is needed including when it was created and how and when it was corrected. The CPA should keep in mind that if a debit balance was created by the adjustment, the start date of the debit balance is the date the event creating the adjustment occurred and not necessarily the date the adjustment was actually corrected.

The trial balance must include the escrow numbers and the balances. The outstanding check list must include the check numbers, dates, escrow numbers and amounts.

5. Additional auditing procedures (refer to page 3 (6),

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(7) (A) (B) (C)). Specific statements are needed regarding the sampling of escrows closed within 60 days prior to the commencement of the audit. The CPA must review escrow instructions, correspondence and documents in the files for authorization of disbursements. Checks are to be reviewed for proper endorsements and traced to escrow instructions.

The escrow ledger balance and outstanding check dormant procedures are frequently omitted. The CPA must review the escrow liability and outstanding check list from the last audit date (normally one year prior). All escrows with balances and outstanding checks 6 months or older as of the last audit date that are no longer on the schedule of escrow liability or are currently outstanding as of the balance sheet date must be reviewed. The CPA must verify that the funds representing escrow balances were properly disbursed. The CPA must verify that the funds representing outstanding checks were paid, were properly canceled back into the escrow and reissued to the original payee or to a new payee in accordance with instructions or were escheated to the State Controller's Office.

6. Statements regarding net liquidity and tangible net worth (refer to page 1 (E)). While most CPAs include a statement regarding whether or not the escrow company met the liquidity and tangible net worth requirements, many do not include a schedule showing the computation. The schedule must include an itemized listing of each item included in the computations. In order for fees receivable to be considered a liquid asset, a copy of the fee ledger at the balance sheet date must be included with the report.

Also, when a licensee changes CPAs, they are required to provide a letter to the Department of Corporations stating the reason for the change including a statement as to whether or not any disputes existed. A copy of this letter must be sent to the former CPA, who must send an acknowledgment letter to the Department either agreeing or disagreeing with the licensee's explanation. ■

Regulatory Examination Cycles

The easiest way for an escrow company to determine whether they are scheduled for a short examination cycle (every one or two years) or a longer cycle (every three to four years) is to look at its trust account bank reconciliation history. Companies that have a history of many uncorrected adjustment items, adjustments with vague descriptions, or adjustments that indicate possible shortages exist are on shorter examination cycles.

Some companies are on longer cycles due to staff reductions made by the Department over the past few years. New examiners have been hired, and the Department expects a return to shorter cycles beginning in 2007.

The following is the current assignment priority. Companies with one or more of the following indicators will recieve top priority for examination.

1. Last exam was four years ago.
2. A new company licensed for two years that hasn't had a regulatory examination.
3. Annual report has not been filed.
4. Serious issues revealed in the annual report such as trust account shortage, bank reconciliation items appear to create shortages, etc.
5. Reports of problems from former employees, customer complaints, referrals from other agencies (these issues are analyzed based on severity and may result in a special examination rather than a full regulatory examination).
6. Risk analysis based on the last regulatory examination. Examples of issues that will shorten a cycle are trust shortages and overdrawn escrows; trust funds deposited into the general or an affiliate's account without immediate replacement; chronic liquid and tangible net worth deficiencies; unauthorized fees; inability to prove a manager is employed and on the premises; and the trust account bank reconciliation either didn't balance or there were many old adjustments.

To qualify for a longer cycle, licensees should review their trust account bank reconciliations when received and make sure all adjustments are corrected before the month-end so they don't reappear in the following month. The general ledger should also be analyzed each month to ensure that the liquidity and tangible net worth requirements are being met. Corrections should be made immediately if the company doesn't meet one or both of the requirements. Taking these steps could mean the difference between a longer or shorter examination cycle. Also, companies that have few reconciling items generally have smaller examination bills. ■

Checks Issued to Creditors

Examiners take exception when they find checks issued to creditors that were canceled and reissued to persons other than the original payees unless the lender giving the original instruction authorizes the re-issuance of the checks. Exception is also taken when it appears the creditor checks are being given directly to the borrowers instead of mailing them to the creditors. The basis for these exceptions is not following the escrow instructions of the lenders.

