



## **Protecting Your Escrow Funds From Theft:**

*For fools rush in where angels fear to tread.*

*Alexander Pope (1688-1744)*

And as this story will show, it's up to you to protect **your** funds held by an escrow agent from any thieves who try to rush in.

While most escrow agents may be on the side of the angels, it only takes one thief to devastate you financially and emotionally.

Above all remember that an escrow agent will have custody of **your** funds even if you are not given a voice in the choice of that escrow agent.

For this reason, due diligence on your part is imperative. If an escrow agent fails **your** test, you should refuse to entrust him or her with your funds, even if you have to replace the real estate agent or lender who chooses the escrow agent.

The following definition may give some insight why escrow agents are necessary to facilitate real estate and other complex financial transactions:

<sup>1</sup>**Escrow Agent**-An entity that has fiduciary responsibilities in the transfer of property from one party to another. Typically associated with selling or buying a home or other property, the escrow agent will secure the property and examine documents to make sure that the terms of the sale are met on each end, serving both the buyer and seller in the transaction.

Escrow agents protect both buyers and sellers by:

- insuring the buyer's funds cannot be withdrawn prior to the transaction closing
- insuring the seller is not paid unless they have complied with all of the terms of the sale contract

While escrow agents are an ingenious solution to the problem of simultaneously protecting the interests of both parties, the problem of who is "watching the watcher" remains.

The following story shows how risk controls to prevent the theft of escrow funds have been circumvented.

It also suggests risk control steps you can take to protect your funds held by an escrow agent.

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<sup>1</sup> "Investopedia" Website-[www.investopedia.com/terms/e/escrow\\_agent.asp](http://www.investopedia.com/terms/e/escrow_agent.asp)



### **The ABC Escrow Agency**

The “ABC” Escrow Agency was founded by a person we’ll call “Lou Siffer”.

Lou was the apparently affluent owner of several diverse companies.

The private corporate jet Lou used to commute to meetings assessing new business opportunities led many clients to assume he was very well capitalized and successful.

His escrow agency did so well during the recent real estate boom it became one of the largest in the state in which it operated.

### **ABC’s Clients**

ABC’s clients ranged from middle class individuals to fairly large real estate investment companies engaged in tax advantaged real estate transactions.

Lou used his gregarious personality to recruit real estate agents and mortgage lenders to attest to ABC’s reputation as a very competent and trusted escrow agency.

ABC’s print and web advertising also offered its services to individual real estate buyers, asking their funds be entrusted to ABC.

### **Regulation of ABC:**

Although the Federal Internal Revenue Service set the rules to qualify for the tax breaks, ABC and their competitors were subject to State regulations including the following:

1. the principals and officers of the escrow agency have no criminal convictions
2. the buyer’s funds be held in a financial institution trust account segregated from the escrow agency’s operating funds
3. the buyer’s trust funds could be held in a bank account or in any “liquid” investment account with the escrow agent entitled to all interest income or investment gains from the buyer’s funds trust account
4. the buyers receive monthly copies of the financial escrow trust account statements

### **The Scam**

ABC started with one type of fraudulent diversion carefully disguised to appear as a legitimate transaction.



And as often happens, emboldened by their initial success, ABC engaged in several different types of scams which relied less and less on disguise over time.

Here's a chronological description of the schemes used to steal hundreds of millions of dollars in less than three years:

1. Lou placed the buyer's escrow funds in an account administered by a large and reputable Stock Broker who took the precaution of assigning two of its officers to safeguard the buyer's funds in that account. The account was used for legitimate transactions in its first two years building a track record of profitability for the stockbroker and trustworthy reputation for ABC. However Lou then recruited one of those officers as a disciple. The disciple, enticed by a six figure cash bribe from Lou, helped Lou leverage his relationship as a profitable client to insist this one officer become the sole supervisor of the trust account. The officer then allowed Lou to divert over \$2 million in client trust funds over a two-week period to repay his own personal debts as well as the debts of some of his additional companies.
2. Next Lou created a new company and named it so that it could be falsely represented as affiliated with a reputable international investment bank. Lou's disciple hid Lou's control of the new company and told his employers it was affiliated with the reputable investment bank. The new company was paid with buyers' trust funds to purchase short term "Corporate Bonds" guaranteed by one of Lou's other companies, which Lou and the officer knew to be worthless. Additional buyers' funds were diverted to pay interest on the initial bond issue but new issues were purchased immediately after the interest payment with the buyers' funds.
3. Six months later the stock brokerage missed the opportunity to uncover the fraud when their officer resigned from the brokerage firm to become an ABC employee. Lou began to transfer buyers' funds directly to his other businesses instead of disguising these diversions as corporate bond purchases at the same time. Perhaps distracted by the significant brokerage fees they had received the brokerage failed to uncover millions of dollars worth of fraudulent direct transfers during the final two years of the fraud.