It is not unusual for lenders to require certain creditors be paid in order to remove their accounts from a borrower's credit report. The Department understands that many times the borrowers don't know how to contact these creditors or they disagree that it is their obligation. In order for an escrow company to be in compliance with the lender's instructions, the escrow officer must insist that the borrower either provide the creditor's address or obtain an amended instruction from the lender authorizing escrow not to pay the creditor in question, before the close of escrow.

Problems arise when creditor checks are handed to the borrowers to mail. Many times the borrowers don't send the checks to the creditors. The checks either remain outstanding until it is time to escheat them, or the borrowers fraudulently endorse the checks and cash them. When this happens, the lender's instructions have not been followed, which is a violation of the Escrow Law.

An instruction signed only by the borrower stating that the escrow agent is handing the borrower the checks is not sufficient, unless the lender specifically acknowledges the instruction.

In order to properly re-issue creditor checks to the borrowers, escrow companies must document their files with proof that either the creditor has already been paid off, the original lender amended its instruction to no longer require the payment to the creditor or the loan made by the lender giving the instruction has been paid off. Otherwise, the escrow company could be liable to the lender for not following instructions.

Further, if a check to a creditor or other third party to the escrow is stopped and reissued, stop payment fees cannot be charged. Third party instructions cannot authorize the fee in exchange for the re-issuance of a check. The third party must receive all of the funds that the principals authorized. ■

Escrow Management Class

The Department's Education and Outreach Section has been working with the Escrow Institute of California to restart the Escrow Management class that at one time was a requirement for all new escrow company owners and managers. The class will be offered to any interested escrow company owner or manager. The format of the class will be similar to what was offered in the past. It will provide an overview of the Department and escrow program including issues that affect the escrow industry including reporting, bonding and financial requirements. It will also cover regulatory issues such as examinations, internal control and bank reconciliations as well as cost saving tips.

The first class is scheduled for Wednesday, January 17th in the Department's Los Angeles office at 320 W. 4th Street in the building's Carmel Room, which is located on the ground floor. To register, any owner or manager may contact the Escrow Institute of California at (800) 337-2769 or send an email to admin@escrowinstitute.org ■

Escrow Law Advisory Committee

The purpose of the Escrow Law Advisory Committee is to assist the Commissioner in the implementation of his duties under the Escrow Law. The committee is comprised of 11 members, including the Commissioner or his designee. Its members, who are appointed by the Commissioner, serve for a period of two years without compensation or reimbursement for expenses. All positions for the committee are designated in Section 17214 of the California Financial Code.

The current Escrow Law Advisory Committee is comprised of the following members:

Patricia J. (P.J.) Garcia
Chairperson – EIC
Beach Pacific Escrow, Inc.
Phone: (714) 842-4594
Fax: (714) 842-9934
Term: December 2005 – December 2006

Bill Nelson
Chairperson-EAFC
Express Escrow
Phone: (714) 847-4747
Fax: (714) 848-9174
Term: September 2006 – September 2007

Jeff Behm, CPA
Certified Public Accountant
Behm & Company
Phone: (949) 222-9040
Fax: (949) 222-9055
Term: June 1, 2006 - June 1, 2008

Aziz Valliani
Medium-Sized Business
Bellflower Escrow Company
Phone: (510) 368-5651
Term: June 2, 2005 – June 2, 2007

Norman J. Kendall
Business Specialization
Hasz Fund Control, Inc.
Phone: (818) 0999-0906
Fax: (818) 999-6321
Term: June 2, 2005 – June 2, 2007

Sunny Maden
Immediate Past Chairperson – EIC
South Hills Escrow Corporation
Phone: (626) 919-3464
Fax: (626) 919-3136
Term: December 2006 – December 2007