### **Circumvented Controls**

1. Although Lou had never been convicted of a crime, a publicly available SEC document found he made materially false statements about one of his companies in a required SEC filing. And a publicly available state Supreme Court ruling upheld a bankruptcy receiver's allegations that Lou had fraudulently misled investors in one of his companies. The intent of the regulation barring convicted criminals from acting as escrow agents was circumvented because both of the above matters were civil, not criminal, matters.

2. ABC sent copies of the monthly account trust account statements to their clients. Since all client funds were held in one trust account, no individual client was able to detect diversion of their escrow funds.
3. Since the state regulation allowed ABC to keep investment proceeds, they were not required to provide the buyers details on the specific investments they made.
4. State regulations required the client funds be held in liquid investments in “safe fiduciary accounts”. The short term of the bogus corporate bonds apparently met the requirement that an investment be liquid. In addition, the fact that the trust account was managed by a reputable stock broker seemed to qualify as a “safe fiduciary account”. Lou was able to take advantage of the fact there were no “Investment Suitability” requirements such as those requiring all bonds have a “Standard and Poors” or “Moody’s” Bond Rating.
5. Normally, there is some inherent protection from such a massive theft of escrow funds since a potential fraud is discovered immediately the very first time a buyer’s escrow funds are unavailable for a real estate closing. This scheme was able to escape detection for almost three years because the hot real estate market bought enough new funds to ABC to allow them to use new funds to meet the closings of buyers whose funds they had stolen. The inevitable downturn in the real estate market lead to the discovery of the fraud, which is known as a “Ponzi Scheme”

#### **Protecting Your Escrow Funds:**

1. Understand the regulation of escrow agents is in your state. Unless the regulation is stringent, it is wise to choose an escrow agent who exceeds state regulatory requirements.
2. Conduct web searches of the escrow agency’s name and the names of its key people to get a sense of their overall reputation. Not being able to find any information on an agency or their key people may be as much of a red flag as any negative information found.
3. Select an escrow agency which keeps each client’s escrow funds in their own dedicated trust account rather than a trust account with the funds of several clients so you will be able to quickly detect any diversions of your funds.
4. Choose an escrow agent who provides written documentation of the specific investments comprising your escrow funds.
5. If your escrow funds are in an investment account select an escrow agent with stringent “Investment Suitability” requirements such as buying only rated bonds or stocks traded on a stock exchange which sets stringent requirements for their listed stocks.
6. Make sure the escrow agent has adequate Employee Theft insurance. But understand Employee Theft policies generally provide limited coverage for your property and typically do not give the clients of the escrow agency any rights under that policy including the right for you to dispute a denial of coverage by the insurer for theft of your escrow funds.



7. Understand the limitations of your due diligence on the escrow agency since a strong real estate market can camouflage serious problems at an escrow agency.
8. If your real estate agent or lender does not allow you to choose the escrow agent they may try to reassure you that their insurance will protect you if the escrow agent steals your money. But as with No. 6 above, their insurance coverage cannot provide absolute protection for your funds in escrow. Always view insurance as a back up to, not a substitute for, your due diligence. Find another real estate agent or lender if they insist *your* funds be entrusted to an escrow agent you are not comfortable with.

The most important thing you can learn from this story is that no single regulation, internal control, insurance policy or risk control technique can completely protect your funds held by an escrow agent.

You must be the guardian angel of your money.

By Kevin Donohue, Underwriting Consultant, CNA Pro Commercial

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