Janet Shreiar
Immediate Past Chairperson - EAFC
The Heritage Escrow Company
Phone: (949) 930-2320
Fax: (949) 930-2250
Term: September 2006 - September 2007

Rose Pothier
Attorney
Pothier & Associates
Phone: (714) 953-8580
Fax: (714) 558-1707
Term: June 2, 2005 - June 2, 2007

Erik Okland
Small Business
Old Town Escrow
Phone: (626) 486-1130
Fax: (626) 486-1136
Term: June 1, 2006 – June 1, 2008

Malia Monroe, President
Other Business
Four Seasons Escrow, Inc.
Phone: (760) 564-4044
Fax: (760) 771-2999
Term: June 1, 2006 – June 1, 2008

The next Escrow Advisory Committee meeting is scheduled for March 13, 2007. in the Department's Los Angeles office. Any issues that you would like to have placed on the agenda should be forwarded to any of the above members. The agenda for the meeting will be posted on the Department's website 10 days prior to the meeting. You can access the website at www.corp.ca.gov Visitors are welcome to attend the meeting; however, only committee members may participate.

Enforcement Actions

The following enforcement actions were taken in 2006:

Asset Escrow Services, Inc., Tessa Sims and Rayna Hill: Notice of Intention to Issue Order Revoking Escrow Agent's License and to Issue an order to Bar from Employment, Management or Control of any Escrow Agent for unlawful transfer of funds out of trust accounts.

A Better Choice Escrow, Inc.: Notice of Intention to Issue Order Revoking Escrow Agent's License issued for failure to file the annual audit report; failure to file a response to the regulatory examination letter; and failure to file liability reports.

Best Escrow - Cerritos and Kam Chung: Notice of Intention to Issue Order Revoking Escrow Agent's License and to Issue an Order to Bar from Employment, Management or Control of any Escrow Agent for unauthorized disbursement of trust funds.

Linda Chavez: Order Issued Barring from any Position of Employment, Management or Control of any Escrow Agent for unauthorized disbursement of trust funds.

Dependable Escrow Co.: Notice of Intention to Issue Order Suspending Escrow Agent's License for books and records issues, not reporting a misappropriation of trust funds and debit balances.

DII Escrow Corp. and Henry Melendez: Order Revoking Escrow Agent's License issued along with an Order Barring Henry Melendez from any Position of Employment, Management or Control of any Escrow Agent for violation of a cease new business order.

Ontario Escrow Service, Inc. and Bobbie Jackson: Order Barring Bobbie Jackson from any Position of Employment, Management or Control of any Escrow Agent was issued for allowing a barred individual to maintain a desk and presence at Ontario Escrow Service, Inc.

Shiraz Escrow, Inc. and Jamshid Saraj: Notice of Intention to Issue Order Revoking Escrow Agent's License and to Issue an Order Barring from Employment, Management or Control of any Escrow Agent for failure to maintain proper books and records.

Tracyoursales.net Escrow Incorporated and Linda J. Dancy: Notice of Intention to Issue Order Revoking Escrow Agent's License and to Issue Order Barring from Employment, Management or Control of any Escrow Agent for allowing unreported individuals to have access to trust accounts, books and records issues; improper accounting for trust funds; and closing escrow files short.

Vineyard Escrow and Timothy Rory Delaney: Order Barring Timothy Rory Delaney from any Position of Employment, Management or Control of any Escrow Agent was issued for commingling of trust funds; and trust account shortages. ■

Escrow Licenses

As of December 31, 2006, there are 828 main and 344 branch offices for a total of 1,172 escrow locations licensed by the Department of Corporations. ■

Acknowledgments

This Escrow Bulletin was published under the direction of Special Administrator Kathleen Partin. Articles for the Bulletin are requested both from the staff and the escrow industry. The material submitted should be timely, topical, and of interest to the industry and the Department staff as a whole. All submissions will be acknowledged, and credits will be given. The Department does, however, reserve the right to select and edit the articles and materials used for publication. ■